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Stock or Debt—That Is the Question

Albert A. De Stefano
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ALBERT A. DE STEFANO†

"Consider what you think justice requires and decide accordingly. But never give your reasons; for your judgment will probably be right, but your reasons will certainly be wrong."¹

Had the courts, faced with the problem of deciding whether certain instruments represented debt or equity, heeded the foregoing admonition, there could hardly have been more confusion than exists today. A veritable Tower of Babel confronts the practitioner in his attempts to obtain from previously decided cases a sound basis for future action.² The picture has been further clouded by the emergence and apparent ready acceptance by the courts of the "thin corporation" concept.³ The end result is a situation which might with charity be described as "confusion confounded".

THE PROBLEM

The utilization of credit rather than equity financing in the arrangement of the financial structure of a corporation affords certain very definite tax advantages. A consideration of these tax savings makes understandable the Commissioner's strenuous and in many instances successful efforts to have the indebtedness considered, for tax purposes, a contribution to capital.

The most apparent saving would result from the allowance to the corporation of a deduction from gross income for the interest paid or accrued on such indebtedness.⁴ On the other hand were the advances held to be capital contributions then the amount paid on such investments would be dividends and therefore not deductible by the corporation.⁵ Parenthetically, it should be noted that while individuals would be accorded like tax treatment on the

† Member of the New York Bar.


2. One need go no further to demonstrate this than the leading case of John Kelley Co. v. Commissioner, 326 U. S. 521 (1946), in which the Supreme Court allowed a deduction in the Kelley case and refused to allow a deduction in the companion Talbot Mills case. While it is true that the Supreme Court's decision was based on the Dobson principle, that the factual determinations of the Tax Court must stand, (Dobson v. Commissioner, 320 U. S. 489 (1946)), the acid dissent at p. 534 of Justice Rutledge is worthy of note: "When no facts can be pointed to which are sufficient to distinguish Tax Court decisions in legal effect, except that the Tax Court has decided differently in two cases, the Court of Appeals and we are bound by law and by our duty to exercise a sound discretion in review to resolve the conflict." See comment on the case in 44 Mich. L. Rev. 827 (1946). See also Section 1141 (a) of the Internal Revenue Code and note its effect on the Dobson rule. 2 RABKIN AND JOHNSON, FEDERAL INCOME GIFT AND ESTATE TAXATION, 3936.

3. A view which condemns as an inherent vice the inadequate capitalization (when compared to debt structure) of a corporation.

4. INT. REV. CODE § 23 (b).

5. 1432 Broadway Corp., 4 T. C. 1158 (1945), aff'd 160 F. 2d 885 (2d Cir. 1947); Charles L. Huisken & Co., 4 T. C. 595 (1945); Pacific Southwest Realty Co., 45 B. T. A. 426 (1941), aff'd, 128 F. 2d 815 (9th Cir. 1942).
receipt of the distributions, be they dividends or interest, the corporate-
recipient would, because of the 85% dividends paid credit, fare better if the
distributions were held to be dividends.6

Another form of savings that is contemplated in the use of a debt structure,
is the tax-free bailing out of corporate earnings and profits, accomplished by
the repayment by the corporation to the debtor of part of the obligation due
and owing.7 However, the grave danger in this situation is that if the securities
be held to be stock rather than debt, their redemption might easily fall within
the purview of Section 115 G of the Internal Revenue Code and be treated as
“essentially equivalent to the distribution of a taxable dividend.”8

While the foregoing considerations are usually paramount, it should be
noted that the use of corporate evidences of indebtedness instead of stock
makes for certain other tax benefits.9 Thus it may also make possible the
accumulation of corporate earnings and profits in spite of the in terrorem
clause of Section 102 of the Internal Revenue Code which penalizes the
unreasonable accumulation of surplus by a corporation for the purpose of
avoiding surtax on the stockholders.10 Further, the determination as to whether
a security is a stock or bond can have important consequences in determining
the amount of deduction allowance in the event of worthlessness11 or in the
proper classification of a corporate entity.12

6. Section 26 of the Internal Revenue Code provides: “In the case of a corporation
the following credits shall be allowed to the extent provided in the various sections im-
posing tax—

“(b) Dividends received—85 per centum of the amount received as dividends from a
domestic corporation which is subject to taxation under this chapter, but not in excess
of 85 per centum of the adjusted net income. . . .”

7. There is a paucity of cases on this phase of the problem. However, in Charles F.
Witt, B. T. A., Docket No. 51595, Dec. 16, 1932, in which this problem was squarely
raised, the court said: “We hold, therefore, that the value of the assets in excess of the
par value of stock issued in exchange therefore, viz. $37,155.36, was a loan or advance
to the corporation by petitioner and that the repayment thereof by the corporation did
not constitute taxable income to the petitioner.” Cf. Curran v. Commissioner, 49 F. 2d 129
(8th Cir. 1931); Benjamin J. Schiff, 3 B. T. A. 640 (1926).

8. Thus, where as part of a recapitalization plan, a corporation issued a note for
$80,000, it was held that payments on the note were “essentially equivalent to the dis-
tribution of a taxable dividend.” Emil Stein, 46 B. T. A. 135, 139 (1942). See also
George P. Dickey, 10 P-H Mem. B. T. A. § 41,336 (1941); W. T. Wilson, 10 T. C. 251
(1948).

9. See Kaufman, Income Tax Consequences of Corporate Debentures, in 7th Annual

properly accumulated . . . if in accordance with contract obligations placed to the credit
of a sinking fund for the purpose of retiring bonds issued by the corporation.”

11. If the bad debt is not represented by evidences of corporate indebtedness with
interest coupons or in registered form and is incurred in the taxpayer’s trade or business;
it would be fully deductible. Int. Rev. Code § 23 (k). On the other hand, worthless
stock is treated as the same as a loss from the sale or exchange of a capital asset. Int.
Rev. Code, § 23 (g).

12. Thus if corporate indebtedness be considered stock, the corporation might then
The Hybrid Security

The attempt to achieve these benefits and at the same time eschew the accompanying obligations and impairment of credit status resulting therefrom, has culminated in the use of a security having the characteristics of both stock and debt. The very hybrid nature of these securities foreshadowed the difficulties that would confront the courts.

The question as to whether a hybrid security is to be treated as a stock or a bond must of necessity depend on the facts and circumstances involved in each case. For that reason none of the decided cases lay down any comprehensive rule which can be used as a yardstick. On the contrary many factors are called into consideration: sometimes a particular one is held controlling; on other occasions a combination of factors has swayed the balance.

An examination of some of the factors singled out will serve to indicate the perplexity of the problem:

1. Fixed Maturity Date. A fixed maturity date on which the holder of the security may demand payment of the obligation has been held to be the most significant feature of a debtor-creditor relationship. Thus in holding that payments designated as interest were not deductible as interest paid, the Tax Court pointed out in Industrial Addition Association v. Commissioner:

"There is, thus, an entire absence here of the most significant, if not the essential feature of a debtor and creditor as opposed to a stockholder relationship, the existence of a fixed maturity for the principal sum with the right to force payment of the sum as a debt in the event of default."

It should be noted, however, that the mere existence of a fixed maturity date is not conclusive.

2. Book Entries and Nomenclature. While neither the name given nor the treatment accorded the securities on the corporate books are decisive, these factors are relevant and courts have been influenced by them.

13. See note 16 infra and accompanying text.
14. "In respect of a question such as we have here, 'many are the criteria named to aid in the determination...'." John Wanamaker Philadelphia, 1 T. C. 937, 944 (1943), aff'd, 139 F. 2d 644 (3d Cir. 1943).
17. Verifine Dairy Products Corp., 3 T. C. 269 (1944); Petit Anse Co., 13 P-H Mct. T. C. § 44, 370 (1944), aff'd, 155 F. 2d 797 (5th Cir. 1946). This is of course especially true where the state law permits a maturity date to be fixed for preferred stock. Commissioner v. Meridian & Thirteenth Realty Co., 132 F. 2d 182 (7th Cir. 1942) reversing 44 B. T. A. 865 (1941).
18. Thus in Commissioner v. O. P. P. Holding Corp., 76 F. 2d 11, 13 (2d Cir. 1935), the court said: "The petitioner urges that the name given to an instrument is not controlling, but that its inherent characteristics will determine its true nature and legal effect. This may be conceded, but it does not follow that the name by which the certificates
3. Management. In a case in which the payments on guaranteed stock were held dividends and not interest, the court, after a consideration of several other factors, noted:

"There was participation in management since the certificate holder was to 'enjoy all priority as to voting privileges.' This criterion is not usually found in certificates of indebtedness."10

However, the mere presence of voting rights is not conclusive but must be considered in conjunction with all the other factors.20

4. Payment Only Out of Net Earnings. Such a restriction would seem to indicate that the payments are dividends, for a true creditor would be entitled to the payment of interest whether or not the corporation had earnings. While most of the cases so hold,21 there are decisions which have held to the contrary.22 Thus in S. Glaser & Sons, Inc., the court stated:

"... the feature that interest was to be paid annually to the extent of the available net earnings did not prevent the instrument from being a debenture."23

5. Subordination to Claims of Creditors. The weight accorded by the courts to the fact that securities have been subordinated to general creditors has varied. Thus in one case the court said:

"The fundamental basis for our conclusion that these securities are more nearly like preferred stock than indebtedness is the fact that the debentures are unsecured and are subordinated to the claims of all creditors of the petitioner and the payment of interest is not absolute."24

In another case, the court stated flatly:

are designated is to be completely ignored. Stocks and bonds both evidence a contract between their holders and the issuing corporation, and, in construing this contract, the language used in reducing it to writing will be indicative of the intention of the parties."19


21. In Bakers' Mutual Cooperative Ass'n, 40 B. T. A, 656, 663 (1939), aff'd, 117 F. 2d 27 (3d Cir. 1941), the court holding that the amounts distributed were dividends and did not constitute interest paid on borrowed money, pointed out: "It will be noted that the certificate holder was 'to share in the profits as declared in said by-laws.' This provision of the certificates was always complied with; and, if there were no profits the association was not obligated to make, and actually did not make, any payments for the use of money. Clearly there was no contract under which 'compensation was to be paid by the borrower of money to the lender for the use.'" Green Bay & W. R.R., 3 T. C. 372 (1944), aff'd, 147 F. 2d 585 (7th Cir. 1945); Pacific Southwest Realty Co., 45 B. T. A. 426 (1941), aff'd, 128 F. 2d 815 (9th Cir. 1942).


"That the debentures are subordinate to claims of general creditors is not fatal to the status of the holders thereof as creditors."25

6. Right to Share in the Profits. Where a security gives the holder the right to share in the profits, it is difficult to spell out anything other than a stockholding relationship.26

Other factors have also been considered by the courts.27 However, it is felt that the foregoing summary of the more general criteria is indicative of the inconclusive nature of the decisions in this field. The best one can do is keep abreast of the latest decisions involving hybrid securities to ascertain which way the pendulum is swinging in evaluating the importance and weight to be given the respective criteria.

The recent decision by the Court of Appeals of the 10th Circuit in the case of Bowersock Mills & Power Co. v. Commissioner28 merits special attention. In this case, the taxpayer in order to strengthen its bank credit entered into a contract with a trustee, which held the taxpayer's bonds in the amount of $550,000. The taxpayer procured the release of these bonds by the authorization and issuance to the trustee of 6,000 shares of preferred stock containing the usual provisions of stock of that class. The stockholders of the taxpayer then entered into a second contract with the trustee, under which they guaranteed the interest dividends, and provided for the obligations of the stock in definitely fixed amounts on definitely fixed days, and in default of either or both, the so-called preferred stockholders became owners of the corporation. The Tax Court, in deciding that the so-called interest was in fact dividends, held that the second contract was not relevant and, using the accepted criteria, pointed out: that the contract referred to the obligation as preferred stock on which dividends were payable only out of net earnings; that there was no maturity date on the stock and that the preferred stockholders were entitled to limited voting rights—all of which were indicia of stock ownership rather than indebtedness.29 The Court of Appeals reversed the Tax Court, holding that the two contracts must be construed together and when so considered their purpose and legal effect is not to change the substance of the original

26. Bonds Inc., 13 P-H MEM. T. C. § 44,561 (1944); Bakers' Mutual Cooperative Ass'n, 40 B. T. A. 656 (1939), af'd, 117 F. 2d 27 (3d Cir. 1941); Hale-Justis Drug Co., 13 P-H MEM. T. C. § 43,219 (1943). Cf. Richmond, F. & P. R.R., 33 B. T. A. 893 (1930), in which the court after noting at 899 that the stockholder "... was entitled to a share in the petitioner's net earnings after the payment of its current liabilities . . . .", decided that no stockholding relationship existed. This decision was affirmed in 90 F. 2d 971 (4th Cir. 1937).
27. Debt allocated in same proportion as stock ownership; the consideration for the debentures; the limitation of creditors' remedies; the right to sue in the event of default. See also IV MERTENS, LAW OF FEDERAL INCOME TAXATION § 26.10 (1942). In this connection, it should be noted that "intent" is also spoken of as a criterion. This is hardly the case, for the criteria are objective means by which the courts decide whether the intention was to form a debtor-creditor or stockholding relationship.
28. 172 F. 2d 904 (10th Cir. 1949).
transaction, but merely to change it in form in order to subordinate it to
general bank credit.

The court in support of its position said:

"The bundle of rights which the stockholders held by virtue of the two contracts
preserved unto themselves all of the rights which they possessed as bondholders,
except their agreement to become subordinate to operating credit. We do not
suppose that a first mortgagee loses his status as a creditor because he elects to
subordinate his security to other indebtedness on condition that if his indebtedness is
not paid when due, he thereby automatically becomes the owner of the mortgaged
property, subject to the intervening indebtedness. We think the situation is not
materially different here."30

While it does not appear that the Commissioner has appealed as yet from
the adverse holding in the Bowersock case, the importance of the case and
the likelihood of an appeal warrant conjecture as to the result in that event.
One might well argue that affirmation of this decision by the United States
Supreme Court upon the grounds urged by the majority should sound the
death knell to much of the current practice of employing hybrid securities.
For after all, the raison d'etre of a hybrid security in many of the situations
is "to subordinate it [the security] to general bank credit,"31 and at the same
time secure the advantages accruing to indebtedness. If the taxpayer in the
Bowersock case is successful in accomplishing this end by utilizing two securi-
ties instead of one, this would appear the far more preferable way for closely
held corporations to achieve the desired results.

However one may agree with the emphasis properly placed by the court
on "intention", it is doubtful, in view of the present composition of the United
States Supreme Court, that the decision will stand. Rather it is felt that the
learned Justices will find a more kindred spirit in the approach eloquently
typified by this vigorous language in the dissent:

"The company likewise was willing to abolish the debtor-creditor relationship and
substitute a stockholder relationship instead for the credit benefits which would result.
Having received these benefits which followed the establishment of the stockholder
relationship and after having obtained the credit it needs, it then wants to lay
aside this cloak and again enshroud itself in the garb of a debtor when it comes
time to file its income tax return. This, it may not do. No one has yet been able
to devise a scheme by which one may eat his cake and yet have it."32

BUSINESS PURPOSE—THE "THIN CORPORATION"

Section 23b of the Internal Revenue Code allows as deductions in com-
puting net income "all interest paid or accrued within the taxable year on
indebtedness."33

The lack of uniformity in the cases in which the courts were called on to
decide whether a particular security, purposely camouflaged to resemble both
debt and equity, was an "indebtedness" within Section 23, is easily under-

30. 172 F. 2d 904, 908 (10th Cir. 1949).
31. Id. at 906.
32. Id. at 910.
standable. Similarly, little fault can be found with the court's refusal to allow
deductions where the indebtedness represented by the debenture is a sham
indebtedness. On the other hand, the corporate business purpose doctrine and
its corollary, the "thin corporation", are not easily gleaned from a mere
examination of the statute.

A literal interpretation of the pertinent sections of the Internal Revenue
Code would certainly support the position that given a bona fide debt the
deduction should be allowed. This would seem especially true since Congress
has specifically singled out transactions involving single premium insurance and "related taxpayers" as those in which the broad scope of Section 23b
should be restricted. However, the Commissioner has and is still urging that
debentures should be considered stock because the purpose of their issuance
was a stockholder rather than a corporate business purpose. The courts have
properly rejected this contention and held that if the indebtedness created
was a real as distinguished from a sham indebtedness then, in the absence of
other controlling factors, the deduction must be allowed.

Thus in the recent case of Cleveland Adolph Mayer Realty Corporation, the Commissioner again advanced the corporate business purpose argument. Rejecting the applicability of this concept, the court succinctly stated:

"We have no such question before us in this proceeding. . . . Our question is
merely whether the debentures which were issued by the petitioner constituted
indebtedness of the petitioner. . . ."

33. This is one situation where there is no room for disagreement, for all courts recognize that Section 23(b) permits only the deduction of genuine interest on a real indebtedness.


35. Section 24(a)(6) of the Internal Revenue Code provides: "GENERAL RULE. In computing net income no deduction shall in any case be allowed in respect of . . . . Any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance or endowment contract. For the purposes of this paragraph, if substantially all the premiums on a life insurance or endowment contract are paid within a period of four years from the date on which such contract is purchased, such contract shall be considered a single premium life insurance or endowment contract. . . ."

36. "UNPAID EXPENSES AND INTEREST. In computing net income no deduction shall be allowed under section 23(a), relating to expenses incurred, or under section 23(b), relating to interest accrued.

"(1) If such expenses or interest are not paid within the taxable year or within two and one half months after the close thereof; and

"(2) If, by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not, unless paid, includible in the gross income of such person for the taxable year in which or with which the taxable year of the taxpayer ends; and

"(3) If, at the close of the taxable year of the taxpayer or at any time within two and one half months thereafter, both the taxpayer and the person to whom the payment is to be made are persons between whom losses would be disallowed under section 24(b)."


38. 6 T. C. 730 (1946), rev’d on other grounds, 160 F. 2d 1012 (6th Cir. 1947).

If any "business purpose" test should be employed in these cases, it is submitted that a proper application of such a test was suggested in a dictum in the recent case of *O'Neill v. Commissioner*. The test should be directed not to the purpose underlying the indebtedness, but rather the purpose underlying the corporation. Thus, if the corporate-debtor has a business purpose and the indebtedness be bona fide, the deduction should be allowed. As Judge Chase stated:

"For, ordinarily, this intent to make the advances as loans would fix their status as such. . . . But that presupposes that the borrower, if a corporation, serves some business purpose substantial enough to make it for tax purposes something more than another name for the lender." and further on:

"The decisive question is whether the corporations were created to, or did, in fact, serve a recognizable business purpose. If so, the same tax consequences would flow from the petitioner's dealings with them as if they were not owned and controlled by him. . . ."

However, when we approach the concept of the inadequately capitalized or "thin corporation", we find the courts in a much more hospitable mood to the contention of the Commissioner. While the legislative history of Section 23b is not within the scope of this paper, attention should be directed to the fact that Congress had in earlier revenue acts set specific limits to the amount of corporate indebtedness cognizable for tax purposes. Whether this may in part afford a rationale for the ready acceptance by the courts of the "thin corporation" concept, despite the fact that basically the concept of in-
adequate capitalization is in its overall aspect merely another facet of the business purpose argument, it is, nevertheless, true that the "thin corporation" attack by the Commissioner has received a far more cordial treatment from the courts.44

The Supreme Court itself has indirectly indicated its acceptance of the inadequate capitalization argument:

"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."45

Thus in the Swoby Corporation case, the taxpayer corporation acquired real estate from the shareholders in exchange for a single 99-year "Income Debenture" of $250,000 and 200 shares of stock having a par value of $1.00 per share. In deciding that the interest paid was not deductible by the corporation, the court emphasized the Supreme Court's admonition:

"That court takes occasion to issue what we cannot but view as a warning when it notes 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.' (321 U.S. at 526) (sic 326 U.S. at 526). The necessity excluded there we cannot now avoid. Dealing with property having a stipulated value of 'at least $250,200', the financing selected was to create a clearly 'nominal' figure of $200 in the common stock and 'an obviously excessive debt structure' of $250,000 in the debenture. This evokes a factor evidently regarded as significant by the Supreme Court, which, unlike either the Talbot Mills or Kelley Co. cases, tends to justify the respondent's treatment."46

The cases that have considered this problem of inadequate capitalization have laid down no general rule, but rather have been content for the most part to state that certain debt ratios were excessive and others were not.47

The effect of the decision in the O'Neill case on this problem must await subsequent decisions. However, it is worthy of note that the Tax Court in the O'Neill case did state that "Advances made by the sole stockholder of a corporation having insufficient capital for ordinary activities have been held, with other facts, to constitute loans."48 While this statement has been critically


46. 9 T. C. 887, 893 (1947). It should be noted that the excessive debt ratio in this case was considered as one of the important factors to be considered, in conjunction with the other criteria heretofore discussed.

47. Held excessive — 1250 to 1 (Swoby Corp., 9 T. C. 887 (1947)); 29 to 1 (Mullin Building Corp., 9 T. C. 350 (1947), aff'd, 167 F. 2d 1001 (3d Cir. 1948)). Held not excessive — 4.8 to 1 (Anderson Corp., 5 T. C. Mem. 392 (1946)); 2.33 to 1 (Cleveland Adolph Mayer Realty Corp., 6 T. C. 730 (1946), rev'd on other grounds, 160 F. 2d 1012 (6th Cir. 1947)).

graded condonation of inadequate capitalization", it cannot be denied that in his opinion Judge Chase inferentially indicated that had the corporations been bona fide organizations having legitimate business purposes, the loans would have been recognized.

Since no criteria have been laid down in those cases in which inadequate capitalization has been the consideration, the question arises as to whether any criteria can effectively achieve a just solution. The suggestion has been made that a quantitative test should be applied, i.e., the determination as to whether the debt structure is excessive should depend on the percentage of the entire contribution which consists of debt. While this approach has, once a definite percentage is ascertained, the practical advantage of certainty, it is difficult, if not impossible, to find any authority for such an approach within the confines of the Internal Revenue Code. Further there can hardly be any doubt that such a solution would result in grave inequities. Another proposal has been the qualitative approach, which would determine a capital structure adequate or inadequate depending on whether it is sufficient and sound economically to run the business contemplated. Each case would, therefore, become a measure unto itself, and while the results would be far more equitable than would be achieved by a quantitative approach, it would hardly contribute to certainty in the law. This same objection can be levied at the proposals which would determine that advances were capital contributions, if the corporation could not have borrowed from informed sources, and conversely debt, if the loans could have been negotiated. This view would appear to be skirting the proposition, advanced by at least one authority, that basically the debt ratio is merely evidentiary, bearing upon intent or the genuineness of the debt.

**CONCLUSION**

Debt or stock? The question still remains an open one. In view of the factual nature of the problem and the varying judicial opinions on the subject, no general rule having real value can be set forth. It may be hoped that the

51. This treatment actually introduces us to the *Deep Rock* doctrine which has developed in the bankruptcy field and is now exerting its influence in the tax field. The *Deep Rock* doctrine formulated in the case of Taylor v. Standard Gas & Electric Co., 306 U. S. 307 (1939), subordinates loans and advances to the claim of creditors, where it is felt the corporation was not properly financed. Thus in Pepper v. Litton, 308 U. S. 295, 309 (1939), the Court in a bankruptcy proceeding by way of dictum said: "And so-called loans or advances by the dominant or controlling stockholder will be subordinated to claims or other creditors and thus treated in effect as capital contributions by the stockholder . . . where the paid-in capital is purely nominal, the capital necessary for the scope and magnitude of the operations of the company being furnished by the stockholder as a loan." It would not be too surprising to find this quotation used by a Tax Court seeking additional authority to sustain its view that the loans and advances to an inadequately (according to the court's standards) capitalized corporation should be regarded as capital contributions.
52. Kaufman, *supra* note 9, at 1027.