DEBT v. EQUITY: CURRENT CRITERIA FOR DISTINGUISHING

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When the Internal Revenue Code of 1954 was under consideration Congress sought to identify the criteria which would determine whether an investment represented a debt or equity.¹ However, the Senate Finance Committee was reluctant to define stock, common stock and securities because of the multitude of forms that such items might take.² In considering the Tax Reform Act of 1969 Congress recognized the problems resulting from the lack of precise definitions in this area but did not remedy the situation.³ The 1969 enactment created section 385 of the Internal Revenue Code which authorizes the Secretary of the Treasury or his delegate to prescribe regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated, for tax purposes, as stock or indebtedness. Subsection (b) provides:

The regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a particular situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists.⁴

In considering what the form of the regulations under section

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¹. This attempt was made in the House version of the bill.


The House bill departs from existing law by introducing the new terms, “participating stock” (corresponding in general to common stock) and “nonparticipating stock” (corresponding in general to preferred stock). It not only defines these terms but also contains a definition of the term “security”. Important tax consequences can flow from these definitions under the House bill. Thus, interest cannot be deducted if the instrument on which it is payable does not meet the test of a “security” as is the case with many income debentures currently outstanding. Your committee believes that any attempt to write into the statute precise definitions which will classify for tax purposes the many types of corporate stocks and securities will be frustrated by the numerous characteristics of an interchangeable nature which can be given to these instruments. Accordingly your committee has returned to the use of the terms “stock”, “common stock”, “securities”, etc., and, as is the case under existing law has not attempted to define them in the statute.


⁴. INT. REV. CODE of 1954, § 385 (b) (emphasis added).
385 of the 1954 code may take, an analysis of the prior case law may be helpful.

Some legal problems are endowed with a case by case uniqueness calling for ad hoc determinations, but the debt-equity problem has exhibited a special kind of singularity. The often cited principle that each case "must be judged on its own facts" has resulted in a lack of uniformity of judgment even in cases where the individual creditor-debtor relationships exhibit ostensible similarity. Because of this, tax practitioners are faced with the undesirable, but seemingly unavoidable, consequence that this field of law continues to defy symmetry.

The debt-equity problems are most acute in situations involving closely held corporations. To a stockholder in such a corporation it often makes little difference, taxation aside, whether his investment is labeled debt or stock. However, attorneys and accountants generally agree that in most instances classifying advances as debt is more desirable than classifying them as equity capital.

Tax planning in this area is extremely difficult. Because of the inherent factual nature of the problems involved the Internal Revenue Service will not issue advance rulings or determination letters. Although the position of the Service may seem undesirable from a planner's point of view, it is consistent with existing

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5. John Kelly Co. v. Commissioner, 326 U.S. 521 (1946), rev'g 148 F.2d 466 (7th Cir. 1944), and, aff'g Talbot Mills v. Commissioner, 146 F.2d 809 (1st Cir. 1944); Tomlinson v. 1661 Corp., 377 F.2d 291 (5th Cir. 1967), aff'g 247 F. Supp. 936 (M.D. Fla. 1965); Moughon v. Commissioner, 329 F.2d 399 (6th Cir. 1964), aff'g 39 T.C. 1124 (1963); Wood Preserving Corp. of Baltimore v. United States, 233 F. Supp. 600 (D. Md. 1964), aff'd, 347 F.2d 117 (4th Cir. 1965); Goodyear Amusement Co., 23 T.C. 408 (1954), aff'd, 326 F.2d 159 (6th Cir. 1963), cert. denied, 352 U.S. 1031 (1957).


9. One instance of when debt classification may not be more desirable is where the investor is a corporation which seeks to take advantage of the eighty-five percent dividends received deduction provided by § 243 of the 1954 Code. See, e.g., Ragland Investment Co., 52 T.C. 867 (1969).

case law allowing the Commissioner and the courts to examine all pertinent facts rather than limiting their view to facts existing at the time the purported indebtedness was advanced to the corporation.\(^\text{11}\)

The aspects of the debt-equity issue which have resulted in the most litigation are: (1) the deduction for interest on indebtedness;\(^\text{12}\) (2) losses sustained when a corporation becomes insolvent;\(^\text{13}\) (3) losses incurred when a stockholder guarantees corporate indebtedness;\(^\text{14}\) (4) repayment of purported loans;\(^\text{15}\) (5) the corporation's basis in property "sold" to it by shareholders;\(^\text{16}\) (6) payments for property "sold" to a corporation by its shareholders;\(^\text{17}\) and (7) classification of the invested funds as either indebtedness or a second class of stock of a small business corporation.\(^\text{18}\)

The enumerated facets of the problem will not be scrutinized individually in this article. It is the intention of this writer to indicate the major factors or criteria which a court may consider in dealing with any or all of them.\(^\text{19}\) However, it should be under-

\(^\text{11}\) See, e.g., Berkowitz v. United States, 411 F.2d 818 (5th Cir. 1969). In denying debt status to certain stockholder advances to a corporation the court considered the following factors which obviously occurred after the advances were made: (1) Failure to retire purported indebtedness when funds were available to do so; and (2) waiting until the end of the fiscal year to declare the "interest rate", just as a dividend would be declared.


\(^\text{13}\) See, e.g., United States v. Henderson, 375 F.2d 36 (5th Cir. 1967), cert. denied, 389 U.S. 953 (1967). The importance of this facet of the debt-equity area seems to have been substantially lessened by the case of Whipple v. Commissioner, 373 U.S. 193 (1963), where the Supreme Court ruled that merely furnishing management and other services to corporations for a reward not different from that flowing to a stockholder in those corporations was not a trade or business, therefore, losses were deductible only as nonbusiness bad debts. The Court was construing § 23(k)(4) of the 1939 Code, predecessor of § 166(d) of the 1954 Code.


\(^\text{17}\) See, e.g., Ainslie Perrault, 25 T.C. 439 (1955), aff'd per curiam, 244 F.2d 408 (10th Cir. 1957), cert. denied, 355 U.S. 830 (1957).

\(^\text{18}\) See, e.g., Catalina Homes, Inc., 23 CCH Tax Ct. Mem. 1381 (1964). Section 1371(a)(4) of the 1954 Code defines a Small Business Corporation as "a domestic corporation . . . which does not . . . have more than one class of stock." (emphasis added.)

\(^\text{19}\) In Edwin C. Hollenbeck, 50 T.C. 740, 747 (1968), aff'd, 422 F.2d 2
stood at the outset that this writer is not attempting to anticipate what regulations will be promulgated under section 385 of the Internal Revenue Code as created by the Tax Reform Act of 1969.

No attempt will be made to determine the relative importance of the various factors discussed herein, because courts seem to weigh them differently depending upon the circumstances involved. Furthermore, one must always be cognizant of the fact that each controversy in this area of the law turns on its particular facts and that no single factor is controlling.\(^2\)

1. **Name of the Instrument**

It seems apparent that if a stockholder is attempting to classify an advance of funds to a corporation as a loan the document or writing evidencing that transfer should be given one of the traditional labels indicating indebtedness, such as "debenture", "bond", "certificate of indebtedness" or "promissory note".\(^2\) Of course one must recognize that such action is no assurance of success.\(^2\)

It has been held that the existence of written evidence is not essential to a determination that an advance to a corporation represents debt,\(^2\) but logic and good planning would seem to require it.\(^2\)

\[^9\text{(9th Cir. 1970), the Tax Court commented:}\]

> The debt-equity inquiry is essentially the same in all areas. The precise determination to be made—is there more than one class of stock, are notes bona fide indebtedness, etc., varies from case to case, but the basic standards remain the same in all cases where the respondent seeks to reclassify debt or equity. The test is whether the form in which the taxpayer has cast the transaction has substantial economic reality.

20. See the cases cited in note 5 supra. This point cannot be overemphasized.

21. One exception to this might be, where the structuring of a transaction in this manner would create an unfavorable balance sheet. See, e.g., United States v. Title Guarantee & Trust Co., 133 F.2d 690 (6th Cir. 1943).


23. See C.M. Gooch Lumber Sales Co., 49 T.C. 649 (1968), where the advances were evidenced by ledger entries. Contra decisions are, Estate of Chism v. Commissioner, 322 F.2d 956 (9th Cir. 1963), aff'd 37 T.C. 1185 (1962); Wachovia Bank and Trust Co. v. United States, 288 F.2d 750 (4th Cir. 1961); and, Wood Preserving Corp. of Baltimore v. United States, 233 F. Supp. 600 (D. Md. 1964), aff'd, 347 F.2d 117 (4th Cir. 1965).

24. This is just one aspect of what courts sometimes refer to as "acting like a creditor". It seems safe to say that very few independent lending institutions would loan funds to anyone without requiring written evidence of the advance.
2. Provision for Unconditional Payment of a Fixed Sum

One essential characteristic of indebtedness is an enforceable obligation to pay a fixed or determinable sum of money. Although the absence of such an attribute in an instrument is not necessarily determinative in a debt-equity dispute, it raises a cogent inference contra to the allegation that the writing represents indebtedness.

The most patent disregard of the fixed sum requirement that this writer has discovered is the case of Sherwood Memorial Gardens, Inc. In the Sherwood case a Mr. Meyer and a Mr. Berkowitz agreed to organize a Tennessee cemetery corporation with a minimum capital of one thousand dollars. A plot of land was purchased by Berkowitz and Mrs. Meyer for $30,000 in Knoxville, Tennessee. Berkowitz and Mrs. Meyer then transferred this land and $30,000 cash to the corporation in exchange for twenty percent each of the corporation’s one thousand “certificates of indebtedness”. In those certificates the corporation promised to pay the holders thereof twenty-five percent of the base sales price of each and every lot sold during a period of fifteen years commencing with the date of the first sale. The Internal Revenue Service challenged the authenticity of the alleged debt. In holding for the Commissioner the Tax Court emphasized the lack of an obligation to repay a definite or determinable amount of money:

[T]here is no way of ascertaining from the certificates of indebtedness (or from the first agreement which gave rise to their issuance) the principal amount of petitioner’s purported obligation. To the extent that petitioner is obligated upon its certificates of indebtedness, it is obligated only for a percentage of its sales (assuming such sales occur), and in no event is it bound to repay the funds initially furnished to it.

The Tax Court was clearly correct in characterizing the advances to the corporation as contributions to capital. It is evident that

26. Treas. Reg. § 1.166-1(c) (1959). In Gilbert v. Commissioner, 248 F.2nd 399, 402 (2nd Cir. 1957) rem’d g 15 CCH Tax Ct. Mem. 688 (1956), Medina, J., defined debt as follows:

The classic debt is an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor’s income or lack thereof.
27. 42 T.C. 211 (1964), aff’d, 350 F.2d 225 (7th Cir. 1965).
28. Id. at 288.
the return on Mrs. Meyer's and Mr. Berkowitz's funds could have been greatly in excess of their investment or could have been almost nothing, depending upon the future success of the venture.29

3. Provision for a Maturity Date

A provision for payment on a fixed or ascertainable maturity date is similar to the preceding criterion in that it is traditionally considered to be one of the essential characteristics of indebtedness.30 The existence of a maturity date is necessary to protect a creditor because without it there can be no default.31 It seems evident that no independent lending institution would advance funds without such a provision and for that reason the courts certainly appear to be justified in considering this aspect of a purported stockholder loan. Absence of a determinable due date in an advance to a closely held corporation would seem to suggest that repayment may be expected only when it is convenient for the corporation, much the same as payment of dividends.32 Because of this it seems imperative that a bona fide stockholder loan include a provision for repayment of the advance on a definite date. Provision for a maturity date would certainly assist in removing a cloud of suspicion that the advance really represented equity.33 However, such a provision should not be relied upon as sufficient to outweigh other indications that the "loan" is really equity capital.34

In addition to establishing a maturity date, most courts require that an effort must be made to adhere to it. Such practices as issuing new promissory notes as old ones become due or completely

29. See Factor 23 in text infra.
30. See the quotation from Gilbert v. Commissioner, note 26 supra.
34. In Arlington Park Jockey Club v. Sauber, 262 F.2d 902, 906 (7th Cir. 1959), aff'd 164 F. Supp. 576 (N.D. Ill. 1958), the court stated: Usually, in a debtor-creditor relationship, a fixed maturity date of the obligation is established, but this court and others have pointed out that under certain factual situations a fixed maturity date does not preclude an ambiguous situation from being construed as a capital investment rather than creating an indebtedness.
disregarding maturity dates\textsuperscript{36} may be considered an indication that the advances to the corporation represent contributions to capital rather than indebtedness.\textsuperscript{37}

4. Duration of the Obligation

This factor is rather ambiguous, but one which courts will often consider.\textsuperscript{38} "Generally, an inordinately postponed due date . . . weighs in favor of characterizing an advance as a capital contribution."\textsuperscript{39} The rationale for this position is that under ordinary circumstances an independent lending institution will be reluctant to advance funds to a small business for a long period of time because the fortunes of those enterprises often fluctuate greatly.\textsuperscript{40}

No rule can be discerned from the varied decisions as to what constitutes a "safe" period of time for the duration of an instrument evidencing indebtedness of a closely held corporation. In \textit{Prentis v. United States},\textsuperscript{41} a promissory note of six months duration was held to represent equity while in \textit{United States v. Title Guarantee \& Trust Co.},\textsuperscript{42} a hybrid security with a twenty year maturity date was determined to represent indebtedness.

In \textit{Camp Wolters Enterprises},\textsuperscript{43} the Tax Court placed the significance of the duration of an advance in its proper perspective:

The test as to whether notes are securities is not a mechanical determination of the time period of the note. Though time is an important factor, the controlling consideration is an over-all evaluation of the nature of the debt, degree of participation and continuing interest in the business, the extent of proprietary interest compared with the similarity of the note to a cash payment, the purpose of the advances, etc.\textsuperscript{44}

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37. See Factor 26 in text infra.
40. An outright loan to the business is to be distinguished from a purchase of machinery and equipment where repayment may be provided for by a long term purchase agreement.
41. 64-1 U.S. Tax Cas. 92,097 (S.D. N.Y. 1964).
42. 133 F.2d 890 (6th Cir. 1943).
44. \textit{Id.} at 751.
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5. **Provision for a Specific Rate of Interest**

It is inconceivable that a bank or other institutional lender would extend a loan to a small corporation (or anyone for that matter) without providing for payment of a specific rate of interest. Consequently, courts will examine this aspect of a purported shareholder loan in determining the bona fides of a transaction. Making no provision for interest must be considered extremely hazardous if one seeks to classify a shareholder advance to a closely held corporation as indebtedness.\(^45\) Providing for fluctuating interest rates seems to be equally perilous.\(^46\)

Once an interest charge is specified in an instrument it must be adhered to. In *Berkowitz v. United States*,\(^47\) certain shareholder advances to a corporation were evidenced by promissory notes bearing interest at the rate of six percent per annum. The corporate directors disregarded the specified interest rate and made it a practice to meet at the end of each year to decide what “interest rate” was to be paid. The corporation paid “interest” to the alleged creditors at rates varying from four to fifteen percent for a seven-year period. In holding that the advances in question constituted equity capital rather than indebtedness the Court of Appeals for the Fifth Circuit commented on the varying “interest” rates: “[T]he appellants, as taxpayer’s directors, waited until the end of the fiscal year to ‘declare’ the ‘interest rate’ in exactly the same way that directors would declare a dividend.”\(^48\) The rate of “interest” annually decided upon was directly proportionate to earnings and profits for the respective years. The directors’ action constituted an obvious scheme to siphon earnings and profits out of the corporation without taxing the corporate entity on the amounts distributed.

\(^45\) Curry v. United States, 396 F.2d 630 (5th Cir. 1968), cert. denied, 393 U.S. 967 (1968); Montclair, Inc. v. Commissioner, 318 F.2d 38 (5th Cir. 1963), aff’d, 350 F.2d 225 (7th Cir. 1965). For cases where a provision for a specific rate of interest supported a determination of indebtedness see J.S. Biritz Construction Co. v. Commissioner, 387 F.2d 451 (8th Cir. 1967); and, Medical Tower, Inc. v. United States, 23 AFTR2d 1230 (E.D. Va. 1969).

\(^46\) John Kelly Co. v. Commissioner, 326 U.S. 521 (1946), rev’g 149 F.2d 466 (7th Cir. 1944), and, aff’g Talbot Mills v. Commissioner, 146 F.2d 809 (1st Cir. 1944). The *Talbot* and *Kelly* cases were virtually identical on their facts except that in *Kelly* the debentures involved provided for a set rate of interest (eight percent) while in *Talbot* the interest rate could vary from two to ten percent. The Supreme Court upheld the Tax Court’s determination in both cases, holding that the advances in *Kelly* represented indebtedness, but that the advances in the *Talbot* case were really equity contributions.

\(^47\) 411 F.2d 818 (5th Cir. 1969).

\(^48\) *Id.* at 821.
6. ** Provision for a Reasonable Rate of Interest

In providing for a definite rate of interest, care must be taken to see that the rate specified is reasonable. In determining reasonableness the courts will usually consider whether or not the rate provided for is commensurate with the risk involved.\(^{49}\) This consideration is grounded on the general premise that a lending institution will charge a high rate of interest for a risky venture and a relatively low rate of interest for a sound investment.\(^{50}\) It seems as though a stockholder-creditor has some degree of latitude in this matter,\(^{51}\) but one must be cognizant of the fact that a specified rate of interest may be deemed to be too high\(^ {52}\) as well as too low.\(^ {53}\)

7. ** Provision for Payment

A bona fide creditor is usually not concerned about the source of payments of principal and interest as long as there is sufficient collateral available to insure that such payments are timely made. A stockholder, on the other hand, is usually primarily interested in the growth and future of a corporation and will wish to be paid a dividend only if such a payment will not jeopardize his investment in the business. In view of the significant effect such differences of purpose could have upon the resolution of the present problem, a court will direct its attention to any provision in a written instrument which restricts the availability of funds for payment of principal or interest on the purported debt.\(^ {54}\) *Fellinger v. United*


\(^{50}\) It must be recognized of course that the general credit standing of the borrower and a myriad of other considerations may be taken into account.

\(^{51}\) *See* Harlan v. United States, 409 F.2d 904 (5th Cir. 1969), and Piedmont Corp. v. Commissioner, 388 F.2d 886 (4th Cir. 1968), *rev'd* 25 CCH Tax Ct. Mem. 1344 (1966). Both cases determined that stockholder advances constituted valid indebtedness even though they only earned interest of five percent.

\(^{52}\) Oak Hill Finance Co., 40 T.C. 419, 435 (1963). In holding that the advances in question constituted equity capital the Tax Court commented:

> The rate of interest paid by the petitioner, i.e., 12 percent per annum, was an unlawful rate under the laws of the State in which the notes were executed and it is further evidence of an equity investments in the corporation (footnotes omitted).

\(^{53}\) *Fin Hay Realty Co. v. United States, 398 F.2d 694 (3rd Cir. 1968) aff'd 261 F. Supp. 823 (D. N.J. 1966); Curry v. United States, 396 F.2d 630 (5th Cir. 1968), cert. denied, 393 U.S. 967 (1968).*

\(^{54}\) *United States v. Snyder Bros., 367 F.2d 980 (5th Cir. 1966), cert. denied, 386 U.S. 956 (1967); United States v. Title Guarantee & Trust Co., 133 F.2d 990 (6th Cir. 1943); Fellinger v. United States, 238 F. Supp. 67 (N.D. Ohio 1964), *aff'd*, 363 F.2d 828 (6th Cir. 1966); Sherwood Memorial Gardens, Inc., 42 T.C. 211 (1964), *aff'd*, 350 F.2d 225 (7th Cir. 1965).*
States is an example of how a court may regard such a limitation. In the Fellinger case the controlling stockholder of a closed corporation sought to dispose of his interest in that entity. It was agreed that the selling stockholder, Vanderbuilt, would receive $1,125,390 from the corporation for his stock. This sum was payable by a certified check for $840,000 and a secured note for $285,390. After the sale the remaining shareholder was of the opinion that the corporation was in need of additional working capital. He persuaded a Mr. Babin to invest $350,000 in the business in exchange for $349,750 worth of debenture bonds and $250 worth of stock. Babin later assigned his interest in the corporation to Fellinger and Bernstien. Litigation resulted when the Commissioner of Internal Revenue asserted that the “payments of principal” to Fellinger and Bernstien were essentially equivalent to a dividend and as a result were taxable as ordinary income, rather than constituting a nontaxable return of capital.

The debentures held by Fellinger and Bernstien provided for payment of principal under the following terms:

If no part of the Company’s indebtedness to Vanderbuilt is then outstanding, the Company shall pay, from time to time, on account of the principal amount then owing on this issue of Debentures such amounts as, in the opinion of the Board of Directors of the Company shall not be required by the Company, from time to time, as a reserve for operating expenses, capital improvements and taxes. In holding for the Commissioner, the United States District Court for the Northern District of Ohio commented on that provision of the debentures as follows:

Such a provision for payment of principal is highly analogous to the manner in which a corporation decides whether or not to declare a dividend and casts further suspicion on the so-called debentures issued to the plaintiffs.

8. Provision for Payment of Interest Only Out of Earnings and Profits

This is merely a species of the preceding criterion, but it has often been considered in resolving a debt-equity issue and is

58. Id.
59. See, e.g., Montclair, Inc. v. Commissioner, 318 F.2d 38 (5th Cir. 1963), aff'd 21 CCH Tax Ct. Mem. 39 (1962); Commissioner v. Meridian &
deemed to be of sufficient significance to be mentioned separately in this article. The essence of a taxable dividend is a distribution of earnings and profits.\textsuperscript{60} Because of this a provision for payment of interest solely from earnings and profits is likely to be viewed with suspicion.\textsuperscript{61} Even where the evidence of indebtedness does not contain such a clause, a practice of paying interest only from this source may be questioned by a court.\textsuperscript{62}

The rationale for this factor is evident. An independent creditor would expect interest payments to be forwarded when due, regardless of the financial success of the debtor. To make payment of interest dependent upon the existence of earnings and profits is to act like a stockholder rather than a creditor.

9. \textit{Right to Enforce Payment}

In traditional forms of stock the shareholders have no absolute right to dividends until they are declared. By contrast, a creditor has a right to interest and principal in any event.\textsuperscript{63} Consequently, courts will closely scrutinize the rights and duties existing between an alleged creditor and the corporation to which he has advanced funds.\textsuperscript{64}

One right which creditors frequently enjoy is the right to accelerated payment in the event of default by a debtor in paying an installment. Hence, it follows that a court may consider the presence or absence of an "acceleration clause" in an instrument when the authenticity of a loan is being questioned.\textsuperscript{65}

The creditor's right to enforce payment must be absolute. In

\textsuperscript{60} INT. REV. CODE of 1954, § 316.

\textsuperscript{61} See Commissioner v. Meridian & Thirteenth Realty Co., 132 F.2d 182 (7th Cir. 1942), for a case in which such a provision was included in the writing evidencing the corporation's obligation.

\textsuperscript{62} Montclair, Inc. v. Commissioner, 318 F.2d 38 (5th Cir. 1963), aff'g 21 CCH Tax Ct. Mem. 39 (1962).

\textsuperscript{63} Commissioner v. Meridian & Thirteenth Realty Co., 132 F.2d 182, 187 (7th Cir. 1942).

\textsuperscript{64} Tomlinson v. 1661 Corp., 377 F.2d 291 (5th Cir. 1967), aff'g 247 F. Supp. 936 (M.D. Fla. 1965); United States v. Snyder Bros., 367 F.2d 980 (5th Cir. 1966), cert. denied, 386 U.S. 956 (1967); Moughon v. Commissioner, 329 F.2d 399 (6th Cir. 1964), aff'g 39 T.C. 1124 (1963); P.M. Finance Corp. v. Commissioner, 302 F.2d 786 (3rd Cir. 1962), aff'g 36 T.C. 1197 (1961); Commissioner v. Meridian & Thirteenth Realty Co., 132 F.2d 182 (7th Cir. 1942); Fellinger v. United States, 238 F. Supp. 87 (N.D. Ohio 1964), aff'd, 365 F.2d 826 (6th Cir. 1966).

\textsuperscript{65} Moughon v. Commissioner, 329 F.2d 399 (6th Cir. 1964), aff'g 39 T.C. 1124 (1963).
the Fellinger case the debentures provided for semi-annual payments of interest. In the event of non-payment of interest within thirty days after the due date, the principal amount outstanding could be declared in default and it then would be due and payable. However, the right to declare a default was subject to a vote of the "creditors". The concurrence of the registered owners of not less than seventy-five percent of the aggregate principal of the debentures was necessary to initiate action to collect the outstanding "debt". The court viewed this provision as one of the circumstances which indicated that the debentures were really contributions to capital.

The mere existence of a clause in an instrument granting a right to require payment may be regarded as evidence that an advance constitutes a debt even though that right is not strictly enforced.

10. Subordination of Indebtedness

This factor has often been considered by the courts in attempting to resolve the debt-equity dichotomy yet it continues to be one of the most equivocal criterion employed to deal with the problem.

67. Id. at 75-76.
68. Tomlinson v. 1661 Corp., 377 F.2d 291 (5th Cir. 1967), aff'd 247 F. Supp. 936 (M.D. Fla. 1965). The appellate court determined that the shareholder-creditors had a right to enforce payment of interest. The court went on to say that the fact that said shareholder-creditors did not assert that right was not necessarily determinative of the debt-equity issue.
Subordination of stockholder-creditor advances usually falls into either of two general categories: (1) debt subordinate to secured creditors but on a par with general creditors; or, (2) debt subordinate to all creditors including general creditors. Although cases in both categories have resulted in inconsistent interpretations by the courts, those in the first classification have generally received more favorable treatment (from a taxpayer's point of view) than those in the second.

This writer has discovered no case in this area where a stockholder-creditor has sought to qualify himself as a secured creditor of a closely held corporation. To do so would certainly be cogent evidence that an advance of funds constituted indebtedness. However, it can readily be seen that an attempt by such a creditor to protect himself in this manner may have the effect of severely limiting the corporation's ability to borrow funds from outside sources should it become necessary to do so. This reason alone would seem to be sufficient to make a shareholder-creditor reluctant to protect his investment by this means.

It seems as though a position subordinate to that of a secured creditor, yet superior to that of a general creditor, may be most advantageous to a stockholder seeking to qualify a corporate advance as indebtedness. Said creditor status would be analogous to that of a second mortgagee. If a clause in the writing evidencing the advance specified that this intermediate position applied to all present and future secured creditors of the corporation, it would allow the corporation to borrow funds from outside sources if it became necessary to do so at a later date. It does not appear as though such a clause would cause general creditors to refuse to do business with the corporation, because they usually extend credit on the basis of the general credit reputation of the business.

11. Treatment of Advances on Corporate Books

Accounting for a stockholder advance to a corporation as a liability rather than as a contribution to capital will usually be con-

75. United States v. Title Guarantee & Trust Co., 133 F.2d 990 (6th Cir. 1943). The corporation carried stockholder advances as preferred stock in order to present a favorable balance sheet to other creditors. Despite that fact, the court concluded that the advances represented debt rather than equity and allowed the corporation a deduction for interest paid on those obligations.


77. Gloucester Ice & Cold Storage Co. v. Commissioner, 298 F.2d 183 (1st Cir. 1962), rev'd 34 T.C. 1161 (1960).


79. J.S. Biritz Construction Co. v. Commissioner, 387 F.2d 451 (8th Cir. 1967).

80. 329 F.2d 399 (6th Cir. 1964), aff'd 39 T.C. 1124 (1963).
corporation of a partnership engaged in the general insurance business. At the time of incorporation the partners transferred tangible assets with a fair market value of $10,000 and $306,000 worth of intangible assets\textsuperscript{81} to the corporation in exchange for capital stock valued at $150,000 and six percent debenture bonds with a face value of $166,000. The debenture bonds were to mature in twenty years. The Commissioner of Internal Revenue alleged that interest on the debentures and sums paid by the corporation in retirement of certain of said debentures constituted dividend income to the alleged creditors. Due to the meager amount of tangible assets a sinking fund would have been particularly appropriate in this case. The appellate court commented upon the failure to provide for such a fund as follows:

Even though periods of prosperity might be enjoyed prior to the 1975 maturity date, no assurance was given of any accumulation of funds for retirement. Full repayment of the debentures is thus seen to be totally dependent on the continuation of corporate earnings and this circumstance affords support for the Tax Court's determination that the consideration for them constituted contributions of equity, or risk, capital rather than loans.\textsuperscript{82}

13. \textit{Free Transferability of Debentures}

Free transferability of an instrument evidencing an advance to a corporation has come to be recognized as one factor which courts will regard as evidence that the advance represents indebtedness.\textsuperscript{83} This appears to be true even where no transfers are subsequently made. In \textit{Tomlinson v. 1661 Corporation},\textsuperscript{84} capital stock and al-

\textsuperscript{81} Id. at 400. The intangible assets consisted of goodwill of the business, contracts with insurance carriers, and customer lists and other records of the partnership. The Commissioner did not contest the value placed on those assets.

\textsuperscript{82} Id. at 401.

\textsuperscript{83} See John Kelly Co. v. Commissioner, 326 U.S. 521 (1946), rev'g 146 F.2d 466 (7th Cir. 1944), and, aff'g Talbot Mills v. Commissioner, 146 F.2d 809 (1st Cir. 1944). In the Kelly case where advances were held to represent indebtedness the "debenture bonds" were freely transferrable while advances were regarded as equity in the Talbot Mills case where the "debenture bonds" were not freely transferrable. See also Tomlinson v. 1661 Corp., 377 F.2d 291 (5th Cir. 1967), aff'g 247 F. Supp. 936 (M.D. Fla. 1965); and Medical Tower, Inc. v. United States, 23 AFTR2d 1230 (E.D. Va. 1969), for examples of where free transferability of notes were regarded as evidence of bona fide indebtedness. For cases where restrictions on transfer of alleged debt were viewed as evidence of a contribution to capital see, United States v. Snyder Bros., 367 F.2d 980 (5th Cir. 1966), cert. denied, 366 U.S. 956 (1967); and Wilfred J. Funk, 35 T.C. 42 (1960).

\textsuperscript{84} 377 F.2d 291 (5th Cir. 1967), aff'g 247 F. Supp. 936 (M.D. Fla. 1966).
leged debt were distributed to stockholder-creditors on a pro rata basis. The Commissioner urged that the complete identity of interest was cogent evidence that the alleged indebtedness was nothing more than a second class of stock. The appellate court discounted this argument by saying:

We think the Government's argument fails to take into account the fact that, while there is a restriction placed on the sale of the stock, no similar restriction is found in the debentures which therefore are freely transferable. Such a transfer would remove the proportional participation and control. It is no answer to point out that no such transfers have occurred or even are contemplated—this may be the result of a variety of factors, not the least of which could be the belief of the doctors [shareholder-creditors] that the investment is a good one which will be repaid, both principal and interest, at the appointed date. It is enough to say that the existence of the right of free transferability substantially dispels the element of proportional control, leaving the mere identity of ownership as only one factor to be weighed in reaching the appropriate result.85


In traditional financing transactions a stockholder protects his investment in a business venture through the exercise of voting rights while a creditor protects his investment by foreclosure or other forced payment proceedings in the event of default on the part of the debtor. Since this is so, a stockholder who wishes to qualify an advance to a closely held corporation as a loan rather than a contribution to capital may be planning himself into litigation if he insists upon voting rights to further protect his investment.86 However, if such a stockholder or group of stockholders with common interests are not in control of a majority of the outstanding stock this factor does not appear to be as detrimental to their contention that the advance constitutes indebtedness.87

15. Failure to Follow the Form of a Transaction

In addition to establishing the proper form for a loan, a stockholder-creditor should be aware of the importance of respecting

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85 Id. at 297 (emphasis added).
87 See, Baker Commodities, Inc., 48 T.C. 374 (1967).
that form in later transactions which may reflect upon that initial
advance. The difficulty here seems to be analogous to problems
which arise when shareholders of a closely held corporation do not
respect the corporation as a separate entity; such as when they fail
to hold annual meetings, to establish a corporate checking account,
etc.

In *Gyro Engineering Corp. v. United States*, the two principal
shareholders of the corporation "sold" residential apartment
buildings to the corporation for a price that greatly exceeded their
basis in the property. The Commissioner asserted that the transfer
of the property in question was a contribution to capital rather
than a sale. The Federal District Court, Central Division, California
held that the transfer of the property in question was in
fact a contribution to capital. In reaching that decision the court
commented upon the failure of the parties to conduct their affairs
in a manner consistent with the allegation that a sale had been
effected:

"[T]axpayers must face the consequences of their acts par-
ticularly of their failure to conform the substance of the
transaction, the manner of its execution and the way in
which they dealt with the property after the transfer, with
its formal aspects, as well as of their failure to follow con-
sistently even the purported form itself."

In *O.H. Kruse Grain & Milling v. Commissioner*, the sole
owner of a business transferred assets of the enterprise to a newly
formed corporation in exchange for stock and an alleged promissory
note with a face value of $200,000 which was to bear interest at six
percent. The transaction was completed during the month of June
in 1950. Subsequent to that time the following transpired: the
corporation accrued and deducted, but did not pay, $9,000 as interest
for 1950 even though under the terms of the note it was not liable
to pay interest for that year; the corporate entity deducted but
did not pay interest in 1951; Kruse on his personal tax return for
1950 and 1951 reported no interest paid or accrued to him by the

88. This is so because courts do not restrict their scrutiny of the au-
thenticity of an advance to facts existing at the time a loan is extended to
the corporation. See note 11 supra.
89. 276 F. Supp. 451 (C.D. Cal. 1967), rev'd, 417 F.2d 437 (9th Cir.
1969).
90. Id. at 472. Although the Ninth Circuit Court of Appeals later
reversed the lower court, the quoted language serves as an example of how
a court may view a failure to adhere to the form of a transaction.
91. 279 F.2d 123 (9th Cir. 1960), aff'g 18 CCH Tax Ct. Mem. 487 (1959).
92. Id. at 128. The court also noted that this amount was even greater
than the six percent later to be due under the note's terms.
corporation; and, the corporation deducted $12,000 as accrued interest in 1952 while Kruse reported only $6,000 on his person tax return for that year. The taxpayer's assertion that these discrepancies were merely bookkeeping errors of mistakes was accorded little weight by the court.93

16. Substance Rather than Form is Controlling

In a corporation which has numerous shareholders with varying interests, the arm's-length relationship between the corporation and a shareholder who supplies funds to it inevitably results in a transaction whose form mirrors its substance. Where the corporation is closely held, however, and the same persons occupy both sides of the bargaining table, form does not necessarily correspond to the intrinsic economic nature of the transaction, for the parties may mold it at their will with no countervailing pull.94

The precise question to be answered in each case involving a closely held corporation is whether or not the substance of the transaction between the corporate entity and its shareholders is sufficiently divorced from the form in which it is cast that the form must be disregarded.95

Gregory v. Helvering96 is the landmark decision regarding this criterion. Although that case did not involve a debt-equity dis-

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93. Id. The Tax Court was of the opinion that the alleged mistakes reflected Kruse's intent when the "notes" were issued. At page 490 of their opinion the court stated:

There is some question as to the sufficiency of the book entries to show interest accrals but we will assume Hobson, the certified public accountant, was at least correct, since 1951, in showing the interest accrals. It is no explanation for Kruse's and the corporation's accountant merely to say there were "mistakes" in the books and corporation income tax return for 1950, and in Kruse's income tax returns for the years 1950, 1951 and 1952. All of these so-called mistakes relate directly to the alleged interest obligation which was the subject of the deduction by the corporation in the years in question. It is obvious the treatment of the interest obligation in these early years must be termed a mistake if petitioner is to argue the note presents an unconditional and legally enforceable obligation for the payment of $200,000. But this treatment of the interest obligation, standing unexplained by O.H. Kruse, is some evidence that casts doubt as to there being an intention to issue a legally enforceable obligation.


95. In J.S. Biritz Construction Co. v. Commissioner, 387 F.2d 451, 459 (8th Cir. 1967), the court stated:

We feel the controlling principle should be that any transaction which is intrinsically clear upon its face should be accorded its legal due unless the transaction is a mere sham or subterfuge set up solely or principally for tax-avoidance purposes.

96. 293 U.S. 465 (1935).
DEBT v. EQUITY

pute, it has been cited with approval by many courts which have been confronted with that issue.

Courts uniformly declare that the substance rather than the form of a transaction is controlling. Brake & Electric Sales Corp. v. United States exemplifies the type of situation in which the form of a transaction will be disregarded. In that case an individual proprietor incorporated his business by transferring $20,000 cash and net assets worth $90,000 to the newly formed corporation in exchange for $20,000 of capital stock and a negotiable promissory note with a face value of $90,000. The terms of the note provided for payment of principal in five years. Interest was to accrue at the rate of five percent per annum. The original note was later cancelled and replaced by three notes identical to the first except two were for $6,000 and one for $78,000. When the notes matured they were extended for five years. When the notes became due again they were extended for one more year. Interest was paid annually during this time, but no principal was paid despite the fact that the corporation prospered. In holding that the alleged interest payments constituted dividends the District Court said:

In the present case the transaction took the outward

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97. The case involved a corporate reorganization under § 112(g) of the Revenue Act of 1928. It was readily apparent that the taxpayers utilized the statute solely to effect a tax avoidance scheme. The Supreme Court held that the transaction was within the letter but not the spirit of the statute in question. In speaking for the Court, Mr. Justice Sutherland stated at page 470:

The whole undertaking, though conducted according to the terms of subdivision (B) [the portion of the statute in question], was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose (emphasis added).


99. In Moughon v. Commissioner, 329 F.2d 399, 401 (6th Cir. 1964), aff'd 39 T.C. 1124 (1963) the court said:

[T]he instruments met the formal criteria of indebtedness, being nominated "debentures," containing an unconditional promise to pay a sum certain at a fixed maturity date, having a fixed interest rate and not being subordinated to general creditors. However, that the substance of a transaction rather than its form controls tax consequences need no longer be debated . . . (citations omitted).

form of a loan and the taxpayer and the other parties concerned appear to have carefully observed all of the formalities of treating it as a loan transaction. But it is the substance and not the form which is important, particularly as here where it would be to the tax advantage of the parties to describe a transaction as something other than it really is.\textsuperscript{101}

The preceding discussion of this factor should not be interpreted to mean that form is unimportant. Even though substance controls form, a court will ignore the form in which parties have cast their transaction only if there is a reasonable basis for doing so.\textsuperscript{102} In Edwards v. Commissioner,\textsuperscript{103} the United States Court of Appeals for the Tenth Circuit summarized this concept in these words:

It is of course true that the contractual form of a transaction cannot control the imposition of tax liability when the realities of the transaction show that form does not represent a bona fide and actual agreement. But it is equally true that the form of a contract is the considered and chosen method of expressing the substance of contractual agreements between parties and the dignity of contractual rights cannot be judicially set aside simply because a tax benefit results either by design or accident. \textit{Form, absent exceptional circumstances, reflects substance}.\textsuperscript{104}

What constitutes a reasonable basis for ignoring the form of a transaction? It depends upon the circumstances. Although this rule of construction may create difficulties from a planning point of view, it is the current state of the law in this area and must be recognized as such.

17. \textit{Participation in Management}

It can readily be seen that a person managing a corporation is


\textsuperscript{102} Piedmont Corp. v. Commissioner, 388 F.2d 886 (4th Cir. 1968), \textit{rev'd} 25 CCH Tax Ct. Mem. 1344 (1966); J.S. Biritz Construction Co. v. Commissioner, 387 F.2d 451 (8th Cir. 1967); Gloucester Ice & Cold Storage Co. v. Commissioner, 298 F.2d 183 (1st Cir. 1962), \textit{rev'd} 34 T.C. 1161 (1960).

\textsuperscript{103} 415 F.2d 579 (10th Cir. 1969), \textit{rev'd} 50 T.C. 220 (1968).

\textsuperscript{104} Id. at 582 (emphasis added).
in a position to invest his funds in that entity in a manner which will result in the greatest tax saving to him. Therefore, it is generally agreed that participation by a stockholder-creditor in the management of a corporation is a factor which courts will regard as unfavorable to an allegation that an advance by such an individual constitutes indebtedness. As with most of the factors discussed in this article, it cannot be said that this criterion will always cause a court to conclude that a specific advance represents equity capital rather than indebtedness. This was made clear by the Tax Court in *Baker Commodities, Inc.* There three partners sought to sell their partnership assets to seven key employees. The business was incorporated and the former partners acquired ownership of thirty percent of the capital stock with payments to be made in installments over a period of fifteen years. The sellers retained a voice in managing the corporation. The Tax Court held that the installment note constituted debt rather than equity despite the fact that the former partners participated in management of the corporation. In speaking for the court, Withey, J., observed that although the former partners continued to participate in managing the business, their degree of management activity had been reduced substantially. Furthermore, they did not possess a controlling interest in the corporate stock.

18. **Identity of Interest of Stockholder and Creditor**

A stockholder who advances money or property to his closely held corporation in exchange for a promissory note or other evidence of indebtedness acquires rights as a creditor in addition to his rights as an owner of stock. Subsequent circumstances may make such a stockholder-creditor reluctant to exercise his rights as a creditor if doing so would jeopardize his equity investment. He may choose to rely solely on his rights as a stockholder to protect his entire interest in the corporation. Such conduct gives rise to

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105. In Gooding Amusement Co., 23 T.C. 408, 420 (1954), aff’d, 236 F.2d 159 (6th Cir. 1956), cert. denied, 352 U.S. 1031 (1957); the Tax Court held that a purported sale of partnership assets to a corporation constituted a tax free incorporation, partially because the transaction appeared to have been effected for the sole purpose of avoiding taxes.


107. 48 T.C. 374 (1967).

108. Id. at 398.
the inference that his total investment in the corporation constitutes equity capital despite the fact that a portion of said investment is in the form of a debt. In *P. M. Finance Corp. v. Commissioner,*\(^{109}\) in which the advances in question were held to constitute debt rather than equity, Biggs, C. J., enunciated the court's consideration of this factor in the following language:

The case at bar presents those problems inherent in a situation where the sole or principal stockholder and his wife hold evidence of unconditional debt issued by their corporation. Many decisions have found this factor to be persuasive evidence that debt in form is not indebtedness for the purpose of income tax. These decisions possess merit. To the sole shareholder-creditor it may make little difference, taxation aside, whether his investment be labeled "debt" rather than "stock". Complete control of the corporation will enable him to render nugatory the absolute language of any instrument of indebtedness.\(^ {110}\)

It is evident that a tax practitioner has reason to be cautious about this factor if he is establishing a plan for financing a newly formed corporation. However, it must be remembered that this is just one of several criteria which may be scrutinized by the courts. It is possible to include this criterion in a plan and still qualify a portion of the advances as debt.\(^ {111}\) However, a planner in this area should also be aware of the fact that the absence of this criterion from a proposed plan of financing a corporation is no assurance that a court will not determine that an advance of funds represents equity capital.\(^ {112}\) In *Zephyr Mills, Inc.*,\(^ {113}\) advances to the corporation involved were from the sole stockholder's husband acting under a power to invest and reinvest the assets of a trust. The husband also managed the affairs of the corporation. In holding that

\(^{109}\) 302 F.2d 786 (3rd Cir. 1962), aff'd 36 T.C. 1197 (1961).

\(^{110}\) Id. at 788-89. For other cases which considered this factor and held that the advances in question represented equity capital rather than debt see, Wachovia Bank and Trust Co. v. United States, 288 F.2d 750 (4th Cir. 1961); and Gooding Amusement Co., 23 T.C. 408 (1954), aff'd, 236 F.2d 159 (6th Cir. 1956), cert. denied, 352 U.S. 1031 (1957).

\(^{111}\) Tomlinson v. 1661 Corp., 377 F.2d 291 (5th Cir. 1967), aff'd 247 F. Supp. 936 (M.D. Fla. 1965); Sun Properties, Inc. v. United States, 220 F.2d 171 (5th Cir. 1955); Baker Commodities, Inc., 48 T.C. 374 (1967).

\(^{112}\) Burr Oaks Corp. v. Commissioner, 365 F.2d 24 (7th Cir. 1966), aff'd 43 T.C. 635 (1965), cert. denied, 365 U.S. 1007 (1967); Foresun, Inc. v. Commissioner, 348 F.2d 1006 (6th Cir. 1965), aff'd 41 T.C. 706 (1964); Sheriff Memorial Gardens, Inc. v. Commissioner, 42 T.C. 211 (1964), aff'd, 350 F.2d 225 (7th Cir. 1965); Motel Co., 22 CCH Tax Ct. Mem. 825 (1963), aff'd, 340 F.2d 445 (2d Cir. 1965).

\(^{113}\) 18 CCH Tax Ct. Mem. 794 (1959), aff'd per curiam, 279 F.2d 494 (3rd Cir. 1960).
the advances in question constituted equity capital, Tietjens, J., commented:

Petitioner makes much of the fact that Donald [the alleged creditor] was not a stockholder of petitioner either individually or as a trustee of the Hofford trusts. However, in view of his positions as president, director and sometime treasurer, of petitioner and the fact that the sole stockholder was his wife and that she and their children were the sole beneficiaries of the Hofford trusts we are unwilling to let this aspect of the case assume controlling importance.\(^{114}\)

19. Pro rata Holdings of Debt and Equity

This is merely one facet of the preceding factor, however, this writer is of the opinion that it is of sufficient importance to be discussed separately. Most of the courts that have considered this factor would apparently concur in the following analysis of the import of this criterion:

The effect of a lending and investing transaction giving creditors, as stockholders, proprietary interest in proportion to their loans, subjects the transactions to close scrutiny, but does not, as a matter of law, require the transaction to be treated as a stock investment, regardless of intent.\(^ {115}\)

There is an abundance of authority demonstrating the danger of a corporation issuing stock and indebtedness on a pro rata basis,\(^ {116}\) yet such a relationship is not necessarily fatal to an allegation of true indebtedness.\(^ {117}\) And, if the corporation involved is attempting to qualify as a small business corporation, it may actually be to its advantage to issue stock and debt in this manner, due to the “only one class of stock” requirement of section 1371(a)(4) of the 1954 Code. The likelihood of qualifying pro rata advances to a small business corporation as indebtedness rather than equity

\(^ {114}\) Id. at 799.

\(^ {115}\) Wilshire & Western Sandwiches Inc. v. Commissioner, 175 F.2d 718, 721 (9th Cir. 1949).


capital is not appreciably different from the situation involving a Subchapter "C" corporation. However, whenever this circumstance is present a court may conclude that even though the alleged debt constitutes equity capital, said "debt" and the authorized capital stock of the corporation comprise only one class of stock. If a court makes such a determination, the corporation will be permitted to retain its status as a small business corporation.\textsuperscript{118} If "debt" is not issued in proportion to outstanding stock, a stockholder holding an inordinate amount of "indebtedness" may possess rights superior to those of fellow stockholders. Such a circumstance permits the inference that the "debt" constitutes preferred stock, i.e., a second class of stock.\textsuperscript{119}

20. Thin Capitalization

_John Kelly Co. v. Commissioner_\textsuperscript{120} was the first debt-equity case to be decided by the Supreme Court of the United States. Justice Reed spoke for the Court when he commented, "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."\textsuperscript{121} Although this remark was only dicta, it was heralded by tax practitioners as at least some semblance of an objective test for determining whether stockholder advances to a corporation represented equity capital or indebtedness. The ratio of debt to equity in the _Kelly_ case was ap-

\textsuperscript{118} W.C. Gamman, 46 T.C. 1 (1966). In holding as it did the Tax Court refused to interpret Treas. Reg. § 1.1371-1(g) (1959), literally.
\textsuperscript{119} This view was just repudiated by the Tax Court in the case of James L. Stinnett, Jr., 54 T.C. No. 20 (1970) (six judges dissented).
[Ed. note: It should be noted that the Tax Court in _Stinnett_ held "invalid as applied to this case" the 1968 revision of Treas. Reg. § 1.1371-1(g) (1968) which reads in part as follows:

A corporation having more than one class of stock does not qualify as a small business corporation. . . . Obligations which purport to represent debt but which actually represent equity capital will generally constitute a second class of stock. However, if such purported debt obligations are owned solely by the owners of the nominal stock of the corporation in substantially the same proportion as they own such nominal stock, such purported debt obligations will be treated as contributions to capital rather than a second class of stock. But, if an issuance, redemption, sale or other transfer of nominal stock, or of purported debt obligations which actually represent equity capital, results in a change in a shareholder's proportionate share of nominal stock or his proportionate share of such purported debt, a new determination shall be made as to whether the corporation has more than one class of stock as of the time of such change.]
\textsuperscript{120} 326 U.S. 521 (1946), rev'g 146 F.2d 466 (7th Cir. 1944), and aff'g Talbot Mills v. Commissioner, 146 F.2d 809 (1st Cir. 1944).
\textsuperscript{121} Id. at 526.
proximately four-to-one. Subsequent financing plans with a debt-equity ratio of four-to-one were considered “safe” by most practitioners because that ratio had been stated to be “not obviously excessive”. The question then became: How high a ratio would the courts permit before they considered a corporation as being “too thinly capitalized”? It now appears as though the significance of the factor of thin capitalization was overstated and a plethora of cases seem to yield the conclusion that the ratio of debt to equity is entitled to no greater weight than any other factor might be.

It appears as though the significance of a designated ratio of debt to equity depends to some extent upon the type of business in which the corporation is engaged. In P. M. Finance Corp. v. Commissioner, a ratio of better than seventy-nine to one was not considered too thin. The court determined that it was customary for a finance company to borrow large amounts of working capital.

A debt-equity ratio may also be greatly affected by a transfer to the corporation of valuable intangible property, in addition to money and other tangible assets which were exchanged for stock.

122. 9 MERTENS, LAW OF FEDERAL INCOME TAXATION, § 26.10(c), p. 79 (Zimit rev. 1965) is a typical example of the inordinate amount of emphasis attributed to this factor.

123. Cases where the corporation was not considered too thinly capitalized include, Piedmont Corp. v. Commissioner, 388 F.2d 886 (4th Cir. 1968), rev’g 25 CCH Tax Ct. Mem. 1344 (1966); J.S. Biritz Construction Co. v. Commissioner, 387 F.2d 451 (8th Cir. 1967); Murphy Logging Co. v. United States, 378 F.2d 222 (9th Cir. 1967), rev’g 239 F. Supp. 794 (D. Ore. 1965); Tomlinson v. 1661 Corp., 377 F.2d 291 (5th Cir. 1967), aff’g 247 F. Supp. 936 (M.D. Fla. 1965); P.M. Finance Corp. v. Commissioner, 302 F.2d 786 (3rd Cir. 1962), aff’g 36 T.C. 1197 (1961); Rowan v. United States, 219 F.2d 51 (5th Cir. 1955); Medical Tower, Inc. v. United States, 23 AFTR2d 1230 (E.D. Va. 1969); Drown v. United States, 203 F. Supp. 514 (S.D. Cal. 1962), rev’d on other grounds, 328 F.2d 314 (9th Cir. 1964); and Baker Commodities, Inc., 48 T.C. 374 (1957).

For cases where the corporation was considered too thinly capitalized see, Tyler v. Tomlinson, 414 F.2d 844 (5th Cir. 1969); Berkowitz v. United States, 411 F.2d 818 (5th Cir. 1969); United States v. Henderson, 375 F.2d 36 (5th Cir. 1967), cert. denied, 389 U.S. 953 (1967); McSorley’s, Inc. v. United States, 323 F.2d 900 (10th Cir. 1963); Jewell Ridge Coal Corp. v. Commissioner, 318 F.2d 695 (4th Cir. 1963), aff’g 38 T.C. 1044 (1962); Wachovia Bank and Trust Co. v. United States, 238 F.2d 750 (4th Cir. 1961); Arlington Park Jockey Club v. Sauber, 262 F.2d 902 (7th Cir. 1959), aff’g 164 F. Supp. 576 (N.D. Ill. 1958); Fellinger v. United States, 238 F. Supp. 67 (N.D. Ohio 1964), aff’d, 363 F.2d 826 (6th Cir. 1966); Bruce v. Knox, 180 F. Supp. 907 (D. Minn. 1960), appeal dismissed, 289 F.2d 936 (8th Cir. 1961); and, Sherwood Memorial Gardens, Inc. v. Commissioner, 42 T.C. 211 (1964), aff’d, 350 F.2d 225 (7th Cir. 1965).

124. 302 F.2d 786 (3rd Cir. 1962), aff’g 36 T.C. 1197 (1961).

125. Id. at 788.

126. Ainslie Perrault, 25 T.C. 439 (1955), aff’d per curiam, 244 F.2d 408.
In Murphy Logging Co. v. United States,127 the United States Court of Appeals for the Ninth Circuit held for the taxpayer after concluding that in addition to putting $1,500 into the new corporation in exchange for capital stock, the shareholders contributed the expectancy of future logging contracts as well as integrity and a reputation for getting things accomplished. The court determined that those intangible assets were of sufficient value to prevent the corporation from being treated as thinly capitalized.128

Should the debt portion of the ratio include indebtedness from independent sources as well as debt obligations to stockholders? This writer has discovered no case which deals directly with the question,129 but logic would seem to dictate that all debt should be included.130 In Berkowitz v. United States,131 the court recognized this issue132 but found it unnecessary to elaborate on the presence of institutional indebtedness in arriving at its decision.

21. The Timing of the Advance

If a corporation becomes liable for substantial stockholder debt at the time that it is organized, that circumstance will be viewed with greater suspicion133 than would ordinarily arise if similar indebtedness were incurred to acquire working capital at a later time.134

In Camp Wolters Enterprises, Inc. v. Commissioner,135 the United States Court of Appeals for the Fifth Circuit affirmed the Tax Court's decision that an alleged sale of assets to a corporation was really a tax free incorporation. In so doing the court summarized this factor as follows:

While petitioner, in its argument, does correctly state the test as to whether notes are securities, we think it clear

(10th Cir. 1957), cert. denied, 355 U.S. 830 (1957). If the intangibles had not been considered, the ratio would have been better than 500-to-1.
127. 378 F.2d 222 (9th Cir. 1967), rev'g 239 F. Supp. 794 (D. Ore. 1965).
128. Id. at 224. The court did not attempt to value these intangibles, but without them the ratio would have been approximately 160-to-1.
129. In Lockwood Realty Co., 17 CCH Tax Ct. Mem. 247 (1958), the Tax Court computed the ratio by including outside indebtedness, but it did so without discussing the matter.
130. See note 7 supra, at 19.
131. 411 F.2d 818 (5th Cir. 1969).
132. Id. at 821. The ratio was approximately 21-to-1 if only shareholder "debt" was considered, and 36-to-1 if all "debt" was included.
that, too greatly preoccupied with the name given to and
the time periods of securities in this case, it has, with fore-
shortened gaze, failed to see the picture whole. Giving
little or no recognition to the fact that the notes did not
evidence an isolated transaction of purchase and sale, hav-
ing its inception after the forming and launching of the
corporation, but were an integral part of the scheme of
its forming and financing, petitioner has wholly mis-
applied the test to the undisputed facts that petitioner
was brought into being for the sole purpose of obtaining
from stockholders in exchange for cash and securities,
stocks and notes, the properties of the enterprise, the lands,
the buildings and the rights.

Perhaps the main, certainly the most important, as-
pect of petitioner's preoccupation is its failure to see that
in forming and launching the corporation, in part on money
paid in by, but in much larger part on notes given to its
stockholders, the giving of the notes was not a separate
purchase from the stockholders, decided upon and made
after the corporation had been fully formed and launched,
but was an integral part of the pot luck no pay no cure
plan, formed before incorporation, of launching petitioner
with cash and securities in note form.136

If a corporation is organized to operate a well established
business, this factor loses much of its significance.137

This criteria, like most of the others discussed in this article, is
not determinative, by itself, of whether or not a shareholder ad-
vance to a corporation constitutes indebtedness or equity capital.138

22. Loans Used to Obtain “Essential Assets”

In addition to considering the timing of an advance, a court
may examine the purpose for which the funds were “loaned” to

136 Id. at 559 (emphasis added).
137 In Baker Commodities, Inc., 48 T.C. 374, 398 (1967), the Tax Court
commented:

In Burr Oaks Corp., . . . we recognized that the transfer of
property to a thinly capitalized corporation raises a “strong infer-
ence” that the transfer is an equity contribution where payment
to the transferee depends “solely upon the success of an untried,
under-capitalized business, the profits of which are uncertain.” We
think the opposite inference arises where, as in the instant case,
the parties intended to and in fact did make principal and interest
payments out of current earnings generated by the continued
success of a well-established business which enjoyed not only a
good past earnings' record but equally good prospects for the
future (citations omitted).

138 See Piedmont Corp. v. Commissioner, 388 F.2d 886 (4th Cir. 1968),
rev'g 25 CCH Tax Ct. Mem. 1344 (1966); and, Tomlinson v. 1661 Corp., 377
F.2d 291 (5th Cir. 1967), aff'g 247 F. Supp. 936 (M.D. Fla. 1965); for exam-
pies of cases where the factor under discussion was present, yet the ad-
vances were held to represent debt.
the corporation. If an advance of funds is used to obtain assets which are essential to commencing the business of the corporation, a court may view such a circumstance as evidence that said funds constitute equity capital rather than indebtedness. This factor is exemplified by the case of Bijou-Pensacola Corp. v. United States, in which the court allowed a bad debt deduction for advances made to defray expenses of operation after the corporate entity started doing business, but refused to allow a similar deduction for funds which had been advanced to complete construction of the building to be used in the corporation's business.

23. Risk

Traditionally, debt is expected to be more secure than equity. Therefore, courts confronted with the debt-equity issue usually apply the following rule of construction: The more risk that is involved in an advance the more the investment appears to be a contribution to capital rather than a loan. This standard is undoubtedly valid because it is grounded upon one of the basic distinctions between a stockholder and a creditor.

The essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it, so that he may enjoy the chances of profit. The creditor, on the other hand, does not intend to take such risks so far as they may be avoided, but merely to lend his capital to others who do intend to take them.

The essence of the risk factor is to determine whether or not, at the time the alleged debt obligation was incurred, the stockholder-creditor could have entertained a "reasonable expectation of repayment". If this question can be answered in the affirmative,

139. See, e.g., Berkowitz v. United States, 411 F.2d 818 (5th Cir. 1969); McSorley's, Inc. v. United States, 323 F.2d 900 (10th Cir. 1963); Wachovia Bank and Trust Co. v. United States, 288 F.2d 750 (4th Cir. 1961); and Brake & Electric Sales Corp. v. United States, 185 F. Supp. 1 (D. Mass. 1960), aff'd, 237 F.2d 426 (1st Cir. 1961). The opposite result was reached in J.S. Biritz Construction Co. v. Commissioner, 387 F.2d 351 (8th Cir. 1967), where it was determined that the assets involved were not essential to the business of the corporation.

140. 172 F. Supp. 309 (N.D. Fla. 1959). The corporation involved was organized to construct and operate a movie theatre.

141. Id. at 313.

142. United States v. Title Guarantee & Trust Co., 133 F.2d 990, 993 (6th Cir. 1943) (citations omitted).

143 For examples of cases where it was determined that a reasonable expectation of repayment did not exist see, Diamond Bros. v. Commissioner, 322 F.2d 725 (3rd Cir. 1963), aff'd 38 T.C. 1043 (1962); Jewell Ridge Coal Corp. v. Commissioner, 318 F.2d 695 (4th Cir. 1963), aff'd 38 T.C.
the advance may be designated debt even though it later proves to be uncollectible.\textsuperscript{144}

There is an abundance of authority regarding the criteria of risk.\textsuperscript{145} Although the cases disclose many different aspects of this factor, there are two which seem to predominate.

The first is where repayment of an advance depends solely upon the future success of a newly formed business as in the instance when funds are used to purchase essential assets.\textsuperscript{146} Any business enterprise which borrows funds usually hopes to repay the loan with future earnings and profits. However, an institutional lender will almost always protect itself by perfecting a security interest in appropriate collateral to enable it to recover its investment even if anticipated future profits are not realized. If one or more shareholders advance funds to a closely held corporation and the future success of the business is essential to the corporation's ability to fully repay the alleged creditors, the advance begins to look more like a contribution to capital than a debt.\textsuperscript{147}

This viewpoint was enunciated by the United States Court of Ap-


Cases which have held that a reasonable expectation of repayment was possible include, Gloucester Ice & Cold Storage Co. v. Commissioner, 298 F.2d 183 (1st Cir. 1962), \textit{rev'd} 34 T.C. 1161 (1960); Kraft Foods Co. v. Commissioner, 232 F.2d 118 (2d Cir. 1956), \textit{rev'd} 21 T.C. 513 (1954); Troop Water Heater Co. v. Bingler, 234 F. Supp. 642 (W.D. Pa. 1954); and Baker Commodities, Inc., 48 T.C. 374 (1967).


\textsuperscript{145} In addition to the cases cited in note 143 \textit{supra}, see Piedmont Corp. v. Commissioner, 338 F.2d 886 (4th Cir. 1968), \textit{rev'd} 25 CCH Tax Ct. Mem. 1344 (1966); J.S. Biritz Construction Co. v. Commissioner, 387 F.2d 451 (8th Cir. 1967); Smith v. Commissioner, 370 F.2d 178 (6th Cir. 1966), \textit{aff'd} 43 T.C. 929 (1964); Burr Oak Corp. v. Commissioner, 365 F.2d 24 (7th Cir. 1966), \textit{aff'd} 43 T.C. 635 (1965), \textit{cert. denied}, 385 U.S. 981 (1966); McSorley's, Inc. v. United States, 323 F.2d 900 (10th Cir. 1963); Aqualane Stores, Inc. v. Commissioner, 269 F.2d 116 (5th Cir. 1959), \textit{aff'd} 30 T.C. 519 (1958); Arlington Park Jockey Club v. Sauber, 262 F.2d 902 (7th Cir. 1959), \textit{aff'd} 164 F. Supp. 576 (N.D. Ill. 1958); Camp Wolters Enterprises v. Commissioner, 230 F.2d 555 (5th Cir. 1956), \textit{aff'd} 22 T.C. 737 (1954), \textit{cert. denied}, 332 U.S. 826 (1966); United States v. Title Guarantee & Trust Co., 133 F.2d 990 (6th Cir. 1943); Sherwood Memorial Gardens, Inc. v. Commissioner, 42 T.C. 211 (1964), \textit{aff'd}, 350 F.2d 225 (7th Cir. 1965); and Wilfred J. Funk, 35 T.C. 42 (1960).

\textsuperscript{146} See Factor 22 in text \textit{supra}.

peals for the Seventh Circuit in the case of Burr Oaks Corp. v. Commissioner:148

When the payment to the transferors is dependent on the success of an untried undercapitalized business with uncertain prospects, a strong inference arises that the transfer is an equity contribution.149

The cogency of that inference apparently depends to some extent upon whether or not the future success of the corporation may be reasonably anticipated. If it appears likely that the business enterprise will prosper, it may be determined that the advances are bona fide indebtedness even though no collateral exists to assure repayment.150

The second major aspect of the risk factor presents itself when advances are made to a struggling corporation in the face of ever increasing declines. This situation often poses a dilemma for the courts. In most instances these advances are undeniably at the risk of the business. However, it has been argued that to characterize such an advance as equity capital, rather than indebtedness, is akin to imposing a penalty on the alleged stockholder-creditor for attempting to keep his business operating and thereby possibly satisfying all third party creditors.151 The cases in this area do not seem


149. Id. at 27.


151. In Troop Water Heater Co. v. Bingler, 234 F. Supp. 642, 649 (W.D. Pa. 1964), the court held that advances by a subsidiary corporation to its parent before it became insolvent were bona fide debt thereby entitling the subsidiary to a bad debt deduction. In ruling as it did the court commented:

The parent was losing money; it needed money to loan to purchasers of motor vehicles in order to make money; it was borrowing money from many sources other than its subsidiary. Any over-reaching by the parent, if there was such, ought not to make its subsidiary lose parity with loans obtained from independent lenders. Domination of a subsidiary by its parent has not been proscribed by the law; hence if actual debts were intended, with reasonable expectation of repayment, the subsidiary should not be penalized by what turned out to be the bad judgment of the common officers, who presumably acted for the benefit of Alabama [the parent] and all of its subsidiaries, including Troop. See also, Rowan v. United States, 219 F.2d 51, 55 (5th Cir. 1955); and C.M. Gooch Lumber Sales Co., 49 T.C. 649, 661 (1968) (dissenting opinion of Drennen, J.).
to suggest a trend favoring one policy or the other. Hence, it seems appropriate that no iron clad rule can be established here because risk constitutes only one factor to be considered in handling the debt-equity issue.

In view of the case of Whipple v. Commissioner, courts may tend to be more sympathetic than they have been in the past to a shareholder-creditor who is attempting to breathe life into a faltering corporate entity. If the corporation becomes insolvent, classification of these advances as indebtedness would in most instances result in only a non-business bad debt deduction rather than a large deduction that can be used to offset ordinary income. If the corporation becomes successful the policy favoring full payment of creditors will be served.

Austin Village, Inc. v. United States is the strongest case for the taxpayer regarding this aspect of the risk factor which this writer has discovered. If the case is affirmed on appeal, it may signal the beginning of a new approach to this facet of the debt-equity issue.

24. Intention to Create Indebtedness

The factor of intention to create indebtedness is not evidentiary in nature, but is a conclusion based upon all of the relevant real and circumstantial evidence surrounding a dispute. In determining the intent of the parties with respect to the creation of indebtedness, an objective rather than a subjective standard is applied:

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154. The opinion expressed by this author is premised upon a fact situation of advances being made to a going concern. Placing large advances at the risk of a newly formed business as part of a plan of financing it is an entirely different matter.

155. 296 F. Supp. 392 (N.D. Ohio 1968). This decision is currently on appeal to the United States Court of Appeals for the Sixth Circuit. [Ed. note: This decision was reversed by the Sixth Circuit. See 432 F.2d 741 (6th Cir. 1970).]

156. See Berkowitz v. United States, 411 F.2d 818, 821 (5th Cir. 1969); Harlan v. United States, 409 F.2d 904, 908 (5th Cir. 1969); and, Kraft Foods Co. v. Commissioner, 232 F.2d 118, 123 (2d Cir. 1956), rev'g 21 T.C. 513 (1954), cited with approval in United States v. Snyder Bros., 367 F.2d 980, 982 (5th Cir. 1966). Gooding Amusement Co., 23 T.C. 408 (1954), aff'd, 236 F.2d 159 (6th Cir. 1956), cert. denied, 352 U.S. 1031 (1957), represents an exception to the general rule. In that case the noteholder made an admission against his interest in revealing his subjective intent. See page 419, footnote 5 of the Tax Court opinion.
This intention must be the objective intent disclosed by all the pertinent factors in the case and not just the formal manifestations of intent declared by the taxpayer.\textsuperscript{157}

What the parties do is more important than what they say. The intent . . . can only be determined by an examination of all of the circumstances existing in the relationship between the corporation and the note-holders.\textsuperscript{158}

One can find an abundance of authority regarding the intention to create indebtedness to support either side of the debt-equity argument,\textsuperscript{159} but it is difficult to evaluate the significance of this factor other than to say that even where the intent of the parties is clear it will probably not be held to be controlling.\textsuperscript{160}

25.\textit{ Intention to Seek Repayment of the Loan Within a Reasonable Time}

When the formal evidence of an advance to a corporation indicates that the parties intended to create indebtedness, a court may inquire whether or not the parties intended to seek prompt repayment of the "loan", particularly if such action would be detrimental to the financial position of the corporation.\textsuperscript{161}

\textsuperscript{157} Drown v. United States, 203 F. Supp. 514, 519 (S.D. Cal. 1962) \textit{rev'd on other grounds}, 328 F.2d 314 (9th Cir. 1964).

\textsuperscript{158} Wilbur Security Co. v. Commissioner, 279 F.2d 657, 662 (9th Cir. 1960), \textit{aff'd} 31 T.C. 938 (1959).

\textsuperscript{159} For examples of cases where courts have held that the parties intended to make a contribution to capital see, Berkowitz v. United States, 411 F.2d 818 (5th Cir. 1969); United States v. Henderson, 375 F.2d 36 (5th Cir. 1967), \textit{cert. denied}, 388 U.S. 953 (1967); United States v. Snyder Bros., 387 F.2d 980 (5th Cir. 1966), \textit{cert. denied}, 386 U.S. 956 (1967); McSorley's, Inc. v. United States, 323 F.2d 900 (10th Cir. 1963); Commissioner v. Makransky, 321 F.2d 598 (3rd Cir. 1963); Wilbur Security Co. v. Commissioner, 279 F.2d 657 (9th Cir. 1960), \textit{aff'd} 31 T.C. 938 (1959); and Commissioner v. Meridian & Thirteenth Realty Co., 132 F.2d 182 (7th Cir. 1942).

Cases in which courts have determined that the intention of the parties was to create indebtedness include, Harlan v. United States, 409 F.2d 904 (5th Cir. 1969); J.S. Biritz Construction Co. v. Commissioner, 387 F.2d 451 (6th Cir. 1967); Tomlinson v. 1661 Corp., 377 F.2d 291 (5th Cir. 1967), \textit{aff'd} 247 F. Supp. 936 (M.D. Fla. 1965); Smith v. Commissioner, 370 F.2d 178 (6th Cir. 1966), \textit{aff'd} 43 T.C. 929 (1964); Byerlite Corp. v. Williams, 286 F.2d 285 (8th Cir. 1960), \textit{rev'd} 170 F. Supp. 48 (N.D. Ohio 1958); Kraft Foods Co. v. Commissioner, 232 F.2d 118 (2nd Cir. 1955); \textit{rev'd} 21 T.C. 513 (1954); United States v. Title Guarantee & Trust Co., 133 F.2d 990 (6th Cir. 1943); Medical Tower, Inc. v. United States, 23 APTR 2d 1230 (E.D. Va. 1969); Troop Water Heater Co. v. Bingler, 234 F. Supp. 642 (W.D. Pa. 1964); and, Drown v. United States, 203 F. Supp. 514 (S.D. Cal. 1962), \textit{rev'd on other grounds}, 328 F.2d 314 (9th Cir. 1964).

\textsuperscript{160} \textit{See, e.g.}, Berkowitz v. United States, 411 F.2d 818 (5th Cir. 1969); and Tomlinson v. 1661 Corp., 377 F.2d 291 (5th Cir. 1967), \textit{aff'd} 247 F. Supp. 936 (M.D. Fla. 1965).

\textsuperscript{161} This factor is particularly relevant to a fact situation where there
This factor was well illustrated by the case of Gooding Amusement Co., which involved the incorporation of a family partnership. The partnership distributed the assets of the business to each of the three partners who in turn “sold” the assets to the corporation. The former partners received stock and five percent promissory notes in exact proportion to their respective interests in the dissolved partnership. Most of the notes which were held by Mr. Gooding were retired as they matured, however no payments of principal were ever made on the notes held by his wife and daughter. In holding that the “notes” represented equity capital the Tax Court commented:

The most significant aspect of the instant case, in our view, is the complete identity of interest between and among the three note-holders, coupled with their control of the corporation. The note-holders were husband, wife, and infant daughter, respectively. The husband held the majority stock in the corporation. It is, in our opinion, unreasonable to ascribe to the husband petitioner, F. E. Gooding, an intention at the time of the issuance of the notes ever to enforce payment of his notes, especially if to do so would either impair the credit rating of the corporation, cause it to borrow from other sources the funds necessary to meet the payments, or bring about its dissolution.

26. Effort to Enforce Payment

This factor relates to conduct of a stockholder-creditor at the time an alleged note matures, as opposed to the preceding factor which is concerned with his state of mind at the time the “indebtedness” was created.

In Charter Wire, Inc. v. United States, three individuals dissolved their partnership and incorporated their business by transferring assets with a net book value of $66,805.74 to the newly formed entity in exchange for six percent promissory notes of equal

is substantial identity of interest between the shareholders and alleged creditors. See Factor 18 in text supra.

162. 23 T.C. 408 (1954), aff'd, 236 F.2d 159 (6th Cir. 1956), cert. denied, 352 U.S. 1031 (1957).

163. Their ownership of the partnership had been in the following proportions: four-sevenths by the husband; two-sevenths by the wife; and, one-seventh by the daughter.


165. Compare the preceding quotation in the text from Gooding Amusement Co. with Berkowitz v. United States, 411 F.2d 818, 821 (5th Cir. 1969); and Aronov Construction Co. v. United States, 223 F. Supp. 175 (M.D. Ala. 1963), aff’d per curiam, 338 F.2d 337 (5th Cir. 1964).

166. 309 F.2d 878 (7th Cir. 1962), aff’g 8 AFTR2d 5993 (E.D. Wis. 1961), cert. denied, 372 U.S. 965 (1963).
value plus $680 worth of capital stock. No principal was ever repaid, but interest was paid regularly, except for a three month period when the corporation's production was hampered by a strike. The original notes were subordinated to obligations to an institutional lender for a period of seven years. A year before the notes were to mature they were cancelled and replaced by new notes which in effect extended the original maturity date by four years. In holding that the alleged indebtedness was equity capital the United States Court of Appeals for the Seventh Circuit commented upon the "noteholders'" lack of effort to enforce their rights as creditors in these words:

The record shows that the note-holders had complete control of the corporation and on several occasions exhibited their primary concern for their position as stockholders in preference to that of creditors. The stockholders subjugated their role as creditors when it was for the corporation's benefit. They called in the notes prior to maturity, issued new notes with a different maturity date, subordinated their notes without protest to that of a bank when asked to do so, and suspended payment of interest for one three-month period; thus they appear to have been little interested in their role as creditors.

A similar view was expressed by the Fifth Circuit when a corporation failed to retire alleged stockholder indebtedness even though it was in a position to do so.

27. Could the "Loans" Have Been Obtained From Institutional Lenders.

Under an objective test of economic reality it is useful to compare the form which a similar transaction would have taken had it been between the corporation and an outside lender, and if the shareholder's advance is far more speculative than what an outsider would make, it is obviously a loan in name only.

If, while advances are being made to a corporate entity by a stockholder, that corporation is also able to obtain loans from an institutional investor, a Court will probably determine that those

167. The stock included the goodwill value of the enterprise.
168. See note 165 supra, at 881.
169. In Berkowitz v. United States, 411 F.2d 818, 821 (5th Cir. 1969), the corporation was allowed to place substantial proceeds ($60,000) from the sale of an asset in a savings account to draw interest rather than repay stockholder advances.
advances constituted true indebtedness. A cogent inference to the contrary arises if it can be demonstrated that at the time a stockholder advanced funds to his corporation, no institutional investor would have extended a similar loan to the enterprise.

Despite the foregoing, it appears as though there may be limited instances when a stockholder may make a legitimate loan to a corporation when an institutional investor would not. In Tomlinson v. 1661 Corporation, stockholder advances to a corporation were held to constitute debt rather than equity capital when stockholder loans were solicited by the corporation only after the cost of third party financing was deemed to be prohibitive. In Motel Co., a stockholder's advance to a corporation was held to constitute indebtedness even though the advance was made after a bank had refused to extend a similar loan to the business. The Tax Court enunciated no specific reason for their decision except to say that stockholders should not be held to the same standards as banks.

28. Stockholder Underestimated the Amount of Capital Necessary to Commence Doing Business

The obvious danger in making advances to a corporation, after the stockholders realize that the amount of capital required to commence operations has been underestimated, is that such advances are usually at the risk of the business.

174. Id. at 300. The court reasoned that, "[I]nability to obtain outside financing is not the same as, and cannot be equated with, the ability to obtain outside financing but at a cost which to the businessman is economically unwise."
175. 22 CCH Tax Ct. Mem. 825 (1963), aff'd, 340 F.2d 445 (2nd Cir. 1965).
176. Id. at 833. In holding for the taxpayer on this issue the Tax Court said:

It cannot be denied that a bank had refused to make an unsecured loan of roughly the same amount [approximately $20,000] and we have considered that fact. But it does seem to us that stockholders need not be as hardnosed as bankers, that is, that in some circumstances they may make a bona fide loan when a banker would not. Without defining the outer limits of such circumstances, we think the circumstances of the present case fall within them.
177. See Factor 23 in text supra.
The utility of this factor appears to be largely dependent upon the credibility of the stockholders' testimony and how a court regards the circumstantial evidence surrounding a transaction. If a court becomes convinced that the stockholders acted in good faith and for a legitimate business purpose, the advances may be held to constitute indebtedness even though they were subject to the fortuities of the future success of the business.\textsuperscript{178} \textit{Austin Village, Inc. v. United States}\textsuperscript{179} represents a decision which taxpayers may tend to rely upon in arguing this point. In that case stockholder advances which became necessary because anticipated outside financing was not available were held to constitute indebtedness. In arriving at its decision the court considered the business purpose for making the advances to be of critical importance.\textsuperscript{180}

29. "Loans" Made Without Regard to Normal Creditor Safeguards

In a bona fide debtor-creditor relationship the creditor may protect his investment in a variety of ways. Two of the most prevalent means of safeguarding an investment are a pledge of collateral or security\textsuperscript{181} and a writing containing an "acceleration clause" to permit the creditor to demand payment in full in the event of partial or complete failure of performance on the part of the debtor.\textsuperscript{182}

The absence of these or other appropriate safeguards to assure repayment of the alleged indebtedness is regarded by most courts as an indication that the advances represent contributions to capital rather than debt.\textsuperscript{183} As a consequence of the court decisions on this point, it appears as though a tax practitioner would be well advised to provide appropriate safeguards for a stockholder-creditor's loan

\textsuperscript{178} Drown v. United States, 203 F. Supp. 514 (S.D. Cal. 1962), rev'd on other grounds, 328 F.2d 314 (9th Cir. 1964).
\textsuperscript{179} 296 F. Supp. 382 (N.D. Ohio 1968) (currently on appeal to the United States Court of Appeals for the Sixth Circuit.) [See editor's note at note 155 supra—ed.]
\textsuperscript{180} Id. at 397 [See editor's note at 155 supra—ed.]
\textsuperscript{181} See note 178 supra. In holding that the advance was indebtedness the court relied in part upon the existence of a chattel mortgage which was executed to secure the stockholder's investment.
\textsuperscript{182} Moughon v. Commissioner, 329 F.2d 399 (6th Cir. 1964), aff'g 39 T.C. 1124 (1963). The court commented on the absence of an acceleration clause in the purported "note" in holding that the alleged indebtedness was really equity capital.
to a corporation, even though the creditor may elect not to exercise those rights at a later date.\textsuperscript{184}

30. \textit{Non-payment of Interest}

This is yet another criterion which a tribunal will often examine in determining whether a stockholder-creditor is "acting like a creditor" in reference to alleged indebtedness. An institutional lender would certainly insist upon regular payments of interest as they became due and a stockholder-creditor is expected to do likewise.

If interest obligations are uniformly disregarded or are only paid sporadically, a persuasive inference arises that the alleged debt is really only equity capital.\textsuperscript{185} The same inference is present when so-called interest payments vary in amount depending upon the relative success of the corporate enterprise during the period for which the payments are being made.\textsuperscript{186}

Although regular and timely payment of interest is often very beneficial to one who is contending that stockholder indebtedness is legitimate,\textsuperscript{187} it will not be considered controlling if other relevant factors indicate that the alleged debt is really equity capital.\textsuperscript{188}

31. \textit{Non-payment of Formal Dividends}

This factor usually becomes significant when interest payments are being made regularly, but no dividends are being paid even though the corporation possesses adequate retained earnings. This situation often creates the impression that the alleged indebtedness is merely a guise to enable the stockholders to draw the profits of the business out of the corporation without incurring a tax on those funds at the corporate level.

\textsuperscript{184} The significance of providing safeguards may be greatly diminished because of other factors in a given case. See, e.g., quotation in discussion of Factor 18 in text \textit{supra}.


\textsuperscript{188} See Oak Hill Finance Co., 40 T.C. 419 (1963).
In *Brake & Electric Sales Corp. v. United States*, a corporation was formed to operate the business of a former sole proprietorship. During the first nine years in which the business functioned as a corporation its gross sales more than tripled and its financial position remained generally favorable. Interest on stockholder “indebtedness” was paid when due during this period of time. Although the corporation had substantial amounts of earned surplus during those years it never paid a dividend. In holding that the “note” represented a contribution to capital the court commented:

> [I]t is significant that at no time since the corporation was formed has it paid a dividend, nor have the directors even discussed the possibility of declaring a dividend, even though its business has been expanding profitably during this entire period and in each year had a substantial earned surplus. The situation thus appears to be one in which Brown through his complete control is able to use the device of drawing off regular profits from the corporation under a label designed to give the corporation an income tax deduction.

32. *Payment of Principal and Interest Only After the Corporate Tax Returns are Audited*

Repayment of principal and interest only after the Internal Revenue Service has commenced an investigation of the corporation’s tax returns gives rise to a very strong inference that the payments were made merely for the sake of appearance rather than to satisfy a legal obligation. In most instances, the situation appears to have an effect similar to that of a little boy getting caught with his hand in a cookie jar; it simply confirms pre-existing suspicions.

Even though no court has stated that this factor is controlling, this writer has not discovered any case in which this criterion has been discussed wherein the decision rendered has favored the taxpayer. If this factor is as devastating to a taxpayer as it appears to be, how should a practitioner advise a client who seeks counsel relative to an audit being initiated by the Service if said client has never made a payment of principal or interest prior to that time?

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190. Id. at 4.
The dilemma presented by this fact situation is obvious and can only be resolved on a case by case basis. A payment of principal or interest in some instances is likely to create the previously mentioned effect. However, failure to make such a payment in other instances would seem to bolster the position of the Service because the time lapse between commencement of an audit and trial is often two or three years. Non-payment during this period, in addition to the time between advancement of funds and initiation of the audit, would seem to permit the inference that the taxpayer was not making an effort to enforce payment of the alleged indebtedness.\(^{192}\)

### 33. Business Purpose for Extending the Loan

When the petitioners decided to make their advances in the form of debts, rather than of capital advances, did they suppose that the difference would appreciably affect their beneficial interests in the venture, other than taxwise?\(^{193}\)

This is an elusive and ambiguous factor yet one which this writer feels is often of critical importance.\(^{194}\) A tax avoidance motive, in itself, is not a factor which will automatically result in a judicial determination adverse to the interests of a taxpayer.\(^{195}\) Surely no one would suggest that a businessman should be required to structure his affairs in a manner which would be most disadvantageous to himself taxwise. However, a problem arises when a business is incorporated or advanced funds in such a manner that tax avoidance appears to be the major, if not the only, reason for executing the designated transaction.\(^{196}\) Consequently the essence of this factor is reduced to an inquiry as to whether the transaction is a mere sham or masquerade utilized primarily for tax avoidance purposes; or whether there was a sufficient business reason for the transaction that the desire to reduce taxes became secondary.

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\(^{192}\) See Factor 26 in text supra.

\(^{193}\) These are the words of Learned Hand, J., enunciated in his concurring opinion in the celebrated case of Gilbert v. Commissioner, 248 F.2d 399, 412 (2d Cir. 1957).

\(^{194}\) See, e.g., Austin Village, Inc. v. United States, 296 F. Supp. 382, 397 (N.D. Ohio 1968) where it was determined that the advances in question represented indebtedness despite the fact that several other factors suggested the opposite conclusion. [See editor's note at note 155 supra—ed.]

\(^{195}\) In Murphy Logging Co. v. United States, 378 F.2d 222, 223 (9th Cir. 1967), rev'd 239 F. Supp. 794 (D. Ore. 1965), the court said, "Tax reduction is not evil if you do not do it evilly." This is the strongest case for the taxpayer which this writer has found regarding the factor under discussion.

\(^{196}\) In Gyro Engineering Corp. v. United States, 276 F. Supp. 454, 471 (C.D. Cal. 1967), revd, 417 F.2d 437 (9th Cir. 1969), the District Court declared:
The significance of this factor is reflected in the fact that if a judicial tribunal is of the opinion that a bona fide business purpose existed for the taxpayer's method of structuring a transaction, it will be very reluctant to hold that alleged indebtedness is in reality a contribution to capital, even though there are other factors present which would support such an inference.\textsuperscript{197} Whereas, if a court is of the opposite view, the alleged debt may be regarded as equity capital, even though the form of the transaction clearly indicates the creation of indebtedness.\textsuperscript{198}

34. Excessive Sale Price

This factor relates only to "indebtedness" which results from a purported sale of assets to a controlled corporation. A high "sales price" will increase the corporation's basis in the property for depreciation purposes, result in larger interest payments, and allow more money to be removed from the corporation at capital gain rates. The obvious tax benefits that accrue to a stockholder from unrealistically inflating the price of assets "sold" to a corporation have caused such conduct to be regarded as evidence that the transfer was a contribution to capital rather than a bona fide sale.\textsuperscript{199} Conversely, a transfer of property to a corporation for a price approximately equal to its fair market value will support the argu-


ment that the transaction is a legitimate sale.²⁰⁰

While it is the hope of this author that no attorney would intentionally be a party to such "price fixing," it may well be asked: How can one avoid even the appearance of such conduct? If the transaction is not at arm's length, a tax planner would be well advised to obtain at least one independent appraisal of the property before consummating the sale. This precaution is regarded as a minimum.

35. Benefit to the Investor

When the stockholder-creditor advanced funds to the corporation did he seek to obtain a benefit, other than taxwise, because of the manner in which he structured the transaction? Although this writer has discovered no case which expressly utilizes this theory, it has been endorsed as a factor which should be controlling in determining a debt-equity issue.²⁰¹ Farley Realty Corp. v. Commissioner²⁰² lends some support for employment of this concept; however, the facts of that case may be so unusual²⁰³ that the decision might be of little value in resolving a typical debt-equity controversy.

CONCLUSION

This writer had hoped that after analyzing the factors set forth herein, some elixir might be prescribed to remedy the enigma of distinguishing debt from equity. However, it is evident that no comprehensive solution can be formulated which will resolve the problem in all instances. Consequently, an analysis of all current factors relevant to each case is essential if a practitioner is to properly advise his clients with regard to the debt-equity dichotomy—at least until promulgation of regulations under the recently enacted section 385 of the Internal Revenue Code.

It should be remembered that no single factor is controlling. Furthermore, one must be cognizant of the fact that judicial application of the various factors is qualitative rather than quantitative; one or two criteria inferring one result may be deemed a more


²⁰³. The creditor involved in that controversy could share in future growth of the corporation, but did not share any risk of loss.
accurate measure of the true substance of a transaction than a host of factors suggesting a contrary conclusion.

It appears as though the real key to understanding the complexity of the debt-equity problem and gaining some insight in dealing with it is to recognize that an ultimate judicial determination in such a dispute is simply a reflection of the court's interpretation of the pertinent facts involved therein. Because of this an analysis of the cases which present a fact situation similar to that with which a practitioner is confronted may prove to be more beneficial than attempting to reconcile conflicting opinions of the courts.²⁰⁴