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A SOLUTION TO THE DEBT-EQUITY PROBLEM

Over the past few decades, one of the most vexing tax problems has been the treatment afforded periodic payments made by corporations upon shareholder advances. Whether they are considered interest or dividends is of great importance not only to the corporation but also to the shareholder.

There is a distinct advantage to the corporation which is able to treat these advances as debt rather than equity funds. The present law allows a corporation to treat interest payments on debt as a business expense, and enables it to deduct such expenses in computing taxable income. If these were considered dividends on stock ownership, no such deduction would be allowable under the Internal Revenue Code of 1954.

The most important effect upon the individual shareholder occurs in connection with repayment of principal. Such is the case, for the return of principal, is tax free to the shareholder up to the amount of the loan, while stock redemption could result in ordinary income and would then be taxable. Likewise, whether the advances are designated debt or equity could be of significance were the corporation to become insolvent. If the firm is unable to meet payments of interest or principal on the loan, the shareholder would find it beneficial to be able to treat the advance as a loan rather than as a contribution to equity. Under the Code, he could obtain a more favorable tax treatment if he were allowed to treat such losses as bad business debt rather than capital loss.

The effect on the shareholder’s personal tax is minimal, however, whether periodic payments by the corporation are labeled interest or dividends.

The significant problem faced by the Commissioner and the courts has been the formulation of the tests to be used in judging the status of stockholder advances. Over the past three decades, the tax court and various federal courts have attempted in vain to lay down definite criteria for the evaluation of these advances. On the whole, they have sought some type of objective standard that could be applied to any case involving stockholder “loans.” In their search, the courts have, in varying degrees, placed emphasis on the

1. Int. Rev. Code of 1954, § 163(a). “There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.”
3. Int. Rev. Code of 1954, § 166(d). Note that even if the advance is declared a loan, the stockholder, in order to take the bad debt deduction, must show that the loan was a business rather than a non-business debt.
4. Int. Rev. Code of 1954, § 34 abolishes, as of 1965, the favorable treatment afforded dividends under the old 4% “dividends received” credit. From 1964 to 1965, the credit is reduced to 2%. At the same time Int. Rev. Code of 1954, § 116 will increase the “dividends received” exclusion from the present $50, to $100. Income received from interest is taxed as ordinary income.
real "intention of the parties" and have varied greatly on what they consid-
ered as being important indicia of this intent.

I. THE PRE-KELLEY ERA

Prior to 1946, the courts were primarily interested in whether the parties intended to create a debtor-creditor relationship or a corporation-stockholder relation. The general approach was that of examining the "four corners" of the instrument, as the courts confined their search for intent to the face of the security. Consequently, they met with little success in forming any comprehensive rule for judging the nature of a particular advance.

Corporations had differing needs, and tailored their financial instruments to meet them. During the early part of the century, corporations began combining the attractive features of debt instruments with those of stock, in order to attract investment funds. These "hybrid securities" were and still are one of the main reasons for confusion in the area of shareholder advances. Because they contain features common to both debt and equity instruments, courts found themselves hard-pressed trying to label them as one or the other. As a result, rather than attempt to set any fixed norms, the courts were more concerned with the total picture presented.

Although the factors which the courts thought were significant in the determination of the nature of any particular instrument may be isolated for discussion, it should be pointed out that, in general, no factor alone would be decisive in this regard. Further, consideration of these factors under the pre-1946 section does not mean that they are not used today. Presently, they are used in conjunction with more "modern" tests.


7. Professor Caplin believes that "the history of 'thin incorporation' may be divided into three major periods: Pre-1946: struggle with hybrid securities; 1946-1956: reliance upon ratios; 1956 to date [1959]: decline of ratio test and search for 'substance.'" Caplin, supra note 5, at 774. An almost identical classification is used by Weis, The Labyrinth of the Thin Corporation, 40 Taxes 568, 569-71 (1962). This type of approach has been criticized as being an "oversimplification in so far as it suggests that courts no longer are confronted with 'hybrids' or no longer think ratios important." Goldstein, Corporate Indebtedness to Shareholders: "Thin Capitalization" and Related Problems, 16 Tax. L. Rev. 1, 18 n.92 (1960).

8. Caplin, supra note 5, at 776; Weis, supra note 7, at 569-70.

9. See De Stefano, Stock or Debt—That Is the Question, 18 Fordham L. Rev. 251, 253 (1949); Weis, supra note 7, at 589.

10. John Kelley Co. v. Commissioner, 326 U.S. 521 (1946); Wetterau Grocer Co. v. Commissioner, 179 F.2d 158 (8th Cir. 1950); Bowersock Mills & Power Co. v. Commissioner, 172 F.2d 904 (10th Cir. 1949); Commissioner v. O.P.P. Holding Corp., 76 F.2d 11 (2d Cir. 1935).

A. Designation

Probably one of the least important factors considered by the courts is the name given to the instrument. However, even this will not always be treated lightly. Generally, the courts take the view that substance predominates over form, and designation by the parties that an advance was a loan, or a payment is interest, does not necessarily make them such. Such confusing names as "debenture preferred stock," "participating dividend debenture certificates" and "liquidation rights certificates" illustrate the many hybrid variations which corporations have devised.

B. Maturity Date

One of the most oft-cited factors for determining the nature of the instrument is the presence or absence of a fixed maturity date, i.e., does the instrument contain a particular date on which the holder might demand the unconditional return of his principal. This factor is significant as it is generally considered one of the elements essential to any debtor-creditor relationship. One case defines a debt as "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." When an instrument lacks such a date, it becomes similar to stock, i.e., with stock the shareholder is contributing to the equity of the business and, theoretically, is not anticipating a return of invested capital on any particular date. Al-
though the failure to have a maturity date will often be fatal, its presence does not, however, assure the taxpayer that the instrument will be considered as evidencing a debt. This is because the inference of debt suggested by the presence of a maturity date may be outweighed by the lack of another essential feature.\textsuperscript{21} Furthermore, it is also quite common for preferred stock to have a fixed maturity date.\textsuperscript{22}

C. Certainty of Payment of Principal

Another important factor considered by the courts has been the nature of the obligation to repay the principal.\textsuperscript{23} That is, is the corporation unconditionally bound to repay the money advanced by the shareholder?\textsuperscript{24} The absence of such a provision indicates that a true debtor-creditor relationship was not intended by the parties. There have been cases that have considered an unconditional and legally enforceable promise to pay an essential feature of this relationship.\textsuperscript{25} Others have treated its presence as decisive.\textsuperscript{26} Certain courts have held that promises to pay only out of surplus,\textsuperscript{27} or from future earnings,\textsuperscript{28} or only if the capital structure of the corporation will not be adversely affected by such payments,\textsuperscript{29} place a contingency on the payment and thus indicate the lack of a debt obligation. Obviously, any payment based on the future performance of the company, inherently carries with it the uncertainty of payment. Such obligations indicate that the funds were

\textsuperscript{21} Commissioner v. Meridian & Thirteenth Realty Co., 132 F.2d 182 (7th Cir. 1942); Pacific Southwest Realty Co. v. Commissioner, 128 F.2d 815 (9th Cir.), cert. denied, 317 U.S. 663 (1942); Verifine Dairy Prods. Corp., 3 T.C. 269 (1944); John Wanamaker Philadelphia, 1 T.C. 937 (1943); Northern Ref rerator Line, Inc., 1 T.C. 824 (1943).


\textsuperscript{23} Bowersock Mills & Power Co. v. Commissioner, 172 F.2d 904 (10th Cir. 1949); Commissioner v. H. P. Hood & Sons, Inc., 141 F.2d 467 (1st Cir. 1944), affirming 11 P-H Tax Ct. Mem. 1588 (1942); Elko Lamoille Power Co. v. Commissioner, 50 F.2d 595, 597 (9th Cir. 1931), affirming 21 B.T.A. 291 (1930); Bruce v. Knox, 180 F. Supp. 907, 912 (D. Minn. 1960).

\textsuperscript{24} Jewel Tea Co. v. United States, 90 F.2d 451, 452 (2d Cir. 1937), affirming 15 F. Supp. 56 (S.D.N.Y. 1936); Commissioner v. O.P.P. Holding Corp., 76 F.2d 11 (2d Cir. 1935); Paul Autenreith, 41 B.T.A. 319 (1940).

\textsuperscript{25} Commissioner v. Page Oil Co., 129 F.2d 748 (2d Cir. 1942), affirming 41 B.T.A. 952 (1940); Commissioner v. J. N. Bray Co., 126 F.2d 612 (5th Cir. 1942), affirming 9 P-H Tax Ct. Mem. 837 (1940).


\textsuperscript{27} Jewel Tea Co. v. United States, 90 F.2d 451 (2d Cir. 1937), affirming 15 F. Supp. 56 (S.D.N.Y. 1936).

\textsuperscript{28} Montclair, Inc. v. Commissioner, 318 F.2d 38 (5th Cir. 1963), affirming 31 P-H Tax Ct. Mem. 45 (1962).

\textsuperscript{29} Northern Refrigerator Line, Inc., 1 T.C. 824 (1943).
placed at the risk of business and are therefore to be viewed as being analogous to stock investments.

Though the absence of a definite promise of repayment is generally regarded as being fatal to the taxpayer's case, the converse, however, is not always considered to conclusively indicate the presence of debt.\(^\text{20}\) The fact that an instrument contains a right to enforce payment upon default, is not given great weight. This is true since in most situations the shareholders never have the opportunity to exercise such a provision, as most cases deal with "going concerns" and the issue of default is not involved.\(^\text{21}\) Furthermore, when the "debt" instruments are held by persons who also own substantial blocks of stock in the corporation, the courts are skeptical about presuming that such persons would bring suit upon default, the rationale being that, in effect, they would be jeopardizing their own positions as stockholders of the firm.\(^\text{22}\) Such suits, if successful, could force the corporation into bankruptcy, whereas nonenforcement of the claim would allow the firm to continue operations, with the possibility of the debt holder recouping his loss as well as protecting his equity investment.

In cases where there has in fact been a default, failure by the stockholder to enforce payment is some evidence that a true debtor-creditor relationship was not contemplated.\(^\text{23}\) Great care should be taken in weighing the significance of this last mentioned consideration. A true debtor-creditor relationship could be intended, but due to the particular facts, a stockholder could, once again, consider it economically imprudent to enforce the defaulted obligation at that particular time. As a demand of payment could result in failure of the corporation, he might allow the firm to continue operations in the hope of recouping his loss as well as protecting his position as a shareholder.

The Tax Court, instead of weighing heavily the fact that there was no actual demand upon a default, should seek evidence on the question of whether the stockholder intended ever to enforce payment. Viewed in the light of sound financial theory, either the renewing of due notes, or the forbearance in their enforcement, should not be conclusive evidence that the holder does not intend to enforce the obligation in the future.\(^\text{24}\)

D. Certainty of Payment of Interest

This factor is in many ways similar to payment of principal. This problem, however, is twofold. First, is the corporation bound to make interest payments

\(^{30}\) Universal Castings Corp. v. Commissioner, 303 F.2d 620 (7th Cir. 1962), affirming 37 T.C. 107 (1961); Pacific Southwest Realty Co. v. Commissioner, 123 F.2d 815 (9th Cir. 1942), cert. denied, 317 U.S. 663 (1942), affirming 45 B.T.A. 426 (1941); Schneider Lumber Co., 25 P-H Tax Ct. Mem. 104 (1956).

\(^{31}\) Universal Castings Corp. v. Commissioner, supra note 30; Pacific Southwest Realty Co. v. Commissioner, supra note 30.


\(^{33}\) Wilshire & Western Sandwiches, Inc. v. Commissioner, 175 F.2d 718 (9th Cir. 1949); Harkins Bowling, Inc. v. Knox, 164 F. Supp. 891 (D. Minn. 1958).

\(^{34}\) For a criticism of this test as applied by the court in the Gooding case, see Rabin, The "Clifford Case" of the Thin Corporation, 34 Taxes 232, 284 (1956).
periodically, and second, is a fixed rate of interest stipulated in the instrument? Lack of an unconditional promise to make periodic interest payments, although not generally fatal as is the lack of repayment of principal, is indicative of a stockholder relationship.35

Stock ownership traditionally involves the placing of funds at the risk of business36 in anticipation of a percentage of the profits, as well as possible capital gains on the original investment. There is no assurance that dividends will be paid since these are contingent upon the relative success or failure of the business. On the other hand, a creditorship allows another the use of funds for a price. Looking at it another way, a debtor is paying a rental fee for the use of a particular asset; in this case, money. Thus, it is clear that as the payment of a rental fee becomes more and more uncertain, the less the chance that the advanced funds are intended as a loan, i.e., they appear to be a permanent addition to the capital structure of the corporation in anticipation of long-run profits.37

On the question of fixed rate of interest, some courts have said that the lack of such a fixed rate is indicative of an equity rather than a debt relationship.38 Conversely, the presence of such a rate can be helpful to the taxpayer's cause.39 However, this can be nullified where payment is made contingent upon the adequacy of earnings, as this indicates investment rather than loan.40

E. Subordination

The fact that shareholders have allowed their claims to be subordinated to those of the general creditors of the corporation is afforded different weight by the courts. Subordination simply deals with the ranking of claims in the event of the corporation's insolvency. Obviously, if insolvency occurs, a person

37. See Boversock Mills & Power Co. v. Commissioner, 172 F.2d 904 (10th Cir. 1949); Bemis Hardwood Lumber Co. v. United States, 117 F. Supp. 851 (W.D.N.C. 1954); Emanuel N. Kolkey, 27 T.C. 37, 58 (1955).
40. Dayton & M.R.R. Co. v. Commissioner, 40 B.T.A. 857 (1939), aff'd, 112 F.2d 627 (4th Cir. 1940); William Cluff Co., 7 B.T.A. 662 (1927). Note that the Supreme Court in John Kelley Co. v. Commissioner, 326 U.S. 521, 526 (1946), apparently felt that the contingency of interest payments was not fatal to the taxpayer's case.
who has allowed the claims of others to supersede his may not recover his funds upon the liquidation of assets. If the shareholder was willing to allow himself to be put in this unenviable position, some courts have felt that this indicated stock rather than debt.\textsuperscript{41} Similarly, equal rank among creditors is indicative of a debt relationship.\textsuperscript{42} Other cases, however, contend that subordination is not fatal to the taxpayer's cause.\textsuperscript{43} From the point of view of modern business practice, it is common for investors to allow their rights to be subordinated in return for higher interest rates or other benefits, when the possibility of default appears to be minimal.\textsuperscript{44}

F. Voting Rights

Generally, instruments containing voting rights are said to resemble stock.\textsuperscript{45} However, where the voting rights do not represent ownership rights, as in the case where such rights are given as additional security for the loan in case of default, a debtor-creditor relationship can still be maintained.\textsuperscript{46}

G. Right To Share in Profits

Since the right to share in the profits of the corporation is generally regarded as one of the most important rights given to stockholders, there is little room for disagreement that the presence of such a provision will be fatal to the taxpayer.\textsuperscript{47}

\begin{itemize}
\item \textsuperscript{41} Montclair, Inc. v. Commissioner, 318 F.2d 38 (5th Cir. 1963), affirming 31 P-H Tax Ct. Mem. 10 (1962); Brown-Rogers-Dixson Co. v. Commissioner, 122 F.2d 347 (4th Cir. 1941), affirming 9 P-H Tax Ct. Mem. 793 (1940); Dayton & M.R.R. v. Commissioner, supra note 40; Elko Lamoille Power Co. v. Commissioner, 50 F.2d 595 (9th Cir. 1931), affirming 21 B.T.A. 291 (1930).
\item \textsuperscript{42} Helvering v. Richmond, F. & P.R.R., 90 F.2d 971 (4th Cir. 1937), affirming 33 B.T.A. 895 (1936); Bemis Hardwood Lumber Co. v. United States, 117 F. Supp. 851 (W.D.N.C. 1954). However, it has been said that this may carry little weight. The Colony, Inc., 26 T.C. 30 (1956), aff'd, 244 F.2d 75 (6th Cir. 1957), rev'd on other grounds, 357 U.S. 23 (1958).
\item \textsuperscript{43} Bowersock Mills & Power Co. v. Commissioner 172 F.2d 594 (10th Cir. 1949); Commissioner v. O.P.P. Holding Corp., 76 F.2d 11 (2d Cir. 1935); Elliott-Lewis Co., 14 P-H Tax Ct. Mem. 139 (1945), aff'd per curiam, 154 F.2d 292 (3d Cir. 1946); Bollinger-Franklin Lumber Co. v. Commissioner, 7 B.T.A. 402 (1927).
\item \textsuperscript{44} See Graham, Dodd & Cottle, Security Analysis 377 (4th ed. 1962); Guthmann & Dougall, Corporate Financial Policy 207 (4th ed. 1962); Johnson, Financial Management 441 (2d ed. 1962).
\item \textsuperscript{45} See Crown Iron Works Co. v. Commissioner, 245 F.2d 357 (8th Cir. 1957), affirming 25 P-H Tax Ct. Mem. 834 (1956); May Hosiery Mills, Inc. v. Commissioner, 123 F.2d 858 (4th Cir. 1941), affirming 42 B.T.A. 646 (1940); Sunny Isles Ocean Beach Co. v. Coyle, 9 Am. Fed. Tax R.2d 588 (W.D.N.Y. 1961); Ernst Kern Co., 1 T.C. 249 (1942). But even as to this factor, there is not total agreement. Helvering v. Richmond, F. & P.R.R., 50 F.2d 971 (4th Cir. 1937), affirming 33 B.T.A. 895 (1936); Hemaway-Johnson Furniture Co., 17 P-H Tax Ct. Mem. 322 (1948), aff'd per curiam, 174 F.2d 793 (5th Cir. 1949).
\item \textsuperscript{47} See Bonds, Inc., 13 P-H Tax Ct. Mem. 1294 (1944); Hale-Justis Drug Co., 12 P-H
\end{itemize}
II. THIN CAPITALIZATION

The sole opinion of the Supreme Court in the area of stockholder advances was handed down in connection with the cases of John Kelley Co. v. Commissioner and Talbot Mills v. Commissioner.48 The court saw fit to combine the two cases since the facts and issues were quite similar.

The Tax Court, in *Kelley*, held that the payments made to the debenture holders were interest and therefore deductible,49 but the court of appeals reversed this decision.60 In *Talbot Mills*, the Tax Court held that the registered notes were equivalent to stock and payments on them were not deductible.61 The court of appeals affirmed.62 The Supreme Court then granted certiorari63 and upheld the decision of the Tax Court in both cases.54

The question in both cases was largely procedural. Namely, was the Tax Court's determination subject to review by a higher court? The Supreme Court relied on the so-called *Dobson Rule*65 in holding that the decisions of the Tax Court are final on all issues except clear-cut questions of law. The Court then stated that whether a payment to shareholders constituted interest or dividend is not such a question.

The holding in this case was overshadowed by its dictum. Mr. Justice Reed's statement, that "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,"66 was quickly seized


49. 1 T.C. 457 (1943). The taxpayer, a family owned corporation, issued $150,000 in income debenture bearer bonds, which provided for interest of 8% noncumulative. The debentures were payable in 20 years on December 31, 1956 and contained a provision conditioning interest payments upon the sufficiency of net income. The bonds were offered only to shareholders but were assignable. They contained no voting rights and were subordinated to the claims of all other creditors.

50. 146 F.2d 466 (7th Cir. 1944).

51. 3 T.C. 95 (1944). The taxpayer was a family owned corporation with capital stock valued at $50,000. In a recapitalization move in 1939, each shareholder was asked to surrender four-fifths of his stock in lieu of registered notes having a total face value of $400,000. The notes were to be payable in 25 years on December 1, 1964 and carried an interest provision which provided for an annual interest rate which was not to exceed 10%, nor fall below 2%. However, the interest was cumulative but could be postponed until the notes' maturity if the financial position of the corporation required it. The agreement forbade the subordination of the notes to any other obligation maturing earlier than the maturity date of the notes. Likewise, the corporation was limited in its rights to mortgage its real assets.

52. 146 F.2d 809 (1st Cir. 1944).


upon the courts and used to justify various thin capitalization tests. Thus, the era when thin capitalization became an oft-used test for determining whether a particular payment was interest or a dividend had arrived.\textsuperscript{57}

It should be noted, however, that Kelley did not render previous tests obsolete. Rather, they were complemented by the thin capitalization factor. As the Supreme Court pointed out, "there is no one characteristic . . . which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts."\textsuperscript{53}

The courts have varied greatly in the weight they have given to inadequate capitalization. During the thin capitalization era, corporations often found that even though they issued straightforward debt securities (\textit{i.e.}, non-hybrid), the Tax Court would strike them down because of inadequate capitalization.\textsuperscript{63} Nevertheless, the courts in their search for some objective standards, could find little agreement as to what was a proper debt-equity ratio. The reason for this, no doubt, is that few courts had a clear notion of what norm should be used in measuring a company's capital structure. Zeal to seize upon an objective standard led some courts to interpret Kelley as approving 4:1 as a "safe" ratio.\textsuperscript{60}

Illustrating the confusion in this area, there have been cases in which the courts have imposed a stockholder relationship where the debt-equity ratio has been comparatively low.\textsuperscript{61} Weighing strongly in other cases, aside from their disproportionate debt structures, was the fact that each of the corporations had been nominally capitalized.\textsuperscript{62} In other cases, where equity investments were more substantial, however, the courts nonetheless refused to find the existence of a debtor-creditor relationship.\textsuperscript{63}

On the other hand, there have been cases in which the debt-equity ratios have been as high as 50:1,\textsuperscript{64} but despite this Tax Court decisions have found the advances to be debt.\textsuperscript{65} As a result of these and other opinions, tax counsel were


\textsuperscript{59} For an extensive listing of "thin capitalization" cases involving straight-forward instruments which were held not to represent debt, see Caplin, supra note 57, at 720-31.

\textsuperscript{60} Although the Supreme Court did not mention it directly, the debt-equity ratio in Talbot Mills after recapitalization was 4:1. 326 U.S. at 524. See Caplin, supra note 57, at 783-84; Wels, The Labyrinth of the Thin Corporation, 40 Taxes 563, 573-74 (1962).


\textsuperscript{64} J. I. Morgan, Inc., 30 T.C. 331 (1958), rev'd on other grounds, 272 F.2d 936 (9th Cir. 1959).

\textsuperscript{65} E.g., Sun Properties Inc. v. United States, 220 F.2d 171 (5th Cir. 1955) (310:1);
hard-pressed when advising their clients as to capital structures which would satisfy the Commissioner and the courts.

III. FIFTH CIRCUIT REJECTS THIN CAPITALIZATION

The Court of Appeals for the Fifth Circuit has refused to accept the debt-equity test. Rather, it has relied primarily on the intention of the parties, as did the courts prior to Kelley. Its position was first made clear in Rowan v. United States. There, the shareholders had contributed 9,000 dollars toward capital, and over a period of several years had made advances on open account, totalling 125,000 dollars. After showing losses for a number of years, the corporation was liquidated by the Rowans and the other two shareholders of the company. The question before the court was whether a 50,944 dollar loss suffered by the taxpayers upon liquidation was a loss on debt or equity funds. In allowing the bad debt deduction, the court stated that "it would obviously work an unwarranted interference by the courts . . . for us to say that there can be established, as a matter of hindsight, a ratio of stockholder owned debt to the capital of the debtor corporation."

In Sun Properties, Inc. v. United States, the Fifth Circuit in allowing a tax refund reaffirmed its position on the thin capitalization test. The record showed that the sole shareholder of the corporation had contributed only 400 dollars to capital and had "sold" to it, on credit, a warehouse valued at 125,000 dollars. The Commissioner contended that since only a nominal amount of capital was invested in the firm, the transfer of the warehouse was not a sale but rather a contribution to capital. The circuit court, however, felt that there was a valid sale and debt. Although the corporation had a ratio of approximately 310:1, the court stated that "we do not think this is any ground to infer that this transaction was a contribution to capital."

IV. TRUE INTENTION

The decision of the Sixth Circuit in Gooding Amusement Co. v. Commissioner, has been hailed as a milestone in the debt-equity controversy. Here the Tax Court upheld the Commissioner's contention that the bonds in question actually represented stock interest. The case seems to stand for the proposition that a court, presented with the question of an advance being debt or equity, has to try to determine the true intent of the parties. This is similar to the pre-Kelley decisions. However, it differs in that the court did not confine itself to the "four corners of the instrument" but rather con-

Rowan v. United States, 219 F.2d 51 (5th Cir. 1955) (14:1); Arthur v. McDermott, 13 T.C. 468 (1949) (19:1).
66. See Weis, supra note 60, at 578-81.
67. 219 F.2d 51 (5th Cir. 1955).
68. Id. at 55.
69. 220 F.2d 171 (5th Cir. 1955).
70. Id. at 175.
72. See Caplin, supra note 57, at 784-88; Rabin, supra note 34, at 282-85; Wels, supra note 60, at 580-83.
considered all surrounding circumstances. The significant fact in Gooding Amusement was that the instruments were straightforward and, in the words of the Tax Court, "the formal criteria of indebtedness are unquestionably satisfied."

The court considered the identity between the shareowners and the bondholders as being significant regarding the question of a possible default on interest or principal payments by the corporation, and felt that it would be unreasonable to assume that the bondholders would enforce the notes upon default because of this identity. This, along with the court's feeling that Mrs. Gooding and her infant daughter would do nothing as shareholders that would be inconsistent with Mr. Gooding's desires, was decisive. In effect, the Goodings' view of the transaction was appraised as being similar to that of any equity owner, i.e., that they would do nothing that would endanger the financial position of the firm.

Another element mentioned was that the notes were subordinated to other creditors. Also deemed significant was the fact that no demand for payment was made after the majority of the notes had reached maturity. In reply to the taxpayer's argument that it had justifiable business purposes in issuing the notes, the court felt that "its status as a motive ... was minor." In the end, the court concluded that "the only substantial purpose motivating the transaction was one of tax avoidance, and therefore it should not be allowed for tax purposes.

One observer notes that "with the advent of Gooding Amusement Company we see the 4:1 'safe' ratio myth shattered at last with the courts now looking towards all the surrounding facts and circumstances." Weis, supra note 60, at 580. (Emphasis omitted.) Another remarked, in connection with Gooding Amusement and similar cases, that "something more than mere compliance with technical or clerical formalities to determine whether a true debtor-creditor status was intended." Comment, The Thin Incorporation Problem: Are the Courts Fighting the Tar Baby?, 5 U.C.L.A.L. Rev. 275, 286 (1958). (Emphasis omitted.)

74. The taxpayer, a closely held corporation (three stockholders: Mr. and Mrs. Gooding and their infant daughter), was formed after a family partnership dissolved itself and transferred its assets to the corporation. In exchange for the re-evaluated assets of the partnership, totalling $281,000, the corporate taxpayer issued $49,000 worth of no-par common stock and $232,000 in short-term interest bearing notes to the Goodings in proportion to their interests in the dissolved partnership. Due to the goodwill transferred from the partnership, the debt-equity ratio was estimated at about 1:1, but this fact carried little weight with the court. The Tax Court noted that "the 'thin capitalization' factor is only one of the indicia from which the presence or absence of a debtor-creditor relationship may be determined. We do not consider it decisive of the present issue." Gooding Amusement Co., 23 T.C. at 419.

75. Id. at 418.

76. Id. at 418-19.

77. Id. at 419. Although the finding of facts by the Tax Court showed that the notes were subordinated, Judge McAllister, dissenting on appeal, claimed that there was never any legal subordination but merely a forebearance in making a claim for the principal due. Gooding Amusement Co. v. Commissioner, 236 F.2d at 167 (dissenting opinion).

78. 23 T.C. at 419.

79. Id. at 420.

80. Id. at 420-21.
On appeal, the Sixth Circuit affirmed, reiterated with favor the Tax Court's reasoning and noted, as did the Tax Court, that transactions, although valid on their faces, which depend on sham or lack genuineness will not be sustained for tax purposes. The old notion that substance prevails over form was echoed by the court.

On the basis of Gooding Amusement, a taxpayer could no longer be safe by simply casting its "debt" transactions with shareholders in an unambiguous form. Furthermore, it was likely to find little protection from the Commissioner's attacks by showing a low debt-equity ratio. Rather, it apparently had to act like a creditor, lest the transaction be susceptible of being labeled a "sham."

V. BUSINESS PURPOSE

Another criterion used periodically by the Tax Court has been the "business purpose" test. The importance of this factor was first suggested in Gregory v. Helvering. Though the decision dealt with reorganization, its reasoning has been carried over into the area of stockholder advances. As a result, taxpayer transactions became susceptible to attack by the Commissioner on the grounds that they were a sham and their sole purpose was tax avoidance. Some cases have scrutinized the taxpayer's initial purpose for incorporating, while others have challenged the motives behind the issuance of certain debt instruments. The result is that the term "business purpose" evades definition.

81. Gooding Amusement Co. v. Commissioner, 236 F.2d 159 (6th Cir. 1956).
82. 293 U.S. 465 (1935). The case involved a reorganization under the Revenue Act of 1928, ch. 852, § 112, 45 Stat. 816. A corporation wholly owned by the taxpayer transferred to a fully owned corporation part of its assets, i.e., 1000 shares of stock in another corporation. The new corporation in return issued all its shares to the taxpayer and shortly thereafter was dissolved. Upon liquidation of the new corporation, the 1000 shares were distributed to the taxpayer who sold them for her private gain. As a result, her tax liability on the gain was less than it would have been had the shares been directly paid to her in the form of an ordinary dividend. The Supreme Court decided that although the transaction conformed with the provisions of the statute, it was nothing more than a masquerade for the purpose of tax avoidance. Id. at 470. However, the Court pointed out that it was permissible for a taxpayer to reduce his taxes, or altogether avoid them, by any means which the law permits. This last criterion was not met by the taxpayer, for although the reorganization statute allowed tax reduction, the intention of the statute was such as to require non-tax business motives to be also evident. For a discussion of the Gregory case and other cases dealing with reorganization, see McCaffery, "Business Purpose" or "Business Continuation"?, 30 Taxes 187 (1952).
83. Miller v. Commissioner, 239 F.2d 729 (9th Cir. 1956); Broadway Drive-in Theatre, Inc. v. United States, 220 F. Supp. 707 (E.D. Mo. 1963); Aldon Homes, Inc., 33 T.C. 582 (1959); Emanuel N. Kolkey, 27 T.C. 37 (1956).
84. Miller v. Commissioner, supra note 83, at 734; Emanuel N. Kolkey, supra note 83, at 60.
85. E.g., Miller v. Commissioner, supra note 83, at 734; Emanuel N. Kolkey, supra note 83, at 60; Comment, The Thin Incorporation Problem: Are the Courts Fighting the Tar Baby?, supra note 73, at 283.
86. Gooding Amusement Co. v. Commissioner, 236 F.2d 159, 166 (6th Cir. 1956); Warren
Does it refer to the corporation's purpose, or the shareholder's purpose? The latter, in closely held corporations, is frequently difficult to separate from the corporation's motives and objectives. Moreover, does it refer to motives at the time of incorporation, or simply to the purpose in issuing certain instruments? Furthermore, what type of business purpose is required; will any business motive suffice? The problem here is that, although the term carries with it a ring of definiteness, no one has been able to reduce it to objective and ascertainable norms.

VI. SUBSTANTIAL ECONOMIC REALITY

In 1962, the Second Circuit, in Nassau Lens Co. v. Commissioner, took a significant step forward in reducing the confusion in the area of debt-equity. The importance of this decision rests in the fact that the court took cognizance of economic realities found in the business world. In allowing the taxpayer's interest deduction, the court appears to have taken a "reasonable man" approach to the problem, as well as having strongly denounced the usefulness of the traditional business purpose test.

The Nassau Lens case involved the transfer of all the assets of an optical supply business to the taxpayer corporation. The owner of the supply business received all the stock of the new corporation, together with debenture notes having the value of 100,000 dollars. As a result of the transfer of assets, the corporation began operations with a total capitalization of approximately 195,000 dollars. In lieu of periodic interest, the notes provided that the corporation would pay the holder 150,000 dollars upon maturity. The taxpayer claimed that 50,000 dollars of this should be discounted and on its 1954 income tax return it deducted 4,904.10 dollars as the amortized discount for the period of January 7, 1954 to December 31, 1954. The Commissioner disallowed this deduction and his decision was sustained by the Tax Court on the ground that the debenture notes, in reality, represented an equity interest in the corporation.

The Tax Court felt that the distribution of the stock and debentures was arbitrary and that "no business reasons appear for the artificial division and allocation of the assets in question." On appeal, the Second Circuit reversed and remanded the case to the Tax Court for further proceedings consistent with its opinion. Judge Thurgood Marshall, having disposed of the Com-
missioner's arguments regarding the valuation of the transferred assets, went on to criticize the traditional "business purpose" test:92

While the existence of a tax motive or the lack of a business purpose is the starting point for a challenge to the form of a transaction adopted by a taxpayer, it is, in the absence of legislative intent to the contrary, not the finish line . . . . And since legislative intent must oftentimes be unclear, the form adopted will usually be recognized except where it is a patent distortion of normal business practice . . . .93

The court here shifted emphasis from a subjective "business purpose" test and emphasized that an investment must have "substantial economic reality in terms of the objective factors which normally surround [it]."94

The court concluded that "non-arm's-length loans by a stockholder to a corporation are to be recognized or disregarded for tax purposes according to the extent to which they comply with arm's-length standards, not the extent to which the taxpayer has a business purpose."95 What the court seems to be saying is that if the taxpayer conforms to accepted business practices, transactions with its stockholders will be adjudged valid debt, though they are motivated by tax avoidance.96

VII. SUBSTANTIAL ECONOMIC REALITY AND TAX AVOIDANCE

At first blush, the term "substantial economic reality" may appear to be just another nice phrase having no useful meaning. However, this is not the case. Judge Marshall, in Nassau Lens, has in fact suggested a reasonable man test for the solution of the debt-equity problem.97 Although an instrument on its face may represent debt, this will be disregarded if the transaction appears not to be economically reasonable. The test of reasonableness, however, is not based on what would be reasonable to the ordinary citizen, as it is in areas such as contracts or torts, but rather, the reasonable man here is the ordinarily prudent businessman.98

When applying this test to determine the motive of the taxpayer, care should be taken to make a distinction which the courts often fail to recognize. There is a marked difference between casting one's transactions in such a way as to achieve legitimate tax avoidance and attempting to obtain tax bene-

92. 308 F.2d at 44-46.
93. Id. at 45. (Emphasis added.)
94. Id. at 46. (Emphasis added.) See Gilbert v. Commissioner, 248 F.2d 399 (2d Cir. 1957). Although there is some difficulty with the interpretation of this case, there appears to be agreement that the decision, like Kraft Foods Co. v. Commissioner, 232 F.2d 118 (2d Cir. 1956), before it, was a weak but actual rejection of the business purpose test. See generally Caplin, supra note 57, at 801; Hickman, supra note 89, at 985.
95. 308 F.2d at 46. (Emphasis added.)
96. Id. at 44-45. See Kraft Foods Co. v. Commissioner, 232 F.2d 118 (2d Cir. 1956), where the court said, in effect, that clear and unambiguous instruments are evidence of the intent of the parties and that tax avoidance alone will not defeat the taxpayer's case when "the acts were real" and not "sham entities." Id. at 128.
97. See 308 F.2d at 45-46.
98. See ibid; Hickman, supra note 89, at 988.
fits in a way inconsistent with the underlying intent of the Internal Revenue Code.

One commentator on the Nassau Lens case strongly suggests that even if the "business purpose" test is not presumed to be defunct today, stockholder debt, with its consequent tax benefits, can still meet this test under the proper circumstances. That is, the incurring of debt, in itself, may be a justifiable business purpose. This stems from what is called "leverage" or "trading on the equity." However, it appears that stockholder-held indebtedness can be justified within the "substantial economic reality" rule emphasized in Nassau Lens, without resort to the traditional "business purpose" test. For many years, it has been accepted practice within the business community to include in a corporation's capital structure a certain percentage of debt funds. The acquisition of funds often is not the primary purpose. Rather, corporate managers are looking for benefits accruing from the use of "leverage." "Trading on the equity" is sound practice even though the funds provided could just as easily have been acquired through equity financing. Leverage is simply the use of borrowed funds with the hope of gaining a return that is higher than the interest charged for these funds. Assuming favorable earnings, its use can materially increase a stockholder's dividends, as well as provide a tax benefit to the corporation. However, it should be noted that a sales decline is likewise magnified to the detriment of the shareholder. Generally, it is therefore incumbent on a company "that permanent

102. Two factors are involved. First, since the interest owed to the bondholders is a fixed sum, any income realized on the borrowed funds over this sum will accrue to the shareholders. Second, since interest is deductible, a higher proportion of bonds results in a greater reduction of the taxable income of the corporation.
103. For example, consider the effects of leverage upon the rates of return in the following table:

<table>
<thead>
<tr>
<th>TRADING ON EQUITY: ILLUSTRATIVE FIGURES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
</tr>
<tr>
<td>--------------</td>
</tr>
<tr>
<td>1. Earnings before interest</td>
</tr>
<tr>
<td>2. Interest on bonds, 6%</td>
</tr>
<tr>
<td>3. Income before income taxes</td>
</tr>
<tr>
<td>4. Income taxes (50%)</td>
</tr>
<tr>
<td>5. Bal. for stockholders</td>
</tr>
<tr>
<td>6. Total earnings, after taxes</td>
</tr>
<tr>
<td>7. Per cent earned on total investment (after taxes)</td>
</tr>
<tr>
<td>8. Per cent earned on stockholders' investment</td>
</tr>
</tbody>
</table>

(d) = deficit

Guthmann & Dougall, op. cit. supra note 100, at 167, Table 10-1. Notice that fluctuations
borrowing should be undertaken only when a reasonable stability of income makes the required payments to the bondholders fairly certain.\textsuperscript{104}

As was mentioned previously, the use of debt financing with its leverage and tax benefits is an important part of modern corporate life. In this connection, it has been pointed out that "since the federal income tax does operate to encourage outsider indebtedness and contributes substantially to its profitability, the corporation which does not or cannot borrow outside, would be placed at a serious competitive disadvantage were the courts to hold that stockholder debt is not eligible for the same treatment as outsider debt."\textsuperscript{105}

Once it is agreed that this type of corporate indebtedness is justifiable on the basis of economic reality, the next question is, how does one determine what is economically reasonable in a given situation? Here, it seems, the often-used and abused debt-equity test has some application. Although this test has allegedly been the basis of numerous decisions, the courts appear to be far from clear as to its nature and application. Obviously, the basic purpose of the ratio is to indicate the extent to which the corporation is making use of leverage. However, to be meaningful, it must be used in conjunction with data reflecting the variability of the company's earnings.

During the "heyday" of the debt-equity test, some suggested that a ratio of 4:1 was "safe."\textsuperscript{106} It must be realized, however, that a certain ratio may mean favorable leverage and tax savings to one corporation where the same ratio, used by another, could mean certain financial disaster. Thus, any debt-equity ratio must be compared with earnings fluctuation, which in turn is a function of the consumer demand, product sold, the competition within the industry, costs and other factors.\textsuperscript{107}

Again, in trying to determine whether a certain amount of debt is excessive for a particular company, i.e., whether it is in conformity with economic

in the rate of stockholder earnings (line 8) are magnified by the use of leverage. The table assumes that both the stockholders and bondholders each invested $1,000,000. Thus, the use of leverage becomes economically unreasonable when a moderate decline in revenue would cause the corporation to default on its bond interest payments or cause it to use its surplus in order to remain solvent. Column "5" shows such a result. This indicates that this company's 1:1 debt-equity ratio is too high. For another company whose sales are more stable, such a ratio may be too low.

\textsuperscript{104} Guthmann & Dougall, op. cit. supra note 100, at 169-70. Theoretically, if a company sold a product whose demand never fluctuated and earnings were the same every year, and this company was the only one selling the item, it could then "trade on its equity" to the extent of having almost its entire capital structure comprised of debt funds. Such situations are practically nonexistent and, therefore, a firm must issue debt only up to that amount which it can safely accommodate under adverse conditions.

\textsuperscript{105} Hickman, supra note 89, at 986. It is interesting to note that a suggested solution, where the outside loan has been guaranteed by a shareholder of the corporate borrower, is to apply the same treatment afforded to a direct loan by that shareholder to the corporation. Holzman, The Current Trend in Guarantee Cases: An Impetus to Thin-Incorporation?, 11 Tax L. Rev. 29, 47-48 (1955).

\textsuperscript{106} Caplin supra note 57, at 783-84; Weis, supra note 60, at 573-74.

reality, the first concern should be the protection afforded the debtholders. That is, are earnings substantial enough so that, even with a decrease in income, debt accommodation will be assured. A text on security analysis shows that in a comparison of thirty major industries in the United States, the percentage of senior securities (preferred stock and debt) in the companies comprising these industries was never greater than 35 per cent. \[\text{103}\] Even if we were to assume that the senior securities section was comprised of debt alone, a capital structure of 65 per cent common stock and 35 per cent debt would give a debt-equity ratio of only about 0.5:1.

108. COMPARISON OF LEVERAGE AND PRICE-EARNINGS RATIOS OF 30 MAJOR INDUSTRIES:

1955-1959 AVERAGES
(Industries ranked by price-earnings ratios)

<table>
<thead>
<tr>
<th>Industries</th>
<th>Common stock as % of total capital</th>
<th>Senior securities as % of total capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electrical supplies and equipment</td>
<td>76</td>
<td>24</td>
</tr>
<tr>
<td>Chemicals</td>
<td>69</td>
<td>31</td>
</tr>
<tr>
<td>Ethical Drugs</td>
<td>37</td>
<td>13</td>
</tr>
<tr>
<td>Proprietary Drugs</td>
<td>35</td>
<td>15</td>
</tr>
<tr>
<td>Paper and allied products</td>
<td>77</td>
<td>23</td>
</tr>
<tr>
<td>Toilet preparations and soap</td>
<td>81</td>
<td>19</td>
</tr>
<tr>
<td>Meat packing</td>
<td>69</td>
<td>31</td>
</tr>
<tr>
<td>Apparel and accessories chain stores</td>
<td>90</td>
<td>10</td>
</tr>
<tr>
<td>Automobiles</td>
<td>86</td>
<td>14</td>
</tr>
<tr>
<td>Radio and television</td>
<td>72</td>
<td>28</td>
</tr>
<tr>
<td>Glass and metal container</td>
<td>66</td>
<td>34</td>
</tr>
<tr>
<td>Nonferrous Metals incl. copper</td>
<td>91</td>
<td>9</td>
</tr>
<tr>
<td>Mail-order</td>
<td>80</td>
<td>10</td>
</tr>
<tr>
<td>Rubber</td>
<td>69</td>
<td>31</td>
</tr>
<tr>
<td>Corn products</td>
<td>84</td>
<td>16</td>
</tr>
<tr>
<td>Building materials</td>
<td>89</td>
<td>11</td>
</tr>
<tr>
<td>Oil industry</td>
<td>85</td>
<td>15</td>
</tr>
<tr>
<td>General industrial machinery</td>
<td>83</td>
<td>17</td>
</tr>
<tr>
<td>Dairy products</td>
<td>79</td>
<td>21</td>
</tr>
<tr>
<td>Grain-mill products</td>
<td>70</td>
<td>30</td>
</tr>
<tr>
<td>Limited-price variety stores</td>
<td>84</td>
<td>16</td>
</tr>
<tr>
<td>Grocery chain stores</td>
<td>72</td>
<td>28</td>
</tr>
<tr>
<td>Steel</td>
<td>80</td>
<td>20</td>
</tr>
<tr>
<td>Distilling</td>
<td>72</td>
<td>28</td>
</tr>
<tr>
<td>Department stores</td>
<td>65</td>
<td>35</td>
</tr>
<tr>
<td>Aircraft</td>
<td>84</td>
<td>16</td>
</tr>
<tr>
<td>Automobile parts and accessories</td>
<td>92</td>
<td>8</td>
</tr>
<tr>
<td>Agricultural machinery</td>
<td>76</td>
<td>24</td>
</tr>
<tr>
<td>Cigarette</td>
<td>65</td>
<td>35</td>
</tr>
<tr>
<td>Textile fabrics</td>
<td>67</td>
<td>33</td>
</tr>
</tbody>
</table>

Graham, Dodd & Cottle, op. cit. supra note 100, at 546, Table 40-6. The right-hand column of the table has not been included since it is not pertinent here.
The same text also offers what it considers the ideal capital structure for public utilities. Even with public utilities, whose earnings are relatively stable because of consistency of demand, government regulation and lack of competition, the suggested capital structure yields a debt-equity ratio of little more than 1.5:1. The relatively low ratios indicate what business men and authors consider to be prudent levels of capitalization. Based on past experience, they reflect the amount of debt which can be safely accommodated, even under adverse conditions, without jeopardizing the solvency of the firms.

These and like figures indicate what is reasonable and prudent business practice. In effect, they represent what Nassau Lens referred to as "substantial economic reality."

Applying these standards to a 1956 proposal of the American Bar Association, which advocated statutory immunity to indebtedness up to a ratio of 10:1, it would seem that the proposal is far too permissive and fails to take account of economic realities. It would allow, without challenge, fifteen to twenty times as much debt in a corporation's capital structure as is now generally accepted as prudent by the business world.

VIII. THE SUGGESTED APPROACH

One author, after proceeding in an analysis similar to the one in the previous section, concluded correctly that the debt-equity ratio as derived from the balance sheet is in itself an inadequate tool in stockholder "loan" controversies since it does not take into account income variation. He therefore concludes that "the most useful approach to a meaningful debt standard lies in an analysis of patterns of variation of income and expense in a given situation or in comparable groups . . . ." Although this approach would be a significant improvement, it still fails to produce any standard which would bring order and consistency to the stock-debt problem.

The solution to the problem lies in regulatory action. Following is a plan which could be used with facility, speed and fairness by the Internal Revenue Service in deciding debt-equity questions. Basically, the plan involves the construction of schedules by the Treasury Department which would reflect reasonable and prudent stock-debt proportions of the various industries as

109. Graham, Dodd & Cottle, op. cit. supra note 100, at 277, suggest the following capital structure as being ideal for public utilities:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds</td>
<td>50%</td>
</tr>
<tr>
<td>Preferred Stock</td>
<td>15</td>
</tr>
<tr>
<td>Common Stock</td>
<td>35</td>
</tr>
<tr>
<td>and surplus</td>
<td></td>
</tr>
<tr>
<td>TOTAL</td>
<td>100%</td>
</tr>
</tbody>
</table>

111. See notes 108 & 109 supra and accompanying text.
112. Hickman, supra note 89, at 990.
113. Id at 991.
114. See note 108 supra. For ease of handling, it would seem that the relationship
determined by the experience of men in the field. With the facilities and information available to the Treasury Department, this type of table could be constructed essentially on a modified form of the debt-equity ratio.

In answer to the obvious objection that the debt-equity ratio does not take into consideration the crucial factor of earnings fluctuation, it is apparent upon closer scrutiny that this factor would already be implicitly recognized in the construction of the guidelines. More precisely, since the percentages used would be derived from actual business practice within a particular industry, they would represent a consensus as to the amount of debt that can be safely accommodated in light of demand variation, competition, product changes and other elements which have a direct bearing on income fluctuation.

Obviously, the proposed schedules, since they would be based on mean figures, would have to contain some provision for variations from the norm in any particular case. Here, a statistical standard deviation process could be used. Thus, any company whose debt content fell within the range prescribed would be unchallenged, provided that there was no other indication that a genuine debtor-creditor relationship was not intended.

In the case of a capital structure whose debt content exceeded the regulatory debt limit, the taxpayer should be given the opportunity to present evidence showing conclusively that its particular capital structure was within the bounds of substantial economic reality. Thus, the burden of proof would be on the taxpayer to show that unusual external business conditions justify what would normally be an excessive debt structure. For example, a corporation may be able to show that in the geographical area in which it operates the demand for its type of product is significantly more stable in comparison to the overall industry demand. Such a factor could favorably affect income stability, thus making it economically feasible to carry a greater proportion of debt. Here again, it is important to note that any company attempting to show that it should not be judged by the regulatory standard must show that within its area of operations, objective conditions materially vary with those experienced by the majority of the others in the industry. Were the statute to allow certain corporations to be afforded special treatment because of unusual internal conditions, or where external conditions varied only slightly from the ordinary, the very purpose of the guidelines, i.e., to provide the Commissioner with readily applicable objective standards, would be defeated.

Finally, one other suggestion should be considered. Historically, in debt-equity cases, the courts have either found all of the loan to be equity or all of it to represent stockownership. Rarely have the cases allowed part of

between stock and debt is better expressed as a percentage rather than as a ratio. The permissible debt-equity percentages could be established as guidelines in a manner similar to depreciation guidelines. 1962-2 Cum. Bull. 419-28.


the advanced funds to be considered debt and the remainder stock. As a result, the taxpayer came out of court either a total winner or a total loser. The proposed guidelines should, therefore, contain provisions whereby a taxpayer whose capital structure is excessive would be allowed to treat at least part of its borrowed funds as debt for tax purposes. Anything over that which the Treasury guidelines considered a reasonable amount of debt would then be regarded as equity. Such an approach seems infinitely more fair than the present all-or-nothing method.

In applying the approach to a particular case, the Internal Revenue Service would initially compare the taxpayer's capital structure to the appropriate regulatory norm. Upon ascertaining that a corporation had not exceeded the limits set forth by the guidelines, the taxpayer would then be allowed to deduct all interest payments. This presumes, however, that there were no other factors present which would tend to indicate to the Commissioner that a true debtor-creditor relationship was not intended.

If the taxpayer's debt structure proved to be excessive, he would then be given the opportunity to show that external factors within its area of operations were so materially different from those faced by the rest of the industry that the industry's norm should not be applied to it. It would then be the Commissioner's task to see if the level of debt was economically reasonable in light of these unique factors.

117. There have been a few cases in which stockholder advances have been allocated between debt and equity for tax purposes but the majority of these have dealt with situations in which the advances were made at various times and thus easily segregated. Arnold v. Phillips, 117 F.2d 497 (5th Cir. 1941) (bankruptcy); Bijou-Pensacola Corp. v. United States, 172 F. Supp. 309 (N.D. Fla. 1959) (tax refund); J. Terry Huffstutler, 12 CCH Tax Ct. Mem. 1422 (1953) (bad debt deductions); George J. Schaefer, 24 T.C. 638 (1955) (bad debt deductions). See Mill Ridge Coal Co. v. Patterson, 58-1 U.S. Tax Cas. 68316 (N.D. Ala. 1958) (operating losses) where $296,756.70 in advance was apportioned between debt and equity.

118. "It is unjust to strike down the entire indebtedness of a corporation inadequately capitalized where a smaller debt would have been recognized if the stockholders were not so ambitious in establishing a favorable tax structure. If the quantitative method of determining inadequate capitalization is adopted, it will be a simple procedure to allow as an indebtedness that portion of the indebtedness in excess of the capital recognized as essential." Semmel, Tax Consequences of Inadequate Capitalization, 48 Colum. L. Rev. 202, 217-18 (1948).

119. If there is a doubt as to the relationship in resolving the question, primary attention should be given to the debt instruments involved. Here the traditional tests (supra pp. 240-45) should be used, with the greatest weight being given to whether the instrument contained an unconditional promise to repay the entire loan by a fixed date and some provision for the payment of interest before maturity without regard to the sufficiency of the debtor's earnings. Any instrument containing these last enumerated factors should be almost invariably regarded as objective evidence of a debtor-creditor relationship. Only in situations where other factors strongly indicate an equity relationship, as in the case of the alleged creditor being given the right to participate in the every day management of the corporation, should these essential elements be given less weight. As indicated before, it does not appear that subordination in general should be considered a strong factor indicative of equity. Supra pp. 244-45.