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INCOME TAX CONSEQUENCES OF CORPORATE DEBENTURES

CHARLES L. KAUFMAN*

The capitalization of a corporation frequently presents problems of business and finance, the solution of which should be governed by considerations wholly apart from a desire to minimize taxes. Nothing—not even taxes—should interfere with the pursuit of a policy which is calculated to meet the corporation's needs and to keep it healthy. But the corporate executive has both the right and the duty to weigh and consider the tax consequences, in reaching every major decision on matters respecting which alternative courses of action are available.

The use of debentures to obtain needed capital may be prompted or necessitated by one or more of a variety of factors not related to taxation. The need for capital may be only temporary. The payment of a fixed interest rate may leave a greater portion of the earnings available for the common stockholders. The condition of the investment market may render it impracticable or impossible to acquire the capital, except through the creation of debt. The issuance of stock may cause an undesirable dilution of the interests of existing stockholders, or loss of their control. Where the corporation is dependent upon its stockholders for financial assistance—as is often true in the case of small corporations—they may demand a security with a fixed maturity and interest rate, either because of their needs, or their desire to limit the risk and exposure involved.¹ On the other hand, sound financial policy might preclude the use of debentures, because the corporation's credit might be thereby impaired or because the corporation's earnings are so uncertain that it should not be burdened with the obligation of making fixed interest payments.²

Through the use of debentures, a substantial tax saving may accrue to the corporation. This does not mean, however, that there will necessarily be a net over-all tax saving to the stockholders, because the re-

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¹See 19 Fletcher, *Cyclopedia Corporations* (Perm. ed. 1940) § 9073; Husband and Thomas, *Principles of Accounting* (1935) 440-441.

²See Dewing, *Corporation Finance* (1931) 56.

duction in the corporation's income tax may be wholly, or at least partially, offset by the intangible personal property tax which the stockholders may be required to bear. For instance, Virginia residents must pay a tax on debentures and other evidences of debt in an amount equal to one-half per cent of the fair market value thereof, whereas no such tax is assessable on stock. But this article will be concerned only with the federal income tax aspects of debentures.

To illustrate the corporate tax saving which results from the use of debentures, let us assume that X-Corporation, at the time of its organization, requires one million dollars, and that it issues \$500,000 common stock and \$500,000 4% debentures. Inasmuch as the Internal Revenue Code³ allows as a deduction in computing net income "all interest paid or accrued within the taxable year on indebtedness," X-Corporation will have an annual interest deduction of \$20,000.00 in determining its income tax liability.

Implicit in the statutory sanction is the mandate that what is deducted must be "interest," and that such interest must have been paid or accrued on an existing "indebtedness." The Commissioner's regulations, accordingly, sound an appropriate warning: "So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income."⁴ It has been frequently desired to avoid the financial disadvantages of bonds, but to obtain advantage of the interest deduction. As a result, many hybrid securities, possessing some attributes of bonds, some of stock, have been created, and a lot of litigation has ensued.

Bonds or Stock?

Stated broadly, the question of whether such securities are to be treated as bonds or stock is one of substance and of fact, the answer to which is dependent upon all the circumstances.⁵ As in most tax cases, the Commissioner is aided by the burden which is imposed upon the taxpayer of proving the so-called interest payment to be in fact "interest"

³Section 23(b).

⁴Regulations 111, § 29.23(b)-1.

⁵See *Cleveland Adolph Mayer Realty Corp.*, 6 T. C. 730 (1946), rev'd on another issue, 160 F. (2d) 1012 (C. C. A. 6th, 1947); *Edward G. Janeway*, 2 T. C. 197 (1943), aff'd 147 F. (2d) 602 (C. C. A. 2d, 1945); *Com'r v. Schmoll Fils Associated, Inc.*, 110 F. (2d) 611 (C. C. A. 2d, 1940); *Com'r v. Proctor Shop*, 82 F. (2d) 792 (C. C. A. 9th, 1936); Mertens, *The Law of Federal Income Taxation*, § 26.09. With respect to the applicability of the same principle to corporate law in general it has been said: "The fact that an instrument is called a bond is not conclusive as to its nature, but regard must be had to the substance of the instrument." *Fletcher, op. cit. supra*, § 2635.

upon an "indebtedness."⁶ Since, then, each case must rest on its own facts, it is not surprising to find a multitude of cases on the subject.⁷ In a leading case it was said: "Precedents are abundant, but because of the widely-varying fact bases upon which the conclusions are reached, they serve only as guides. Many are the criteria named to aid in the determination. Sometimes a particular one is called decisive,—or the most important test,—sometimes a combination of the elements sways the determination."⁸

In the last three years approximately twenty-five cases of "interest versus dividend" have been decided. In about sixty percent thereof the Commissioner's disallowance of the deduction was upheld. Those cases, as well as some of the earlier ones, emphasize the importance of the following criteria:⁹

1. Fixed maturity date. This is probably the most important ingredient of a debenture, if it is to come within the ambit of indebtedness. Ordinarily, there must be a fixed maturity date on which the holder can demand payment of the obligation.¹⁰ However, the existence of a fixed maturity date will not necessarily assure classification of the security as indebtedness.¹¹ Moreover, the security may be treated

⁶See, e.g., *Texas Drivurself System, Inc.*, T. C. Memo. Op., Docket No. 112159, Mar. 31, 1944.

⁷References herein are confined to a few of the older, leading cases and the more recent cases, especially those decided in 1945 and later years. All the authorities are collected in Mertens, op. cit. supra, §§ 9.24 and 26.10.

⁸*Com'r v. Meridian & Thirteenth R. Co.*, 132 F. (2d) 182, 185 (C. C. A. 7th, 1942).

⁹Professor Mertens sets out ten principal considerations. Briefly they are: intent of the parties; nomenclature; a fixed maturity date; preference as to payment of interest and principal at maturity; whether voting powers are granted holders; whether security bears a fixed rate of interest; redemption or retirement provisions; unconditional obligation to pay; whether redeemable at election of holder; amount of risk involved. Mertens, op. cit. supra., § 26.10.

¹⁰See *Pottstown Finance Co., Inc. v. U. S.*, 73 F. Supp. 1011 (E. D. Pa. 1947); *Bowerstock Mills & Power Co.*, T. C. Memo. Op., Docket No. 9186, Oct. 16, 1947; *Mullin Bldg Corp.*, 9 T. C. . . . No. 52, Sept. 16, 1947, aff'd *Mullin Bldg. Corp. v. Com'r of Internal Revenue*, 167 F. (2d) 1001 (C. C. A. 3d, 1948); *Texas Drivurself System, Inc.*, supra, n. 6; *Brown-Rogers-Dixson Co. v. Com'r*, 122 F. (2d) 347 (C. C. A. 4th, 1941); *Com'r v. Schmoll Fils Assoc'd, Inc.*, supra, n. 5. Cf. 250 *Hudson St. Corp.*, T. C. Memo. Op., Docket No. 7468, Aug. 9, 1946; *Cleveland Adolph Mayer Realty Corp.*, supra, n. 5; *Com'r v. H. P. Hood & Sons*, 141 F. (2d) 467 (C. C. A. 1st, 1944); *Chas. Olson & Sons, Inc.*, T. C. Memo. Op., Docket No. 109980, Nov. 10, 1942; *Com'r v. Proctor Shop*, supra, n. 5; *Com'r v. O. P. P. Holding Corp.*, 76 F. (2d) 11 (C. C. A. 2d, 1935).

¹¹E.g. 1432 *Broadway Corporation*, 4 T. C. 1158 (1945), aff'd 160 F. (2d) 885 (C. C. A. 2d, 1947); *Com'r v. Meridian & Thirteenth R. Co.*, supra, n. 8. The fact that the existence of a definite maturity date is not alone controlling may be considered settled in view of the decision in *Talbot Mills v. Com'r*, 3 T. C. 94, aff'd 146 F. (2d) 809, 326 U. S. 521, 66 S. Ct. 299, 90 L. ed. 278 (1946).

as an indebtedness even in the absence of a fixed maturity date.¹²

2. Nomenclature. Calling the securities "debentures" is merely another factor in favor of the taxpayer. Where the securities have not been so named, the deduction has been disallowed.¹³ Where, however, the securities have been called debentures, the deduction has been both allowed¹⁴ and disallowed.¹⁵

3. Subordination to rights of others creditors. Where the rights of the debenture holders have been subordinate to those of general creditors, the deduction has been both allowed¹⁶ and disallowed.¹⁷ In a leading case decided by the Second Circuit, it was held that it was not fatal to the debenture holder's status as a creditor that his claim was subordinate to those of general creditors: "The fact that ultimately he must be paid a definite sum at a fixed time marks his relation to the corporation as that of creditor rather than shareholder. The final criterion between creditor and shareholder we believe to be the contingency of payment. The shareholder is entitled to nothing, prior to liquidation, except out of earnings. . . . These debenture bondholders were not so limited. The interest could be . . . collected . . . from the corpus . . ."¹⁸ But in a later case, the Tax Court stated that one "fundamental basis for our conclusion that these securities are more nearly like preferred stock than indebtedness is the fact that the debentures . . . are subordinated to the claims of all creditors . . ."¹⁹ In an unusual case, decided by the Fourth Circuit, where the rights of the debenture holders were preferred over the rights of other creditors, even though there was no fixed maturity date, the deduction was allowed.²⁰

4. Interest. If so-called interest is payable irrespective of earnings, it is manifest that the securities more nearly resemble debentures than

¹²*Helvering v. Richmond, F. & P. R. Co.*, 90 F. (2d) 971 (C. C. A. 4th, 1937). Similarly, to the effect that the maturity date may be postponed, see *Cleveland Adolph Mayer Realty Corp.*, supra, n. 5.

¹³*Bowersock Mills & Power Co.*, supra, n. 10; *Mullin Bldg. Corp.*, supra, n. 10.

¹⁴*250 Hudson St. Corp.*, supra, n. 10; *Chas. Olson & Sons, Inc.*, supra, n. 10; *Com'r v. O. P. P. Holding Corp.*, supra, n. 10.

¹⁵*Swoby Corp.*, Docket No. 10284, Oct. 31, 1947; *Chas. L. Huisking & Co.*, 4 T. C. 595 (1945); *Com'r v. Schmoll Fils Assoc'd, Inc.*, supra, n. 5.

¹⁶*Com'r v. H. P. Hood & Sons*, supra, n. 10; *Com'r v. Proctor Shop*, supra, n. 5; *Com'r v. O. P. P. Holding Corp.*, supra, n. 10.

¹⁷*Swoby Corp.*, supra, n. 15; *Pottstown Finance Co., Inc. v. U. S.*, supra, n. 10; *Mullin Bldg. Corp.*, supra, n. 10; *Chas. L. Huisking & Co.*, supra, n. 15; *The Humko Co., T. C. Memo. Op.*, Dockets No. 112235, 79, Dec. 11, 1943; *Com'r v. Schmoll Fils Assoc'd, Inc.*, supra, n. 5.

¹⁸*Com'r v. O. P. P. Holding Corp.*, supra, n. 10, at p. 12.

¹⁹*Chas. L. Huisking & Co.*, supra, n. 15, at p. 599; see, also, *Com'r v. Meridian & Thirteenth R. Co.*, supra, n. 8.

²⁰*Helvering v. Richmond, F. & P. R. Co.*, supra, n. 12.

stock. Nevertheless, the cases disclose that, in such a situation, the deduction has been allowed²¹ and disallowed.²² Conflicting conclusions have also been reached where interest was payable only out of earnings.²³ Where payment of the so-called interest is discretionary, rather than mandatory, it manifestly resembles and will doubtless be treated as a dividend.²⁴ Judicial consideration has also been given to the fact that the money could have been borrowed from banks at a substantially lower rate than was payable on the "notes,"²⁵ or that the "creditor" could share in profits over and above the fixed "interest" rate.²⁶

5. Treatment on corporate books. When the balance sheet includes the "debentures" under the heading of "capital stock," a factor is present to support the disallowance of the deduction.²⁷ However, such treatment is not conclusive, but merely evidentiary.²⁸

6. Right to sue in event of default. This right ordinarily inheres in a debt, and any limitation thereon will doubtless have a marked or controlling influence in characterizing the security as stock.²⁹

7. Voting rights. The existence or non-existence of voting rights clearly constitutes a pertinent factor.³⁰

8. Consideration for debentures. Where the so-called "debentures" have been issued not for money, but in exchange for stock or property, this element has been considered along with others in determining

²¹250 Hudson St. Corp., supra, n. 10; Cleveland Adolph Mayer Realty Corp., supra, n. 5; Charles Olson & Sons, Inc., supra, n. 10; Helvering v. Richmond, F. & P. R. Co., supra, n. 12; Com'r v. O. P. P. Holding Corp., supra, n. 10.

²²Texas Drivurself System, Inc., supra, n. 6; Golden Belt Lumber Co., 1 T. C. 741 (1943).

²³Deduction allowed: Com'r v. H. P. Hood & Sons, supra, n. 10 (however, accrued interest was payable at maturity). Deduction disallowed: Swoby Corp., supra, n. 15; Bowersock Mills & Power Co., supra, n. 10; Mullin Bldg. Corp., supra, n. 10; Com'r v. Schmoll Fils Assoc'd, Inc., supra, n. 5.

²⁴Ticker Publishing Co., 46 B. T. A. 399 (1942); Chas. L. Huisking & Co., supra, n. 15.

²⁵The Humko Co., supra, n. 17. Cf. Cleveland Adolph Mayer Realty Corp., supra, n. 5.

²⁶The Humko Co., supra, n. 17. Cf. Helvering v. Richmond, F. & P. R. Co., supra, n. 12.

²⁷Mullin Bldg. Corp., supra, n. 10; Texas Drivurself System, Inc., supra, n. 6; Golden Belt Lumber Co., supra, n. 22; Brown-Rogers-Dixson Co. v. Com'r, supra, n. 10.

²⁸Cf. Chas. Olson & Sons, Inc., supra, n. 10.

²⁹See Mullin Bldg. Corp., supra, n. 10; Texas Drivurself System, Inc., supra, n. 6; 1432 Broadway Corporation, supra, n. 11. Compare 250 Hudson St., Corp., supra, n. 10; Com'r v. Proctor Shop, supra, n. 5.

³⁰Helvering v. Richmond, F. & P. R. Co., supra, n. 12; cf. Texas Drivurself System, Inc., supra, n. 6. Compare Com'r v. H. P. Hood & Sons, supra, n. 10; Com'r v. Proctor Shop, supra, n. 5.

the real nature of the securities. In *Mullin Bldg. Corp.*³¹ the Tax Court stated: "Also the transaction lacks the elements of a loan. New capital was not wanted or obtained by the issuance of the debentures. The absence of a true borrowing element we recognize is not always determinative, . . . but such absence under certain circumstances is considered as indicating the creation of a stock interest rather than a debt." Thus, with this element present, in some instances the securities have been held to be stock³² and in other instances debentures,³³ depending upon the additional facts and circumstances involved. Where the debentures were issued in payment of a taxable dividend, this has been considered as a factor supporting the interest deduction.³⁴

9. Intent. The above criteria are important principally as aids in determining whether the parties really *intend* to create a creditor or a stockholder relationship to the corporation.³⁵ As the court observed in *Commissioner v. Proctor Shop, Inc.*,³⁶ "none of the decided cases lay down any comprehensive rule by which the question presented may be decided in all cases, and 'the decision in each case turns upon the facts of that case,' . . . in each case it must be determined whether the real transaction was that of an investment in the corporation or a loan to it The real intention of the parties is to be sought and in order to establish it evidence aliunde the contract is admissible." In that case parol evidence was admitted to show that the "angel" was willing only to make a loan, and that the hybrid type of security was used to preserve the corporation's credit.³⁷

The general nature of the problem under discussion is most aptly and authoritatively delineated by two cases decided in 1946 by the Supreme Court, which merit more detailed consideration.

³¹ *Supra*, n. 10.

³² *Brown-Rogers-Dixson Co. v. Com'r*, *supra*, n. 10; 1432 Broadway Corporation, *supra*, n. 11; Swoby Corporation, *supra*, n. 15; Mullin Bldg. Corp., *supra*, n. 10; Chas. L. Huisking & Co., *supra*, n. 15; Golden Belt Lumber Co., *supra*, n. 22; Rolfe Bldg. Materials Co., T. C. Memo. Op., Docket No. 110268, Jan. 30, 1943.

³³ *E.g.*, John Kelley Co. v. Com'r, discussed *infra*, in text at n. 38; Cleveland Adolph Mayer Realty Corp., *supra*, n. 5; Dade-Commonwealth Title Co., 6 T. C. 332 (1946); Annis Furs, Inc., T. C. Memo. Op., Docket No. 110894, Jan. 28, 1943.

³⁴ T. R. Miller Mill Co., 37 B. T. A. 43, *aff'd* 102 F. (2d) 599 (C. C. A. 5th, 1939); Dade-Commonwealth Title Co., *supra*, n. 33.

³⁵ See, *e.g.*, Mullin Bldg. Corp., *supra*, n. 10; Com'r v. O. P. P. Holding Corp., *supra*, n. 10.

³⁶ *Supra*, n. 5, 82 F. (2d) 792, at 794 (C. C. A. 9th, 1936). This language was quoted with approval by the First Circuit in *Talbot Mills v. Com'r*, discussed *infra*, in text at n. 41, 146 F. (2d) 809, at 811 (C. C. A. 1st, 1944).

³⁷ See, also, Texas Drivurself System, Inc., *supra*, n. 6; Bowersock Mills & Power Co., *supra*, n. 10; Ticker Publishing Co., *supra*, n. 24; Wilshire and Western Sandwiches, Inc., T. C. Memo. Op., Docket No., 10638, June 29, 1948.

In *John Kelley Co. v. Commissioner*,³⁸ a family corporation was reorganized through the issuance of \$150,000 income debentures of which about \$115,000 were exchanged for preferred stock and the balance sold to the stockholders. The bonds were payable to bearer twenty years after date. Interest was payable thereon at the annual rate of 8%, but it was noncumulative and conditioned on the sufficiency of net income to meet the obligation. Holders of the debentures had priority over common stockholders, but their rights were subordinate to those of general creditors. The debentures contained typical acceleration provisions for specific defaults and were redeemable at the option of the corporation. The Tax Court³⁹ held that the 8% payments constituted interest and were deductible. The Tax Court decision was reversed by the Seventh Circuit⁴⁰ which characterized the debentures as having every aspect of preferred stock, except that they had a definite maturity date which, in the appellate court's opinion, was not controlling.

In *Talbot Mills v. Commissioner*,⁴¹ a family corporation had outstanding 5000 shares of \$100 par stock, of which 4000 shares were surrendered ratably by the stockholders in exchange for \$400,000 of the corporation's notes of registered form, with a definite maturity date. Interest was payable thereon at an annual rate of not more than 10% nor less than 2%, subject to a computation that took into consideration the net earnings. Such interest was cumulative, and payment thereof could be deferred until maturity if necessary. No dividends on the stock could be paid until all interest due on the notes was paid. By action of the directors, the notes could be subordinated to any obligation maturing not later than the maturity date of the notes. The Tax Court⁴² held that 10% payments on the notes constituted dividends and not interest, distinguishing the *Kelley* case on the ground that in *Kelley* a flat rate of interest was payable, rather than a profit-determined rate. Perhaps another distinguishing feature of the *Talbot Mills* case is found in the Tax Court's statement that: "The factor of tax avoidance loomed large in the minds of the parties, by their own admission, and indeed it appears to have been the only substantial purpose motivating the transaction."⁴³ In view of all the facts involved

³⁸326 U. S. 521, 66 S. Ct. 299, 90 L. ed. 278 (1946).

³⁹1 T. C. 457.

⁴⁰146 F. (2d) 466 (C. C. A. 7th, 1944).

⁴¹326 U. S. 521, 66 S. Ct. 299, 90 L. ed. 278 (1946).

⁴²3 T. C. 95.

⁴³3 T. C. 95, 100.

in *Talbot Mills*, it cannot be said that the tax avoidance feature was controlling: that it was anything more than one of a number of elements which together forged the decision. The extent to which the tax avoidance motive constitutes a proper consideration will be discussed further below. Placing primary emphasis on the variable interest rate, the First Circuit affirmed the Tax Court's decision in *Talbot Mills*.⁴⁴ Judge Magruder, dissenting, thought the notes were characteristic evidences of indebtedness in that they contained an unqualified obligation to make a fixed principal payment on a day certain, clothed the holders thereof with no voting power or voice in management, and outside the field of taxation the holders thereof would have the recognized status of creditors.

In the *Kelley* and *Talbot Mills* cases, the Tax Court reached opposite conclusions on facts which are distinguishable but strikingly similar. The decisions of the Tax Court in both cases were affirmed by the Supreme Court, on the basis of the *Dobson* rule,⁴⁵ the issues involved being factual, and there being ample evidence to support the Tax Court's conclusions in both cases.⁴⁶ The Supreme Court Justices, however, were not of one opinion, Mr. Justice Black, Mr. Justice Burton and Mr. Justice Rutledge having dissented.⁴⁷ Mr. Justice Jackson took no part in the decisions.

⁴⁴146 F. (2d) 809 (C. C. A. 1st, 1944).

⁴⁵*Dobson v. Com'r*, 320 U. S. 489, 64 S. Ct. 239, 88 L. ed. 248 (1943), holding that the Tax Court is the final arbiter of facts, and only clearcut questions of law are reviewable.

⁴⁶"The documents under consideration embody elements of obligations and elements of stock. There is no one characteristic, not even exclusion from management which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts. So called stock certificates may be authorized by corporations which are really debts and promises to pay may be executed which have incidents of stock. Such situations seem to us to fall within the *Dobson* rule." 326 U. S. 521, 530, 66 S. Ct. 299, 304, 90 L. ed. 278, 284 (1946). See, also, the decision of the Second Circuit, affirming the Tax Court in 1432 Broadway Corporation, *supra*, n. 11.

⁴⁷"I think the judgments in both cases should be affirmed. On the records presented, I can see no satisfactory basis for deciding one case one way and the other differently. And I agree with the Court of Appeals that, on the substantially identical facts, the payments were dividends and not interest." Mr. Justice Rutledge dissenting, 326 U. S. 521, 531, 66 S. Ct. 299, 304, 90 L. ed. 278, 284 (1946). "Tax liability should depend upon the subtle refinements of corporate finance no more than it does upon the niceties of conveyancing. Sheer technicalities should have no more weight to control federal tax consequences in one instance than in the other. The taxing statute draws the line broadly between 'interest' and 'dividend.' This requires one who would claim the interest deduction to bring himself clearly within the class for which it was intended. That is not done when the usual signposts between bonds and stock are so obliterated that they become invisible or point equally

While the cases provide many helpful guides, it is evident therefrom that the use of a hybrid security, as the product of a desire to take an interest deduction but to escape the obligation of debt, will probably raise an issue which is essentially a factual one, and that the answer thereto may remain doubtful until it is judicially decided.

Is There a Business Purpose Doctrine?

Mr. Justice Holmes once said that "... the very meaning of a line in the law is that you intentionally may go as close to it as you can if you do not pass it."⁴⁸ Unfortunately for many a taxpayer this language has not been followed literally.

In *Gregory v. Helvering*⁴⁹ the Supreme Court said: "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. . . . But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended. . . . Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character. . . ."⁵⁰

Although the *Gregory* case involved a reorganization, the effort has been made to apply the doctrine enunciated therein to a variety of cases, including those presenting the issue of whether the securities are stock or debt. The question therefore arises as to whether there must be a corporate business purpose behind a bond issue to prevent its being called stock. The issue was squarely met in *Annis Furs, Inc.*,⁵¹ decided in 1943. There a deduction was allowed where the corporation issued 6% debentures in exchange for an equal amount of preferred stock. In his brief the Commissioner argued, citing the *Gregory* case, that the debentures should be treated as stock because the purpose of their issuance was to secure a permanent income to the debenture holders, which was a personal, stockholder purpose, rather than a corporate

in both directions at the same time." 326 U. S. 521, 534, 66 S. Ct. 299, 306, 90 L. ed. 278, 306.

⁴⁸*Superior Oil Co. v. Miss.*, 280 U. S. 390, 395, 50 S. Ct. 169, 170, 74 L. ed. 504, 508 (1930).

⁴⁹293 U. S. 465, 55 S. Ct. 266, 79 L. ed. 596 (1935).

⁵⁰293 U. S. 465, 469, 55 S. Ct. 266, 267, 79 L. ed. 596, 599 (1935).

⁵¹*Supra*, n. 33.

purpose. The Tax Court rejected this argument in the following language:

"If in order for petitioner to prevail in this case it was necessary for petitioner to show that there was a financial reason or some other similar reason or purpose which made necessary the recapitalization . . . we would be inclined to agree with the Commissioner that no such business purpose has been shown

"However, it seems to us that when we have facts brought before us which show that a corporation and its preferred stockholders did in fact make an exchange whereby all the preferred stock was taken up and cancelled and debenture bonds substituted therefor bearing interest at 6 per cent per annum, payable semi-annually, we must recognize the change and allow the interest deduction under the provisions of section 23 (b), Internal Revenue Code.

"Of course if the indebtedness represented by the debenture bonds is a sham indebtedness, and the interest coupons attached to the bonds represent sham interest obligations, the deduction claimed would not be allowable. But the facts which have been stipulated seem to us to show clearly that the indebtedness created by the bonds was a real indebtedness and the interest coupons attached to the debentures represented a bona fide agreement to pay interest according to the tenor thereof.

"If a corporation and its preferred stockholders for reasons satisfactory to themselves agree upon an exchange of preferred stock for debenture bonds, then it seems to us that such is business purpose enough and we need look no further, provided of course that the obligation created by the bonds is genuine. Cf. *Commissioner v. Proctor Shop, Inc.*, 82 Fed. (2) 792; *John Kelley Company*, 1 T. C. 457."⁵²

At the end of the same year the question respecting the existence of a corporate business purpose was again discussed in *The Humko Co.*⁵³ In that case preferred stock was retired and the proceeds were simultaneously "loaned" to the corporation under circumstances which caused the Tax Court to view the transaction as a sham and to treat the "interest" paid on such "demand loans" as dividends. No resolu-

⁵²*Id.* at 1 T. C. M. 507. In the Kelley Case the Tax Court stated, 1 T. C. 457, 462: "It is apparent that the holders of the preferred stock, in exchanging the stock for '20 year 8 per cent income debentures,' preferred the debtor-creditor status of debenture holders to that of stockholders, and stockholders have the right to change to the creditor-debtor basis, though the reason may be purely personal to the parties concerned."

⁵³*Supra.* n. 17.

tion had been adopted authorizing the corporation to borrow from its stockholders, and no notes or written agreement had ever been executed. The so-called demand loans carried 6 percent interest, while the corporation could borrow from banks at 3 percent interest. The "indebtedness" created by such loans was subordinated to the corporation's bank indebtedness. The facts and circumstances were such that the Tax Court viewed the transaction as "unreal on its face." The Court stated: "The evidence shows that the purported retirement of the preferred stock was a sham and a device in a tax scheme, that it had no business purpose to petitioner, and that no debtor-creditor relationship was created by the alleged loans of \$176,000 to petitioner."⁵⁴

While agreeing completely with the Court's ultimate conclusion in the *Humko* case, some may feel that the reference to "business purpose" is an unhappy and disturbing one: that it casts a cloud of doubt over the Tax Court's earlier decision in *Annis Furs* in which the business purpose doctrine, as applied to the interest deduction, was flatly rejected, and the case of a sham transaction was expressly distinguished. The *Humko* case is quite obviously in the "sham" class, and for that reason some may argue that any consideration or mention therein of the business purpose doctrine was both unnecessary and improper.

While reference to the lack of a corporate business purpose in *Humko* may have been unnecessary, it is the author's opinion that it was not improper, and that it creates no obstacle in the way of reconciling the decisions in *Humko* and *Annis Furs*. In a "sham" case, the absence of a corporate business purpose is merely one of the elements or criteria to be considered along with others, in determining whether the alleged debtor-creditor relationship is genuine or fictitious. This does not mean that the existence of a corporate business purpose is essential to the establishment of a bona fide debtor-creditor relationship. Under the Code there would seem no warrant for such a rule. But there must be a genuine debt to support the interest deduction, and there is therefore ample justification for a consideration of all facts pertinent to the determination of whether a debtor-creditor relationship really exists.

The later cases appear to recognize this distinction. In *Clyde Bacon, Inc.*,⁵⁵ decided in 1945, the Tax Court found that the debentures were evidences of indebtedness, and disposed of the business purpose argument in these words: "At the formation of the corporation there was no obligation on the petitioner to issue any definite amount of stock

⁵⁴Id. at 2 T. C. M. 1125.

⁵⁵4 T. C. 1107 (1945).

in exchange for the assets received. It had the privilege of determining the character and amount of its securities so exchanged if they were satisfactory to the recipient. The petitioner had the right to replace the stock interest with an evidence of indebtedness, if it so desired. . . . The petitioner also presented cogent and proper business reasons for creating the debenture certificates. It is not necessary to enumerate or discuss them, since the face of the instrument affords ample ground for our conclusion that the debenture certificates were evidences of indebtedness and not shares of stock."⁵⁶

The year 1946 found the Commissioner again arguing for the application of the business purpose doctrine in the *Mayer Realty* case.⁵⁷ As authority he relied on the now famous *Bazley* case involving a reorganization,⁵⁸ in which the business purpose doctrine was applied by the Tax Court. Rejecting the Commissioner's contention, the Court 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 and whether the interest paid upon such debentures is deductible from gross income."⁵⁹ The *Mayer Realty* decision was cited with approval in a later case where the Tax Court again distinguished the "business purpose" from the "sham" principle.⁶⁰

It will be observed from the foregoing discussion that in cases in which the debentures have come into existence via the reorganization route, the tax avoidance motive has been frequently urged and considered, along with the lack of business purpose, as a basis for disallowance of the interest deduction. To what extent, then, does the tax avoidance motive constitute a proper element for consideration?

The courts have repeatedly and consistently recognized that "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."⁶¹

In *Talbot Mills* the Tax Court stated that tax avoidance "appears to have been the only substantial purpose motivating the transaction,"⁶²

⁵⁶Id. at p. 1116.

⁵⁷Supra, n. 5.

⁵⁸J. Robert Bazley, 4 T. C. 897, since then affirmed, 155 F. (2d) 237 (C. C. A. 3d, 1946), 331 U. S. 737, 67 S. Ct. 1489, 91 L. ed. 1330 (1947).

⁵⁹Cleveland Adolph Mayer Realty Corp., supra, n. 5 at p. 741.

⁶⁰250 Hudson St. Corp., supra, n. 10.

⁶¹Gregory v. Helvering, 293 U. S. 465, 469, 55 S. Ct. 266, 267, 79 L. ed. 596, 599 (1935).

⁶²Supra, n. 43.

but other factors were also present from which the Court concluded that "what the parties really intended to create was a security retaining the profit-sharing advantage of stock, leaving intact their voice in the management, but extending a tax advantage to the corporation not possible in stock."⁶³ Certainly it cannot be said that the Tax Court considered the tax avoidance motive as controlling: as anything more than an element to be considered in determining whether there was a genuine intent to create a debtor-creditor relationship. Indeed, the Court stated that "The question [whether the securities are stock or debt] is factual, and no one factor may be said to be controlling,"⁶⁴ and then proceeded to enumerate the "determining factors" among which the tax avoidance motive does not even appear. The only factor mentioned to which such a motive could possibly be related is "intent of the parties." In view of the Court's reference to the tax avoidance motive, it is a reasonable conclusion that the Court regarded this element as material to the determination of intent. Whether consideration of such motive, even to this limited extent, is proper, presents a serious question. Moreover, assuming that it is, the inference that a tax saving motive tends to show the lack of genuine intent to create a debtor-creditor relationship, might well be challenged, as it could be argued with considerable force that the desire for the interest deduction would indicate an intent to create a debt in order to qualify for such deductions. Undoubtedly, in many of the cases where debentures are issued—particularly where they are issued in exchange for stock—the corporate tax saving has been a motivating consideration. And yet in only a very small number of the cases is there even a reference to the tax avoidance motive. Evidently, the courts have ordinarily felt that such a motive is not only legal, but immaterial to the issue involved.

Although the First Circuit affirmed the *Talbot Mills* decision upon the ground that the question was factual and the *Dobson* rule governed,⁶⁵ Judge Magruder dissented vigorously, and in so doing struck directly at the core of the problem. He said:

"The result would be no different if we assume that the main motive for the recapitalization was to achieve a tax advantage. *Commissioner of Internal Revenue v. H. P. Hood & Sons, Inc.*, 1 Cir., 1944, 141 F. 2d 467, 471. To test this, suppose that, at the organization of the corporation, the fifteen individuals who were to put up the money

⁶³Ibid.

⁶⁴3 T. C. 99.

⁶⁵See notes 44 and 45, supra.

had considered the alternatives of having the corporation issue to them 5,000 shares of stock at \$100 a share, or 1,000 shares of the stock and ordinary interest-bearing notes in an amount of \$400,000; and had decided on the latter course in order to give the corporation the advantage of the interest deduction under section 23 (b). This advantage would have been achieved had they chosen the second alternative at the outset. . . . If interest deductibility could be achieved by an original capitalization as above supposed, it could equally well be achieved by a subsequent recapitalization along the same lines. . . . It is not suggested that the notes are a sham, that is, that they do not embody the real understanding of the parties to the transaction."⁶⁶

It is interesting and perhaps significant to observe that although the Supreme Court opinion in the *Talbot Mills* case contains a rather detailed statement of the facts, no reference whatsoever is made therein to the tax avoidance feature.

In *1432 Broadway Corporation*, although the deduction was disallowed because "the evidence does not show that the debentures were, or were intended to be, evidences of indebtedness,"⁶⁷ the Tax Court recognized that ". . . a taxpayer has the right to cast his transaction in such form as he chooses, and the form he chooses will generally be respected. . . ."⁶⁸

In the frequently cited case of *Commissioner v. H. P. Hood & Sons*, some "debentures" were sold for cash, some were issued as a common stock dividend, and some were exchanged for preferred stock. The Tax Court found that the debentures possessed the criteria of indebtedness and allowed the interest deduction. Affirming, the First Circuit referred to the Tax Court's finding that although tax saving may have been one of the considerations, it was not the sole consideration for the issue. "At any rate," the Court added, "there is nothing to prevent this taxpayer from replacing an instrument [preferred stock] which rests on one side of the line separating indebtedness from proprietorship with one which rests on the other side of the line."⁶⁹

While reference was made to the tax avoidance motive in some of the cases where debentures were issued in exchange for stock, in all those cases the debentures were mixed-breeds. The same thing is true of the cases in which reference was made to the lack of business purpose. There appears no sound reason why, quoad the interest deduc-

⁶⁶146 F. (2d) 809, 813 (C. C. A. 1st, 1944).

⁶⁷4 T. C. 1166.

⁶⁸4 T. C. 1165.

⁶⁹141 F. (2d) 467, 471 (C. C. A. 1st, 1944).

tion, more rigorous standards should be applied to debentures issued in a reorganization than to debentures issued otherwise. It is no more sinful, or any less legal, to reduce an established tax liability by legal means than to minimize an unborn liability.

While the three theories—sham, lack of corporate business purpose, and tax avoidance—are frequently boon companions, they are clearly separable and distinguishable:

All the courts have recognized that section 23 (b) is designed to permit only the deduction of "genuine interest on a genuine indebtedness," and there is no room for quarrel concerning the validity of the "sham" principle.

While the lack of a corporate business purpose may be one of the elements entitled to consideration in a sham case, it is nothing more than that.

Although some cases indicate that the tax avoidance motive may be considered in determining intent, its materiality and probative value both seem highly questionable.

Is There An Excessive Debt Structure Rule?

Some recent decisions have also suggested that there *might* be a limit to the amount of the debentures, if the interest thereon is to be deductible. If the corporate debt structure is "excessive" the section 23 (b) interest deduction might be disallowed. Such suggestions inspire two questions: Is there really any such rule? If so, what constitutes an excessive debt structure? Suppose that X-Corporation carries out its plan to issue \$500,000 in stock and \$500,000 in debentures. In the alternative, suppose that X-Corporation issues only three shares of qualifying stock and \$999,700 in debentures. If there is a line, where is it to be drawn?

In the *Mullin Bldg. Corp.* case,⁷⁰ the capital structure consisted of \$10,000 common stock and \$290,000 of so-called debenture preferred stock. Upon consideration of all the facts, the Tax Court reached the almost inescapable conclusion that the securities were stock. The Court stated: "Furthermore, the intention of the parties indicates that the debenture stock was stock rather than a debt. It was called stock. It was carried on petitioner's books as capital and so represented to the business world. Had it not been so represented petitioner would have appeared as a company with a ratio of debt to capital of 29 to 1." The

⁷⁰Supra, n. 10.

reference to the debt ratio was manifestly merely incidental to the matter of intent.

Prior to the recapitalization in the *Kelley* case, the authorized capital of the corporation consisted of 1500 shares of no par common and \$300,000 in preferred stock; thereafter, it consisted of \$600,000 in common and \$300,000 in preferred stock, and \$250,000 in debentures. The capital structure of the *Talbot Mills* corporation was recapitalized from \$500,000 common stock to \$100,000 common stock and \$400,000 in "notes." Probably in answer to a question raised by the Commissioner in his argument, the Supreme Court stated: "*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.*"⁷¹ This sentence would seem to mean only that inasmuch as an "extreme situation" was not involved in those cases, there was no occasion for the Court to deal with the question.

However, the possibility suggested by the dictum was embraced in the recent case of *Swoby Corporation*⁷² where the stock consisted of \$200 total par value and an "income debenture" of \$250,000 was issued. Judge Opper, in an opinion reviewed by the Court, stated:

"While the specified factual distinction between *John Kelley Co. v. Commissioner* and *Talbot Mills v. Commissioner*, 326 U. S. 521, furnishes little assistance in determining whether the 'debenture' in issue represents an indebtedness and the interest carried by it is hence deductible, two other factors not present in those cases but alluded to by the Supreme Court in the same opinion seem to indicate that it is not.

"That Court takes occasion to issue what we can not 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). The necessity excluded there we can not now avoid. Dealing with property having a stipulated value of 'at least \$250,000,' 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."

⁷¹326 U. S. 521, 526, 66 S. Ct. 299, 302, 90 L. ed. 278, 281 (1946) [italics supplied].

⁷²Supra, n. 15.

The other factors involved—the absence, in effect, of a maturity date falling “in the reasonable future,” the subordinate feature of the “debenture,” and the dependency of “interest” payments not only on available profits, but in reality on the decision of the directors—manifestly provided adequate grounds for the Tax Court’s decision, without reference to the excessive debt element.

Although, the application of the excessive debt test has not yet been clearly defined, the *Swoby* case indicates that excessive debt is a factor to be considered, along with all other pertinent factors, in determining the real nature of the securities.

What constitutes an excessive debt ratio is a question for the future. The tacitly approved ratio in the *Talbot Mills* case was 4 to 1, and the amount of stock invested was considered material. In the *Mullins* case the amount of stock was certainly material, but the ratio was 29 to 1. In *Swoby* the ratio was 1250 to 1, and substantially no stock was issued. Prior to the decisions in these cases, opinions have been written involving the following capital structures: \$30,000 stock and \$270,000 debentures;⁷³ about \$22,000 stock and \$42,000 notes;⁷⁴ \$20,000 stock and \$260,000 bonds;⁷⁵ \$600 stock and \$210,000 debentures;⁷⁶ \$20 stated value stock and \$750,000 debenture notes;⁷⁷ and \$1000 stock and \$99,000 debenture preferred.⁷⁸ In none of these cases was the excessive debt structure theory even mentioned.

The “excessive debt structure” has been considered thus far only in cases in which hybrid types of securities were involved, and the courts were called upon to determine whether the securities were stock or debentures. In such cases, where it is necessary to determine the real nature of the mongrel, the existence of an excessive debt structure may be a proper consideration because of its manifest relevancy to the question of intent. This, however, does not mean the courts should or will consider and treat simon pure debt as stock, no matter how excessive the debt may be in relation to stock. In view of the clear mandate of the Internal Revenue Code, interest paid on genuine indebtedness constitutes an allowable deduction, regardless of the debt ratio. The Commissioner’s resort to fiction for the purpose of imposing a tax would seem just as unwarranted as a taxpayer’s for the purpose escap-

⁷³Clyde Bacon, Inc., *supra*, n. 55.

⁷⁴Edward G. Janeway, *supra*, n. 5.

⁷⁵Com’r v. O. P. P. Holding Corp., *supra*, n. 10.

⁷⁶Cleveland Adolph Mayer Realty Corp., *supra*, n. 5.

⁷⁷250 Hudson St. Corp., *supra*, n. 10.

⁷⁸Com’r v. Proctor Shop, *supra*, n. 5.

ing it. Under the law, taxpayers have the choice of doing business as a corporation or as a partnership. If they select the latter, they, of course, pay no corporate tax. They are entitled to the same freedom of choice respecting the manner in which they capitalize their corporations. Moreover, the need and desirability of having fixed standards for the measurement of taxes should deter courts from using such a variable as an "excessive debt structure" as an ultimate standard.

From the foregoing discussion the moral seems clear: if one wants to avoid the rocks and shoals which make tax navigation both difficult and dangerous, he would do well to set sail in a sound craft and to follow closely the established charts which define the boundaries of stocks and bonds.