Financing Small Corporations: Debt or Equity

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INTRODUCTION

The method of financing corporate activities is one of the most difficult problems confronting the organizers of small, closely-held or family corporations. Prior to incorporation, careful consideration should be given to the probable amount of fixed and working capital requirements and the manner in which this capital is to be obtained. Financing can be either in the form of equity capital, resulting from stock issues and characterized by the proprietary or ownership interest of the stockholders, or debt capital, representing corporate borrowing and characterized by a debtor-creditor relationship between corporation and holders of the bonds or notes. The usual corporate financial structure is a combination of these two methods, each serving particular purposes and each having characteristics which measure its usefulness to the corporate set-up. Traditionally, equity capital represents the fixed assets of a corporation, with borrowed capital, if necessary, providing additional fixed assets and supplying working capital. There is no hard and fast rule to be applied in determining the proportion of one form to another. Business and tax reasons surround each method and influence the corporate organizers in determining the amount and proportion of debt and equity.

Realistically, a majority of small, closely-held corporations will require additional capital to enable them to function after stock has been issued in exchange for assets from their stockholders and so, these business and tax reasons aside, the most significant reason for corporate borrowing is a result of simple necessity. It is possible for a corporation to look to two sources for its borrowed capital; third party lenders and its shareholders. Where the latter source has been used, the courts have had considerable difficulty in determining whether money or other property advanced to a corporation by its shareholders as loans should be classified as debts for tax purposes. This article will attempt to set out an analysis of the tax law in this area of corporate financing.

There are non-tax reasons for borrowing from stockholders which should be taken into consideration by corporation organizers prior to casting the financial structure. It will be subsequently noted herein that presence or absence of non-tax or business purposes for borrowing from within is attaining increased importance in tax law. Hence, it is important that the incorporators be able to substantiate their organization's internal debts by one or more solid business, non-tax purposes.

For example, a corporation may prefer to give its shareholders
the benefit of interest payments made on corporate debts instead of making them to outside creditors having no other business relationship to the corporation. In a closely-held corporate entity, shareholders may insist that it borrow from them and secure the loans with corporate assets, instead of investing additional risk capital, lost if the business fails. The directors might also prefer to keep debts of the corporation consolidated by borrowing from within. A newly incorporated business might find itself required to seek its loans from its shareholders simply because of an inability to obtain outside financing. The idea of a steady interest payment as income might also prompt a shareholder to lend additional money to a corporation instead of taking more stock with no similar guaranteed source of income.

With regard to the tax advantages of debt as opposed to equity and particularly debt owed to shareholders, the principle advantage to the corporation is found in the interest deduction which may be taken when such interest is paid or accrued to creditors.\(^{1}\) Another tax benefit is the fact that a corporation may retain additional earnings and not run afoul of the Accumulated Earnings Tax,\(^{2}\) where such earnings are earmarked for retiring indebtedness. The chief tax advantage available to the shareholder where he holds corporate debt securities is experienced upon retirement of such by the corporation in which case the distribution to the shareholder constitutes a return of capital, whereas in the case of a retirement of stock by the corporation, this transaction could easily be considered a disguised dividend, taxable in full as ordinary income.\(^{3}\) Where corporate debt securities are held by a stockholder, a bad-debt deduction\(^{4}\) is available to him in the event of corporate failure.

Tax disadvantages exist in this area, and as to the corporation, when a debt is retired at a discount, ordinary income will be attributed to it.\(^{4a}\) The shareholder-creditor, upon receipt of interest payments, is not entitled to a dividend exclusion nor a 4% credit against tax\(^{5}\) which is available to him when he receives dividends. But the multitude of litigated disputes since the inception of the interest deduction in 1909\(^{6}\) indicates that tax disadvantages to both corporation and shareholder are decidedly outweighed by the benefits.

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\(^{1}\) INT. REV. CODE OF 1954, §163 (a).

\(^{2}\) INT. REV. CODE OF 1954, §531.

\(^{3}\) INT. REV. CODE OF 1954, §§301-302.

\(^{4}\) INT. REV. CODE OF 1954, §166. Of course, whether this is more favorable than a loss deduction on stock depends upon whether the bad debt can be classified as a business bad debt under §166 (a), rather than a non-business bad debt under §166 (d) or a worthless security under §165 (g).

\(^{4a}\) Recognition of income here can be postponed by an election to reduce the basis of a corporation's assets under §108 (a).

\(^{5}\) INT. REV. CODE OF 1954, §§116 and 34.

\(^{6}\) 36 Stat. 113 (1909), §38 (2) (third). The act of 1909, and subsequent acts
The tax law in this area has been formulated as a result of judicial decisions inasmuch as no specific regulations have ever been promulgated by the Internal Revenue Service, which would provide a standard of compliance for the taxpayer. On one principle the courts have always agreed; that no single rule is applicable to every case but rather, each situation must be determined on the basis of its facts. However, it is felt that, in effect, the courts have been guided by one broad standard, the intention of the parties to the transaction, manifested by the conduct of the stockholders and corporation in creating a bona fide debt, bidding on the corporation. Throughout the history of the issue, considering all the various tests applied by many tribunals in various instances, such as name and form of the instrument used to cast the indebtedness, presence or absence of a maturity date, and existence of adequate security for the debt, just to mention a few, the decisive element has historically been the intent of the parties to create a debt and to be bound thereby. The trend of the decisions, however, has been to broaden the area of search for intent, that is, to increase the number of factors relevant in determining what the parties intended.

The Earlier Decisions

In 1943, the Tax Court dealt with two factual situations resulting from similar corporate activities of John J. Kelley Company and Talbot Mills Company. The Kelley Company, a family corporation in the furniture manufacturing business, pursuant to a plan for corporate reorganization, issued "income debenture bonds" and "income debenture stock" to its shareholders, partly in exchange for preferred stock and partly by subscription. A portion of this issue was also

of 1913 and 1916 allowed a deduction for interest paid on a corporate indebtedness which indebtedness did not exceed: a) the amount of corporate stock (1909); b) one and one half times the amount of stock, 38 Stat. 173 (1913); and c) two times the amount of stock, 39 Stat. 173 (1916). No statutory limit is presently imposed but judicial interpretation has suggested various limits which will be noted further in this article.

There are more than 200 decisions from the Tax Court and Federal Courts since 1935 dealing directly with the problems of advancing money to a corporation. 1958 P-H Tax Service, Paragraph 13,096.

7 John Wanamaker, Philadelphia, 1 T. C. 937, affd. 139 F. 2d 644 (3d Cir. 1943); U.S. v. Title Guarantee and Trust Co., 133 F. 2d 990 (6th Cir. 1943); Elko Lamoille Power Co. v. Comm., 50 F. 2d 595 (9th Cir. 1931).
8 Comm. v. Schmoll Fils Assoc., Inc., 110 F. 2d 611 (2d Cir. 1940); Jewel Tea Co. v. U.S., 90 F. 2d 451 (2d Cir. 1937).
9 Comm. v. O.P.P. Holding Corp., 76 F. 2d 11 (2d Cir. 1935).
10 Where the parties obviously had no intention to create a binding obligation against the corporation in favor of the stockholders, courts will not permit an interest deduction by the corporation, regardless of whether or not the loan meets formal requirements and is designated as such on the corporate books. Pacific Southwest Realty Co. v. Comm., 128 F. 2d 815 (9th Cir. 1942); Comm. v. Meridian and Thirteenth Realty Co., 132 F. 2d 182 (7th Cir. 1942).
11 1 T.C. 457 (1943).
12 3 T.C. 95 (1944).
available for public subscription. On its books, the taxpayer referred to these debt devices as "income debenture bonds." The bonds contained provisions for the payment of 8% non-cumulative interest, bore a maturity date of 20 years hence, provided that the net earnings of the corporation were to be the source of the interest payments, contained acceleration clauses in the event of default in interest payments, gave bondholders a right to demand repayment superior to shareholders, and stated that the holders were to have no proprietary status in the corporation. For the three years in question, 1937-1939, $30,000 was credited to the bondholders on the corporation's books as interest accrued on these debentures. Thereupon, the taxpayer-corporation took these interest payments as a deduction from its gross income. The Commissioner disallowed the deduction after finding that the debenture bonds did not represent a bona fide indebtedness within the meaning of the Internal Revenue Act. In its opinion, the Tax Court stated that no single factor regarding a corporation's debt device is controlling as to what it actually is, but rather a decision must be based on a consideration of all the elements present, and then proceeded to examine the debentures in the light of what constitutes a "Classic Debt."

The court decided that the form of this debt was proper, ostensibly, inasmuch as the name given to the certificates was indicative of debt, the certificates contained a maturity date of December 31, 1956, and payments of interest, although dependent upon net earnings, were fixed at 8% and were non-cumulative. The court further found that normal creditor safeguards were at least nominally present because the bondholders, through trustees, could declare the bonds due and payable upon default of interest, they had the right to sue the corporation upon the underlying debt, and their status as creditors, although subordinated to outside creditors, was superior to the common and preferred stockholders, which, in case of corporate failure, would at least give these creditors a larger slice of the corporate assets than the shareholders. The court also noted that because these bondholders had no right to participate in management, there was an indication that the debt represented by these debentures was not subject to risks of the business and their holders occupied the same status as outside creditors. Finally, the court commented upon the element of intent of the parties to create a bona fide debt, but unfortunately, merely

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13 A fixed interest rate which is present in a corporate debt held by a stockholder may be said to be directly related to the previously mentioned non-tax purposes for creating internal debt, because an intent on the part of the shareholder to obtain a steady income is objectively manifested by the presence of such fixed interest rate.

14 Revenue Act of 1932, §23 (b). Under the 1954 code, §163, a similar deduction is allowed: "INTEREST: (a) General Rule: There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."
stated that if the parties intended that the device was to represent a charge against the corporation instead of a contribution to risk capital, such would indicate the existence of a corporate debt. Perhaps it would have been more significant for future reference had the court specifically stated what evidence was relevant in determining “intent of the parties”, but this factor was given no different status nor greater importance than the preceding six factors, which suggests that the intention of the parties is established by the presence or absence of all the other elements. From this examination of the court's opinion, the reader can conclude that: 1) The Tax Court desired to enumerate an objective set of requirements for minimal compliance, in order to establish a corporate security as “debt”; and 2) compliance with these requirements, viewed in retrospect, indicates that the parties intended to create a corporate indebtedness.

The Talbot Mills case was tried by the Tax Court immediately after Kelley, and although it was similar to Kelley on its facts, the court disallowed the taxpayer's interest deduction. The determining factor is found in the court's conclusion that it was the intent of the parties to create additional equity by the use of “registered notes” issued to stockholders, rather than to establish a bona fide indebtedness against the corporation. As in Kelley, the “notes” were prima facie evidences of debt, having the usual technical features such as fixed maturity date, stated interest rates and nomenclature suggestive of debt. However, the court, referring to the Kelley decision's enumeration of the factors to be considered, decided that there were an insufficient number of factors favorable to Kelley present in this transaction. Inasmuch as interest was variable between 2% and 10% per annum, able to be deferred by a vote of corporate directors, and because the notes were held by stockholders in direct proportion to their shareholdings, the parties intended to retain the same control over the corporation as before the “debt” was contracted. The factor of proportionate holding of stock and debt was an additional element, not noted in Kelley, but considered by the court to be relevant to the question of intention.

After both cases were appealed to Circuit Courts of Appeal, the Supreme Court, considering the two cases in a single opinion, approved the decisions of the Tax Court for the reasons stated therein.

15 The court cited Comm. v. O.P.P. Holding Corp., supra note 9, wherein an intent to create an indebtedness was adduced from the language of the security. This would indicate an objective intent manifested by the terms of the instrument.

16 Comm. v. John J. Kelley, 146 F. 2d 466 (7th Cir. 1944); Talbot Mills v. Comm., 146 F. 2d 809 (1st Cir. 1944).

17 326 U.S. 521 (1946).
In reaching this decision, the court applied the rule of *Dobson v. Commissioner*:15

... Congress intended to leave to the final determination of the Tax Court, all issues which were not clear-cut questions of law.

Although the rule in *Dobson* has since been overruled by Congressional action,19 it appeared at that time that the Supreme Court was attempting to bring about some measure of uniformity in the tax field. Had the court stopped at this point, the test of a "*Kelley Classic Debt*" might well have been the only substantive tax feature to be taken out of this case. However, in its dicta, the court made reference to a previously unimportant element in the issue of corporate financing, to wit: the amount of a corporation's debt in relation to its equity. This factor had never before been seriously considered in a determination of the problem of the indebtedness of a corporation and it is unlikely that the Supreme Court wished to establish it as consequential at this time, judging from its language:20

As material amounts of capital were invested in stock, we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessive debt structure.

This mere mention of what is now the very significant debt-to-stock ratio was practically unnoticed by readers of this case immediately thereafter,21 and actually one may only speculate as to what significance the Supreme Court wished to attach to this ratio, because, by its own admission, it was not called upon to consider the question. However, speculation creates theories and theories can result in settled opinions22 which contribute to changing or modifying the law in any area. And because of the dicta of the Supreme Court in a decision, whose only

15 320 U.S. 489 (1943). The Supreme Court indicated that *Kelley* contained questions of both law and fact and inasmuch as no error could be found in the Tax Court's determination as to questions of law, its decision should not be disturbed.

19 INT. REV. CODE OF 1954, §748 (a), gives U.S. Courts of Appeals exclusive power to review Tax Court decisions in the same manner and to the same extent as District Court decisions in civil actions tried without a jury.

20 326 U.S. 521, at 526.

21 In Comment, 44 Mich. L. Rev. 827 (1946), a writer, commenting on the *Kelley* decision 2 years after Tax Court rendition, considers this opinion and states that the most significant test regarding this issue is whether or not the so-called "interest" payments were fixed-rate payments out of net earnings of the corporation. He does not allude to the ratio question raised by the Supreme Court's decision in 1946.

22 4 MERTENS, LAW OF FEDERAL INCOME TAXATION §26.10 (b) (1954): "Peculiarly enough, the importance of the Supreme Court's decision [*Kelley*] rests not on its discussion of the procedural aspects of reviewing Tax Court decisions but on the dictum [regarding debt-equity ratios] just quoted."

Semmel, *Tax Consequences of Inadequate Capitalization*, 48 COLUM. L. REV. 202 (1948), states that the significance of adequate capitalization of a corporation was brought out by the Supreme Court in its dictum in *Kelley*. 
objective purpose was to insure the efficacy of Tax Court decisions, the highly complex issue of corporate indebtedness became burdened with another consideration, the debt-equity ratio.

In the period immediately following the Supreme Court's entry into this area of tax law, the Tax Court handed down several decisions which were ruled to a great extent by the ratio of a corporation's debt to its equity. The ratios (ranging from 7-to-1 to 20:1-to-1 in these cases) were of major importance here but it would seem that the question of excessive ratio was meant to be only another evidentiary step towards establishing intent of the parties to create a bona fide debt and to be bound thereby. These decisions made mention of the other circumstances surrounding the transactions relevant to the issue of intention to create a "Classic Debt" as in Kelley and commented on factors extraneous to a 'Classic Debt' not previously considered of significance in a determination of this issue, such as a finding of no reasonable expectation of repayment on the part of the stockholders. This is indicative of the broadening of the area of search by the court in order to establish true intent of the parties. However, taking into account the emphasis placed by the court on the situation of a large debt and small equity, this fact alone is practically conclusive evidence of lack of intent to create a debt, with the other factors in these decisions merely supplying make-weight evidence. At this point, it should be noted that the rationale of these cases is a one-way street for the Tax Court, because a favorable ratio does not conclusively establish a bona fide debt, such determination then hinging upon a finding of a sufficient number of the other indicia of intention being present in a given transaction. Of course, such decisions immediately raised the issue as to what constituted a "safe" ratio of debt to equity. Surprisingly enough, Kelley was used as authority by the Tax Court in suggesting that if the amount of indebtedness did not exceed four times the amount of corporate equity, such ratio would be considered acceptable, though, as already emphasized, not conclusive evidence of a bona fide corporate indebtedness. An investigation of the decisions of this period indicates that the Tax Court made every attempt to stamp as fatal an excessive ratio of debt to

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23 Swoby Corp., 9 T.C. 887 (1947); Sam Schnitzer v. Comm., 13 T.C. 43 (1949); Isidor Dobkin, 15 T.C. 31 (1950). (Dobkin has become the mainstay of these so-called "ratio" decisions. A ratio of 35 to 1 was considered excessive and the corporation's interest deduction was disallowed.) George L. Sogg, 9 T.C.M. 927 (1951); Erard A. Matthiessen, 16 T.C. 781 (1951), aff'd., 194 F.2d 659 (2d Cir. 1951).

24 Ruspyn Corp., 18 T.C. 769 (1952). The court here made reference to Kelley in comparing the taxpayer's ratio of 3½ to 1 to the Kelley ratio of 4 to 1, noting the previously quoted Supreme Court language in Kelley concerning invested capital, supra note 20, and drew the conclusion that the taxpayer in question was within the "safe" ratio of debt-to-stock sanctioned by the high court.
During this period, the Commissioner of Internal Revenue acquiesced to the Tax Court’s decision in *Ruspyn*, which, as to its compliance with the requirements of a formal debt, was ruled by the Tax Court’s *Kelley* opinion, and the Supreme Court’s reference to the importance of a sufficient capital investment in its determination of *Kelley* furnished the foundation for its consideration of the ratio issue.

*Ruspyn* should be taken as the representative case of this period, inasmuch as an interest deduction was allowed the taxpayer, as in *Kelley*, and it received the subsequent backing of the Internal Revenue Department. The case involved the transfer of certain real estate by 12 individuals to the taxpayer corporation. The property had a value of $2,700,000 and was given in exchange for $2,100,000 in “Gold Debenture Bonds” and $600,000 in common stock. The bonds bore a stated interest rate of 6% and conformed in other respects to the requirements of the *Kelley* “Classic Debt.” Interest deductions of $96,000 were allowed in the decision, based on a finding that the parties intended to be bound by the debt. The court noted that the device was proper as to nomenclature and form, that there was a reasonable relation between debt of the corporation and its equity (3½ to 1), and briefly commented upon the presence of sufficient business reasons for creating the obligation internally, a factor which was not considered in *Kelley* as part of a “Classic Debt” and which may not have been substantially significant at this time. However, it will be noted subsequently that the element of business or non-tax reasons for a corporation’s borrowing from its shareholders has now become a material factor in determining the intent of the parties, evidenced by recent opinions concerning this issue. But from *Ruspyn* and other decisions of its time, it would seem that the Tax Court was generally inclined to follow its standard for intent as found in the “Classic Debt” of *Kelley*, in situations where the ratio requirement, suggested by the Supreme Court, was met, with cases involving an excessive ratio of debt to stock resulting in an almost automatic adverse finding to the taxpayer. Certainly, the intent rule of *Kelley* was not changed, but merely modified so as to include this now significant ratio element.

Practitioners in the tax field had come to treat the Tax Court de-

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25 Penell, *Tax Planning at the Time of Incorporation*, 35 *Taxes* 927, at 935 (1957), where, in considering the significance of the ratio of debt to stock, it is noted that the Tax Court, from 1949 to 1954, almost summarily disallowed any corporate interest deductions in cases where the ratio of corporate debt to stock exceeded the “safe” ratio standard set down, presumably, in *Kelley*.


27 Cases cited in supra note 23.
cisions of this 8 year period\textsuperscript{28} as an attempt by the court to establish some mathematical certainty of rule-of-thumb on the problem of ratio of debt to stock. The Commissioner indicated acceptance of this suggested ratio and, although complete harmony cannot be found in Circuit Court decisions,\textsuperscript{29} as a general rule attributable to this period, if a corporation had a debt-equity structure which was within the suggested "safe" limit previously brought out, and had complied with requirements for a "Classic Debt", its indebtedness with respect to its stockholders would be recognized as such for income tax purposes.

**RECENT DEVELOPMENTS AND THE PRESENT STATE OF THE LAW**

The present application of tax law dealing with the subject of debt or equity, beginning in 1954, abounds with decisions on this question, presumably due to a greater use of the corporate form of conducting small or family enterprises and the constantly increasing tax rates. Whatever the reason is, the frequency with which this question has appeared in the past four years points to the fact that no clear-cut rule is available to the tax counselor in setting up this corporate debt device. The *Kelley* tests of "Classic Debt" and ratio of debt to stock for determining this capitalization are still relied upon by the Commissioner and the Tax Court as rules for determining intent of the parties, but most of these cases contain additional factors, many of which were briefly mentioned and never considered of substantial significance in earlier decisions, now elevated to positions of extreme importance in these recent decisions. Both the taxpayers and the Commissioner have a wealth of opinions from which to draw conclusions as to what will or will not constitute a bona fide corporate indebtedness. The tax law, especially in the absence of Regulations as in this area, does not remain inert when interpretation must be made judicially. Characterizing the courts' broadening of the intent standard is the trilogy of *Gooding Amusement Co., Inc. v. Comm.*,\textsuperscript{30} *Kraft Foods Co. v. Comm.*,\textsuperscript{31} and *Benjamin D. Gilbert.*\textsuperscript{32}

The *Gooding* decision was ruled by what was referred to as a "sham" arrangement set up for tax avoidance purposes. If *Kelley* stood for an intent test based on the name of the instrument and the

\textsuperscript{28} The Tax Court has suggested, in alluding to the *Kelley* decision, and tax advisers have come to rely somewhat on a 4 to 1 "safe" ratio, as previously noted. In cases to be discussed later, *Gooding Amusement Co.*, 23 T.C. 408 (1954) and *Benj. D. Gilbert*, 15 T.C.M. 688 (1956), the Tax Court held as invalid debts bearing rates of 1 to 1 and 2.19 to 1 to corporate stock. However, other factors influenced these decisions and the question of a "safe" ratio was not considered conclusive in itself.

\textsuperscript{29} In *Rowan v. U.S.*, 219 F. 2d 51 (5th Cir. 1955), the Fifth Circuit did not consider a ratio of about 14 to 1 to be excessive.

\textsuperscript{30} 23 T.C. 408 (1954), *affd.*, 236 F. 2d 159 (6th Cir. 1956).

\textsuperscript{31} 21 T.C. 513 (1954), *rvsd.*, 232 F. 2d 118 (2d Cir. 1956).

\textsuperscript{32} 15 T.C.M. 588 (1956); *rvsd. and remanded*, 248 F. 2d 399 (2d Cir. 1957) *on remand*, P-H Memo T.C. par. 58,008 (1959).
form of the device used to cast the indebtedness, and the subsequent ratio requirement was based on the objective and arithmetic comparison of one amount to another, the Gooding decision stands for a much more subjective approach in examining the debt structure of a corporation. Quite obviously, the "sham" referred to in this opinion was not a result of a defect in the form of the debt (promissory notes at 5% interest which matured at a fixed date) nor of "thin capitalization" (the Tax Court admitted that the debt-to-stock ratio was favorable but such fact in itself was not conclusive evidence of a bona fide corporate indebtedness). A fatal tax avoidance purpose was nevertheless found from a failure of the parties to conduct themselves in the manner of debtor and creditor, evidenced by the combination of an actual subordination of the notes to third party creditors, a failure of the corporation to pay the notes which were overdue at the time of the action, a failure of the shareholders (creditors) to enforce these obligations, and in general, a state of mind on the part of the note-holders which was not consistent with that of creditors, but rather with that of shareholders who realize that the money advanced is subject to the ordinary risks of the business. Possibly contributing to the strict finding of the court was the fact that the corporation in question was a small (two shareholders) family-held unit.

In Kraft Foods, the element of lack of sufficient business purposes for borrowing from corporate shareholders, a factor extrinsic to the actual debt transaction, was held to be significant by the Tax Court in a consideration of this issue, wherein an interest deduction was disallowed. Business purpose had been a part of previous decisions, but had never received the emphasis placed upon it by the court in this decision. Although the case was reversed by the Second Circuit on appeal, it would appear that the importance given to this extraneous feature, proved only by evidence independent of the debt transaction, is a warning that the Tax Court is further narrowing its opinion of what constitutes a bona fide corporate debt by increasing the number of necessary requirements. Also noteworthy is the fact that the transaction involved a large corporation and its subsidiary, and the appellate court in its review of a Tax Court finding, might not be as liberal in a case where the underlying transaction of a small or family-held corporation has been held to lack sufficient business or non-tax reasons to justify this form of financing. Just how important the element of having adequate business purposes will be in the future cannot be answered at this time. However, if the present judicial trend relating to this issue is to broaden its requirements for determining intent of the parties to the transaction, the language of the Tax Court in Kraft Foods, together with a Federal District Court's recent decision33 in-

icates to the tax planner that a convincing non-tax reason for corporate borrowing from within gives added weight to his argument that the parties in fact intended to be bound by the creation of this debt. 

*Gilbert* involves a fact situation wherein a shareholder of a small corporation sought a bad-debt deduction for money advanced to his corporation allegedly as a loan and on which the corporation, bankrupt at the time of the action, was in default. Although the deduction sought was different from the interest deduction previously noted, the decision is ultimately a determination of whether or not a bona fide corporate indebtedness existed. Loans of $110,000 were advanced to the corporation by shareholders in exchange for demand promissory notes bearing an interest rate of 3½% per annum. When this money was loaned, from 1946 to 1948, the corporation was in serious financial straits, and was eventually dissolved in 1948. In its first decision, the Tax Court held that although the notes satisfied the formal requirements of debt as to nomenclature, stated maturity date and fixed interest payments, and the ratio of debt to stock (2.19 to 1) was not excessive if measured by the accepted standards, nevertheless, the taxpayer's advances were not loans but rather advances of risk capital. The biggest single factor in support of the court's finding was the failure of the corporation to offer security for these notes. This factor had also been mentioned in earlier decisions, but in *Gilbert* it received its initial emphasis as being a material element of intent. Because of this fact, the court felt that although the parties probably intended to create a debt *per se*, they never realistically anticipated collection of the debt for inasmuch as they were unsecured creditors, repayment would be unlikely if the business failed. This substitution of its own business judgment by the court for that of the businessman presents the stiffest test for intent ever to be applied to this problem. Certainly, the lack of security might well have been the only reason why a small corporation is unable to obtain outside financing, which financing the court would consider to be above reproach. On appeal, the Second Circuit decided that the opinion of the lower court was merely a conclusion of law without reasons. In its decision, the court stated that a bare conformity with technical requirements for a debt

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34 INT. REV. CODE OF 1954, §166 (a).
35 23 T.C. 408 (1954).
36 248 F. 2d 399 (2d Cir. 1957).
should never preclude further inquiry by the Commissioner. Even an intent to create a debt will not be sufficient for tax purposes if the parties thereby fail to create an obligation of practical enforceability. The court pointed out that although some variance from the form of the “Classic Debt” is not fatal to the taxpayer, too great a deviation from an obligation to pay a sum certain, at a reasonably fixed maturity date along with a guaranteed payment of a percentage of interest, will raise suspicions as to the true nature of the transaction. The court did not stop its inquiry here, but proceeded to mention tax avoidance which has an ability to seep through even the most meticulously established debt transaction, resulting in a nonrecognition of it as a debt by the Commissioner. In Justice Medina’s words:

... we think it helpful to point out that the taxpayer’s motive is not the crucial factor. This is but a corollary of the undoubted proposition, ‘the incidence of taxation depends upon the substance of a transaction.’

What appears to be the essence of this statement is that tax avoidance per se is not inherently evil, but as the sole purpose for a transaction by a taxpayer, it becomes the subject of immediate suspicion by the Commissioner. The taxpayer cannot prove that a given debt transaction is above mere tax avoidance by the form in which the debt is cast but must rely on evidence aliunde to the instrument, such as favorable debt-to-stock ratio, non-proportionality of a shareholder’s debt and stock holdings in the corporation (which evinces no attitude of controlling the amount of individual risk), the use to which “loans” are put, availability of outside financing, and a reasonably well-founded expectation of repayment. A conclusion of fatal tax avoidance can be based on the attempt to take an interest deduction on an advance which in fact was too risky to qualify as a loan for tax purposes. Therefore, after the alleged debt was tested as a “matter of substantial economic reality,”37 the case was sent back to the Tax Court for proceedings consistent with the opinion. Taking its cue from the language of the Court of Appeals, the Tax Court made quick disposition of the matter38 and found that capital contributed to the corporation upon incorporation was not sufficient to finance the conduct of its business, the corporation did not have adequate security to induce outside investments, advances were made by shareholders in direct proportion to their stock holdings, thus limiting their losses in the

37 Judge Medina, in this decision, 248 F. 2d 399, at 407, speaks of the congressional policy as imposing the test of a reasonable expectation of repayment. From this it would seem that intent of the parties, manifested by the creation of a “Classic Debt”, in itself is not conclusive evidence of a bona fide indebtedness where factors independent of the transaction, such as corporate insolvency at the time of borrowing, indicate a contrary intent.

38 P.H. Memo T.C. par. 58,008 (1958).
event of corporate failure, advances were made by the taxpayer without regard to normal creditor safeguards, the taxpayer made no efforts to enforce collection of obligations which evidenced the indebtedness, and at the time of the advances, it was unreasonable to expect that the "debts" would be repaid unless the business venture proved successful. The court in this case and in subsequent decisions to be noted, does not attempt to make a direct break with the traditional tests for indebtedness, such as the "Classic Debt" test of Kelley and its "safe" ratio requirement. What it seems to be inferring is that basically, all the tests relied upon by courts are those which suggest a situation of normalcy, comparing this internal debt with the arms-length transaction involving an outside creditor. But the effect of these decisions is to greatly tighten the rules laid down in Kelley wherein a debt was determined by intent of the parties manifested in the transaction itself. Admittedly, Kelley presented a very favorable set of facts for the taxpayer which did not necessitate investigation further than the actual form of the debt. But now, under the present interpretation of bona fide debt, if money which is due to a shareholder as a corporate debt is not paid when due, or if this debt is not backed by adequate security, these facts in themselves, upon the authority of Gooding and Gilbert, could turn the debt into capital. Such results could mean that a stockholder-creditor, in order to avoid adverse income tax consequences, would have to be less lenient with his company than would an outside creditor. Had this interpretation been applied in the very recent decisions? A consideration of a few of these cases might indicate the answer and the present state of the law on this issue.

Litigation on this question of debt or stock continues unabated and the rules to be taken from these decisions generally indicate a narrowing of the permissible perimeter in which a corporate debt, resulting from advances by stockholders, can exist. Unquestionably a product of the triad of decisions just noted, this status of the tax law finds support in cases such as Martin M. Dittmar39 (a case determined on the authority of Gooding), Harkins Bowling, Inc. v. Knox,40 (de-

39 23 T.C. 789 (1955). This decision, R. M. Gunn, 25 T.C. 424 (1955), The Colony, Inc. 26 T.C. 30 (1956), and Lockwood Realty Corp., P-H Mem T.C. par. 58,049 (1958), all referred to the "intent" tests of Gooding and, although the formal requirements of the debt were satisfied, there was a general state of mind of the parties inconsistent with that of debtor and creditor.

40 164 F. Supp. 801 (D.Minn. 1958): "The significant factor, in the minds of the framers of the act, is whether the funds were advanced with reasonable expectations of repayment regardless of the success of the venture or were placed at the risk of the business. [citing Gilbert].

"The important consideration here is not intent of the parties, since their intent has been objectively manifested in the notes. The important consideration is rather whether the intent and acts of these parties should be disregarded in characterizing the transaction for Federal Tax purposes." [citing Kraft Foods].
cided by the rules of *Gilbert* and *Kraft Foods*), and *Northline Realty Corp.*\(^1\) (the failure of the corporation to give security for its loans, as in *Gilbert*, was fatal to the taxpayer here). Whereas the intent to make an indebtedness in 1946 could be characterized by a creation of a "Classic Debt," today intent is also determined by a shareholder-creditor making noise like a creditor. This "creditor's noise" is, by judicial decision, best typified by the insistence upon adequate security prior to the making and by a shareholder's unequivocal demand against the corporation for payment when the debt is due. As can readily be observed, these strict requirements, added to the other already established requirements for a bona fide debt such as proper form and "safe" ratio, could make borrowing from shareholders an almost impossible undertaking for a small or closely-held corporation in many cases.

Although such corporate activity appears to be subject to closest scrutiny of the Commissioner and the courts as evidenced by these decisions of the past 4 years, recent authority can be found in support of the tax planner who still feels that an attempt to cast indebtedness of a corporation in this manner is worth the effort. Compliance with the *Ruspyr* decision\(^4\) as to the requirements for a formal debt and an acceptable debt-to-stock ratio, adequate security for the debt in the form of 1st mortgage trust deeds on the corporate assets, held to be of great importance in *Gilbert*,\(^4\) and solid non-tax reasons for creating debt instead of equity, a significant feature in *Kraft*,\(^4\) all combined to result in a finding of bona fide indebtedness of the corporation in *Dominion Oil Co., Inc. v. U. S.*\(^4\) and its companion case, *Dennis Corp. v. U. S.*\(^4\) The conduct of the taxpayers in question appears to have satisfied a Federal District Court judge and the language of his opinion might be used as authority. Conforming as closely as possible to the debt make-up of this case, and noting that *Kelley* still furnishes authority for proper form of the debt and ratio of debt to equity, a small or closely-held corporation would very likely gain an approving nod from the Commissioner, as long as sufficient "creditor's noise," so important in *Gooding*, is made by the shareholders in enforcing the obligations of the corporation. The difficulty and impracticability of conformance to these criteria is, of course, the source of the trouble, inasmuch as the small corporation is seldom physically equipped to measure up to such an ideal debt structure. Some variance in formal requirements is likely to be per-

\(^{1}\) P.-H Memo T.C. par. 58,021 (1958).
\(^{2}\) Cited at *supra* note 24.
\(^{3}\) Cited at *supra* note 32.
\(^{4}\) Cited at *supra* note 31.
\(^{46}\) Cited at *supra* note 33.
mitted as long as a situation of normalcy remains apparent from an examination of the debt. This transaction is admittedly a hybrid form of indebtedness, but no conduct on the part of the shareholders which suggests hybrid creditors will be tolerated. Such would appear to be the present state of the law concerning this issue.

**CONCLUSION**

To meet all the requirements of a bona fide indebtedness as interpreted by the Commissioner and the courts, while at the same time gaining benefits of internal financing through shareholder loans presents a Herculean challenge to organizers and tax counselors of a small corporation. To say that the parties to the transaction must intend to create a debt and to be bound thereby is one thing, but, as evidenced by the recent cases noted previously, to prove this intent is another. The criteria used by the Commissioner and the courts and of which corporate planners must take cognizance are numerous and oft-quoted. The number of requirements and emphasis placed on certain principal ones have been increased over the past decade as a result of "judicial legislation." It is apparent that this area is in need of Internal Revenue Regulations or Revenue Rulings in order to establish a set of rules which approach a degree of certainty. Intent is unquestionably the ultimate requirement, and although determined by exacting tests as to the instrument, conduct of the parties, and purposes surrounding the transaction, it is certainly possible to succeed in setting up a corporate debt structure which will very likely pass the Commissioner's inspection. Careful consideration of the most recent decisions noted herein present what is as objective a standard as can be established in the absence of specific regulations.

Of course, the advantages of borrowing from within might have to be compromised greatly if a corporation is to conform to this strict standard for intent set up by the courts and very often it will be impossible for a small or closely-held organization to comply sufficiently with tax requirements and at the same time to establish an internal debt structure because of the very nature of the corporation or its inability to secure its debts. The recent addition to the Internal Revenue Code47 concerning the election by a small business corporation to be taxed other than as a corporation will offer relief from the "double taxation" burden for those corporations which are able to

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47 Public Law 85-866, 85th Cong., 2d Sess., (1958), adding sections 1371-1377 to the Internal Revenue Code of 1954. The effect of this new legislation is presently unknown and too many problems and ramifications exist with this election to consider in this article, but it is noted that many small corporations would be disqualified from electing to be taxed under this section, or, for income tax purposes of either the corporation or stockholder, would prefer corporate taxation. This legislation in no way eliminates the need for Revenue Regulations concerning the validity of a corporate debt for tax purposes.
qualify and find this method beneficial. This legislation does not solve the problem of debt or equity for those units which do not prefer or are unable to so elect. The final answer is not likely to appear, as is the case in most areas of taxation, but clarification and semi-finality would result from Regulations. Until then it is the responsibility of the corporation to convince the Commissioner that it was the intention of the parties to create and enforce a bona fide indebtedness.

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