June 1988

The Closely Held Corporation: Its Capital Structure and the Federal Tax Laws

William J. Rands

Follow this and additional works at: https://researchrepository.wvu.edu/wvlr

Part of the Business Organizations Law Commons, and the Tax Law Commons

Recommended Citation

Available at: https://researchrepository.wvu.edu/wvlr/vol90/iss4/4

This Article is brought to you for free and open access by the WVU College of Law at The Research Repository @ WVU. It has been accepted for inclusion in West Virginia Law Review by an authorized editor of The Research Repository @ WVU. For more information, please contact researchrepository@mail.wvu.edu.
THE CLOSELY HELD CORPORATION: 
ITS CAPITAL STRUCTURE AND THE
FEDERAL TAX LAWS

WILLIAM J. RANDS*

The labyrinthine provisions of the Internal Revenue Code make a decision on whether or not to incorporate a closely-held business astoundingly complex. To decide properly, one must understand the terms "C corporations," "S corporations," a partner's "distributive share," and a host of other cryptic concepts. Even those initiated into the inner sanctums of Subchapters C², K³ and S⁴ must advise

* B.A., Centenary College; J.D., Tulane University; member of the Arkansas and Louisiana state bars. The author thanks his research assistants, Linn Tweksbury, Mark Diersks, and Sohal Qadar, for their hard and excellent work. He also thanks the University of Cincinnati College of Law for funding his research assistants. © Copyright 1988 by William J. Rands.

1. "C corporation" is a residual category that includes all corporations whose shareholders have not made a valid election under Subchapter S of the Internal Revenue Code (I.R.C.). I.R.C. § 1361(a)(2) (1987). C corporations are distinct taxpayers, separate and apart from their shareholders. They compute their own tax income or loss from the year, file their own return and pay the amount of taxes, if any, that is due.

"S corporation" is a "small business corporation" whose shareholders have elected Subchapter S of the Internal Revenue Code. Id. § 1361(a)(1) (1987). Generally speaking, an S corporation is a conduit for tax purposes, the tax consequences from its operations being passed through to its shareholders. Id. § 1366 (1987).

"Partnership" is generally defined as an unincorporated business owned by two or more legal entities. See 1 Z. CAVITCH, BUSINESS ORGANIZATIONS WITH TAX PLANNING, §§ 1.01, 5.01[3] (1986). I.R.C. § 7701(a)(2) (1987) gives a catch-all definition of partnership, which includes "a syndicate, group, pool, joint venture, or other unincorporated organization . . . which is not . . . a corporation."

While not defined by either the Internal Revenue Code or the Treasury Regulations, the term "proprietorship" is generally thought of as an unincorporated business operated by one person in his own right and without an independent organization separate and apart from himself. L. RIBSTEIN, BUSINESS ASSOCIATIONS §§ 1.01, 1.04 (1983).

For a description of these basic forms of business organizations, see Rands, Closely Held Businesses: Tax Advantages and Disadvantages of the Different Forms of Business Organizations, 91 COM. L.J. 61, 62-71 (1986).

For a full discussion of the legal criteria for differentiating between a corporation and a partnership for federal tax purposes, see generally Rands, Organizations Classified as Corporations for Federal Tax Purposes, 59 ST. JOHN'S L. REV. 657 (1985).

2. Subchapter C, I.R.C. §§ 301-86 (1987), provides rules regulating transfers of stock, securities, cash and other types of property between corporations and their shareholders, between shareholders inter sese and between corporations. Subchapter C by no means includes all of the sections
their clients that their counsel is based on the enterprise’s projected revenues and expenses, estimates that may prove to be far off the mark. Moreover, changes in the Internal Revenue Code have been so constant that no one can feel confident in assuming that the tax laws in X number of years will be the same as they are now. Despite these nettlesome problems affecting this most common of business decisions, one might not feel too exercised, if, after incorporation, he could be rid of the layers of abstruse tax law, free to formulate plans for business reasons. Unfortunately, this is not the case. Whether one likes it or not, tax considerations continue to be vital elements in strategic business planning even after the decision to incorporate has been made.

The purpose of this paper is to examine the impact of the tax laws on a key aspect of post-incorporation planning — formulation of the capital structure of the closely-held corporation. The paper tries to identify and explain the various components in such a capital structure effected by the tax laws. It examines several of the amorphous tax issues affecting capital structures, e.g., the debt-equity distinction. And, where appropriate, it seeks to evaluate the policy implications of the impact of the tax laws on capital structures.

I. CAPITAL STRUCTURES, GENERALLY

"Capital structure" is the term of art that refers to the allocation among the investors of three basic components of business ownership: (1) the right to control the business, (2) the right to be paid the income generated by the business, and (3) the right to receive the assets of the business upon termination of the business. Capital

---

governing the taxation of corporations. For example, I.R.C. § 11 (1987) contains the corporate income tax rates.


4. Subchapter S, I.R.C. §§ 1341-79 (1987), contains rules that govern the taxation of S corporations and their shareholders. Generally speaking, an S corporation is a "small business corporation whose shareholders have elected the special tax treatment available under Subchapter S, id. § 1361(a)(1), i.e., a corporation treated as a conduit whose income, losses, deductions or credits are passed through to its shareholders. Id. at § 1366.

structure includes the mix of long-term debt and stock, i.e., the sum of bonds (or debentures) and owner-contributed capital.\(^6\)

Traditionally, it is stated that there are three basic modes of corporate capital structures. The first, and simplest, is for the owners of the business to contribute all of the funding to the corporation in exchange for all of its common stock. The founders then retain complete control, and any economic growth in the company inures solely to them. If the business fails, financial failure falls upon them as common stockholders.

The second mode of capital structure is for the owners again to furnish all the assets needed by the corporation, but to receive "senior securities" (corporate long-term debt or nonparticipating preferred stock) in addition to common stock.\(^8\) A variation of the second mode is for the owners to characterize the transfer of operating assets to the corporation as a lease instead of an outright conveyance while paying a nominal cash price for the common stock.\(^9\) As discussed in depth later, this investor as creditor or leasor of the corporation is provided with probable tax advantages and a status higher than that of a common stockholder in the event of the corporation’s bankruptcy. The use of preferred makes sense only when not issued proportionately to each of the common stockholders.

The third mode of capital structure is for the owners to contribute only a part of the corporate funding and to allow the corporation to issue senior securities to outsiders. The founders of the business, of course, might need to look to outsiders for financing if they do not have enough money to fund their project. They may,

---


7. Senior securities is a term of art in corporate finance. It refers to stock or long-term debt that has a prior but limited claim to corporate earnings. W. Cary & M. Eisenberg, Cases and Materials on Corporations 1108 (5th ed. 1980). It includes nonparticipating preferred stock, id. at 1111-12, and long-term corporate debt, e.g., bonds, debentures. Id. at 1108-10. From the perspective of the holders, it has two major advantages over common stock. It provides them with a fixed rate of return and a higher priority in bankruptcy. Its major disadvantage is that the holder doesn’t share in the prosperity, if the corporation grows. Instead, the holder is stuck with its fixed rate of return. Usually, it also offers no rights of control to the holders.


9. Id.
however, be gambling on the financial concept of "leverage" or "trading on equity." Leverage refers to the decision made by the board of directors on behalf of the common stockholder to cause the corporation to issue senior securities to investors other than common stockholders. In effect, the common stockholders are betting that the infusion of the new funds will generate income that will exceed the costs of paying the outsiders their fixed rate of return.\textsuperscript{10} If the founders of the business have the resources to finance the corporation fully, the resort to outside funding obviously has the disadvantage of requiring a payment of a portion of the enterprise's revenue to outsiders, either as interest or dividend preferences.\textsuperscript{11} Moreover, the common stockholders take the risk that the income from the project may be insufficient to cover the fixed charges payable to the outsiders so that nothing will be left for them.\textsuperscript{12} Yet so long as the founders keep all of the common stock, the issuance of senior securities usually does not dilute their right to control and to retain the lion's share of any future economic growth for themselves.

The financial configurations of modern closely-held corporations obviously can deviate substantially from the three traditional modes of capital structures outlined above. These modes ignore common financing devices like (i) short-term loans supported by security interests in accounts receivable or inventory or (ii) credit lines with trade creditors who are willing to sell supplies, raw materials, or inventory on open account. Additionally, the traditional modes ignore the factor of loyal, hopeful, or naive employees who in effect finance many closely-held corporations by accepting lower than market compensation or compensation in the form of minority equity interests. Moreover, each traditional mode presupposes a readily identifiable group of people who will take the controlling block of


\textsuperscript{11} F. O'Neal, \textit{supra} note 8, at § 2.09.

\textsuperscript{12} F. Hamilton, \textit{supra} note 5, at 395.
common stock and become the "owners" or "founders" of the business about to be incorporated. The modes may not serve as a useful analytical tool when the real issue is whom to include within the group of controlling common stockholders.

Then a myriad of other questions may crop up. For example, does the person with the idea for the business have enough money of his own to get the business started? Even if he does, would it make good sense to find another investor anyway? If he finds another investor, should he offer this second investor common stock? Will the second investor insist on common stock? Should the second investor be placed on an equal footing with the first investor who had the idea for the business in the first place and probably will do most of the work? Should the first investor be placed on the same footing with the second investor who likely is providing most of the capital for the business? These may be key questions. Yet at some point, one or more persons will decide to gamble by making a long-term investment in a particular closely-held corporation. That person or persons must decide how to structure that long-term investment. Then the traditional concept of capital structure does present a context for useful analysis. It is the starting point for allocating the benefits and risks among the investors.

II. COMMON STOCK

Defining common stock is somewhat like describing the verb "to be." Everyone knows what it means, but it is difficult to define precisely. It is the basic ownership unit for American corporations. If a corporation has only one class of stock, it is common stock. All corporations have at least some common stock. Unless a corporation's articles of incorporation provide otherwise, each share of stock is common stock. Each share of common stock consists of identical proportions of the three attributes of stock ownership as each other share of common stock (voting rights, rights to dividends, and rights to assets in liquidation). While it is possible to grant voting control to preferred stockholders,13 ordinarily the common

13. Modern American corporation law allows the shareholders to set their own internal rules
stockholders have voting control and elect the board of directors. Typically, the common stockholders have the biggest financial stake in the corporation, although it is possible to provide the common stockholders with only a minimal financial interest in the corporation while still granting them full control. Common stock is stock that has neither a dividend nor a liquidation preference. Instead, common stock provides its holders with a “residual” but “unlimited interest in the corporation’s earnings and assets.” In contrast, corporate debt and preferred stock entitle their holders to be paid in full before the corporation pays anything to common stockholders. But the holders of the debt and preferred stock are usually entitled to payment of a finite amount. Once that is paid, they get no more. The rest of the corporate income and assets are for the common stockholders. Thus, if the business takes off, it is the common stockholders with their residual and unlimited interest in corporate income and assets who benefit. The downside of this residual characteristic is that payments to creditors and preferred stockholders may exhaust the corporation’s income or its supply of assets leaving nothing for the common stockholders. In the worst case, bankruptcy, the common stockholders are last in line and often get nothing.

The possibility of the subchapter S election is the major tax inducement for a close corporation using just common stock. Indeed, a corporation can elect S corporation tax treatment only when it has just one class of stock, which, by definition, would have to be classified as common stock.

The major tax disadvantage of common stock, shared by all types of stock, is double taxation. The distributed earnings of a C corporation are taxed twice. First they are taxed to the corporation

in almost any way that they want, usually through a provision in the articles of incorporation. See, e.g., A. Conard, R. Knauss & S. Siegel, Corporations Cases, Statutes, and Analysis 54-55, 124-26 (2d ed. 1982); R. Jennings & R. Buxbaum, Corporations Cases and Materials 94-96 (5th ed. 1979); F. O’Neal, supra note 8, at § 3.53; Organizing Corporate and Other Business Enterprises, §§ 6.03[4], 6.04 (C. Rohrlich 5th ed. 1981). Hence, the articles could provide for a class of preferred stock with voting rights. Typically, however, preferred shares are made nonvoting, or they grant the right to vote only after dividends have been in arrears for a stipulated number of dividend periods. F. O’Neal, supra note 8, at § 3.37.

when earned and second to the shareholders when distributed.\textsuperscript{16} Even if the close corporation retains its earnings rather than distributing them as dividends, the common stockholders nevertheless will be taxed on the resulting appreciation in value of their stock,\textsuperscript{17} when they sell,\textsuperscript{18} exchange,\textsuperscript{19} redeem,\textsuperscript{20} or surrender their stock in a liquidation.\textsuperscript{21} Though dividend distributions of corporate earnings are generally tax-free to S corporation shareholders,\textsuperscript{22} these other transactions are taxable events to shareholders in both C and S corporations.

\section*{III. Shareholder-Held Debt, Generally}

Free from the constraints of the public market, the shareholders in a close corporation have virtually unlimited power to determine the terms of transactions between themselves and the corporation. Hence, when they commit their own property to the corporate enterprise, they can term the transfer to the corporation as a payment for stock, a loan, a sale, or a lease. Strangely, the American legal system, including the tax laws, discourages them from taking stock ("equity") as the primary consideration from the corporation in exchange for their assets. Instead, they are likely to pay a relatively low cash price for the stock and to lend the corporation the balance of whatever other cash they are providing. Furthermore, if the shareholders personally own the fixed or operating assets that the cor-

\begin{enumerate}
\item See id. §§ 301(c)(1), 316(a) (1987).
\item The retention of earnings generally increases the value of common stock, simply because the corporation has more assets than it would if it had distributed them as dividends. Retained earnings tend to have little effect on senior securities (nonparticipating preferred stock and corporate debt), which have a fixed but limited right to income and to assets in liquidation.
\item See I.R.C. § 1001(a) (1987).
\item See id. The shareholder may be able to avoid recognizing the gain, if the exchange meets one of the several subchapter C nonrecognition sections. See, e.g., id. §§ 354(a)(1), 368(a)(1)(A) (1987) (nonrecognition treatment for shareholder exchanging stock for stock in a state-law merger qualifying as a "reorganization").
\item See id. § 302(a), (d) (1987).
\item Shareholders generally must recognize a gain or a loss when they receive a liquidating distribution. See I.R.C. § 331(a) (1987). Several of the other liquidation sections, however, provide nonrecognition treatment for the shareholder under certain circumstances. See id. § 332(a) (1987) (liquidation of an 80% owned subsidiary), § 354(a) (1987) (shareholders receiving stock in a liquidation that is part of a qualifying reorganization).
\item Id. § 1368 (1987). The shareholder receiving a tax-free distribution from the S corporation must decrease his basis in his stock. Id. § 1367(a)(2)(A).
\end{enumerate}
poration will use in the business, they probably will not contribute those assets to the corporation in exchange for stock. Instead, they will lease or make an installment sale of those assets to the corporation. Both a cash loan and an installment sale of assets make that shareholder a creditor of the corporation. This is a status the shareholders want even when they themselves are providing all the money, property, and other assets needed for the business.23

Why this heavy emphasis on "debt"?

The first reason is to provide the shareholder in the close corporation with a hedge against bankruptcy. The bankruptcy law generally honors the state law principle that shareholders and their corporations are distinct legal entities. Like anybody else, a shareholder can lawfully become a creditor of his own corporation. Provided that the transaction is not abusive, he can then share in the corporation's assets in a bankruptcy like any external creditor.24 Indeed, he is not even precluded from taking a security interest in corporate property to protect his loan and then asserting his lien in the bankruptcy proceeding.25

The second reason for the pervasive use of the debt (discussed in detail over the next few pages) is the perception by most tax-

23. F. O'NEAL, supra note 8, at § 2.09.

See, e.g., Comstock v. Group of Inst'l Investors, 335 U.S. 211, reh'g denied, 335 U.S. 837 (1948); In re Branding Iron Steak House, 536 F.2d 299 (9th Cir. 1976); Theriot v. Plane, 126 F.2d 1015 (9th Cir. 1942); In re Lumber, Inc., 124 F. Supp. 302 (D. Or. 1954); In re Erie Drug Co., 416 Pa. 41, 204 A.2d 256 (1964); In re Mader's Store for Men, Inc., 77 Wis. 2d 578, 254 N.W.2d 171 (1977).


25. F. O'NEAL, supra note 8, at § 2.13; Cohen, supra note 24, at 268-271; Annotation, Validity of Security for Contemporaneous Loan to Corporation by Officer, Director or Stockholder, 31 A.L.R.2d 663 (1953 & Supp. 1987).

planners and writers that debt produces better tax consequences than stock, for both the investor and the corporation. 26

A third reason for using shareholder-held debt is to implement certain business bargains among owners of the business, giving the shareholder group holding the debt a claim to income and to assets in a liquidation that is surperior to that of the nondebtholding shareholder group. The corporation can use preferred stock the same way, and more of the specifics of such uses are described in the section of this paper on preferred stock, infra. The relative advantages and disadvantages of the use of debt and preferred stock for this reason are also discussed in those sections.

Unfortunately, no one has been able to develop a precise system for classifying an interest as either debt or equity, although the courts, 27 Congress, 28 the Treasury Department, 29 and commentators 30


Not all writers agree. For example, one characterizes the “dominant view,” which favors use of debt, as “extreme managerial myopia, focusing exclusively on the corporate-level tax and totally ignoring the influence of individual taxes on securities holders.” W. Klein, Business Organizations and Finance Legal and Economic Principles 243 (1980).

27. See B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders § 4.02 (4th ed. 1979); 1 Z. Cavitch, supra note 1, at § 91.04[1].

28. The courts have had to make the debt-equity distinction literally hundreds of times. Some cases involved the issue of the deductibility of bad debts, see, e.g., Beaver Pipe Tools, Inc. v. Carey, 240 F.2d 843 (6th Cir.), cert. denied, 353 U.S. 958 (1957); but the bulk of them focused on the issue of dividend versus interest. See, e.g., Stinnett’s Pontiac Serv., Inc. v. Commissioner, 730 F.2d 634 (11th Cir. 1984).

In its original version of the Internal Revenue Code of 1954, the House of Representatives included a section (§ 312) that defined securities and participating and nonparticipating stock. Only the payments on unconditional obligations to pay a sum certain, which were not dependent on corporate earnings, could be considered as interest on “securities.” The House would have limited the interest expense deduction to instruments containing an unconditional obligation to pay a sum certain and which payment did not depend on corporate earnings. Nonconforming instruments were to be considered nonparticipating stock, and any payments on them were not deductible as interest expenses. H. R. Rep. No. 1337, 83d Cong., 2d Sess., reprinted in 1954 U.S. CODE CONG. & ADMIN. NEWS 4017, 4206, 4235-437.

Noting the difficulty in applying bright line rules in the debt-equity area, the Senate rejected
have all tried. The problem is that the line of demarcation between what is debt and what is equity is simply unclear. Between the classic versions of debt\(^{31}\) and equity\(^{32}\) is a continuum of interests that have


Everyone seems to agree that it is unlikely that the Treasury will take another shot at issuing section 385 regulations. See, e.g., J. Eustice, 1987 Cumulative Supplement to Abridged Student Edition of Federal Income Taxation of Corporations and Shareholders ¶ 4.05.

In 1984 the Treasury Department, in a Report to the President, confirmed that problems still existed in the debt or equity controversy. It noted that no guidelines had been developed and that the increasing sophistication in financial instruments were creating even more controversy. 2 Office of the Secretary, Department of the Treasury, Tax Reform for Fairness, Simplicity, and Economic Growth 135 (1984). The report, however, only proposed to try to equalize the treatment of interest and distributions and did not address the debt-equity distinction problem itself. See generally id.


31. “The classic debt,” according to one court, is “an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable
aspects of both debt and equity. An interest labeled as debt might have characteristics more generally associated with equity. Conversely, an interest labeled as equity might have characteristics more generally associated with debt. This article discusses in depth the criteria for classifying an interest as either debt or equity later in the text.

Most classification controversies involve instruments that purport to be debt and that the taxpayers want to be debt, but that the government claims not to be debt. They also usually involve debt issued by closely-held corporations to their own shareholders who, regardless of the debtor's income or the lack thereof.” Gilbert v. Commissioner, 248 F.2d 399, 402 (2d Cir.), later appealed, 262 F.2d 512 (2d Cir. 1957), cert. denied, 359 U.S. 1002 (1959).

32. Common stock would have to be considered the “most classic” of the classic version of equity.

For several early definitions of equity, see United States v. Title Guar. & Trust Co., 133 F.2d 990, 993 (6th Cir. 1943) (“[t]he stockholder’s intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it, so that he may enjoy the chances of profit.”); Commissioner v. Meridian & Thirteenth Realty Co., 132 F.2d 182, 186 (7th Cir. 1942) (“[a] stockholder . . . intends to make an investment and take the risks of the venture . . . .”); Commissioner v. O.P.P. Holding Corp., 76 F.2d 11, 12 (2d Cir. 1935) (“[t]he shareholder is an adventurer in the corporate business; he takes the risk, and profits from success.”).

See generally Plumb, supra note 28, at 404.

33. An example would be a convertible, participating, voting, subordinated debenture. The voting rights would make it resemble common stock in terms of control. The conversion feature would make it resemble common stock in terms of cashing in on future growth of the corporation. The participation right would mean that the holder would not be stuck with a fixed rate of return like he would with a senior security. The subordination feature places the holder at risk in a bankruptcy much like a preferred shareholder with a liquidation preference. For a discussion of these features, see generally A. CONARD, R. KNAUSS, & S. SIEGEL, BUSINESS ENTERPRISES, supra note 13, at §§ 8.03, 8.07, 8.08.

34. An example would be nonvoting, cumulative preferred with a mandatory redemption after a period of years.


See, e.g., John Kelley Co. v. Commissioner, 326 U.S. 521 (1946); Slappey Drive Indus. Park v. United States, 561 F.2d 572 (5th Cir. 1977); J.S. Biritz Co. Constr. v. Commissioner, 387 F.2d 451 (8th Cir. 1967); Taft v. Commissioner, 314 F.2d 620 (9th Cir. 1963); Jack Daniel Distillery v. United States, 379 F.2d 569 (Cl. Cl. 1967). But see Post Corp. v. United States, 640 F.2d 1296 (Cl. Cl. 1981).

because they make the decisions for the corporation, can label an instrument debt no matter how many equity characteristics it might have. The government rarely challenges the status of debt issued by publicly-held corporations, which, due to the constraints of the public markets and the numbers of shareholders, lack the closely-held corporation's ability to affix tax-motivated labels and terms desired by their shareholders on the corporation's securities.

IV. DEBT VS. EQUITY: TAX CONSEQUENCES

The contrast between tax treatment accorded debt and equity is stark. In some instances, the distinctions affect the corporation and in others the investors. More often than not, taxpayers prefer the tax treatment for debt and strive to construct a capital structure heavily laden with debt.

A. The Corporation: Interest vs. Dividend

The Internal Revenue Code allows the corporation to deduct interest paid to lenders, even when the lender is also a shareholder of the corporation. It does not allow the corporation to deduct dividends distributed to its shareholders.

The deductibility of interest and the nondeductibility of dividends furnish a powerful incentive for using debt rather than stock to finance corporations. Assuming that the corporation is going to pay a flat rate of return to the investor, the deduction for interest results in a tax savings that makes it cheaper for the corporation to pay the interest than to distribute the dividend. This is the result

38. See, e.g., Rowan v. United States, 219 F.2d 51, 55 (5th Cir. 1955).
39. Technically, the generic term for a one-way transfer of cash or assets by a corporation to a shareholder is “distribution.” A distribution is a “dividend” to the extent that the distributing corporation has earnings and profits. I.R.C. §§ 301(e)(1), 316(a). But the distinction between a “distribution” and a “dividend” is irrelevant with respect to the deductibility of the payment by the distributing corporation because the distributing corporation is not entitled to deduct the distribution, whether or not it is a dividend. See, e.g., Fin Hay Realty Co., 398 F.2d 694.
40. 1 Z. Cavitch, supra note 1, at § 91.04[1][c]; A. Conard, Corporations in Prospective § 36 (1976); D. Kahn & P. Gann, Corporate Taxation and Taxation of Partnerships and Partners 597 (1979); Hoffman, Coping with the Thin Incorporation Problem, 17 Tul. Tax Inst. 49, 50-51 (1968); Comment, Hybrid Instruments, supra note 30, at 118, 137.
because it pays interest with pre-tax dollars and dividends with post-tax dollars.\textsuperscript{41} To illustrate, suppose that X Corp., a C corporation in the 34\% corporate income tax bracket, has agreed to pay $660 annually to an investor, Anne, in return for Anne's investment in X. To pay a $660 dividend to Anne, X needs to earn $1,000, because it must pay $340 in tax (34\% tax rate x $1000 earnings = $340 corporate income tax), before it has the $660 to distribute to Anne. It needs merely to earn $660 to pay Anne $600 interest, however, because, due to the interest deduction, it does not pay tax on the $660 of revenues that it uses to pay Anne the interest.

Except for the contrasting tax treatment, it makes no difference to the shareholders of a close corporation whether these routine, periodic extractions of current income from their corporation are called "interest" or "dividends," provided that they hold the corporate debt in proportion to their stockholdings (and often they do). The payment of interest, like a dividend, is a method of extracting cash from corporation without disturbing their proportionate interest in it. Moreover, the corporation uses "borrowed capital" the same way it uses "contributed capital."\textsuperscript{42} Additionally, absent tax difference, interest and dividends are the same thing economically to the corporation — a fee payable to investors in return for the funding they provide the business.\textsuperscript{43}

\section*{B. The Corporation: Principal Payments on Corporate Debt vs. Payments of Capital to Shareholders.}

Unlike the distinctive treatment accorded interest and dividends, the tax laws give roughly parallel treatment to debt and equity when the corporation returns the corpus of the investment to the investor.

\textsuperscript{41} See generally, Plumb, supra note 28, at 372-73, Comment, Hybrid Instruments, supra note 30, at 120, 137.


\textsuperscript{43} See generally T. COPELAND & J. WESTON, FINANCIAL THEORY AND CORPORATE POLICY 382-83 (2d ed. 1983); Miller, Debt and Taxes, 32 J. Fin. 261 (1977); Plumb, supra note 28, at 620-21; Comment, Hybrid Instruments, supra note 30, at 133-42.
1. *Cash payments.*

A cash payment on the principal of corporate debt ordinarily does not result in any tax consequences to the corporation.\(^{44}\) It does not get a deduction. It does not have any income, gain or loss. The payment does not entitle the corporation to increase its basis in any of its assets, even if the debt was incurred in connection with the purchase of an asset. (Under the *Crane* doctrine, it already has included such a liability as part of its basis in the property).\(^{45}\)

Like any other taxpayer, however, the corporation does have income for the discharge of indebtedness when the creditor accepts a payment less than the full amount due in full satisfaction of the debt.\(^{46}\) In a famous case, the United States Supreme Court held that the reacquisition of a corporation’s own bonds at less than the amount due resulted in taxable income to the reacquiring corporation.\(^{47}\) Prior to the Tax Reform Act of 1984 (TRA of 1984), however, the courts had held that a corporation did not realize taxable income from discharge of indebtedness when it issued its own stock to discharge its debt, notwithstanding that the value of the stock was less than the amount of debt.\(^{48}\) TRA of 1984 eliminated the stock-for-debt exception for discharge of indebtedness income.\(^{49}\)

\(^{44}\) One major exception involves deductions for original issue discount. If the debtor corporation has issued original issue discount obligations, it is allowed to deduct a portion of the original issue discount each year, though the debt instrument refers to the original issue discount as principal. I.R.C. § 163(e)(1) (1987).

\(^{45}\) If the liability was incurred in connection with purchase of an asset and that purchase was taxable to the seller, the corporation would include the liability in its basis under the *Crane* rationale. See *Crane v. Commissioner*, 331 U.S. 1 (1947). Hence, it has no need to increase its basis by the amount of any payments on principal, because the unpaid principal is already part of its basis under *Crane*. If a corporation took a carryover basis in encumbered assets and the liability was not part of the transferor’s basis, its inability to add principal to its basis in those assets would be a disadvantage for the use of debt.


\(^{48}\) See e.g., Commissioner v. Motor Mart Trust, 156 F.2d 122 (1st Cir. 1946); Commissioner v. Capento Sec. Corp., 140 F.2d 382 (1st Cir. 1944); Tower Bldg. Corp. v. Commissioner, 6 T.C. 125 (1946). See also CONF. REP. ON THE DEFICIT REDUCTION ACT OF 1984, supra note 46, at 1517.

cording to new section 108(e)(10), a debtor corporation realizes taxable income for discharge of indebtedness when it satisfies its debt with stock having a fair market value less than the principal of the debt. The taxable income is the excess of the principal of the debt over the fair market value of the stock. The new rule mandating taxable income does not apply when the debtor corporation is in a Title 11 bankruptcy proceeding or is insolvent. It also does not apply to a corporation with "cash flow and credit problems" that is engaging in a "qualified workout" with creditors.

2. Equity.

Redemptions and liquidating distributions to shareholders are the functional equivalent of principal payments to the holders of corporate debt. The investor recovers what he put into the corporation, and his investment in the corporation is reduced or extinguished. Such payments to shareholders, if in cash, result in no deduction, income, gain, or loss for the corporation.


(a) Debt.

If a corporation uses property-in-kind to pay a debt (whether principal or interest), the transaction ordinarily is treated as a taxable sale of the distributed property by the corporation and is governed by the regular Code sections outside of Subchapter C. The corporation’s amount realized is the amount of the debt discharged.

51. Id. See also Conf. Rep. on the Deficit Reduction Act of 1984, supra note 46, at 1517.

The obvious intent of the workout exception is to permit a debtor corporation in serious financial straits to issue stock to its creditors outside of a bankruptcy proceeding without incurring discharge of indebtedness income.

54. Curiously, a shareholder receiving a distribution from a corporation without some earnings or profits treats the distribution as if received for the sale of his stock — a tax-free return of capital up to his basis in his stock and a gain thereafter. I.R.C. § 301(c)(2),(3) (1987). The idea is that if the corporation has no earnings of profit, the distribution is an extraction of capital from the business.
Accordingly, it will be compelled to recognize a gain to the extent that the cancelled debt exceeds its basis in the transferred property.\textsuperscript{55} The creditor must recognize gain on receipt of the property to the extent that the fair market value of the property exceeds the creditor's basis in the debt discharged.\textsuperscript{56}

The corporation is entitled to recognize a realized loss,\textsuperscript{57} but only if it can avoid section 267, which disallows loss deductions on sales or exchanges of property between related parties. Related parties include corporations and their shareholders owning 50\% or more of the corporation's stock.\textsuperscript{58} For purposes of this 50\% test, the shareholder constructively owns stock actually owned by his brothers, sisters, spouse, ancestors, and linear descendants.\textsuperscript{59} Obviously, the constructive ownership rules are often going to make the debt-holding shareholders in closely-held corporations shareholders owning more than 50\% (if they aren't already) and, thus, related parties.

(b) Equity.

General. If the corporation uses property-in-kind to make a section 301 distribution or redeem its stock, (including debt recharacterized by the IRS as stock), the recently revamped section 311 rules will require it to recognize a gain to the extent that the fair market value of the property exceeds the distributing corporation's basis in it.\textsuperscript{60} If its basis exceeds the property's fair market value,
however, the corporation will not be able to recognize a loss on the exchange.\textsuperscript{61} New section 336(a) reverses the formal general rule of section 336(a) so that a liquidating corporation generally will recognize a gain or loss on a distribution of appreciated property in a complete liquidation.\textsuperscript{62}

\textit{Transitional relief for "small corporations."} The Tax Reform Act of 1986 provided transitional relief for liquidating "small corporations." They are allowed to distribute appreciated property to shareholders in a liquidation without recognition of gain, provided the liquidation is completed before January 1, 1989. The nonrecognition rule applies only to assets that, if sold, would produce long-term capital gain. A "small corporation" is a corporation worth no more than \$10 million and that has 50\% or more in value of its stock owned by ten or fewer people. Full nonrecognition is available only for corporations worth \$5 million or less. The benefit of non-recognition is phased out for corporations with a value between \$5 million and \$10 million.\textsuperscript{63}

(c) Exception to recognition.

\textit{Subsidiaries.} The new law also continues the old rule that an 80\% or more owned subsidiary recognizes no gain or loss when making liquidating distributions to its parent.\textsuperscript{64} The subsidiary now


\textsuperscript{64} The 1954 Code needed no special subsection to provide nonrecognition for a liquidating subsidiary, because nonrecognition was the general rule for all liquidating corporations. \textit{See} I.R.C. § 336 (1954). The depreciation recapture sections contained special exemptions from recognition to recapture income for liquidating subsidiaries in § 332 liquidations, however. \textit{See, e.g.,} I.R.C. §§ 1245(b)(3), 1250(d)(3) (1984). Now that recognition is the general rule for liquidating corporations, liquidating subsidiaries in a § 332 liquidation no longer need a special subsection to be protected from recognition of gain. This rule is contained in I.R.C. § 337(a) (1987). Congress left unchanged the exemptions from recapture income for liquidating subsidiaries in § 332 liquidations. \textit{See, e.g., id. §§ 1245(b)(3), 1250(d)(3) (1987).}
recognizes a gain\textsuperscript{65} (but not a loss)\textsuperscript{66} when distributing property to a shareholder other than its parent, i.e., a minority shareholder.

\textit{Stock dividends}. The corporation still recognizes no gain or loss when it distributes its own stock (or stock rights) to its shareholders.\textsuperscript{67}

\textit{Corporate divisions and reorganizations}. Additionally, the new Code still generally allows a corporation to exchange appreciated property tax-free for stock or securities in qualifying corporate divisions or reorganizations and to distribute that stock or those securities tax-free to its shareholders.\textsuperscript{68} A corporate transferor in a section 351 exchange also can drop down the stock it receives in the exchange to its shareholders without incurring a taxable gain.\textsuperscript{69}

\textit{Limitations on losses in liquidations}. New section 336(d) tries to prevent shareholders from manufacturing artificial losses for their closely-held corporations in anticipation of a liquidation. The temptation is especially great now that the liquidating corporation must recognize gains on all of its appreciated property. Without this barrier, the shareholders could contribute loss property to the corporation and make the corporation in turn either sell it at a loss or distribute it back to the shareholders for a loss as part of the liquidation. Section 336(d)(1) disallows recognition of the loss on liquidating distributions of loss property to majority shareholders, if either (i) the loss property is distributed only to the majority share-

\textsuperscript{65} The nonrecognition rule contained in new § 337(a) applies only to distributions to "80-percent distributee[s]" in § 332 liquidations, i.e., the parent corporation. See \textit{id.} §§ 337(a) (1987). That means that distributions to minority shareholders in § 332 liquidations are governed by § 336(a), which provides the general rule of recognition of gain for the liquidating corporation. See \textit{id.} § 336(a) (1987).

\textsuperscript{66} \textit{Id.} § 336(d)(3) (1987) (no loss recognized to the liquidating corporation on any distribution in a § 332 liquidation).

\textsuperscript{67} \textit{Id.} § 311(a)(1) (1987).

\textsuperscript{68} \textit{Id.} § 361(a),(b). Section 361(c), however, requires the corporation to recognize the gain of a distribution of other types of property as if the property had been sold to the distributee at its fair market value. \textit{id.} § 361(c) (1987). For the garbled mess that this set of rules makes, see Eustice, \textit{A Case Study In Technical Tax Reform: Section 361, or How Not To Revise A Statute}, 35 \textit{Tax Notes} 283 (1987).

\textsuperscript{69} \textit{See id.} § 351(c) (1987) (corporate transferor counted in control group despite drop-down of stock to shareholders).
holders,\textsuperscript{70} or (ii) the corporation had acquired the loss property in section 351 exchange or as a contribution to capital within the preceding five years.\textsuperscript{71} Section 336(d)(2) requires a liquidating corporation to reduce its basis by the amount of the "built-in loss" (excess of fair market value over the corporation's basis at time of acquisition), when computing its loss on the sale or exchange of loss property contributed by shareholders.\textsuperscript{72} Section 336(d)(2) requires the basis reduction only when the shareholder's purpose in contributing the property was to create a loss for the corporation.\textsuperscript{73}

The changes in the liquidation sections in the new Code are a mix of good and bad for the closely-held corporation holding loss property. Unlike the old law,\textsuperscript{74} the liquidating corporation sometimes now can recognize a loss on the distribution of loss property to its own shareholders.\textsuperscript{75} Moreover, subject to the section 336(d)(2) built-in loss limitation rule for recently contributed property and the section 267 rules, the Code still lets the corporation recognize a loss on the sale of property and then distribute the proceeds to the shareholders. That is the good. As to the bad: (i) section 311(a) prevents the corporation from recognizing a loss when distributing the property as a dividend or in redemptions;\textsuperscript{76} (ii) section 336(d) inhibits the recognition of the loss by a liquidating corporation;\textsuperscript{77} (iii) and

\textsuperscript{70} A threshold requirement for the application of § 366(d)(1) is that the liquidating corporation distribute the property to a person related within the meaning of § 267. \textit{Id.} § 336(d)(1)(A)(1987). An individual shareholder and a corporation are related under § 267, if the individual, directly or indirectly, owns more than 50\% in value of that corporation's outstanding stock. \textit{Id.} § 267(b)(2) (1987). A shareholder that is a corporation is related to the distributing corporation, if the shareholder corporation owns more than 50\% of the stock of the distributing corporation. \textit{Id.} §§ 267(b)(3), (f), 1563(a).

Section 336(d)(1)(A)(i) provides the first of the two alternative conditions for the applicability of the nonrecognition rule, provided that the threshold requirement of a distribution to related party is met. The first alternative is that the distribution is disproportionate. Since it has to be made to a 50\% or more shareholder, a disproportionate distribution would seem to be a distribution made solely to a majority shareholder. \textit{See id.} § 336(d)(1)(A)(i) (1987). Apparently, a distribution of loss property to all shareholders as tenants-in-common would not trigger section 336(d)(1)(A)(i), because it is not "not pro-rata." \textit{Id.}

\textsuperscript{71} \textit{Id.} § 336(d)(1)(A)(ii), (B) (1987).

\textsuperscript{72} \textit{Id.} § 336(d)(2) (1987).

\textsuperscript{73} \textit{Id.} § 336(d)(2)(B)(ii) (1987).

\textsuperscript{74} \textit{Id.} § 336 (1954) (nonrecognition of loss as well as gain for liquidating corporation).

\textsuperscript{75} \textit{Id.} § 336(a) (1987) (general recognition rule for liquidating corporations).

\textsuperscript{76} \textit{Id.} § 311(a) (1987). \textit{See generally supra} note 61.

\textsuperscript{77} \textit{Id.} § 336(d) (1987).
section 267 sometimes forecloses the possibility of taking a loss by transferring it to cancel debt held by a shareholder-creditor.\textsuperscript{78}

C. The Corporation: Receipt of Funds

Section 1032(a), a key section in corporate tax law, provides that a corporation recognizes no gain or loss when it issues its own stock in return for money or other property.\textsuperscript{79} This nonrecognition rule applies to the issuance of treasury shares as well as to authorized but unissued shares.\textsuperscript{80} Section 1032(a) applies in transactions that various Subchapter C code sections make tax-free to the shareholder who is paying money or conveying other property in exchange for the stock, e.g., a section 351 exchange.\textsuperscript{81} Section 1032(a) also provides nonrecognition treatment to the issuing corporation when the transaction is a taxable sale or exchange to the shareholder.\textsuperscript{82} The issuance by a corporation of its own shares as compensation for services is considered as a disposition by such corporation of such shares for money or other property, i.e., 1032(a) governs such an issuance.\textsuperscript{83}

\begin{itemize}
  \item \textsuperscript{78} Id. § 267 (1987).
  \item \textsuperscript{79} Id. § 1032(a) (1987). But see id. § 108(e)(10) (1987).
  \item \textsuperscript{80} Id. § 1032(a) (1987).
  \item Prior to the enactment of section 1032(a) in 1954, the government sometimes posited that a corporation should recognize a gain when it "deals in its own shares as it might in the shares of another corporation." See Treas. Reg. § 39.22(a)-15(b) (1939). Section 1032 consciously eliminated the pre-1954 distinction between payments received for treasury shares and payments received for newly issued shares. B. WOLFMAN, FEDERAL INCOME TAXATION OF BUSINESS ENTERPRISE 93 (2d ed. 1982). See also H.R. REP. No. 1337, 83d Cong., 2d Sess., reprinted in 1954 U.S. CODE CONG. & ADMIN. NEWS 4017, 4410; S. REP. No. 1622, 83d Cong., 2d Sess., reprinted in 1954 U.S. CODE CONG. & ADMIN. NEWS 4621, 5069.
  \item \textsuperscript{81} For the tax-free treatment of the transferor of property in a section 351 exchange, see I.R.C. § 351(a) (1987).
  \item Another example would be the parent corporation in a D reorganization. The first step in a D reorganization is for a corporation to transfer assets to a controlled corporation. Id. § 368(a)(1)(D) (1987). If the controlled corporation issues stock for those assets, section 1032(a) insulates it from the recognition of a gain or a loss. If the controlling corporation does receive stock in that exchange, section 361(a) protects it from recognizing a gain or loss for transferring property in exchange for the stock of the controlled corporation. For the transaction to constitute a D reorganization, the controlling corporation must distribute the stock of the controlled corporation to the shareholders of the controlling corporation in a transaction qualifying under sections 354, 355 or 356. Id. § 368(a)(1)(D) (1987). Sections 354 and 355 provide nonrecognition treatment for the shareholders in the controlling corporation on receipt of the stock of the controlled corporation. Id. §§ 354(a)(1), 355(a)(1) (1987).
  \item \textsuperscript{82} See, e.g., Grant v. Commissioner, 44 T.C.M. (CCH) 893 (1982).
  \item \textsuperscript{83} Treas. Reg. § 1.1032-1(a) (1987).
\end{itemize}
A corporation, like any other taxpayer, has no income, gain or loss, when it issues debt in exchange for money or other property. It does not treat borrowed money as income because conceptually the increase in liabilities offsets the increase in assets. The borrowing does not increase its net worth.

D. The Investor: Tax Consequences on Payment of Obligation

1. Debt.

If an investor’s interest in a corporation is determined to be debt, a payment on the principal of the debt is a tax-free return of capital up to the investor’s basis in the debt. Prior to the TRA of 1984, principal payments in excess of the investor’s basis in the debt ordinarily were treated as capital gains, though a portion of the principal payment occasionally would have been treated as ordinary income under original issue discount rules. The TRA of 1984 substantially expanded the applicability of the original issue discount rules, which are discussed in IV(e), infra, and they are now more likely than before to produce interest income for the holder on discounted debt issued by a close corporation. The TRA of 1984 also introduced a new tax concept, market discount, that sometimes requires payment on principal above the owner’s basis to be treated as interest income. The market discount rules, discussed in IV(f), infra, do not affect the general rule that payments of principal up to the investor’s basis are tax-free returns of capital, but they can affect the tax treatment of payments of principal above basis.

84. B. WolfeMAN, supra note 80, at 94.
86. Id. § 1271(a)(1) (1987).
Interest paid on a debt is taxable as ordinary income to the recipient\(^\text{89}\) regardless of the corporation's earnings and profits.

2. **Stock.**

Closely-held corporations have a variety of choices in structuring transfers of corporate assets to shareholders, and the tax treatment for the shareholders varies according to the particular structure chosen. But before mastering the Code sections that implement the rules respecting these transfers, one needs to be well-versed in a certain amount of jargon. One of the key words is "distribution." It refers to a transfer of something by a corporation to its own shareholders who receive the distributed item in their capacity as shareholders. In other words, rent paid by a corporation to a shareholder who is leasing property to the corporation is not considered a distribution.\(^\text{90}\) Distributions include dividend-style distributions, "stock dividends,"\(^\text{91}\) some transfers to shareholders in corporate divisions and reorganizations,\(^\text{92}\) and distributions in redemptions and liquidations. The commonality in these transactions is a transfer of something by a corporation to its own shareholders. In this section, "liquidating distribution" is used to refer to payments to shareholders, "redemption proceeds" is used to refer to payments made to redeem stock, and "distribution" is used to refer to a dividend-style distribution of cash or property by a corporation to its own shareholders — a one-way nonliquidating transfer from a corporation to its own shareholders.

(a) Liquidating distributions.

The shareholder usually is entitled to "sale or exchange" treatment upon receipt of a liquidating distribution from the corpora-

---

\(^{89}\) *Id.* § 61(a)(4) (1987).

\(^{90}\) Often the best tax consequences are produced by finding a reason other than the recipient's status as a shareholder. For example, the closely-held corporation might be able to hire the shareholder as an employee and pay him a salary, which the corporation can deduct as a business expense. Since the purpose of the text is to discuss the tax consequences of payments to shareholders in their capacity as shareholders, this and other similar devices are not discussed at this point.

\(^{91}\) "Stock dividend" itself is a term of art that refers to a one-way transfer of a corporation's own stock to its own shareholders. I.R.C. § 316(a) (1987).

\(^{92}\) The term "distribution" properly can be used to refer to a parent's distribution of a subsidiary's stock in a corporate division.
tion, a tax-free return of capital up to the shareholder’s basis in the stock and a recognized gain thereafter. Liquidating distributions have nothing corresponding to the interest paid to debtholders. Unlike the interest paid to the debtholder, no part of the liquidating distribution is routinely ordinary income to the shareholder. The debtholder is entitled to exchange treatment (tax-free return of basis and a recognized gain thereafter), but only on the repayment of the principal of the debt. He does not get exchange treatment on the interest. For both debt and stock, the Code contains several exceptions to this capital gain treatment the original issue discount and market discount rules for debts and the collapsible corporation rules for stock.

(b) Dividend-style distributions.

The key sections of the Internal Revenue Code that govern non-liquidating, dividend-style corporate distributions are:

1. Section 61(a)(7), which states that gross income includes dividends;
2. Section 316(a), which defines the term “dividend”;
3. Section 312, which contains “earnings and profits” rules, which in turn determines which distributions will be considered dividends under section 316;
4. Section 301, which describes the tax treatment for shareholders receiving nonliquidating distributions;
5. Section 311, which describes the tax treatment for corporations making div-

---

93. See I.R.C. § 331(a) (1987). The Code contains several exceptions to the rule quoted in the text. See, e.g., id. § 332(a) (nonrecognition to a parent corporation on receipt of a liquidating distribution from an 80% or more owned subsidiary). See also I.R.C. § 333 (1954) (complete or partial nonrecognition for shareholders in certain “one month” liquidations). A shareholder may be entitled to nonrecognition on receipt of a liquidating distribution when the distribution is part of a reorganization. See id. §§ 354(a)(1), 368(a)(1)(C), (2)(G)(i)(1987).
94. See id. §§ 331(a) (1987) (liquidations), 1271(a)(1) (exchange treatment for amounts received by a holder on retirement of a debt instrument).
95. See id. § 1271-75 (1987).
96. See id. §§ 1276-78 (1987).
98. Id. § 316(a) (1987).
99. Id. § 312 (1987).
100. Id. § 301 (1987).
101. More particularly, § 301 describes the tax treatment for shareholders receiving dividend-style corporate distributions. Id. § 301 (1987). Other nonliquidating distributions, e.g., redemptions, are sometimes treated by other code sections in Subchapter C. See, e.g., id. § 302 (1987) (redemptions).
102. Id. § 311 (1987).
idend-style distributions to their own shareholders;\(^{103}\) and

(6) Section 243(a),\(^{104}\) which entitles corporations receiving dividends to deduct 80% of dividends received from nonaffiliated corporations and 100% of dividends received from affiliated corporations.

"Dividend" is one type of a distribution. It is specifically defined in section 316 of the Internal Revenue Code as any distribution of property made by a corporation to its shareholders to the extent that the corporation has either accumulated or current earnings and profits.\(^{105}\) "Distribution," thus, is a general term, "dividend," a specific term. A dividend-style distribution — a one-way transfer of cash or property-in-kind to a shareholder — is a dividend only to the extent that the distributing corporation has earnings and profits. The determination that part of a distribution is a dividend is of immense tax significance, because "dividends" must be included in the recipient’s gross income under sections 61\(^{106}\) and 301(c)(1),\(^{107}\) subject to the section 243 dividends received deduction for corporations.\(^{108}\) Any part of a dividend-style distribution that exceeds the distributing corporation’s earnings and profits are not "dividends" for tax purposes. The concept of a dividend for tax purposes, thus, is what an old-fashioned economist would consider to be a dividend transaction — a profitable corporation passing out assets (including cash) to its shareholders.

To the extent that the earnings and profits do not cover the distribution, it is treated like a payment to the shareholder on the sale of his stock. It is a tax-free return of capital up to his basis in his stock\(^{109}\) and a recognized gain thereafter.\(^{110}\)

\(^{103}\) Section 311 applies to most dividend-style distributions and redemptions. Id. Other sections in Subchapter C sometimes apply to particular, nonliquidating distributions, however. See, e.g., id. § 361(b)(1)(B) (1987) (tax-free treatment for distributions to own shareholders of property-in-kind or money received by a corporation in a reorganization).

\(^{104}\) Id. § 243(a)(1), (3) (1987).

\(^{105}\) Id. § 316(a) (1987).

\(^{106}\) Id. § 61(a)(7) (1987).

\(^{107}\) Id. § 301(c)(1) (1987).

\(^{108}\) Id. § 243(a)(1), (3) (1987).

\(^{109}\) Id. § 301(c)(2) (1987).

\(^{110}\) Id. § 301(c)(3)(A) (1987). Usually, recognized gain is a capital gain. If the corporation is collapsible, however, the shareholder probably will be required to treat the gain as ordinary income. Id. § 341(a)(3) (1987).
When the corporation has substantial earnings and profits, dis-
tributions to shareholders generally produce inferior tax conse-
quences for the unincorporated investor than do payments to
debtholders. To debtholders, interest is always ordinary income.\textsuperscript{111} Payments of principal are tax-free returns of capital up to basis.\textsuperscript{112} Payments of principal above basis are capital gain,\textsuperscript{113} unless there is some original issue discount or market discount. Payments of principal above basis are ordinary income to the extent of the original issue\textsuperscript{114} or market\textsuperscript{115} discount. None of these tax consequences depend on earnings and profits. In contrast, the presence or absence of earnings and profits plays a key role to the shareholder receiving a distribution. If the corporation has enough earnings and profits to cover the full amount of its distributions, that full amount is ordinary income to the shareholder.\textsuperscript{116} No part of the distribution is a capital gain. Moreover, unlike the debtholder, the shareholder is not entitled to reduce the amount of the payment includable in his income by his basis in his investment.

Investors that are themselves corporations must be excepted from the group of investors who generally prefer the tax consequences of debt repayments over the receipt of dividends. As discussed later, this excepted group of taxpayers is entitled to the section 243 dividends received deduction\textsuperscript{117} and often prefers receiving dividends.

(c) Stock Redemptions.

Stock redemptions are governed by their own, unique subsystem inside Subchapter C. The key section is section 302. If a redemption

\footnotesize{111. Id. § 61(a)(4) (1987).
112. Id. § 1271(a)(1) (1987) (exchange treatment of amounts received by a debt holder on re-
tirement of any debt).
115. Id. § 1276(a)(1) (1987).
116. Id. §§ 301(c)(1), 316(a) (1987). The statement in the text assumes that the recipient of the distribution is a human being, not another corporation. A corporate recipient of a distribution is entitled to a § 243(a) dividends-received deduction. See id. § 243(a) (1987).
117. See id. § 243(a) (1987). The corporation is generally entitled to an 80% dividends-received deduction. Id. § 243(a)(1) (1987). An electing member of an affiliated group can choose to deduct all of the dividend. Id. § 243(a)(3), (b) (1987).}
meets any of the four tests contained in section 302(b), the shareholder treats the redemption proceeds as if received in payment in exchange for his stock,\textsuperscript{118} i.e., tax-free return of capital up to his basis and a recognized gain thereafter. If a redemption fails all of the section 302(b) tests, the redemption proceeds are treated as a section 301 distribution,\textsuperscript{119} i.e., a dividend and ordinary income to the extent of the distributing corporation's earnings and profits. The distinction in tax treatment between stock redemptions failing all of the 302(b) tests and repayments on debt is essentially the same as those discussed under the heading "Liquidating distributions." The distinction in tax treatment between stock redemptions not meeting one of the 302(b) tests and repayments on debt is essentially the same as those discussed in the heading entitled "Dividend-style distributions."

3. \textit{Purported debt instruments recharacterized as stock or a contribution to capital.}

The government frequently tries to characterize "loans" by shareholders to closely-held corporations as either contributions to capital or as payments for "stock." If the government successfully recharacterizes a purported debt instrument as equity, any "interest" payments on the debt are considered section 301 distributions\textsuperscript{120} and are dividends to the extent of the distributing corporation's earnings and profits. Dividends are treated as ordinary income. "Principal" payments on the debt usually are considered distributions in redemption of the "STOCK."\textsuperscript{121} More often than not these "redemptions" fail the section 302(b) tests and are treated as section

\textsuperscript{118} Id. § 302(a) (1987).
\textsuperscript{119} Id. § 302(d) (1987).
\textsuperscript{121} See, e.g., Dillin v. United States, 433 F.2d 1097 (5th Cir. 1970); Peterson v. Commissioner, 380 F.2d 1 (9th Cir., 1967); Burr Oaks Corp. v. Commissioner, 43 T.C. 635 (1965), aff'd, 365 F.2d 24 (7th Cir. 1966), cert. denied, 385 U.S. 1007 (1967); Rev. Rul. 73-122, 1973-1 C.B. 66.
\textit{See also} B. Bittek & J. Eustice, \textit{supra} note 27, at ¶ 4.08; Bacon & Patterson, \textit{supra} note 120, at A-34.
301 distributions because (A) that debt is apt to be recharacterized as stock only when the stock holders hold it in proportion to their stock ownership, (B) the "redemptions" of the purported debt instruments are consequently likely to be proportionate, and (C) proportionate redemptions generally fail the section 302(b) tests and are treated as section 301 distributions.

It is possible that the initial payment by the investor to the corporation might be reclassified as a contribution to capital and not even as a purchase of stock. If that is the case, the payment by the corporation to the investor is outside of section 302, since the investor has no stock to be redeemed. Hence, the payment must be treated as a section 301 distribution.122

E. The Investor and Original Issue Discount

Discounted debt is a debt issued for less than the amount due on the debt at maturity. Original issue discount is the difference between the issue price and the amount due at maturity.123 Economically, it is identical to interest—an amount charged for the use or forbearance of money.124 The Supreme Court held that in a pre-1954 transaction, gain realized on account of original issue discount was taxable as ordinary income because the discount was the economic equivalent of interest.125 Congress first promulgated statutory rules on original issue discount when it enacted section 1232 in 1954.126

122. See, e.g., B. BITTKER & J. EUSTICE, supra note 27, at ¶ 4.08.
125. Id. at 67.
126. As originally enacted in 1954, section 1232 stated:
(a) General Rule. For purposes of this subtitle, in the case of bonds, debentures, notes, or certificates or other evidences of indebtedness, which are capital assets in the hands of the taxpayer, and which are issued by any corporation, or government or political subdivision thereof—
(1) Retirement. Amounts received by the holder on retirement of such bonds or other evidences of indebtedness shall be considered as amounts received in exchange therefor (except that in the case of bonds or other evidences of indebtedness issued before January 1, 1955, this paragraph shall apply only to those issued with interest coupons or in registered form, or to those in such form on March 1, 1954).
(2) Sale or Exchange.
(A) General Rule. Except as provided in subparagraph (B), upon sale or exchange of
According to those rules, which affected bonds issued between 1954

bonds or other evidences of indebtedness issued after December 31, 1954, held by the taxpayer more than 6 months, any gain realized which does not exceed an amount which bears the same ratio to the original issue discount (as defined in subsection (b)) as the number of complete months that the bond or other evidences of indebtedness was held by the taxpayer bears to the number of complete months from the date or original issue to the date or maturity, shall be considered as gain from the sale or exchange of property which is not a capital asset. Gain in excess of such amount shall be considered gain from the sale or exchange of a capital asset held more than 6 months.

(B) Exceptions. This paragraph shall not apply to —

(i) obligations the interest on which is not includable in gross income under section 103 (relating to certain governmental obligations), or

(ii) any holder who has purchased the bond or other evidence of indebtedness at a premium.

(C) Election as to inclusion. In the case of obligations with respect to which the taxpayer has made an election provided by section 454(a) and (c) (relating to accounting rules for certain obligations issued at a discount), this section shall not require the inclusion of any amount previously includable in gross income.

(b) Definitions.

(1) Original issue discount. For purposes of subsection (a), the term "original issue discount" means the difference between the issue price and the stated redemption price at maturity. If the original issue discount is less than one fourth of 1 percent of the redemption price at maturity multiplied by the number of complete years to maturity, then the issue discount shall be considered to be zero. For purposes of this paragraph, the term "stated redemption price at maturity" means the amount fixed by the last modification of the purchase agreement and includes dividends payable at that time.

(2) Issue price. In the case of issues of bonds or other evidences of indebtedness registered with the Securities and Exchange Commission, the term "issue price" means the initial offering price to the public (excluding bond houses and brokers) at which price a substantial amount of such bonds or other evidences of indebtedness were sold. In the case of privately placed issues of bonds or other evidence of indebtedness, the issue price of each such bond or other evidence of indebtedness is the price paid by the first buyer of such bond. For purposes of this paragraph, the terms "initial offering price" and "price paid by the first buyer" include the aggregate payments made by the purchaser under the purchase agreement, including modifications thereof.

(3) Issue date. In the case of issues of bonds or other evidences of indebtedness registered with the Securities and Exchange Commission, the term "date of original issue" means the date on which the issue was first sold to the public at the issue price. In the case of privately placed issues of bonds or other evidences of indebtedness, the term "date of original issue" means the date on which each such bond or other evidence of indebtedness was sold by the issuer.

(c) Bond with excess number of coupons detached. If —

(1) a bond or other evidence of indebtedness issued at any time with interest coupons is purchased after the date of enactment of this title, and

(2) the purchaser does not receive all the coupons which first become payable more than 12 months after the date of the purchase, then the gain on the sale or other disposition of such evidence of indebtedness by such purchaser shall be considered as gain from the sale or exchange of property which is not a capital asset to the extent that the market
and 1969, the debt-holder was not taxed on the discount until the debt was paid off at maturity or sold or otherwise disposed of at a gain in a taxable transaction.\textsuperscript{127} The cases, however, allowed the corporation to deduct the discount as interest ratably over the life of the debt.\textsuperscript{128} The amount of the gain attributable to the discount was treated as ordinary income.\textsuperscript{129} In 1969,\textsuperscript{130} Congress amended section 1232 so that the holder of a corporate bond was required to include the original issue discount in his income ratably over the time he held the bond.\textsuperscript{131} In 1982\textsuperscript{132} and 1984,\textsuperscript{133} Congress again amended the original issue discount rules, which are now contained in sections 1271 through 1275\textsuperscript{134} and several other related sections.\textsuperscript{135}
The thrust of the 1982 change was to take into account the concept of the time value of money. The 1984 legislation also eliminated some of the exceptions to the applicability of the original issue discount rules.

1. Tax consequences.

New section 1271(a)(1) recodified the rule formerly contained in section 1232(a), payments in retirement of corporate debt are considered amounts paid in exchange therefor. Hence, they represent a tax-free return of capital up to the holder’s basis in the debt and a recognized gain thereafter. If the debt is issued with original discount, however, section 1272(a)(1) requires the holder of the debt to include a part of the original issue discount in his gross income each year. Each inclusion in income results in an increase in the holder’s basis in the debt. If, at the time of the original issuance

135. For example, the expansion of the original issue discount rules required a concomitant reduction in the scope of the imputation of interest rules in section 482. See Tax Reform Act of 1984, supra note 49, at § 41(b). The ‘84 Act also amended sections 1235(c), 6706, 103A(l)(2)(c), 163(e), 165(j)(3), 249(b)(1), 263(g)(6)(B), 822(b)(3), 1037(b), 1251(h) and 6049(d)(6) and repealed sections 1232, 1232A and 1232B. Id. §§ 41-42.


137. The Tax Reform Act of 1984 extended the original issue discount rules to discounted debt (1) issued for property, even though neither the debt nor the property is publicly traded, (2) discounted debt that is not a capital asset and discounted debt issued by individuals. Tax Reform Act of 1984, supra note 49, at § 41(a); J. Eustice, supra note 87, at ¶ 2.02; Cliff & Levine, Interest Accrual and the Time Value of Money, 34 Am. U.L. Rev. 107, 135-38 (1984).


140. The excess of the principal payment over the debt-holder’s basis is a capital gain, only if the debt is a capital asset in his hands.

141. I.R.C. § 1272(a)(1) (1987). The amount includible each year is based on compound interest principles.

142. Id. § 1272(d)(2) (1987).
of the discounted debt, the parties intended that the debt would be called before maturity, the gain on a sale, exchange, or redemption prior to maturity must be treated as ordinary income to the extent of any untaxed original issue discount.\footnote{143} Section 163(e)(1) allows the issuing corporation an interest expense deduction on that portion of the original issue discount that accrued during the taxable year.\footnote{144}

2. \textit{Applicability to closely-held corporations.}

If a closely-held corporation issues a debt instrument with an original issue discount in exchange for cash, the "issue price" of that instrument is the cash price paid by the issuee of that debt instrument,\footnote{145} and the tax consequences described in the preceding section apply.

Prior to the TRA of 1984, the original issue discount rules did not apply to debt instruments issued in exchange for property when neither the debt itself nor the property received in the exchange was publicly traded.\footnote{146} TRA of 1984 eliminated that exemption.\footnote{147} Thus, if a corporation issues a discounted debt instrument in exchange for property, the original issue discount rules generally apply.\footnote{148} As a practical matter, however, the statute is written to allow closely-held corporations to issue discounted debt in exchange for property worth $250,000 or less and still avoid the original issue discount rules.

This practical limitation operates as follows. Section 1273(a)(1) defines original issue discount as the excess of stated redemption price at maturity over issue price.\footnote{149} Sections 1273(b)(1) through (4)\footnote{150}
and 1274151 contain all of the definitions of "issue price." Section
1273(b)(1)152 defines the term "issue price" for publicly offered debt
instruments issued for cash, section 1273(b)(2)153 for other debt in-
struments issued for cash, and section 1273(b)(3)154 for debt instru-
ments issued for property where either the debt instrument itself is
publicly traded or is issued in exchange for stock or securities that
are publicly traded. Of these definitions, only that in section
1273(b)(3) could apply to debt issued by a closely-held corporation
in exchange for property, and then only if the closely-held corpor-
ation received publicly traded stock or securities in the exchange.
Section 1274 defines "issue price" for discounted debt issued in
exchange for property when neither the debt nor the property re-
ceived in the exchange is publicly traded.155 This is the typical trans-
action between an investor and a closely-held corporation. Section
1274(c)(4)(C), however, renders the issue price definition of section
1274 inapplicable to a debt instrument when the aggregate amount
of all consideration to be paid to acquire the property, including
the aggregate amount of the payments due under the debt instru-
ment, totals $250,000 or less.156 The only other definition of issue
price is in section 1273(b)(4), a catch-all provision. It defines "issue
price" for a debt instrument issued for property and not covered
by section 1273(b)(1), (2) or (3) or section 1274.157 The section
1273(b)(4) definition of "issue price" is the "stated redemption price
at maturity."158 This definition effectively denies the applicability of
the original issue discount rules to transactions within section
1273(b)(4)’s coverage because the stated redemption price at maturity
must exceed the issue price to have any original issue discount.159
Since section 1271(b)(1) defines "issue price" as stated redemption
price at maturity,160 the issue price cannot possibly exceed the stated

151. Id. § 1274 (1987).
152. Id. § 1273(b)(1) (1987).
153. Id. § 1273(b)(2) (1987).
154. Id. § 1273(b)(3) (1987).
155. Id. § 1274 (1987).
156. Id. § 1274(c)(3)(C) (1987).
158. Id.
160. Id. § 1271(b)(1) (1987).
redemption price at maturity, and there cannot be any original issue
discount.

The original issue discount rules do apply to discounted debt
issued by a closely-held corporation in exchange for property when
the aggregate consideration to be paid to acquire the property ex-
cceeds $250,000.\textsuperscript{161} Section 1274 details an elaborate scheme for de-
determining issue price\textsuperscript{162} and, therefore, the amount of original issue
discount, if any, for these transactions.\textsuperscript{163}

\textbf{F. The Investor and Market Discount.}

"Market discount" is any excess of stated redemption price of
a bond at maturity over its basis to its holder immediately after its
acquisition.\textsuperscript{164} "market discount bond" is any bond having market
discount.\textsuperscript{165} The term "bond" includes notes, certificates or "other
evidence of indebtedness" as well as traditional bonds or deben-
tures.\textsuperscript{166} Market discount typically arises when the interest rate on
an existing bond is less than the current market rate of interest for
bonds with similar terms and credit risks.\textsuperscript{167} To sell such a bond,
the holder discounts the sale price to a point below the stated re-
demption price at maturity to account for the bond's below-market
interest rate. To the purchaser of the bond, the market discount is

\begin{quote}
\textsuperscript{161} The transaction would not fall under the practical exemption of section 1274(c)(3)(C), which
is described in the preceding paragraph in the text. See id. § 1274(c)(3)(C) (1987).
\textsuperscript{162} Id. § 1274 (1987).
\textsuperscript{163} For a full discussion of these rules, see generally J. Eustice, supra note 87, at ¶ 2.02[2];
RESEARCH INSTITUTE OF AMERICA, THE R.I.A. COMPLETE ANALYSIS OF THE TAX REFORM ACT OF 1984,
¶ 106 (1984); Canellos, supra note 87, at 356-61; Cliff & Levine, supra note 137, at 136-37.
\textsuperscript{165} If the bond has original issue discount, the stated redemption price of the bond at maturity
equals its "revised issue price," which means the sum of the issue price of the bond plus the aggregate
amount of original issue discount includible in the gross income of all holders before acquisition of
the bond by the taxpayer. Id. § 1278(a)(4) (1987).
\textsuperscript{166} Id. § 1278(a)(1)(A) (1987).
\textsuperscript{167} The term "market discount bond" does not include obligations with a fixed maturity date of
one year or less, tax-exempt obligations, United States savings bonds and section 453B installment
\textsuperscript{168} Id. § 1278(a)(3) (1987).
\textsuperscript{169} Abusive Tax Shelters, supra note 136, at 108.
\end{quote}
the equivalent of interest\textsuperscript{168} since, when added to the interest rate stated on the bond, it bootstraps the return on the bond up to the interest rates prevailing at the time of the acquisition of the bond. Since the purchaser uses the sale price as his basis in the bond and the sale price is lower than the stated redemption price at maturity, he takes a basis lower than the stated redemption price at maturity.

Prior to TRA of 1984, the market discount on debt obligations generally was taxed as a capital gain on payment of the obligation at maturity under old 1232(a).\textsuperscript{169} Because market discount is the equivalent of interest to the purchaser of the debt, Congress finally decided that it should be taxed to him as ordinary income like other forms of interest.\textsuperscript{170} TRA of 1984 added sections 1275 through 1278 to the Code.\textsuperscript{171} After a taxpayer buys a bond at a market discount, the market discount accrues during the period that he holds the bond.\textsuperscript{172} Unlike the treatment under the original issue discount rules, however, he is not taxed on the accrual.\textsuperscript{173} Instead, when he disposes of the bond or it is retired, his realized gain is recognized as ordinary income to the extent of the "accrued market discount," i.e., the market discount that accrued from the date of his purchase to the date of the disposition or retirement.\textsuperscript{174} The gain in excess of the accrued market discount is treated as a capital gain.\textsuperscript{175}

\begin{footnotes}
\item[169.] I.R.C. \textsection 1232(a) (1954).
\item[170.] See, e.g., Abusive Tax Shelters, supra note 136, at 108-09; Deficit Reduction, supra note 168; Revenue Provisions, supra note 168.
\item[171.] See I.R.C. \textsection 1276(a)(1) (1987).
\item[172.] See also Abusive Tax Shelters, supra note 136.
\item[173.] According to the legislative history, Congress thought it would have been "correct" to require the bond holder to include the discount in income annually, but, for administrative convenience, decided to require computation of the periodical accrual market discount and recognition of the market discount as ordinary income only when the bond is sold or paid out at maturity. See Abusive Tax Shelters, supra note 136, at 108-09; Deficit Reduction, supra note 168, Revenue Provisions, supra note 168.
\item[174.] I.R.C. \textsection 1276(a)(1) (1987).
\item[175.] See generally Auster, Market Discount Elections With Respect to Accrued Market Discount, supra note 136, at 108-09; Revenue Provisions, supra note 168; Deficit Reduction, supra note 168.
\end{footnotes}
The holder of a bond with market discount can deduct interest on debt incurred to purchase or carry the market discount bond only to the extent that the interest expense exceeds the market discount allocable to that bond for that particular year.\textsuperscript{176} The disallowed interest deduction is deferred until the taxable year when the purchaser makes a taxable disposition of the market discount bond.\textsuperscript{177} The purpose of this deferral of the interest deduction is to require the taxpayer to match his interest deduction for purchasing the bond with the inclusion of the market discount in his income. The mismatching of expenses and income—current expense deductions and


Section 1276(b) provides two alternative methods for computing the accrued market discount. The first is a straightline method based on the number of days between the acquisition of a market discount bond and the bond’s maturity date. For example, if the holder purchased the bond 1,000 days from maturity at a market discount of $20,000, the market discount would accrue at $20 a day ($20,000 market discount divided by 1,000 days to maturity). If he sells the bond at a $5,000 gain after holding it for 400 days, his accrued market discount would be $800 (400 days x $20 accrued market discount per day). He would be required to treat the $800 accrued market discount as interest income. The other $4,200 of gain would be treated as if received in exchange for the bond, i.e., probably a capital gain.

Alternatively, the holder can elect to compute the accrued market discount under the “yield to maturity” or “constant interest” principles of the section 1272(a) original issue discount rules. In general, this means that the market discount accrues from the date of acquisition through the date of maturity on compound interest principles.

Under compound interest principles, the interest accruals are smallest at the beginning of the term and highest at the end of the term, because on the date of each compounding, the accrued interest for that period is added to the amount against which the interest will be computed for the new period. When these compound interest principles are applied to the accrual of market discount, they produce much smaller accruals at the beginning than under the straight-line method. Since both the straight line and compound interest approaches are designed to produce the same aggregate amount of accrued market discount on the date of maturity of the bond, the choice between the two makes little difference to the investor who holds the bond until maturity, unless he elects to include the accrued market discount in his income currently. The choice makes an enormous difference to the investor who intends to sell the bond shortly after he purchases it, because the compound interest method will produce smaller accruals and, therefore, smaller interest income on the sale. The investor interested in the quick resale ought to choose the compound interest alternative, unless, for some reason, he wants to accelerate income or avoid the interest deduction deferral rule of section 1277.\footnote{J. Eustice, \textit{supra} note 87, at ¶ 2.02[4][a] n.97.}

175. The statement in the text assumes that the bond is a capital asset to the holder, which it is, unless held by a dealer. The rules on market discount require the gain on the disposition of a market discount bond to be treated as ordinary income to the extent that it is covered by the accrued market discount on the bond. I.R.C. § 1276(a)(1) (1987). That leaves any gain above accrued market discount to be governed by general tax rules. If the gain is realized on retirement of the debt, that means § 1271(a)(1) applies. It provides exchange treatment. \textit{Id.} § 1271(a)(1) (1987).

176. \textit{Id.} § 1277(a), (c) (1987).

deferral of taxation of income—had long been a staple of tax shelters.  

The purchaser can elect to include the accrued market discount in gross income in the taxable year when it accrues. If the purchaser elects to include market discount in income currently, he avoids the rule requiring ordinary income treatment upon disposition or retirement of the market discount bond and need not defer the deduction for his interest expense incurred in buying or carrying the bond.

The market discount sections parallel the recapture sections in their treatment of transactions governed by nonrecognition sections. As a starting point, section 1276(a)(1) provides that the ordinary income treatment it requires overrides the nonrecognition rules provided by other sections, except as otherwise provided in section 1276. For example, section 1276(a)(1) overrides the nonrecognition rule of former section 337(a) since section 1276 does not specifically exempt section 337(a) transactions from section 1276's coverage. Exempted from immediate recognition of ordinary income under the market discount rules are transferors in nonrecognition exchanges wherein the transferee takes a carryover basis. Transactions fitting under this exemption include section 332 liquidations, section 351 exchanges, reorganizations, and transfers at death. Instead,

178. See, e.g., Abusive Tax Shelters, supra note 136, at 21; Revenue Provisions, supra note 168.
181. Id.
182. Id. § 1276(a)(1), (c) (1987).
183. Id. § 1276(a), (c)(1) (1987). Section 1276(c)(1) uses the term "transferred basis" rather than "carryover basis."
184. Section 332 applies to a complete liquidation of an 80% or more owned subsidiary. Id. § 332 (1987). The parent in a § 332 liquidation takes a carryover basis in the assets it receives from the subsidiary. See id. § 334(b)(1) (1987).
185. Section 351 refers to the transfer of property to a controlled corporation in exchange for that corporation's stock or securities. Id. § 351 (1987). The transferee corporation in § 351 exchanges takes a carryover basis (plus any gain recognized to the transferor) in the transferred assets. Id. § 362(a)(1) (1987).
187. Section 1276(d)(1)(A) makes it explicit that gifts, though they do not trigger a recapture under § 1245(b)(1), are not exempted from recognition of accrued market discount. Section 1276 does
the transferee taking a carryover basis in a market discount bond in the nonrecognition transaction inherits the accrued market discount from the transferor, though the transferor can adjust its basis in the market discount bond to reflect gain recognized by the transferor and any original issue discount or market discount income included in the transferor’s gross income.

As originally enacted, property acquired in a tax-free exchange for a market discount bond was tainted with the accrued market discount of the transferred bond only if the transferee did not take a carryover basis in the market discount bond and the transferor took a substituted basis in the property received in exchange therefor. This provision permitted the holder of a market discount bond to transfer the bond to a controlled corporation in a section 351 exchange and receive stock that was free of the accrued market discount taint. Congress quickly amended the law so that the accrued market discount is taxed as interest income to the transferor in a section 351 exchange. The corporate transferee of the market discount bond takes the bond with the basis that reflects any gain recognized to the transferor, including that on account of any market discount. If the stated redemption price of the bond exceeds the corporate transferee’s basis immediately after acquisition, the bond constitutes a market discount bond in the hands of the corporate transferee.

If a taxpayer conveys appreciated property to a controlled corporation in exchange for a security of that corporation, the exchange is covered by section 351, and the transferor takes a substituted basis in that security. The substituted basis should be less than the re-
demption price of the security, which presumably would be equal to the fair market value of the transferred appreciated property. Thus, the stated redemption price of the security would exceed its basis immediately after acquisition to the extent that the appreciation of the transferred property is greater than its basis to the transferor immediately before the transfer. Because market discount is defined as any excess in the stated redemption price over basis, there was much initial concern that, under a literal interpretation of that definition, market discount would be created on the issuance of a security by the controlled corporation in such a section 351 exchange. 

Such an interpretation of the market discount rules would result in most securities issued in section 351 exchanges being treated as market discount bonds. The 1986 Act, however, provided that, with certain exceptions, no market discount is created on the original issuance of a bond. This later clarification was aimed specifically at preventing a security issued in exchange for appreciated property in a section 351 exchange from being a market discount bond.

G. Equity Classification Favorable for Noncorporate Shareholders of Corporations With Small or No Earnings and Profits.

One of the exceptions to the generally more favorable tax consequences of debt over equity occurs when the corporation has little or no earnings and profits. A stockholder receiving a dividend-style distribution has a dividend, i.e., ordinary income, only to the extent that the distributing corporation has earnings and profits. Any part of the distribution above earnings and profits is treated by the stockholder as if received upon the sale of his stock—a tax-free return of capital up to his basis and a recognized gain thereafter.

194. Id. J. Eustice, supra note 87, at ¶ 2.02(4)(a) n.100.
199. Id. § 301(c)(2) (1987).
200. Id. § 301(c)(3) (1987).
In contrast, interest paid on a debt is taxable as ordinary income to the stockholder,\(^\text{201}\) regardless of the corporation’s earnings and profits account. Moreover, if the corporation has little or no earnings and profits, it likely has little or no taxable income and, therefore, little need for an interest deduction, which, in addition to the shareholders’ avoidance of dividend treatment, is the primary tax advantage of debt over equity.

A side effect of recasting debt as equity is to increase the holder’s aggregate basis in his “stock” (his regular stock plus a debt instrument recast as equity).\(^\text{202}\) This increase results in more basis to be absorbed by a section 301 distribution in excess of earnings and profits and, thus, a smaller recognized gain for the holder.

**H. Equity Classification Favorable for a Shareholder that is a Corporation.**

A shareholder that is also a corporation is entitled to an 80% deduction on dividends received.\(^\text{203}\) In the case of electing affiliated corporation, the deduction is 100%.\(^\text{204}\) Thus, at most only 20% of the dividends received is taxable income. This is likely to be less than the interest income that it would have had upon receipt of payment of interest on debt.\(^\text{205}\) The tax planner must remember, however, that the distributing corporation loses the interest expense deduction, which it would have on repayment of debt, but which it does not have on the distribution of dividends. The better tax consequences for the shareholders, who in close corporations are usually concerned with the aggregate tax to be paid by the cor-

---

202. With some exceptions, see, e.g., Motel Co. v. Commissioner, 340 F.2d 445 (2d Cir. 1965), a purported debt instrument is virtually never recast as equity, unless the issue of that debt instrument owns regular stock in the corporation. Because the holder of the recast debt instrument is adding more “equity” to the corporation, he is entitled to increase his basis in his equity holdings.
204. *Id.* § 243(a)(3), (b) (1987).
205. Suppose, for example, that the distributing corporation is to pay $100 to the investing corporation each year. The 80% dividends-received deduction results in only $20 of each year’s payment being taxable income, if the payment is considered a dividend. If the $100 is considered a repayment on debt, however, it would produce taxable income of $20 or less only if $80 or more of the payment constituted a repayment of principal. If the interest component of the payment was more than $20, a classification of the investment interest as debt produces more taxable income.
poration and themselves and not merely with what they themselves must pay, may not be beneficial enough to offset the worse tax consequences for the distributing corporation. This is another one of those situations where the tax planner must put pencil to paper to compute which alternative produces the better tax consequences.

I. Losses on Sale or Exchange or Worthlessness; Section 1244 Stock.

An investor in a corporation does not have a loss deduction until he sells or exchanges his interest at a loss or his interest becomes worthless. Mere diminution in value short of worthlessness does not permit recognition. The tax treatment of losses is the same for stock as it is for debt securities. Except for dealers, a loss on a sale or exchange of stock or debt securities is usually treated as a capital loss. The investor is also entitled to a capital loss under section 165(g) when his stock or debt securities becomes worthless.

An exception to this general rule of capital loss treatment is the treatment of “section 1244” stock. Section 1244 permits shareholders in qualifying corporations (called “small business corporations”) to treat a recognized loss on the sale, exchange or worthlessness of stock as an ordinary loss instead of a capital loss. It does not take away capital treatment for recognized gains. It limits the ordinary loss deduction to $50,000 per shareholder per year ($100,000 for a husband and wife filing a joint return). This special treatment is available only to the original issuee of the stock, i.e., not to vendees, donees or other transferees. The issuing corporation

206. See Plumb, supra note 28, at 374, n.25. For an example of when the distributing corporation wanted debt classification to get the interest deduction and the investing corporation wanted equity classification to get the dividend-received deduction, see Ragland Inv. Co. v. Commissioner, 52 T.C. 867 (1969), aff'd, 435 F.2d 118 (6th Cir. 1970).


208. Stock and securities are usually treated as capital assets. See Treas. Reg. § 1.165-5(a), (b), (c) (1987). A loss of a sale or exchange of a capital asset, of course, is allowed only to the extent allowed in sections 1211 and 1212 of the Code. I.R.C. § 165(f) (1987).


210. Id. § 1244(a) (1987).

211. Id. § 1244(b) (1987).

212. Id. § 1244(a) (1987). The issuee must also be either an individual or a partnership. Id.
must be a domestic corporation.\textsuperscript{213} Its shareholders must have put in no more than $1 million into the corporation as payment for stock or contributions to capital.\textsuperscript{214} This $1 million includes amounts paid for the section 1244 stock. When the shareholder sustains the loss on section 1244 stock, the corporation must have derived 50% or more of its gross revenues for the preceding five years, or for its lifetime if the corporation has not yet existed for five years, from other than passive investments.\textsuperscript{215}

The purpose of section 1244 is to equalize the treatment of losses between partnerships, proprietors and small business corporations. It is a rare gem in the tax treatment of closely-held corporations, allowing the best of both worlds—capital gain and ordinary loss. It is all good and no bad. It requires no election (as it did prior to 1978) and imposes no sanctions or penalties for failure to meet any of its criteria.

\textbf{J. Bad Debts Owed by the Corporation to the Investor.}

Worthless debts not amounting to a security are treated differently than stock or securities. Debts that are not securities are governed by section 166, the bad debt section, instead of section 165, the loss section. For noncorporate taxpayers, section 166 divides bad debts into business bad debts and non-business bad debts.\textsuperscript{216} A business bad debt is a bad debt incurred in connection with an individual's trade or business.\textsuperscript{217} If a business debt becomes noncollectible or worthless, it is "business bad debt," and the creditor is entitled to deduct it against ordinary income.\textsuperscript{218} If a non-business bad debt becomes noncollectible or worthless, it is a "non-business" bad debt, and the creditor/investor treats it as a short term capital loss,\textsuperscript{219} an intermediate position\textsuperscript{220} between the ordinary loss treatment for busi-

\begin{itemize}
\item \textsuperscript{213} \textit{Id.} § 1244(e)(1) (1987).
\item \textsuperscript{214} \textit{Id.} § 1244(e)(3)(A) (1987).
\item \textsuperscript{215} \textit{Id.} § 1244(e)(1)(C), (2)(A) (1987).
\item \textsuperscript{216} \textit{Id.} § 166(d)(2) (1987).
\item \textsuperscript{217} Section 166(d)(2) makes "nonbusiness debt" a residual category that includes all debt not created or acquired in connection with a taxpayer's trade or business.
\item \textsuperscript{218} \textit{Id.} § 166(a), (d) (1987).
\item \textsuperscript{219} \textit{Id.} § 166(d)(1)(B) (1987).
\item \textsuperscript{220} See e.g., Plumb, supra note 28, at 384.
\end{itemize}
ness bad debts and the long-term capital loss treatment generally accorded losses on stock and securities. The law presumes that a debt owed to a corporation is a business debt.\(^\text{221}\)

In one of the most litigated areas of corporate tax law, shareholders in close corporations have generally been unsuccessful when arguing that debts owed to them by their corporations should be treated as business debts rather than non-business debts\(^\text{222}\) (and thus as deductions against ordinary income instead of short-term capital losses). Most loans by shareholders to their close corporations are intended to enhance the value of the shareholder's investment in the corporation and are deemed to be incurred in connection with the shareholder's investment and not with his trade or business.\(^\text{223}\) The business bad debt characterization may be allowed to a promoter who is in the business of seeking out opportunities, organizing and financing the enterprises, and selling them at a profit or loss,\(^\text{224}\) or

---

\(^\text{221}\) Section 166(d), which provides that a taxpayer must treat worthless nonbusiness debts as short-term capital losses, does not apply when a corporation is the holder of the debt. I.R.C. § 166(d)(1) (1986).

\(^\text{222}\) See e.g., Smith v. Commissioner, 49 T.C.M. (CCH) 353 (1984), aff'd, 800 F.2d 930 (9th Cir. 1986); Roy v. Commissioner, 42 T.C.M. (CCH) 1333 (1981); Estate of Ripson v. Commissioner, 39 T.C.M. (CCH) 224, 231 (1979); Thaler v. Commissioner, 37 T.C.M.(CCH) 147 (1978).

A 1963 Supreme Court case, Whipple v. Commissioner, 373 U.S. 193, reh'g denied, 374 U.S. 858 (1963), made it more difficult for taxpayers to win these cases, though they do occasionally win. See e.g., Bowers v. Commissioner, 716 F.2d 1047 (4th Cir. 1983); Anderson v. United States, 555 F.2d 236 (9th Cir. 1977); La Staiti v. Commissioner, 41 T.C.M. (CCH) 511 (1980); Estate of Avery v. Commissioner, 28 T.C.M. (CCH) 364 (1969); Morrow v. Commissioner, 24 T.C.M. (CCH) 239 (1965).

\(^\text{223}\) See e.g., Betson v. Commissioner, 802 F.2d 365 (9th Cir. 1986); Smith, 49 T.C.M. (CCH) 353; Roy, 42 T.C.M. (CCH) 1333; LaStaiti, 41 T.C.M. (CCH) 511; Estate of Ripson, 39 T.C.M. (CCH) 224; Thaler, 37 T.C.M. (CCH) 147. See generally Cohen, Supreme Court Restricts Business Bad Debt Treatment of Stockholder-Corporate Loans, 36 J. TAX'n 194, 195 (1972); Note, Characterization of Shareholder Creditor Bad Debt: United States v. Generes Sounds the Knell for Deductions from Ordinary Income, 26 VAND. L. REV. 105 (1973).

\(^\text{224}\) The promoter qualifies for the business bad debt characterization only if the particular loan was proximately related to the promotion. See Whipple, 373 U.S. 193; Anderson 555 F.2d 236; Schlumberger Technology Corp. v. United States, 443 F.2d 1115 (5th Cir. 1971); United States v. Clark, 358 F.2d 892 (1st Cir.), cert. denied, 385 U.S. 817 (1966); Giblin v. Commissioner, 227 F.2d 692 (5th Cir. 1955); Hutton v. Commissioner, 35 T.C.M. (CCH) 16 (1976); Farris v. Commissioner, 31 T.C.M. (CCH) 821 (1972); Braunstein v. Commissioner, 21 T.C.M. (CHH) 1132 (1962). Moreover, even a person who organizes corporations does not qualify as a promoter, if he neither earns fees for the promotion nor profits from quick sales, but seeks only the usual investor's gains from long-term investments in the businesses. See Syer v. United States, 380 F.2d 1009 (4th Cir. 1967); United States v. Byck, 325 F.2d 551 (5th Cir. 1963); Townshend v. United States, 384 F.2d 1008 (Cl. Ct. Cl. 1967); Plumb, supra note 28, at 384 n.75.
to a taxpayer whose business is lending money for profit. Few shareholders in close corporations are promotors or professional lenders, however, and an investment in a close corporation, by itself, does not constitute a trade or business.

The shareholder’s greatest chance of success is to show that he needed to extend credit to the corporation to preserve his job, since such an expenditure, so obviously connected with his trade or business, counts as a business debt. For example, a real estate salesman was allowed a business bad debt deduction on a loan to his corporation because he earned substantial commissions from the company and his compensation depended on corporate profits. A pair of Supreme Court opinions, however, has squelched the hopes of many shareholders/employees by requiring that, for a loan to a close corporation to count as a business debt, protection of one’s job be the shareholder’s dominant motive in making the loan. Unfortunately, protecting one’s investment is usually too important for preservation of one’s salary to be considered the primary motivation for the loan.

K. Miscellaneous Tax Consequences Affected by Reclassification of Debt as Stock.

The reclassification of an instrument as debt or stock can change tax consequences in a variety of other ways. Some of these differences are discussed below.

225. See Gross v. Commissioner, 401 F.2d 600 (9th Cir. 1968); United States v. Henderson, 375 F.2d 36 (5th Cir.), cert. denied, 389 U.S. 953 (1967); Marks v. Commissioner, 46 T.C.M. (CCH) 1408 (1983); Christie Coal & Coke Co., Inc. v. Commissioner, 28 T.C.M. (CCH) 498 (1969); Constantine v. Commissioner, 28 T.C.M. (CCH) 308 (1969); Plumb, supra note 28, at 384 n.75.

226. See e.g., United States v. Generes, 405 U.S. 93, reh'g denied, 405 U.S. 1033 (1972); Niblock v. Commissioner, 417 F.2d 1185 (7th Cir. 1969); Adelson v. United States, 782 F.2d 1010 (Fed. Cir. 1986); Raab v. IRS, 85-2 U.S. Tax Cas. (CCH) ¶ 9859 (E.D. Pa. 1985).

227. See e.g., B.B. Rider Corp. v. Commissioner, 725 F.2d 945 (3d Cir. 1984), on remand, Stratmore v. Commissioner, 48 T.C.M. (CCH) 1369 (1984), rev'd 785 F.2d 419 (3d Cir. 1986); Anderson, 555 F.2d 236; Raab, 85-2 U.S. Tax Cas. (CCH) ¶ 9859; Brown v. United States, 74-2 U.S. Tax Cas. (CCH) ¶ 9622 (D. Vt. 1974).

228. See Bowers, 716 F.2d 1047.

229. See Whipple, 373 U.S. 193; Generes, 405 U.S. 93.

230. See e.g., Generes, 405 U.S. at 104; Raab, 85-2 U.S. Tax Cas. (CCH) ¶ 9859; Cohen, supra note 223, at 195.
1. **Subchapter S.**

If a purported debt instrument is reclassified as stock for tax purposes, is it a second class of stock that renders the issuing corporation ineligible for S corporation status? Generally no, provided the debt meets the Code’s "safe harbor" conditions for straight debt, an issue discussed, *infra*, in the section on S corporations.

2. **Measurement of Control.**

The applicability of numerous corporate tax code sections depends on the percentage of stock ownership of a particular taxpayer. For example, section 368(c) defines "control" for section 351 exchanges, \(^{231}\) corporate divisions, \(^{232}\) and reorganizations \(^{233}\) as the ownership of stock possessing at least 80% of the total combined voting power and at least 80% of the total number of all other classes of stock. \(^{234}\) A revenue ruling, which is generally recognized as properly stating the law, construes section 368 as requiring the shareholder to own 80% of each class of nonvoting stock. \(^{235}\) Thus if a purported debt instrument is considered to be a separate class of stock, a taxpayer must own 80% of it to have "control" of the corporation under section 368(c). \(^{236}\)

Other sections whose applicability depends on a percentage of stock ownership include sections 267, \(^{237}\) 269A, \(^{238}\) 243, \(^{239}\) 246A, \(^{240}\) 301(f), \(^{241}\) 302(b), \(^{242}\) 304(c), \(^{243}\) 318, \(^{244}\) 341(e), \(^{245}\) 542, \(^{246}\) 1235, \(^{247}\) and 1239. \(^{248}\)

---

231. I.R.C. §§ 351(a), 368(c) (1987).
232. Id. §§ 355(a)(1)(A), (d), 368(c) (1987).
233. Id. § 368(a), (c) (1987).
234. Id. § 368(c) (1987).
238. Id. § 269A(b) (1987).
239. Id. § 243(a) (1987).
240. Id. §§ 246A(c)(2)(A), (B) (1987).
241. Id. § 301(f) (1987).
243. Id. § 304(c) (1987).
244. Id. §§ 318(a)(2)(C), (3)(C) (1987).
245. Id. § 341(e) (1987).
246. Id. § 542 (1987).
247. Id. § 1235(d) (1987).
248. Id. § 1239 (1987).
Several other provisions, including sections 332, 338, 382, 1504 and 1563 depend on the percentage of stock ownership, but say to disregard nonvoting stock that is limited and preferred as to dividends. Since debt reclassification as stock is likely to be viewed as a class of nonvoting preferred stock, it should have no effect on these provisions.

3. *Avoidance of the accumulated earnings tax.*

Accumulations of funds to retire corporate debt are more likely to be considered within the reasonable needs of the business, and thereby avoid imposition of the accumulated earnings tax, than accumulations to redeem stock. The accumulated earnings tax regulations permit the close corporation to accumulate funds to retire bona fide debt created in connection with the corporation's trade or business. The regulations clearly contemplate funds accumulated to pay off securities as well as short-term debt, since they offer the establishment of a sinking fund to retire bonds as a justifiable ground for accumulating earnings. Courts are less willing to find a corporate purpose for the accumulation of earnings to fund a redemption of stock, though a corporate purpose is sometimes found when the redemption is to break a deadlock in a closely-held corporation.

249. Id. § 332(b)(1) (1987).
250. Id. § 338(d)(3) (1987).
251. Id. §§ 382(g), (j)(1), (k), (l)(2)(A), (D) (1987).
252. Id. § 1504(a)(2), (4) (1987).
253. Section 1563(a) gives the definitions for a "controlled group of corporations." Several of the definitions give alternative control tests: either 80% of the combined voting power of all classes of stock or 80% of the total value of all classes of stock. Id. § 1563(a)(1), (2) (1987). The definition following the "semi-colon" would include non-voting, preferred stock.
254. See Plumb, supra note 28, at 395.
256. Id.
V. DEBT EQUITY: CLASSIFICATION CRITERIA

Despite the important differences in tax treatment of debt and equity, no one has been able to devise workable criteria for classifying an interest as either debt or equity. While the debt-equity distinction has always been an implicit part of the tax codes, required by the fact that interest payments have been deductible in computing corporate income while dividends have not, Congress has never provided a statutory definition of either term. In 1969, it attempted to clarify the manner in which the distinction should be drawn by adding section 385 to the Code. Instead of establishing statutory criteria, however, section 385 empowers the Treasury to prescribe regulations containing classification criteria. Section 385 also suggests “factors” that the regulations might use in formulating the criteria. The Treasury made three abortive attempts at issuing regulations under section 385, the first not coming until 1980 and the last in 1983. All three sets were criticized extensively. At this point, it seems doubtful that the Treasury will try again. Additionally, the Commissioner refuses to issue advance rulings or determination letters on whether an interest in a corporation is to be treated as stock or debt where the determination is primarily one

258. Comment, Hybrid Instruments, supra note 30, at 122 n.23.
261. The “factors” listed by section 385(b) are: (1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money return for an adequate consideration in money or money’s worth, and to pay a fixed rate of interest, (2) whether there is subordination to or preference over any indebtedness of the corporation, (3) the ratio debt to equity of the corporation, (4) whether there is convertibility into the stock of the corporation, and (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.
262. See supra note 29.
of fact.265 As a practical matter, this means that there will be few rulings or letters as resolution of most of these disputes depend on factual findings. The courts have fared even worse. Literally hundreds of reported decisions discuss the criteria for differentiating debt and equity. Unsurprisingly, it is impossible to harmonize so many cases. The caselaw has been called a "jungle,"266 a "morass,"267 "bewildering,"268 and "labyrinthine."269 One judicial way, impishly comparing the process of separating debt and equity to the problem of defining pornography, adopted Justice Stewart's famous line, saying as hard as it is to define the distinction, "I know it when I see it."270 The voluminous literature on the subject contains titles describing the debt-equity law as the "Old Disease"271 and the "Augean Stables."272 It is, of course, fun to select epithets to describe the confused state of the law. And it is probably better for the psyche to formulate comic descriptions of the problem than to fall into despair. The tax professional enjoys a good joke like anyone, but, in the end, must grapple with this classification problem.

As a starting point, one should be mindful that it has often been stated that owners are free to commit such capital as they choose to their corporation and to lend such additional amounts as they wish, thus reserving the right to share with other creditors in the distribution of assets if the enterprise fails.273 Nevertheless, there is a pitfall in using debt, especially a high percentage of debt, because courts in both tax and bankruptcy cases may declare the creditor-owners to be shareholders and nothing more and reclassify the "debt" as stock, or, even worse, treat the "loan proceeds" as a contribution to capital. In the tax cases, the government is likely to contend that

268. Comment, Hybrid Instruments, supra note 30, at 127.
270. Sansberry v. United States, 70-1 U.S. Tax Cas. (CCH) ¶ 9216, at 82-862 n.4 (S.D. Ind. 1970).
271. Hickman, The Thin Corporation; Another Look at an Old Disease, 44 Taxes 883 (1966).
272. Natbony, supra note 263.
273. Rowan, 219 F.2d at 55.
the instruments they claim to represent debt are really equity at the
risk of the business and should be taxed accordingly.\textsuperscript{274}

According to one case,

The classic debt is an unqualified obligation to pay a sum certain at a reasonably
close fixed maturity date along with a fixed percentage in interest payable re-
gardless of the debtor's income or lack thereof. While some variation from this
formula is not fatal to the taxpayer's effort to have the advance treated as debt
for tax purposes, . . . , too great a variation will preclude such treatment.\textsuperscript{275}

The "classic" distinction between shareholder and creditor has been
stated as follows:

The shareholder is an adventurer in the corporate business; he takes the risk, and
profits from success. The creditor, in compensation for not sharing the profits,
is to paid independently of the risk of success, and gets a right to dip into the
capital when the payment date arrives.\textsuperscript{276}

With these platitudes out of the way, the next few sections try to
explain the classification criteria as clearly as possible.

\textbf{A. Unqualified Obligation to Pay Principal on a Fixed Maturity
Date.}

Inherent in debt is the expectation that at some point the debt
will be fully paid and the debtor-creditor relationship will be extin-
guished. To qualify as debt, the instrument should carry an un-
qualified obligation to pay the principal on a fixed or ascertainable
maturity date.\textsuperscript{277} Since preferred stock often carries a set or ascer-
tainable date for redemption,\textsuperscript{278} the presence of a maturity date is

\textsuperscript{274} F. O'Neal, supra note 8, at § 2.10.

\textsuperscript{275} Gilbert, 248 F.2d at 402-03. \textit{See generally} Plumb, supra note 28, at 404-05.

\textsuperscript{276} \textit{O.P.P. Holding Corp.}, 76 F.2d 11.

\textsuperscript{277} \textit{See e.g.}, I.R.C. § 385(b)(1) (1986); \textit{see also} Texas Farm Bureau v. United States, 725 F.2d
307 (5th Cir.), \textit{reh'g denied}, 732 F.2d 437 (5th Cir. 1984), \textit{cert. denied}, 469 U.S. 1106 (1985); Bauer
v. Commissioner, 748 F.2d 1365, 1370 (9th Cir. 1984); \textit{In re} Lane, 742 F.2d 1311, 1315-16 (11th Cir.
1984); \textit{Stinnett's Pontiac Serv., Inc.}, 730 F.2d at 639; \textit{Scriptomatic, Inc. v. United States}, 555 F.2d
364 (3d Cir. 1977); \textit{Alterman Foods, Inc. v. United States}, 505 F.2d 873 (5th Cir. 1974), \textit{reh'g denied},

\textsuperscript{278} \textit{See e.g.}, Messenger Publishing Co. v. Commissioner, 168 F.2d 903 (3d Cir. 1948); Charles
L. Huisking & Co. v. Commissioner, 4 T.C. 595, 599 (1945). \textit{See generally} \textit{TAX RESEARCH INST. OF
AM. FEDERAL TAX COORDINATOR} 2d \textsection K-5122 (2d ed. 1977).
not conclusive of debt status, but numerous cases holding an instrument to be debt have stressed the presence of such a date. The absence of a maturity date has often been fatal to investors' claims that an instrument should be debt. A debt without a fixed maturity date is too much like cumulative preferred stock to be treated as debt. Management is awaiting future events to determine when, if ever, it will allow the corporation to pay the creditor. The creditor has the right to demand payment only in a liquidation. These are risks normally associated with stock but not debt.

The cases are not especially helpful in defining what counts as an ascertainable maturity date. If there is any theme at all, it is that the presence of a contractual term making payment contingent on anything other than the election of the holder is a factor tending to show stock and not debt. The less likely an occurrence of the contingency, the less likely the instrument will be called debt. For example, when the holder can enforce payment only upon dissolution of the corporation or a sale of substantially all of its assets, the instrument is likely to be classified as stock and not debt. If the corporation has the right to defer payment solely at its option, that right in the corporation is a strong indicator that the obligation has no fixed maturity date and is not a bona fide debt. Moreover,

280. See e.g., Scriptomatic, Inc., 555 F.2d 364; Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972); Alamositas Cattle Corp. v. Campbell, 62-1 U.S. Tax Cas. (CCH) ¶ 9458 (N.D. Tex. 1962).
281. See e.g., Lane, 742 F.2d at 1317-18; Stinnett's Pontiac Serv., Inc., 730 F.2d at 739; Foresun, Inc. v. Commissioner, 348 F.2d 1006 (6th Cir. 1965), aff'g on this point, 41 T.C. 706 (1964).
282. See e.g., P.F. Scheidelman & Sons, Inc. v. Commissioner, 24 T.C.M. (CCH) 168 (1965).
283. See e.g., Texas Farm Bureau, 725 F.2d 307; Lane 742 F.2d 1311; Stinnett's Pontiac Serv., Inc., 730 F.2d 634; Austin Village, Inc. v. United States, 432 F.2d 741 (6th Cir. 1970).
284. See e.g., Texas Farm Bureau, 725 F.2d at 313; Lane, 742 F.2d at 1316; Stinnett's Pontiac Serv., Inc., 730 F.2d at 638-39; Slappey Drive Indus. Park, 561 F.2d at 582-83; Beaver Pipe Tools, Inc. v. Carey, 139 F. Supp. 470 (N.D. Ohio 1955), aff'd, 240 F.2d 843 (6th Cir.), cert. denied, 353 U.S. 958 (1957); Mullin Bldg Corp. v. Commissioner, 9 T.C. 350 (1947), aff'd, 167 F.2d 1001 (3d Cir. 1948).
286. See, e.g., Texas Farm Bureau, 725 F.2d at 313; Stinnett's Pontiac Serv., Inc., 730 F.2d at 639.
when payment is made contingent on the existence of surplus, earnings etc., the instrument is likely to be considered stock and not debt. The investor’s return on his investment, like a shareholder’s, is subject to the risks of the business, a factor tending strongly toward stock and against debt classification. The mere expectation that payment on the debt will be made from future earnings does not automatically taint debt as equity as many lenders and borrowers rely on future earnings to pay the debt obligation. But a true contingency, either in the contract or in the parties’ informal expectations, causes a problem.

Demand notes perhaps should pass muster as debt, because payment, though contingent on demand, is at the election of the holder. The holder has a more powerful position than the holder of a note with a fixed maturity date. A pattern of not making demand on the note may be likened to an informal subordination, however, a factor tending toward debt rather than stock and one emphasized in recent cases.

B. Unqualified Right to Payment of Interest at a Fixed Rate.

Another key characteristic of debt is that it entitles the holder to an unqualified right to collect interest when due at a fixed or

287. A number of cases have said that if repayment is possible only out of corporate earnings, the transaction has the appearance of a contribution of equity capital. See, e.g., Stinnett’s Pontiac Serv., Inc., 730 F.2d at 638; Estate Of Mixon, 464 F.2d at 404.
288. See, e.g., Bauer, 748 F.2d 1365; Slappey Drive Indus. Park, 561 F.2d 572; Fin Hay Realty Co., 398 F.2d 694.
289. See, e.g., Biritz Constr. Co., 387 F.2d 451; Estate of Miller v. Commissioner, 239 F.2d 729, 732 (9th Cir. 1956).
290. See, e.g., Stinnett’s Pontiac Serv., Inc., 730 F.2d 634; Jones v. United States, 659 F.2d 618 (5th Cir. 1981); Scriptomatic, Inc., 555 F.2d 364.
292. See Plumb, supra note 28, at 418; A.L.I., INCOME TAX PROBLEMS, supra note 291.
293. See, e.g., Lane, 742 F.2d at 1317-18; Stinnett’s Pontiac Serv. Inc., 730 F.2d at 640; Tyler v. Tomlinson, 414 F.2d 844, 849 (5th Cir. 1969); Fin Hay Realty Co., 398 F.2d at 698; O.H. Kruse Grain & Milling v. Commissioner, 18 T.C.M. (CCH) 487, 489-90 (1959), aff’d, 279 F.2d 123, 126 (9th Cir. 1960); Plumb, supra note 28, at 418-19.
ascertainable rate. In contrast, dividends, though the economic equivalent of interest, are normally contingent, first, upon the corporation having the requisite amount of surplus to justify their distribution, and, second, upon the declaration of a dividend by the board of directors. Thus, to qualify as debt, an instrument should bear interest at a fixed or ascertainable rate\(^\text{294}\) and should entitle the holder to collect the interest when due,\(^\text{295}\) regardless of the corporation's surplus or earnings.\(^\text{296}\)

The last version of the section 385 regulations, though rescinded, provided an excellent definition of what should be considered an "ascertainable" rate of interest: the rate is ascertainable if it is (a) applied to a definitely ascertainable principal either (b)(i) at an invariable rate, e.g., 10% per year or (b)(ii) at a variable rate determined according to an external standard not subject to the borrower's control and that is not related to the success or failure of the borrower's business or activities, e.g., 1% above prime.\(^\text{297}\)

Courts have looked askance at instruments with interest payments restricted to net profits or surplus\(^\text{298}\) or interest rates pegged to either income or dividend rates,\(^\text{299}\) such interest provisions indicating, though not necessarily determining, equity status.\(^\text{300}\)

C. Subordination.

A primary advantage of debt over equity is that upon insolvency of the corporation, the holders of the debt must be paid in full before anything at all can be paid to the shareholders.\(^\text{301}\) If necessary,

---

\(^{295}\text{See, e.g., Scriptomatic, Inc., 555 F.2d 364; Fin Hay Realty Co., 398 F.2d 694; Dobkin v. Commissioner, 15 T.C. 31 (1950), aff'd, 192 F.2d 392 (2d Cir. 1951).}\n
\(^{298}\text{See, e.g., Stinnet's Pontiac Serv., Inc., 730 F.2d 634; Jones, 659 F.2d 618.}\n
\(^{299}\text{See, e.g., Slappey Drive Indus. Park, 561 F.2d 572.}\n
\(^{300}\text{See, e.g., Texas Farm Bureau, 725 F.2d 307; Post Corp., 640 F.2d 1296. See also Plumb, supra note 28, at 432.}\n
\(^{301}\text{See generally Z. Cavitch, supra note 1, at § 71.05; H. Schlagman, Encyclopedia of The Law of Private Corporations § 7417 (1981); B. Manning, A Concise Textbook on Legal Capital 6-8 (2d ed. 1981); L. Ribstein, supra note 1, at 2-47.}\n
the entire assets of the corporation must be devoted to payment of its creditors, even if such payment leaves nothing for the corporation or its shareholders. Inversely, absent some contractual arrangement like a shareholder guarantee, the creditors of the corporation must look solely to the pool of assets belonging to the debtor corporation for payment of their debt. If the corporate assets are insufficient to pay all claims, the creditors are out of luck, absent a special arrangement for recourse to assets lying outside the corporate enterprise. To be sure, the creditors of the corporation take less risk than the shareholders, since the creditors have first shot at the corporate assets in bankruptcy. Nevertheless, the creditor faces the possibility that the corporation, if bankrupt, may not have enough assets to pay anybody anything. As a protective measure, apprehensive creditors sometimes exact a promise by the debtor corporation to defer extractions of cash (or assets) by its shareholders until the debt has been paid off. If this type of limitation is imposed on the repayment of debt reflecting advances by shareholders to their own corporation, it is called a subordination. The subordination can be formal or informal. It might be a continuing obligation throughout the life of the corporation, or it might become operative only upon insolvency. A contractual subordination of a corporate debt held by a shareholder is a factor tending to show that the instrument is equity rather than debt, though the subordination feature is not always fatal to a claim of the shareholder-creditor that the debt should be honored as debt for tax purposes. The absence of a subordination feature is a factor indicating a bona fide debt.

If the subordination takes place at insolvency, the subordination feature makes the holder look like a preferred stockholder, the
shareholder-creditor being in an intermediate position, taking after the holders of the senior debt but before the common stockholders. Yet more objectionable is a complete subordination that prohibits or limits payments on subordinated debt until the senior debt has been retired.\textsuperscript{309} Less offensive is the arrangement, typical in subordinated debentures, wherein the subordination takes place \textit{only} upon insolvency, a corporation being permitted to make regular payments to the holders of the subordinated debt outside of bankruptcy or at least prior to a default on the senior debt.\textsuperscript{310}

An informal subordination on the part of the shareholder creditor is yet another factor indicating that the purported debt instrument held by the shareholder ought to be reclassified as stock. The continued failure to enforce payment, tolerance of prolonged defaults, making advances after default, repeated extensions of the maturity date, and failure to make demand on a demand note or an open account all are factors indicating equity instead of debt because, instead of acting like a bona fide creditor, the shareholder-creditor is playing the part of an ordinary shareholder who has subjectet his investment to the risks of the business and to prior claims of creditors.\textsuperscript{311} However, such informal subordination arrangements by no means invariably lead to equity classification.\textsuperscript{312} Creditors who are unrelated to the debtor frequently decide that it is not in their best interest to enforce every single contractual or legal right they have. For example, the creditor might believe that it has a better


309. See, e.g., Jones, 659 F.2d 618; Scriptomatic, Inc., 555 F.2d 364; Tyler, 414 F.2d 844; Reef Corp. v. Commissioner, 368 F.2d 125, 132 (5th Cir. 1966), cert. denied, 386 U.S. 1018 (1967); P.M. Fin. Corp. v. Commissioner, 302 F.2d 786, 790 (3d Cir. 1962); Plumb, supra note 28, at 425.

310. See, e.g., Scriptomatic, Inc., 555 F.2d at 370-71; Harlan v. United States, 409 F.2d 904, 907-08 (5th Cir. 1969) (inchoate subordination equals no subordination); Plumb, supra note 28, at 425.

311. See, e.g., Bauer, 748 F.2d at 1370; Stinnett's Pontiac Serv., Inc., 730 F.2d at 640; Scriptomatic, Inc., 555 F.2d at 370-71; Slappey Drive Indus. Park, 561 F.2d at 582-83; Hollenbeck v. Commissioner, 422 F.2d 2, 4 (9th Cir. 1970); Tyler, 414 F.2d at 849; Berkowitz v. United States, 411 F.2d 818, 821 (5th Cir. 1969); Dodd v. Commissioner, 298 F.2d 570, 578 (4th Cir. 1962); Fin Hay Realty Co. v. United States, 261 F. Supp. 823, 827, 829 (D.N.J. 1966), \textit{aff'd}, 398 F.2d 694 (3d Cir. 1968); Foresun, Inc., 41 T.C. at 714, 717. See also Plumb, supra note 28, at 493.

312. See, e.g., Jones, 659 F.2d at 622.
chance of full payment by allowing the debtor corporation to continue operating its business rather than forcing it into a bankruptcy liquidation.

Timely payments of interest and principal indicate that the debt instrument should be honored as a debt.\textsuperscript{313} Even without principal payments, regular interest payment may indicate debt,\textsuperscript{314} especially if paid when the corporation has no earnings.\textsuperscript{315}

### D. Convertible Debt and Warrants.

The aborted section 385 regulations treated convertibility as an equity feature.\textsuperscript{316} The cases,\textsuperscript{317} revenue rulings,\textsuperscript{318} and regulations,\textsuperscript{319} however, mostly honor convertible debt as debt, until it is converted into stock. It is only after the conversion that it is treated as equity. The law has taken a parallel approach in treating bonds issued with stock or stock warrants added as a sweetener. The bonds are treated as bona fide debt despite the equity flavor added by the stock or the warrant.\textsuperscript{320}

\begin{itemize}
  \item 313. See, e.g., Piedmont Corp. v. Commissioner, 388 F.2d 886, 891 (4th Cir. 1968); Jack Daniels Distillery, 376 F.2d at 582; Plumb, supra note 28, at 491.
  \item 314. See, e.g., Bauer, 748 F.2d at 1370; Sinnet's Pontiac Serv., Inc., 730 F.2d at 640; Slappy Drive Indus. Park, 561 F.2d at 582; Utility Trailer Mfg. Co. v. United States, 212 F. Supp. 773, 786 (S.D. Ca. 1962); Plumb, supra note 28, at 702.
  \item 315. See, e.g., Sinnet's Pontiac Serv., Inc., 730 F.2d at 638; Slappy Drive Indus. Park, 561 F.2d at 582-83; Estate of Mixon, 464 F.2d at 405; Kipsborough Realty Corp. v. Commissioner, 10 T.C.M. (CCH) 932 (1951); Plumb, supra note 28, at 492.
  \item 319. The regulation on original issue discount limits the amounts of the interest deduction for the issuer of a convertible bond, thereby inferentially recognizing convertible debt as debt and not as equity. See Treas. Reg. § 1.163-3(c)(2) (1987). See also Plumb, supra note 28, at 435 n.364.
  \item 320. See, e.g., Helvering v. Richmond, F. & P. R.R., 90 F.2d 971, 974 (4th Cir. 1937); Leach
E. Economic Participation Rights.

Corporate debt typically is nonparticipating, meaning that its holders are limited to specified payments of principal and interest regardless of the amount of corporate earnings or of dividends paid on common stock. Since the rights of debtholders are largely a matter of contract, however, it is possible to grant participation rights to debtholders that approximates those normally associated with stock.\textsuperscript{321} For example, there is such a thing as an income bond, a debt security on which interest is payable only to the extent covered by corporate earnings.\textsuperscript{322} Such arrangements are indicative of equity,\textsuperscript{323} though the courts have occasionally been lenient in honoring their debt status,\textsuperscript{324} at least where the participation rights are not fully within the discretion of management.\textsuperscript{325} Participation rights that


The most recent case was Scriptomatic, Inc. v. United States, 555 F.2d 364 (3d Cir. 1977). In Scriptomatic, one of the two basic government arguments was that "where an advance would not have been made without the accompanying equity feature, an inference arises that the package represents preferred stock." Id. at 370. The court felt it did not need to decide the question of whether such an inference arises, because other factors favoring debt status predominated. Id. But see, e.g., Universal Castings Corp. v. Commissioner, 303 F.2d 620, 625 (7th Cir. 1962), aff'g 37 T.C. 107 (1961).

322. Id. at 113.
323. See, e.g., Richmond F. & P. R.R. v. Commissioner, 528 F.2d 917 (4th Cir. 1975), aff'g 62 T.C. 174 (1974); Universal Castings Corp., 302 F.2d at 620; Leach Corp., 30 T.C. at 566-67; Unitex Indus., Inc. v. Commissioner, 30 T.C. 468, aff'd, 267 F.2d 40 (5th Cir. 1959); Gordon Lubricating Co., 24 T.C.M. (CCH) at 711; Lasker v. McDonnell & Co., 75-2 U.S. Tax Cas. (CCH) ¶ 9622 (Del. Ch. 1975); Plumb, supra note 28, at 437.
depend upon action by management\(^{326}\) or are measured by profits or dividends\(^{327}\) on common stock are factors indicating an equity interest and not debt.

What would seem to be especially noxious to the Commissioner is debt that truly participates, i.e., debt with interest pegged to a percentage of profits with neither a floor nor a ceiling on the amount of interest payable. Like the stockholder, the holder of such debt earns no income unless the business prospers, but he can earn far more than his capital investment if the business does prosper. Subject to the risks of the business, although a participant in its success, his state is about the same as that of a shareholder.\(^{328}\)

\textbf{F. Voting Rights.}

Where the articles of incorporation are silent, each share of stock has one vote irrespective of the class to which it belongs.\(^{329}\) Preferred shares are usually made nonvoting, although they may grant the right to vote only after dividends have been in arrears for a stipulated number of dividend periods.\(^{330}\) Many state statutes grant shareholders the right to vote on specified matters, even where the articles of incorporation label the shares as nonvoting. Thus, they are likely to have a statutorily guaranteed right to vote on charter amendments, consolidations, mergers, distributions in partial liquidation, sale of all corporate assets, dissolution and perhaps other matters.\(^{331}\) The holders of debt typically are not granted voting rights, though statutes in some states specifically allow the articles of incorporation to confer voting rights upon the holders of debt se-

\footnotesize{326. See, e.g., Berkowitz, 411 F.2d 818; O.P.P. Holding Corp., 76 F.2d 11; Nat'l Sav. & Trust Co. v. United States, 285 F. Supp. 325, 332 (D.D.C. 1968); Wilbur Sec. Co. v. Commissioner, 31 T.C. 938, aff'd, 279 F.2d 657 (9th Cir. 1960); Hale-Justis Drug Co. v. Commissioner, 2 T.C.M. (CCH) 39, 41, 43 (1943); Plumb, supra note 28, at 438.


329. See, e.g., F. O'Neal, supra note 8, at § 3.37.

330. Id.

331. Id. § 3.20.}
securities, and creditors occasionally insist on some type of control mechanism to protect their loan. For example, when a debtor corporation is in a precarious financial condition, creditors sometimes insist on a shareholder voting trust that empowers the creditors to elect the board of directors until the debt is repaid.

Though virtually all laundry lists of factors mention voting rights as factors indicating equity, the courts have not stressed them in determining the debt-equity issue, probably because, when present, they serve the same basic purpose for both preferred stock and debt—a sort of protective device for the investor, akin to a security interest. Accordingly, their presence in a debt instrument generally does not require reclassification of the instrument as stock, though as with virtually every rule or factor in the debt-equity area, there are some contrary cases. Since neither preferred stock nor debt usually carry voting rights, the absence of voting rights in an instrument is generally given no or little weight in distinguishing debt from equity. Moreover, since voting rights in a debt instrument

332. See, e.g., CAL. CORP. CODE § 204(7) (West 1977); DEL. CODE ANN. tit. 8, § 221 (1983); N.Y. BUS. CORP. LAW § 518(c) (McKinney 1986).
333. See, e.g., W. CARY & M. EISENBERG, supra note 7, at 414.
334. See, e.g., O.H. Kruse Grain & Milling v. Commissioner, 279 F.2d 123 (9th Cir. 1960); R.C. Owen Co. v. United States, 180 F. Supp. 369 (1960). Virtually all recent cases list "participation in management" as number five of thirteen. See, e.g., Bauer, 748 F.2d at 1368; Lane, 742 F.2d at 1314; Stinnett's Pontiac Serv., Inc., 730 F.2d at 639; Jones, 659 F.2d at 622 n.12; Fin Hay Realty Co., 398 F.2d at 696 (participation in management and voting power both listed as factors); J.S. Biritz Constr. Co., 387 F.2d at 457.
337. Decisions that went against taxpayers at least partly on the basis of voting rights or rights to participate in control include Stinnett's Pontiac Serv., Inc., 730 F.2d at 639; Gardens of Faith, Inc. v. Commissioner, 23 T.C.M. (CCH) 1045, 1058 (1964), aff'd, 345 F.2d 180 (4th Cir.), cert. denied, 382 U.S. 927 (1965); Hale-Justis Drug Co., T.C.M. (CCH) at 43-44.
338. See, e.g., John Kelley Co., 326 U.S. 521; Diamond Bros. Co. v. Commissioner, 322 F.2d 725 (3d Cir. 1963); McSorley's, Inc. v. United States, 323 F.2d 900 (10th Cir. 1963); H.P. Hood & Sons, 141 F.2d at 469; Portage Plastics Co., 301 F. Supp. at 690; Green Bay & W. R.R. v. Commissioner, 3 T.C. 372, 379 (1944), aff'd, 147 F.2d 585 (7th Cir. 1945); Plumb, supra note 28, at 449.
would be superfluous to a debtholder owning a controlling block of stock in the debtor, the presence or absence of such rights in debt held by controlling shareholders is usually considered to be meaningless. 339

Voting rights acquired or effective only after default should not be considered as indicating an equity interest, at least if their purpose is merely to allow creditors to control the process of winding up. 340

G. *The Intrinsic Economic Nature of the Transaction.*

In addition to determining whether the contract between the corporation and investor, as written, includes key debt characteristics and excludes key equity characteristics, the courts also evaluate the "intrinsic economic nature of the transaction" to determine whether or not the investment interest it created is truly debt. 341 According to one case, "the ultimate question [is] whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or represents a strict debtor-creditor relationship." 342 After such analysis, an investment interest with prototypical debt features can be reclassified as equity on the basis of economic realities. 343 Conversely, stock can be reclassified as debt after an economic analysis, 344 but such a reclassification is rare.

---

339. See, e.g., Texas Farm Bureau, 725 F.2d at 313 n.13; Dillin, 433 F.2d at 1101; Talbot Mills v. Commissioner, 146 F.2d 809, 811 (1st Cir. 1944), *aff'd sub nom.* John Kelley Co. v. Commissioner, 326 U.S. 521 (1946). *See also* Plumb, *supra* note 28, at 436.

In the debt-equity area, research always produces a few cases with a rule contrary to the majority position. For examples of cases that do take into account voting rights in connection with debt held by controlling shareholders, see, e.g., Tomlinson, 377 F.2d at 297; Lundgren v. Commissioner, 376 F.2d 623, 626 (9th Cir. 1967); *Lansing Community Hotel Corp.*, 14 T.C. at 189. *See also* Plumb, *supra* note 28, at 449.


343. *See, e.g.*, *Fin Hay Realty Co.*, 398 F.2d 694.

The next three sections discuss the most commonly used methods for determining the economic reality of an investment interest—the comparison of the terms of the obligation to those that would be reached in an arms-length transaction, the corporation’s debt to equity ratio, and the proportionality of the debtholding to the stockholding.

1. **Equivalence to an Arms-Length Transaction.**

According to some cases, the "touchstone of economic reality" is whether an outside lender would have extended credit on terms similar to those existing between the debtor corporation and the shareholder-lender. This is an inherently fact-oriented issue. To decide a case properly under this standard, a court must vigorously scrutinize the debtor corporation, investigating its net assets, cash flow, debt to equity ratio, credit history, current assets, current liabilities, and the extent to which its assets are encumbered, amongst other things. External factors also may have to be considered. For example, the state of the local economy may have a profound effect on the ability of a small corporation in a service industry to pay its debts on time. The court must then compare the terms of the debt (the amount, the adequacy of the interest rate, payment schedules, maturity date, security interests supporting the debt, etc.)

346. See, e.g., *Stinnett's Pontiac Serv., Inc.*, 730 F.2d at 640; *Scriptomatic, Inc.*, 555 F.2d at 367-68; *Austin Village, Inc.*, 432 F.2d 741; *Fin Hay Realty Co.*, 398 F.2d at 697.
with the terms of a similar transaction with a hypothetical outside lender. Would an outside lender lend this corporation that much money? Does the obligation bear an adequate interest rate? Considering the risk, is the security interest sufficient? The more "no" answers there are to these and other questions, the more likely the purported debt will be reclassified as stock. Finally, the court must study the behavior of the parties to determine whether they treated the obligation as an arms-length debt transaction. To determine this, the court should consider the factors discussed in section V(c) on informal subordination. The tolerance of prolonged defaults, for example, would be inconsistent with the normal behavior of an outside creditor and would thus indicate equity. On the other hand, timely payments of interest and principal would indicate that the debt instrument should be honored as debt.

One problem is especially noteworthy. Not uncommonly, shareholders of a floundering close corporation must infuse their company with new capital to stave off insolvency and to save their investment. If they do not do it, no one will, since outside creditors are least likely to extend a new credit during financially dire times. Naturally, the shareholders want to characterize these advances as loans, both for the better tax consequences flowing from debt and to attain creditor status in case of bankruptcy. These last ditch advances would seem to epitomize capital contributions. Yet the courts have sometimes relaxed the criteria in favor of these shareholder-lenders, recognizing these advances as debt. A point arrives, however, when the advances must be treated as capital contributions instead of debt, although the demarcation of that point is unclear.

351. See, e.g., Texas Farm Bureau, 725 F.2d at 314; Motel Co., 340 F.2d at 446; Universal Racquetball Rockville Centre Corp. v. Commissioner, 52 T.C.M. (CCH) 143, 158-59 (1986); Toney v. Commissioner, 51 T.C.M. (CCH) 472 (1986). See also Plumb, supra note 28, at 493-94.

352. See, e.g., Estate of Mixon, 464 F.2d at 410; Piedmont Corp. v. Commissioner, 388 F.2d 886, 891 (4th Cir. 1968); Bradshaw v. United States, 683 F.2d 365 (Cl. Ct. 1982); Allen v. Commissioner, 49 T.C.M. (CCH) 677, 683-84 (1985). See also Plumb, supra note 28, at 490-91.


2. Thin Corporations: Corporations with High Debt to Equity Ratios.

In 1946, the Supreme Court stated in dictum: "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."\(^{355}\) Since then, "thin incorporation," which refers to an initial capital structure with a relatively high percentage of debt and a correspondingly low percentage of equity, has been one of the most discussed factors in the debt to equity imbroglio.\(^{356}\) Currently, an excessively high debt to equity ratio probably would be considered as a highly significant but not controlling factor in determining whether purported debt ought to be reclassified as stock.\(^{357}\) Furthermore, it is one of the section 385 "factors" that the Treasury can consider in formulating the regulations on debt and equity.\(^{358}\)

The antipathy towards thin capitalization and high debt to equity ratios perhaps had its origins in the bankruptcy courts where the

---

355. *Talbot Mills*, 146 F.2d 809. *See also* Small v. Williams, 313 F.2d 39, 42 (4th Cir. 1963); *F. O'Neal*, *supra* note 8, at § 2.11.


For some of the books with sections on thin capitalization, *see generally Z. CAVITCH, supra* note 1, at §§ 71.01-.07; *D. Hervitz, Business Planning* ch. 1, §§ 4El-6 (1966); *F. O'Neal, supra* note 8, at § 2.10; *W. Painter, Corporation and Tax Aspects of Closely Held Corporations* § 2.04 (2d ed. 1981); *I. Shriver & J. Skiba, The Closely Held Corporation: Tax Financial and Estate Planning* ¶ 106 (1983).


judges sometimes have subordinated shareholders' claims as creditors to those of unrelated, third parties. Fairness is at the heart of most of these cases. The judges sense that it would be unfair for a shareholder to participate equally with unrelated, third party creditors in a bankruptcy liquidation when the shareholders did not provide their own corporation with adequate funding. Some of these decisions are based on a misperception that a high debt to equity ratio means that a corporation is inadequately financed. Whether based on a misperception or not, these decisions reflect an underlying judicial attitude toward the close corporation and its shareholders; the courts expect the shareholders as the owners of a business to make an unqualified commitment of their own money to the business enterprise. If they do not, they are somehow acting unfairly, and the law can take that unfairness into account in the bankruptcy


For general discussions, see, e.g., F. O'Neal, supra note 8; Ashe, Subordination of Claims Equitable Principles Applied In Bankruptcy, 84 Banking L.J. 778 (1967); Herzog & Zweibel, Equitable Subordination of Claims and Bankruptcy, 15 Vand. L. Rev. 83, 93-98 (1961); Reimer, Claims Against Bankrupt Corporations Based On Advances By Controlling Shareholders Or Parent Corporations, 73 Com. L.J. 273 (1968); Note, Subordination of Stockholder Loans on the Grounds of Corporate Under-Capitalization: Obre v. Alban Tractor Company, 23 Md. L. Rev. 260 (1963); Note, supra note 24; Comment, Disregarding The Corporate Entity: Contract Claims, 28 Ohio St. L. Rev. 441 (1967).

360. One such case is Costello, 256 F.2d 903. Two partners incorporated their plumbing supply business. Since their business was already in financial distress, they constructed a capital structure with a high debt-equity ratio. While it would be hard to quarrel with the court's decision to subordinate the two shareholders' claims as creditors to those of outside creditors, it is far more difficult to accept the court's hyperbolic comments that the two shareholders "stripped" the corporation of its "capital," thereby endangering the corporation. Id. at 910. True, the shareholders tried to get a leg up on bankruptcy. Moreover, in contrast to their partnership, their corporation had a high debt-equity ratio. Yet the inference that the corporation capital structure somehow was a type of theft against the corporation was ill-founded. No matter what the debt-equity ratio was, the same amount of money was committed to the corporate enterprise.

context by surounding their claims as creditors to those of outside creditors.

This sense of unfairness has spilled over into federal tax law where there is this feeling that the close corporation shareholder must commit at least a threshold amount of equity capital to that close corporation. If this threshold is not reached, he can be penalized by having his loans reclassified as stock or contributions to equity. Paradoxically, the fairness approach to debt-equity determinations is a virtual invitation to high debt equity ratios since the federal courts have more or less initially adopted the California state law standards for piercing the corporate veil on account of inadequate capitalization. Under the standards, the purported debt instrument should be honored as debt where the amount of equity is at least more than nominal or not insubstantial. Naturally, one should not expect the Internal Revenue Service to be keen on the fairness approach.

While unfairness is still an undercurrent, more recent cases treat debt-equity ratios as bearing on the economic reality of the purported debt since they affect the ability of the debtor corporation to pay the debt when due. Since the economic realities test depends


363. See, e.g., Bauer, 748 F.2d at 1368-69; Lane, 742 F.2d at 1314; Tyler, 414 F.2d at 848; Piedmont Corp., 388 F.2d at 890-91; Liflans Corp., 390 F.2d at 970; Dixie Dairies Corp. v. Commissioner, 74 T.C. 476, 497 (1980); J.F. Stevenhagen Co. v. Commissioner, 34 T.C.M. (CCH) 852 (1975), aff'd, 551 F.2d 106 (6th Cir. 1977). See generally Plumb, supra note 28, at 512-513; Taylor, supra note 30, at 655-57.
on the unique circumstances of each particular case, the fixing of a "safe" ratio generally is impossible, though numerous commentators have suggested safe harbor ratios, e.g., 4 to 1. One problem is that a normal ratio of debt to equity in one industry would be excessive debt in another industry, and even within the single industry no two enterprises are exactly the same. Moreover, an infinite variety of circumstances in addition to the corporation's debt to equity ratio also affects the decision whether a particular security represents debt or stock. As a result, the cases are a tangle. What might be viewed as an acceptable ratio under one set of circumstances might be unacceptable under another set.

Since a high debt to equity ratio is merely one factor indicating equity, other factors have influenced courts to uphold shareholder advances as debts despite rather thin capitalizations. For example, debt status was sustained in one case where the debt to equity ratio was 700 to 1, but the corporation had sufficient cash flow and earnings power to pay its debts as they became due. In calculating debt to equity ratios, the courts use the true value of property owned by the corporation rather than its book value.

---

364. See, e.g., Fischer, 441 F. Supp. at 38 n.16; Lehman-Mehornay, Inc. v. United States, 72-2 U.S. Tax Cas. (CCH) ¶ 9582 (W.D. Mo. 1972); Steiner v. Commissioner, 41 T.C.M. (CCH) 1392, 1398 (1981). Other cases say much the same; each case must be decided on its own facts. See e.g., Fin Hay Realty Co., 398 F.2d at 696-97; Tomlinson, 377 F.2d at 295.

365. See, e.g., F. O'Neal, supra note 8, at § 2:10 (just under 4:1); Benjamin, Thin Corporations — Whose "Substance Over Form"?, 34 Tul. L. Rev. 99, 103-106 (1959) (3:1 or 4:1); Wels, supra note 356, at 899 (2:1).

366. See, e.g., Bauer, 748 F.2d at 1365; Post Corp., 640 F.2d at 1307; Security Fin. & Loan Co., 210 F. Supp. 603; Scotland Mills, Inc. v. Commissioner, 24 T.C.M. (CCH) 265 (1965). See generally F. O'Neal, supra note 8, at § 2.10.

367. See, e.g., Texas Farm Bureau, 725 F.2d at 311; Lane, 742 F.2d at 1314-15; Scriptomatic, Inc., 555 F.2d at 367. See generally, F. O'Neal, supra note 8, at § 2.10.; Holzman, The Interest-Dividend Guidelines, 47 Taxes 4 (1969) (listing 38 factors).


369. See Baker Commodities, Inc., 48 T.C. 374 noted in 27 J. Tax'n 170 (1967). In one case involving an asphalt manufacturer, the court accepted a 20,000 to 1 debt-equity ratio. See Byerlite Corp., 286 F.2d 285.

chises and licenses have also been included in calculating equity capital.\(^{371}\) Courts have also allowed the shareholder to assign a value to good will upon incorporation of an ongoing business.\(^{372}\) The judges are sometimes suspicious about assigning value to intangibles, however, since they are likely to have little or no value in a liquidation.\(^{373}\) Courts have been especially reluctant to assign a value for ability and experience of a shareholder-employee,\(^{374}\) unless backed by an employment contract and a covenant not to compete\(^{375}\) or unless there is convincing evidence that the intangibles have a direct and primary relationship to the well-being of the corporation.\(^{376}\) In any event, the tax advisor should urge his clients to document the unrealized appreciation of the assets and the value of the intangibles.\(^{377}\)

In calculating the equity part of the debt to equity fraction, the court should include accumulated earnings as well as stated capital and paid-in-surplus for shareholder advances made to an ongoing corporation.\(^{378}\) With some exceptions,\(^{379}\) the cases have included debts owed by the debtor corporation to outside creditors as well as to their own shareholders in calculating the debt to equity ratio.\(^{380}\) It

---

371. See, e.g., Motel Corp. v. Commissioner, 54 T.C. 1433, 1437 (1970); Perrault v. Commissioner, 25 T.C. 439, 451 (1955), aff'd, 244 F.2d 408 (10th Cir. 1957).

372. See, e.g., Murphy Logging Co. v. United States, 378 F.2d 222, 224 (9th Cir. 1967); Estate of Miller, 239 F.2d at 733 n.10; Nye, 50 T.C. at 215; La Staiti, 41 T.C.M. (CCH) at 520 n.8; Fischer Bros. Aviation, Inc. v. Commissioner, 30 T.C.M. (CCH) 1351, 1355 (1971).

373. See, e.g., Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712, 723 (5th Cir.), cert. denied, 409 U.S. 1076 (1972); Moughon, 329 F.2d at 400.

374. See, e.g., Plantation Patterns, Inc., 462 F.2d at 723; Allen H. Dahme Assoc. v. United States, 436 F.2d 486 (Cl. Ct. 1971). But see Murphy Logging Co., 378 F.2d at 224; Bradshaw, 683 F.2d at 374. See generally Goldstein, supra note 308, at 19; Plumb, supra note 28, at 517-18.

375. See, e.g., Plantation Patterns, Inc., 462 F.2d at 723; Allen H. Dahme Assoc., 436 F.2d 486; Plumb, supra note 28, at 517-18.

376. See, e.g., D. KAHN & P. GANN, supra note 40, at 600; See also Plantation Patterns, Inc., 462 F.2d at 723.

377. F. O'NEAL, supra note 8, at § 2.10 n.6.


380. See, e.g., Ambassador Apts. v. Commissioner, 50 T.C. 236, 241 (1968), aff'd, 406 F.2d 288 (2d Cir. 1969); Motel Co. v. Commissioner, 22 T.C.M. (CCH) 825, 831-833, aff'd, 340 F.2d 445 (2d Cir. 1965); Lockwood Realty Corp. v. Commissioner, 17 T.C.M. (CCH) 247, 251 (1958),
has also been held that when initial capitalization has been adequate, later shareholder loans to the corporation are to be recognized as debt, regardless of the debt to equity ratio at the time the advances are made.\textsuperscript{381} Similarly there has been a judicial tendency towards the conclusion that debt is not bona fide if issued to shareholders in exchange for assets required to get the business underway.\textsuperscript{382}

3. \textit{Shareholder Guarantees}.

Some commentators have suggested shareholder guaranteed loans to the close corporation as a solution to the risks of thin incorporation.\textsuperscript{383} Instead of the shareholders furnishing all of the capital necessary to launch the corporation, a considerable part of the capital can be borrowed in the corporate name from a bank or other institutional lender, with the shareholders guaranteeing the loan. Hopefully, the corporation will be able to deduct the periodic interest payments, and its shareholders will not be required to treat payments on the loan as constructive dividends.\textsuperscript{384} Others have questioned this device, suggesting that if a direct loan by a shareholder to the corporation would constitute a capital contribution due to too thin capitalization, it is rash to assume that the technique of a guaranteed loan would change the result.\textsuperscript{385} These reservations are

\textit{modified}, 264 F.2d 241 (6th Cir. 1959).

This no longer seems to be an issue, as it should not be. When a shareholder advances money to his corporation, corporate debts owed to outside creditors clearly have an impact on whether or not the corporation is thinly capitalized.


\textsuperscript{382} See, e.g., \textit{Lane}, 742 F.2d at 1315; \textit{Estate of Mixon}, 464 F.2d at 410; \textit{Dillin}, 433 F.2d at 1102. \textit{See generally} Natbony, \textit{Worthlessness, Debt Equity, and Related Problems}, 32 HASTINGS L.J. 1407, 1470-71 (1981); Taylor, \textit{supra} note 30, at 657.


\textsuperscript{384} Past proponents of guaranteed loans include F. \textit{O'Neal}, \textit{supra} note 8, at \textsection 2.12; Calkins, Coughlin, Hacker, Kidder, Sugarman & Wolf, \textit{Tax Problems of Close Corporation; A Survey}, 10 W. RES. L. REV. 9, 32 (1959).

partly borne out by the attitude of the government. Since the lenders generally rely on the credit—worthiness of the shareholders guaranteeing the loan rather than that of the close corporation — the government has sometimes argued that the substance of the transaction is a loan to the shareholder followed by a prearranged equity investment of the borrowed funds by the shareholders. When the government has successfully recast the transaction in this manner, the result is a disallowance of the corporate deduction for interest payments made on account of the loan and a characterization of the corporate payments on the loan as constructive distributions to the shareholders who guaranteed it. The government has also lost in some of these cases.

Commercial banks are still a primary source of credit for small corporations. Since shareholder guarantees constitute a normal protective device for the lenders, it would be unduly harsh for the government to try to characterize all shareholder guaranteed loans as capital contributions. These recharacterizations probably should be limited to thinly capitalized corporations and cases in which it is shown that the parties did indeed consider the corporation as no more than a depository for a loan made to shareholders. According to some commentators, the government has been most successful when the loans involved corporations with high debt to equity ratios.

**H. Proportionality of Debt to Stock.**

If loans made by the individual shareholders are substantially in proportion to their stockholdings, that is a strong factor tending to

---


387. See, e.g., Plantation Patterns, Inc., 462 F.2d 712; Tax Research Inst. of Am., supra note 278, at ¶ K-5182.

388. See, e.g., Murphy Logging Co., 378 F.2d at 224; Ackerson v. United States, 277 F. Supp. 475, 476-77 (W.D. Ky. 1967); Santa Anita Consol. Inc., 50 T.C. at 550; La Staiti, 41 T.C.M. (CCH) at 514; Estate of Ripson, 39 T.C.M. (CCH) at 231.

389. See, D. KAHN GANN, supra note 40, at 602-03; Comment, Guaranteed Loans, supra note 383.

390. Several of the cases certainly bear out the contention of the commentators. See e.g., Plantation Patterns, Inc., 462 F.2d 712; Atkinson, 48 T.C.M. (CCH) at 577.
support a holding that the loans are not bona fide and should be treated as contributions to capital.\textsuperscript{391} Conversely, debt securities are not as likely to be treated as stock, if the individual holdings of debt are substantially disproportionate to their holdings of stock.\textsuperscript{392} Section 385 of the Internal Revenue Code also lists proportionality as one of the "factors" that the Treasury can consider in formulating regulations,\textsuperscript{393} and the aborted section 385 regulations especially emphasized it.\textsuperscript{394}

Property concepts partly underlie the emphasis on proportionality. When each shareholder owns the same proportion of stock as he does of the ostensible debt, the division of each shareholder's contribution to the corporation into debt and equity does not affect his relative percentages of ownership of the corporation.\textsuperscript{395} The shareholders have the same "bundle of sticks," i.e., the same voting rights and the same income and liquidation percentages, with the debt as they would have without the debt. Most importantly, pay-

\textsuperscript{391} See, e.g., Roth Steel Tube Co., 620 F.2d at 630; Texas Farm Bureau, 725 F.2d at 312-13; Bauer, 748 F.2d at 1370; Stimnett's Pontiac Serv., Inc., 730 F.2d at 639-40; Slappey Drive Indus. Park, 561 F.2d at 583-84; Tyler, 414 F.2d at 849; J.S. Biritz Constr. Co., 387 F.2d at 457; Covey Inv. Co. v. United States, 377 F.2d at 403, 404 (10th Cir. 1967); McSorley's Corp., 323 F.2d at 902; Universal Casting Corp., 303 F.2d at 625-26. See generally Plumb, supra note 28, at 470-82; Stone, supra note 36, at 253-65; Taylor, supra note 30, at 648-50; Note, Debt-Equity Financing Guidelines: Capital Problems For Closely Held Business, 9 Fordham Urb. L. Rev. 1019, 1024-26 (1981); Comment, Tax and the Closely Held Corporation, 1969 Wis. L. Rev. 1199, 1224.

\textsuperscript{392} See cases cited infra note 401.

\textsuperscript{393} I.R.C. § 385(b)(5) (1987).


According to Professor Eustice, the proposed regulations treated proportionality as a "key issue," a "super factor," a "megafactor." J. Eustice, supra note 29, at ¶ 4.04 n.29.


\textsuperscript{395} See, e.g., Texas Farm Indus., 725 F.2d at 313; Slappey Drive Indus. Park, 561 F.2d at 583-84; Fin Hay Realty Co., 398 F.2d at 697; Gilbert, 248 F.2d at 406; Rolwing Moxley Co. v. United States, 452 F. Supp. 385, 388 (E.D. Mo. 1978), aff'd per curiam, 589 F.2d 353 (8th Cir. 1978); Inductotherm Indus. v. Commissioner, 48 T.C.M. (CCH) 167, 188 (1984); Steiner v. Commissioner, 41 T.C.M. (CCH) 1392, 1398 (1981).
ments on the debt perform the same economic functions as dividends, since they allow the shareholders to extract earnings from the corporation without disturbing their relative ownership rights.

Yet more basically, it is a sense of distrust that has most influenced courts and the government to pay close attention to corporate debt held proportionally by shareholders. This distrust can be best explained, perhaps, by referring to the inverse situation—corporate debt held by shareholders in disproportion to their stockholdings. The shareholder-creditor who holds a disproportionately high percentage of the corporate debt usually has paid extra for the special advantages that the debt accords him. Though as a stockholder he is still interested in the welfare of the corporation, he is more likely to enforce the terms of the debt according to their tenor, like a true creditor, due to his advantage over the other shareholders. In contrast, shareholders who hold debt in proportion to their stockholders are more likely to have a silent agreement that none of them will enforce the debt obligation when it would be harmful to their jointly-owned corporation to do so. Moreover, since disproportionate debt does provide greater rights for some shareholders, it is less likely to be a pure tax planning device designed solely to produce better tax consequences on corporate distributions to shareholders.

Proportionality by itself is not enough to require reclassification of debt as equity since the written terms of the debt, the economic realities of the transaction, and the behavior of the borrower and lender towards the obligation might all be probative of the genuineness of the debt. Thus, whereas proportionality of debt and

396. See, e.g., Ortmayer v. Commissioner, 265 F.2d 848, 854-55 (7th Cir. 1959); Earle v. Jones & Son, 200 F.2d 846, 850 (9th Cir. 1952); Post Corp., 640 F.2d at 1308 n.10; Hofert Co. v. United States, 69-1 U.S. Tax Cas. ¶ 9220, at 84,003 (C.D. Cal. 1969); Morgan, Inc. v. Commissioner, 30 T.C. 881, 893 (1958), rev'd on another issue, 272 F.2d 936 (9th Cir. 1959); Tauber v. Commissioner, 24 T.C. 179, 184 (1955). See generally Plumb, supra note 28, at 473-75.


398. See, e.g., Priv. Ltr. Rul. 80-06-012; Texas Farm Bureau, 725 F.2d at 311; Lane, 742 F.2d at 1314-15; Stinnett's Pontiac Serv., Inc., 730 F.2d at 638; Slappey Drive Indus. Park, 561 F.2d at 584 n.19; In re Indian Lake Estates, Inc., 448 F.2d 574 578-79 (5th Cir. 1971); P.M. Fin. Corp.,
stock invites close scrutiny, the government must show something more than proportionality (e.g., thin capitalization) to convince a court to disregard the investor’s interest as debt.

As noted above, debt securities are not as likely to be treated as stock, if the participants’ holding of the debt are substantially disproportionate to their holdings of stock. Though a few courts have completely disregarded disproportionality as a factor indicating debt, courts generally have reclassified disproportionately held debt as stock only in extreme circumstances. For example, disproportionately held debt was reclassified as equity when it had no fixed maturity date, did not earn interest, and the holder neglected to

302 F.2d at 789; Earle, 200 F.2d at 850; Universal Racquetball Rockville Centre Corp. v. Commissioner, 52 T.C.M. (CCH) 143, 146 (1986); R-W Specialties, Inc. v. Commissioner, 43 T.C.M. (CCH) 34, 41 (1981); Taylor, supra note 30, at 647-48; Note, supra note 391, at 1024-25; Note, supra note 385, at 58-59; Comment, supra note 391, at 1224.

399. See, e.g., Slappey Drive Indus. Park, 561 F.2d at 583; P.M. Fin. Corp., 302 F.2d at 789; Earle, 200 F.2d at 850; Sayles Finishing Plants, Inc. v. United States, 399 F.2d 214, 221 (Ct. Cl. 1968); Peraino v. Commissioner, 44 T.C.M. (CCH) 1099, 1106 (1982).

400. See, e.g., Adelson, 782 F.2d at 1573 n.6; Slappey Drive Indus. Park, 561 F.2d at 584 n.19; United States v. Haskel Eng’g & Supply Co., 380 F.2d 786, 788 (9th Cir. 1967); P.M. Fin. Corp., 302 F.2d at 789; Liflans Corp., 390 F.2d at 971; Sayles Finishing Plants, Inc., 399 F.2d at 221.

See also Plumb, supra note 28, at 470-71. The reader should note that the burden of proof rests with the taxpayer, though there must be present something other than proportionately for him to lose.

401. See, e.g., Bauer, 748 F.2d at 1370; Piedmont Minerals Co., 429 F.2d at 563; Lansall Co. v. United States, 512 F. Supp. 1178, 1181 (S.D.N.Y. 1981); Coast Sash & Door Co. v. United States, 75-2 U.S. Tax Cas. (CCH) ¶ 9680 at 88,079 (W.D. Wash. 1975); Hutton v. United States, 73-1 U.S. Tax Cas. (CCH) ¶ 9166 (W.D. Tenn. 1972), aff’d on another point, 501 F.2d 1055 (6th Cir. 1974); Curry v. Commissioner, 43 T.C. 667, 687 (1965); Gooding Amusement Co. 23 T.C. at 422; R-W Specialties, Inc., 43 T.C.M. (CCH) 34; Johnson v. Commissioner, 36 T.C.M. (CCH) 1780, 1788 (1977). See also Calkins, Coughlin, Hacker, Kidder, Sugarman & Wolf, supra note 384, at 36; Goldstein, supra note 308, at 7; Plumb, supra note 28, 473-82; Stone, supra note 36, at 262; Note, supra note 391, 1024-25; Comment, supra note 391, at 1224.


403. See, e.g., Roth Steel Tube Co., 800 F.2d at 632; Indian Lake Estates, Inc., 448 F.2d 574; Gooding Amusement Co., 23 T.C. at 408; Universal Racquetball Rockville Centre Corp., 52 T.C.M. (CCH) at 146-48; Artistic Venetian Blind Corp. v. Commissioner, 15 T.C.M. (CCH) 192 (1956). See also Kavitch, 507 F. Supp. at 1339 (same analysis but in a shareholder-guarantee situation). See generally Plumb, supra note 28, at 474, 480-81.
make demand for payment. Courts also take familial and economic solidarity into account when determining whether the debt is truly disproportionate. Husband and wife, for example, have been treated as a unit for purposes of determining the proportionality of their advances.

VI. "Securities": Tax Consequences

An instrument purporting to be the debt of a corporation can be interpreted to be one of three things: (1) stock (or evidence of a contribution to capital); (2) a bona fide debt amounting to a security; or (3) a bona fide debt not amounting to a security. The next few pages discuss the distinctions in tax treatment between bona fide debts amounting to a security and bona fide debts not amounting to a security. Then follows an examination of classification criteria.

404. See Colony Inc. v. Commissioner, 357 U.S. 28 (1958); Roth Steel Tube Co., 800 F.2d at 631; Uneco, Inc., 532 F.2d at 1210; Universal Racquetball Rockville Centre Corp., 52 T.C.M. (CCH) at 147.

405. See, e.g., Slappey Drive Indus. Park, 561 F.2d at 584; Foresun, Inc., 348 F.2d at 1008; Motel Co., 340 F.2d at 446; P.M. Fin. Corp., 302 F.2d at 788 n.11; Liflians Corp., 390 F.2d at 971; Peco Co. v. Commissioner, 26 T.C.M. (CCH) 207, 212 (1967); B. BITTKER & J. EUSTICE, supra note 27, at ¶ 4.04 n.30.


In a few cases, courts have been willing to honor the disproportionality when the family members were adults and seemed capable of acting independently. See, e.g., Hofert Co., 69-1 U.S. Tax Cas. (CCH) ¶ 9220, at 84,003; Curry, 43 T.C. at 687.

If family relations are disharmonious, perhaps the disproportionality should be a factor despite the family ties. Cf. Slappey Drive Indus. Park, 561 F.2d at 584. If enough rancor exists between family members, perhaps disproportionality between stock and debt ought to be disregarded as a factor, too, since the warring parties are unlikely to act as a financial unit. More probably, at least one of them will act like a true creditor.
A. Section 351 Exchanges.

The most common controversy over whether a debt constitutes a "security" occurs when someone transfers appreciated property to a controlled corporation and in exchange receives a piece of paper purporting to represent a debt of the transferee corporation.\footnote{408 See, e.g., \textit{Slappey Drive Indus. Park}, 561 F.2d at 572; Hayutin v. Commissioner, 508 F.2d 462, 472 (10th Cir. 1974); Dennis v. Commissioner, 473 F.2d 274 (5th Cir. 1973); \textit{Estate of Mixon}, 464 F.2d at 394; Gyro Eng'g Corp. v. United States, 417 F.2d 437 (9th Cir. 1969); \textit{Piedmont Corp.}, 388 F.2d at 886; Aqualane Shores, Inc. v. Commissioner, 269 F.2d 116 (5th Cir. 1959); \textit{Bradshaw}, 683 F.2d at 365; Stanley, Inc. v. Schuster, 295 F. Supp. 812 (S.D. Ohio 1969), \textit{aff'd}, 421 F.2d 1360 (6th Cir.), \textit{cert. denied}, 400 U.S. 822 (1970); \textit{D'Angelo Assoc. v. Commissioner}, 70 T.C. 121 (1978); \textit{Adams v. Commissioner}, 58 T.C. 41 (1972); \textit{Nye}, 50 T.C. 203; \textit{Burr Oaks Corp.}, 43 T.C. 635; Camp Wolters Enter. v. Commissioner, 22 T.C. 757 (1954), \textit{aff'd}, 230 F.2d 555 (5th Cir.), \textit{cert. denied}, 352 U.S. 826 (1956).} For example, as explained in a recent Court of Claims case,\footnote{409 See \textit{Bradshaw}, 683 F.2d 365.} a landowner with a large tract of appreciated land suitable for development knows that ultimately he will be taxed on that appreciation if he develops that land. Naturally, he prefers that his taxable gain be characterized as a capital gain rather than as ordinary income. While he would be entitled to a capital gain on an outright sale of the property to an outsider, he would then be deprived of the profits to be reaped from its development. If he develops and sells the property himself, he probably would be treated as a dealer, and any gain generated through the sales, including the gain associated with the land's appreciation in value while still undeveloped, would be taxable to him as ordinary income. Therefore, instead of the outright sale to an outsider, he tries to make a taxable sale of the property to his own controlled corporation. If the Internal Revenue Service honors the transaction as a taxable sale, the appreciation in value of the undeveloped lands will be taxed to him as a capital gain and not as ordinary income, and, at the same time, he can preserve his opportunity to participate in the developmental profits as the shareholder of the controlled corporation. Additionally, the transferee corporation (the controlled corporation) will take a cost (i.e., fair market value) basis in the property, thereby reducing the amount of ordinary income to be realized from subsequent sales. Not surprisingly, the government has repeatedly challenged the character-
izations of such incestuous transactions as taxable sales, instead maintaining that the transfers are really either capital contributions or nontaxable section 351 exchanges.410

In many of the other reported decisions, the transferee corporation is the only taxpayer before the court,411 perhaps because the statute of limitations already has run on the year of the transfer, thereby insulating the transferor from an inquiry into his characterization of the transfer; the dispute is the size of the depreciation deductions taken by the transferee corporation some years after the transfer.412

If all that the transferor receives is the debt and it is treated as a bona fide debt not amounting to a security, which is often the tax treatment desired by the taxpayers,413 the transaction is a taxable sale, and these are the tax consequences:

1. the transferor recognizes the gain on the sale of his property to the corporation;414
2. the recognized gain sometimes is a capital gain;415
3. the transferor takes a cost basis in the debt;416
4. the transferee corporation takes a cost basis in the transferred property;417

410. See id. at 368.
411. See, e.g., Hayutin, 508 F.2d 462; In re Drage, 78-2 U.S. Tax Cas. (CCH) ¶ 9632 (M.D. Fla. 1978); Burr Oaks Corp., 43 T.C. 635.
412. See, e.g., C-Lec Plastics, Inc. v. Commissioner, 76 T.C. 601 (1981); D'Angelo Assoc., 70 T.C. 121; Adams v. Commissioner, 58 T.C. 41 (1972); Kamborian v. Commissioner, 56 T.C. 847 (1971), aff'd, 469 F.2d 219 (lst Cir. 1972); Nye, 50 T.C. 203.
413. See, e.g., Piedmont Corp., 388 F.2d 886; Aquanlne Shores, Inc., 269 F.2d 116; Bradshaw, 683 F.2d 365; Burr Oaks Corp., 43 T.C. 635.
415. The character of the gain to the transferor, of course, depends upon the nature of the asset transferred and, for capital assets, the transferor's holding period. In addition to problems with the usual recapture rules, the tax lawyer must be especially alert to section 1239, which requires ordinary income treatment for the full amount of gain recognized on the sale or exchange of depreciable property between a shareholder and an 80-percent owned corporation. See I.R.C. § 1239 (1987).
416. See, e.g., I.R.C. § 1012 (1987). See also Kettler v. Commissioner, 196 F.2d 822 (7th Cir. 1952); Gould Sec. Co. v. United States, 96 F.2d 780 (2d Cir. 1938); Society Brand Clothes, Inc. v. Commissioner, 18 T.C. 304 (1952).
417. See, e.g., Bradshaw, 683 F.2d 365; C-Lec Plastics, Inc., 76 T.C. 601; D'Angelo Assoc., 70 T.C. 121; Nye v., 50 T.C. 203.
(5) for the transferor, later principal payments on the debt will be nontaxable returns of capital up to his basis in the debt; and

(6) since the principal usually is the transferor's "cost" in the debt, 100% of the principal payments ordinarily will be nontaxable returns of basis to the transferor;

(7) the transferee corporation will take an interest deduction for those payments on the debt that constitute interest, (though it gets no deduction for payments on principal);

(8) because the transferee corporation takes a cost basis in the transferred property, it will have a smaller taxable gain on resale, which is especially important for property which is intended for resale but which will not qualify for capital gains treatment, e.g., the undeveloped real estate mentioned above; and

(9) again because the transferee corporation takes cost basis in the transferred property, it will have larger depreciation deductions, which is important when the transferred property is depreciable.

The tax consequences substantially differ when the instrument is honored as debt, but is treated as a "security." This is because section 351 usually applies when a shareholder transfers property to a controlled corporation in exchange for securities of that corporation. Unless he receives boot, the transferor does not recognize his gain and is required to take the lower substituted basis in the debt: the transferee corporation takes the lower, carryover basis in the transferred property. Principal payments on the debt will still be nontaxable up to the transferor's basis, but to his lower, substituted basis, the principal payments will exceed his basis in the debt, and that excess of principal payments over basis will be taxable to him. The transferee corporation still will be entitled to deduct interest payments, but the lower, carryover basis will result in lesser depreciation deductions or greater gains on resale of the property.

419. See id. § 163(a) (1987).
420. See Fin Hay Realty Co., 398 F.2d at 696 n.8; Bradshaw, 683 F.2d 365.
421. See, e.g., C-Lec Plastics, Inc., 76 T.C. 601; D'Angelo Assoc., 70 T.C. 121; Adams, 58 T.C. 41; Kamborian, 56 T.C. 847; Nye, 50 T.C. 203.
If the transaction is treated as a contribution to capital, the transferor does not recognize any gain on the transfer, increases his basis in his stock by his basis in the transferred property, and treats payments on the debt as section 301 distributions, i.e., ordinary income to the extent of the transferee corporation’s earnings and profits. The transferee corporation gets no interest deduction for making the payments, because they are section 301 distributions; it takes the lower, carryover basis in the transferred assets, resulting in lower depreciation deductions and greater gain on resale of the transferred property.

If the debt instrument is treated as stock, the transaction is a 351 exchange. Neither the transferor nor the transferee corporation recognizes a gain. The transferor takes the substituted basis in his stock. The corporation takes a carryover basis in the transferred property. Principal payments on the debt are treated as payments in redemption of stock, meaning that the shareholder might be entitled to exchange treatment, though more typically he must treat the payments as section 301 distributions. Interest payments are section 301 distributions. The corporation has no interest deduction and is stuck with the lower, carryover basis for purposes of depreciation and resale of the transferred property.

427. See, e.g., Falkoff v. Commissioner, 604 F.2d 1045 (7th Cir. 1979); Wheeler v. United States, 75-1 U.S. Tax Cas. (CCH) ¶ 9170 (W.D. Tex. 1974).
430. See id. § 351(a) (1987).
431. Id.
432. Id. § 1032(a) (1987).
435. See, e.g., Brams v. Commissioner, 734 F.2d 290 (6th Cir. 1984); Coates Trust v. Commissioner, 480 F.2d 468 (9th Cir.), cert. denied, 414 U.S. 1045 (1973); Commissioner v. Stickney, 399 F.2d 828 (6th Cir. 1968).
436. See, e.g., Falkoff, 604 F.2d 1045; Wheeler, 75-1 U.S. Tax Cas. (CCH) ¶ 9410.
437. See, e.g., Rushing v. Commissioner, 52 T.C. 888 (1969), aff'd, 441 F.2d 593 (5th Cir. 1971).
The tax law adds a wrinkle when the transferor of property to the controlled corporation receives both stock and debt in the exchange. If the debt is treated as a security, the transaction is fully nontaxable under section 351. If the debt is treated as stock, the transaction is also fully nontaxable. If the debt is treated as a debt not amounting to a security, however, it is treated as boot, i.e., the recipient of the boot is required to recognize any realized gain to the extent of the boot received. The boot recipient takes a fair market value basis in the boot, which ordinarily ought to be the face value of the debt. Since payments in retirement of debt are a nontaxable return of capital up to the holder's basis, the debt-holder is unlikely to have any additional taxable gain upon collection, except for the interest payments. The transferee corporation's basis in the transferred property will be carryover plus the gain recognized to the transferor on account of the boot.

B. Reorganizations and Corporate Divisions.

The term "securities" is also used in the Code sections on reorganizations and corporate divisions. Indeed, much of the jurisprudence concerning the meaning of the term "securities" developed in reorganization cases. "Securities" has the same mean-
ing for reorganizations and corporate divisions as it does for section 351 exchanges.\textsuperscript{447}

In reorganizations and corporate divisions, investors are entitled to receive securities tax free, but only to the extent that the principal amount of the securities received does not exceed the principal amount of the securities surrendered.\textsuperscript{448} If a security holder surrenders securities in exchange for other securities and the principal of the securities received exceeds the principal of the securities surrendered, the fair market value of that excess is treated as boot.\textsuperscript{449} If a shareholder receives stock and securities and surrenders stock but no securities, the securities are treated as boot.\textsuperscript{450} If a shareholder surrenders stock and receives only securities in return, the transaction is outside the reorganization sections and is fully taxable to him.\textsuperscript{451} A security holder who exchanges securities for stock is entitled to nonrecognition treatment.\textsuperscript{452}

These detailed rules are based on a theory that an investor exchanging stock for securities is cashing out his investment to the extent of the securities—he's not entitled to nonrecognition treatment under the continuity of interest principle.\textsuperscript{453} The security holder


449. Id. § 356(d) (1987).


who surrenders his securities for stock is upgrading the character of his investment rather than cashing out and, accordingly, ought not to be taxed on the exchange.\textsuperscript{454}

If an investor receives nothing except debts not amounting to a security, the transaction is completely outside of the reorganization sections and is fully taxable, both under the language of the Code itself\textsuperscript{455} and the landmark Supreme Court case of \textit{Pinellas Ice & Cold Storage Co. v. Commissioner}.\textsuperscript{456} This rule applies even if the investor himself surrendered securities. If, in addition to the debt not constituting a security, the investor receives other consideration that qualifies for nonrecognition treatment, i.e., stock, then the debt not amounting to a security is treated as boot.\textsuperscript{457}

In addition to classifying the interest received by an investor in an exchange, an investor may need to classify the interest that he is giving up. If the only interest surrendered is a debt not amounting to a security, the transaction is again completely outside the reorganization sections,\textsuperscript{458} which apply only to exchanges in which both sides surrender either stock or securities.

The classification issue can also affect a corporation that transfers property in a reorganization. If it exchanges the property solely for stock or securities, it does not recognize a gain.\textsuperscript{459} But if, in addition to stock or securities, it receives a debt not amounting to a security, that debt is considered boot. It must recognize its realized gain to the extent of any boot received, including the debt, but only if it does not distribute the boot pursuant to a plan of reorganization.\textsuperscript{460}

\textsuperscript{454} See, e.g., \textit{Le Tulle}, 308 U.S. 415.
\textsuperscript{456} \textit{Pinellas Ice & Cold Storage Co.}, 287 U.S. 462.
\textsuperscript{457} See, e.g., \textit{Carlberg v. United States}, 281 F.2d 507 (8th Cir. 1960); \textit{Henkel, supra} note 451, at 651; \textit{Plumb, supra} note 28 at 588.
\textsuperscript{458} See, e.g., \textit{Paulsen}, 469 U.S. 131; \textit{Neville Coke & Chem. Co.}, 148 F.2d at 599; \textit{Sisto Fin. Corp.}, 139 F.2d 253; see also \textit{Griswold, "Securities" and "Continuity of Interest"}, 58 HARV. L. REV. 705 (1945); \textit{Henkel, supra} note 451; \textit{Plumb, supra} note 28, at 558 n.1144.
\textsuperscript{459} I.R.C. § 361(a) (1987).
\textsuperscript{460} Id. § 361(b)(1) (1987). \textit{See also} \textit{Plumb, supra} note 28, at 557-58.
For a corporate division to be tax-free, the parent must distribute all of the securities it owns in the controlled corporation, unless excused by good business reasons. The parent need not distribute a debt of the controlled corporation that is not considered a security.

C. Miscellaneous Tax Rules Using the Term "Securities."

Other Code sections use the term "securities." (1) Section 165(g) is probably the most important. It provides for capital loss treatment on the worthlessness of any "security." As discussed earlier, debts not amounting to securities are governed by section 166, the bad debt section. (2) For purposes of the rules on distributions and redemptions, section 317(a) defines the term "property" to include securities. (3) Section 333, the "one month liquidation" section now repealed, allowed nonrecognition treatment for certain shareholders on the receipt of liquidating distributions. Even qualified electing shareholders, however, had to recognize their realized gain to the extent that they received, amongst other things, securities acquired by the liquidating corporation after 1953. (4) Section

462. Plumb, supra note 28, at 559.
464. See id. § 166 (1987).
465. Id. § 317(a) (1987).
466. See id. § 333 (1954).
467. Id. § 333(e)(2), (f)(1) (1987). More particularly, a qualifying electing shareholder other than a corporation recognized his realized gain on the greater of (1) his ratable share of the distributing corporation's accumulated earnings and profits and (2) any money, stock or securities distributed to him. His recognized gain was a dividend to the extent that it was covered by the distributing corporation's earnings and profits. Any recognized gain above his dividend was treated as a capital gain. Id. at § 333(e).

A qualifying electing shareholder that was also a corporation recognized its realized gain to the same extent as would a shareholder other than a corporation. No part of the recognized gain, however, was a dividend. Instead it was a capital gain. Id. at § 333(f).

If the liquidating corporation has no accumulated earnings and profits, the qualified electing shareholder who received no cash, stock or securities recognized no gain. Id. at § 333(a), (e), (f).
367(a)(1) denies the nonrecognition treatment accorded by sections 332, 351, 354, 356 and 361 when a "United States person" transfers property to a foreign corporation.\(^{468}\) Section 367(a)(2), however, renders section 367(a)(1) inapplicable, i.e., restores the nonrecognition treatment accorded by those five sections, when the property transferred consists of securities of a foreign corporation that is a party to the transaction.\(^{469}\) (5) Section 1244, the section granting preferential tax treatment for losses on "small business stock," is not available to the holders of (A) stock issued for securities\(^{470}\) or (B) issued by a corporation that, for five years preceding the loss, derived more than 50\% of its aggregate gross receipts from a variety of investment activities, including sales or exchanges of securities.\(^{471}\)

VII. "SECURITIES:" CLASSIFICATION CRITERIA

Neither the Internal Revenue Code nor its regulations define the term "securities."\(^{472}\) Although the need to define the term has engendered substantial litigation,\(^{473}\) the line of demarcation between securities and other debts is said to be "shrouded" with much the same uncertainty as the line between debt and equity.\(^{474}\) Unfortunately, the Internal Revenue Service does little to help the tax practitioner; as it has a policy of not issuing advance rulings on whether

\(^{468}\) Id. § 367(a)(1) (1987).

\(^{469}\) Id. § 367(a)(2) (1987).

\(^{470}\) Id. § 1244(c)(1)(B) (1987).

\(^{471}\) Id. § 1244(c)(1)(C) (1987).

\(^{472}\) While the Code does not provide a general definition, section 165, the general section on losses, provides a definition of the word "security" for purposes of the rule on "worthless securities." See id. § 165(g)(2) (1987).

\(^{473}\) See, e.g., Pinellas Ice & Cold Storage, 287 U.S. 462; Dennis, 473 F.2d 274; United States v. Mills, 399 F.2d 944 (5th Cir. 1968); United States v. Hertwig, 398 F.2d 452 (5th Cir. 1968); Wolf Envelope Co. v. Commissioner, 197 F.2d 864 (6th Cir. 1952); Neville Coke & Chem. Co., 148 F.2d 599; Sisto Fin. Corp., 139 F.2d 253; Bradshaw, 683 F.2d 365; D'Angelo Assoc., 70 T.C. 121; Camp Wolters Enter., 22 T.C. 737.

\(^{474}\) Plumb, supra note 28, at 559.

debt instruments payable within 10 years amount to securities. At least one certain comment can be made: outside of section 165’s treatment of worthless securities, in tax law the word “securities” refers to debt obligations only. It does not include both stock and debt, as it does in the financial world.

What debts are “securities” for tax purposes? Despite the frequent judicial protestations that the time period of the instrument is not determinative, the term of the debt is clearly the single most important factor in determining whether a debt obligation amounts to a security. Debt instruments payable in full within five years generally are not considered securities, except in unusual circumstances. The rationale is that such debts are too close to a cash equivalent to be considered an investment in the business, a sine qua non for securities status. In contrast, a debt instrument maturing in ten years or more is almost certainly to be considered a security, for it is then an integral part of the capitalization of the corporation. Though some might consider debts maturing within a five to ten year period to be of questionable status, debts within that time frame generally have been deemed to be securities. Debts calling

---

477. See, e.g., W. CARY & M. EISENBERG, supra note 7, at 1106-12; F. O’NEAL, supra note 8, at § 2.10.
478. See, e.g., Sisto Fin. Corp., 139 F.2d at 255; Bradshaw, 683 F.2d at 377; Nye, 50 T.C. at 212. See also Camp Wolters Enter., 230 F.2d at 560; Plumb, supra note 28, at 562.
479. See, e.g., Dennis, 473 F.2d 274; Hertwig, 398 F.2d 452; Campbell v. Carter Found. Prod. Co., 322 F.2d 827, 832-35 (5th Cir. 1963); Bradshaw, 683 F.2d at 377 n.28. See also W. BITTKER & M. EUSTICE, supra note 27, at § 3.04; Plumb, supra note 28, at 562.
480. See Pinnellas Ice & Storage Co., 287 U.S. 462; Neville Coke & Chem. Co., 148 F.2d 599; Bradshaw, 683 F.2d at 377 n.28; Nye, 50 T.C. at 212 n.9; W. BITTKER & M. EUSTICE, supra note 27, at § 3.04; Plumb, supra note 28, at 562-63.
481. See Campbell, 322 F.2d at 832-35; Plumb, supra note 28, at 563.
482. See, e.g., Hertwig, 398 F.2d 452 (12 1/2 years); Parkland Place Co. v. United States, 354 F.2d 916 (5th Cir. 1966), aff’d, 248 F. Supp. 974 (N.D. Tex. 1964) (ten years); Burnham v. Commissioner, 86 F.2d 776 (7th Cir. 1936), cert. denied, 300 U.S. 683 (1937) (ten years); Bradshaw, 683 F.2d at 377 n.28; Nye, 50 T.C. at 203 (ten year installments). See generally Kaufman, supra note 474, at 119; Plumb, supra note 28, at 563.
483. See, e.g., Kaufman, supra note 474, at 120; Plumb, supra note 28, at 563. Cf. Bradshaw, 683 F.2d at 377 n.28; Nye, 50 T.C. at 212 n.9.
484. See, e.g., Parkland Place Co., 354 F.2d 916 (ten year promissory note); Campbell, 322 F.2d 827 (five year promissory note); Commissioner v. Freund, 98 F.2d 201 (3d Cir. 1938) (six year
for payments both before and after the five year dividing line—a common occurrence—resist easy classification. The authorities have looked at both the average term and the date of final payment. The redemption feature generally does not destroy a long-term debt's status as a security. If it did, few long-term debts would be securities since virtually all of them are redeemable. Moreover, though short-term debt and redeemable long-term debt share the potential for being paid in full shortly after their creation, the power to redeem the long-term debt usually rests with the corporation, not the holder. In contrast, the power to compel full payment of the short-term debt resides with the holder, a fact that renders that debt less investment-like than redeemable long-term debt. A Supreme Court case implies that redeemable debt held by a controlling shareholder in a close corporation is more like cash than a security since the holders control the decision-making process inside the corporation and can make the corporation call the debt at any time. This rationale would seem to apply with equal force to and debts held by the controlling shareholders of close corporations, whether redeemable or not. In such circumstances, a formal redemption feature is superfluous because the holders have the power to make the corporation prepay the debt at any time anyway. Yet none of the cases applied the implication from the Supreme Court case to redeemable much less nonredeemable debt.

Courts have also had to wrestle with early prepayment of long-term debt. Does the prepayment impair the debt’s status as a se-

serial bonds); Burnham, 86 F.2d 776 (ten year promissory note); Watts, 296 U.S. 387 (one to seven year bonds); Camp Wolters Enter., 230 F.2d 555 (installment notes payable between five and nine years). See also Plumb, supra note 28, at 563-64.


486. See Wolf Envelope Co., 197 F.2d 864; Camp Wolters Enter., 22T.C. at 752; Pan Am. Travel Co. v. Commissioner, 4 T.C.M. (CCH) 555 (1945). See also Plumb, supra note 28, at 564.

487. See Wolf Envelope Co., 197 F.2d 864; Pan Am. Travel Co., 4 T.C.M. (CCH) 555; Plumb, supra note 28, at 564.


490. See Bazley, 331 U.S. 737; Adams, 58 T.C. 41; Plumb, supra note 28, at 565.
curity? In a landmark case, the debtor corporations paid off five to nine year installment notes should be examined as of the date of issuance. Other courts, though, have stressed early payments as a factor not indicating security status. The issue, therefore, should be considered unsettled.

A second major factor is the extent to which the payment on the corporate obligation depends upon the ultimate success or failure of the business. To have an "investment quality," i.e., to be a security, the debt must provide a "degree of participation and continuing interest in the business." Accordingly, when on the date of issuance it appears that repayment is inextricably and indefinitely tied up to success of the venture, the debt constitutes a security. Thus, the emphasis is on the degree of risk taken by the holder of the debt. If (1) the debtor corporation lacks sufficient liquid assets to retire the debt soon after its creation, (2) the debt can be paid only through a sale of the business as a going concern at that point, and (3) payment is intended to be derived from future earnings, which may or may not occur, that debt is likely to be considered a security (or maybe even equity), even if the ostensible due date falls within less than five years.

491. Camp Wolters Enter., 22 T.C. 737. Camp Wolters has been cited for stating the applicable test for the definition of "securities" seventeen times by circuit courts alone. See, e.g., Dennis, 473 F.2d at 279; Mills, 399 F.2d at 947; Hertwig, 398 F.2d at 455; Turner Constr. Co., 364 F.2d at 535; Bradshaw, 683 F.2d at 376.

492. Camp Wolters Enter., 22 T.C. 737.


494. See, e.g., Hertwig, 398 F.2d at 455; Camp Wolters Enter., 230 F.2d 560; Bradshaw, 683 F.2d at 376; American Processing & Sales Co., 371 F.2d at 856-57; Nye, 50 T.C. at 217.

495. Nye, 50 T.C. at 217.

496. See Camp Wolters Enter., 230 F.2d at 560; See also Nye, 50 T.C. at 213-14.

497. See Camp Wolters Enter., 230 F.2d at 560; Bradshaw, 683 F.2d at 376; Nye, 50 T.C. at 217.

498. See Mills, 399 F.2d at 947-48; Hertwig, 398 F.2d at 455; Bradshaw, 683 F.2d at 374-75; D'Angelo Assoc., 70 T.C. at 134; Nye, 50 T.C. at 217.

499. Several of the courts have recognized that virtually the same risk-taking analysis is used in deciding the debt-equity issue. See, e.g., Bradshaw, 683 F.2d 365; Nye, 50 T.C. 203; Camp Wolters Enter., 22 T.C. 737.
Inferentially, since high risk is indicative of a security, low risk is indicative of a debt not amounting to a security. For example, in one case, a close corporation issued promissory notes to its sole shareholder in exchange for real estate. Though still undeveloped, the property already had substantial commercial value and predictably was later developed into a swank residential subdivision. The notes were held not to be securities because, in part, the prospects for financial success were always bright and the promise of repayment was never in jeopardy due to the value of the land. Repayment on the notes was not subject to the fortunes of the business.

The court found a stark contrast with another case where a corporation issued notes in exchange for mangrove swampland. Vast improvements were essential to that tract's successful development, which, even then, was highly speculative. Because repayment depended on the risks of the business, those debts were held to be securities.

See Bradshaw, 683 F.2d at 377; D'Angelo Assoc., 70 T.C. at 135.
Bradshaw, 683 F.2d 365.

Bradshaw presented a prototypical section 351 dispute. An owner of real estate formed a corporation and paid cash for all of its stock. In what he hoped would be considered a separate transaction, he then transferred the undeveloped real estate to the corporation in exchange for promissory notes. If, as he hoped, the second transaction was considered a sale that fell outside of section 351, he would recognize a capital gain on the pre-transfer appreciation in the value of the property; the corporation would take a stepped-up fair market value basis in the property so that it would have less ordinary income on subsequent sales of the property after its development; since the transferor would take a basis in the notes equal to their full principal amount, he would treat principal payments on the notes as a tax-free return of his basis; and the corporation would be entitled to deduct interest payments on the note. The government, on the other hand, wanted the payment of the cash and the transfer of the property for notes to be considered part of one section 351 exchange. The corporate transferee would then be required to take a section 362(a)(1) low carryover basis in the transferred property, resulting in greater ordinary income upon the later sales of the property after its development. This would have happened if the notes are considered either stock or securities, but not if the notes were considered debts not amounting to a security. The government also wanted the transfer of the property to the corporation to be considered either a contribution to capital or an exchange of property for stock. Then all of the payments on the notes would be section 301 distributions to the shareholder, and the corporation would not be entitled to any interest deductions.

Id. at 370.

Id. at 368, 369.
Id. at 375.
Aqualane Shores, Inc., 269 F.2d 116.
Id. at 117-18.
Id. at 119.
Id. at 119-20.
Most of the cases using risk analysis could have been rested as well on the term of the debt. Risk analysis has never resulted in a debt payable over more than ten years being found a debt not amounting to a security. Risk analysis does help to explain those "unusual circumstances" when debt instruments payable in full within five years are considered securities. For example, risk analysis resulted in security status for a demand note, a one year note, and a debt payable in five annual installments. In each of these cases, the actual payments on the notes extended well beyond their due dates, a fact that strongly influenced the courts in declaring the debts to be securities.

The lone statutory definition of the word "security" is contained in section 165(g), the section on "worthless securities." According to this definition, corporate debt constitutes a "security" only if it is issued with interest coupons or in registered form. Outside the section 165 context, it is well settled that promissory notes, which neither have coupons nor are registered, may qualify as securities. Section 165(g)'s definition of "security" also includes stock and rights to subscribe or "receive" stock. In that respect, section 165 differs

509. See, e.g., Hertwig, 389 F.2d 452, (debts payable over a 12 1/2 year period held to be securities); Bradshaw, 683 F.2d at 377 n.28 (corporate notes with maturity dates ranging from 2 1/2 to 6 1/2 years held not to be securities).

510. D'Angelo Assoc., 70 T.C. at 133-36.

511. Mills, 399 F.2d 944. In Mills the parties contemplated an indefinite extension of the note. Id. at 947.

512. Aqualane Shores, Inc., 269 F.2d 116. In Aqualane, a five year installment obligation was held to be a security, since its repayment depended on a plan to reclaim and subdivide swampland, a risky venture. Id. at 118-19.

513. See, D'Angelo Assoc., 70 T.C. 121 (only 50% of principal paid after 16 years). See also, Mills, 399 F.2d 944 (annual renewal of 1 year notes); Aqualane Shores, Inc., 269 F.2d 116 (no payments until 4 years after maturity).

514. I.R.C. § 165(g)(2) (1987). According to the general rule of section 165(g), the holder of a "security" that becomes worthless during the year recognizes the capital loss, provided that the security is a capital asset. Id. at § 165(g)(1) (1987). With the exception of dealers, securities generally are capital assets.

515. Id. § 165(g)(2)(C) (1987). See also Treas. Reg. § 1.165-5(a)(3) (1987); Plumb, supra note 28, at 383 n.70. Plumb, supra note 28, at 383 n.71 mentions that securities held by a dealer for sale to customers would be excepted from such treatment, i.e., would not result in long-term capital gain.

516. See, e.g., Mills, 399 F.2d at 947; Campbell, 322 F.2d at 833-35; D'Angelo Assoc., 70 T.C. at 133; Nye, 50 T.C. at 212-14.

from the more general tax definition of "securities," which is limited to debt and excludes stock.\textsuperscript{518}

VIII. PREFERRED STOCK

Preferred stock has a variety of uses in close corporations, most of which are not tax-oriented.\textsuperscript{519} While a detailed discussion of all of them is beyond the scope of this text, it might be helpful to describe two of the most important ones as illustrations.

First, preferred stock may be useful in carrying out the business bargain between the founders of the enterprise, because it furnishes a method of giving some of the participants priorities in earnings and in assets.\textsuperscript{520} It can be used to distribute risk, control, and participation among the investors of the business.\textsuperscript{521} Commentators, have often advocated its use when one investor provides the newly formed enterprise with capital and another provides special skills or the promise of services. They each might agree to take 50% of the common stock so that they can share equally in the control and in future growth of the business. In the early stages of the enterprise, the party offering the skills is likely to realize a "senior" return in the form of reasonable compensation for services performed. The party providing the capital, no less than the party providing the skills, may insist that he too be entitled to a senior return, representing reasonable compensation for the use of his capital in the

\textsuperscript{518} But see id. § 165(g)(2) (1987) (term "worthless securities" includes stock rights and corporate or government debts).

\textsuperscript{519} "Preferred stock" refers to a class of stock that grants its holders either a dividend or liquidation preference or both. It has a dividend preference, if the corporation is prohibited from distributing a dividend to common stockholders until after it pays the preferred stockholders a dividend in a stated amount. It has a liquidation preference, if the corporation is prohibited from distributing anything to its common stockholders in a liquidation until after it pays a stated amount to the preferred stockholders. For either of these preferences to exist, they must be stated in the corporation's articles of incorporation. The exact terms of the preferences (and any other special attributes) must be stated in the articles of incorporation. Frequently, preferred stock is cumulative, redeemable, convertible and nonparticipating and provides only contingent voting rights. The permutations of rights and limitations are endless, however. For full discussions of preferred stock, see generally I Z. CAVITCH, supra note 1, at § 2.21; F. O'NEAL, supra note 8, at § 2.15; ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES, supra note 13, at § 8.06.

\textsuperscript{520} See F. O'NEAL, supra note 8, at § 2.15.

\textsuperscript{521} See ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES, supra note 13, at § 8.06.
enterprise. Moreover, the provider of capital might need some protection against an early liquidation where the provider of skills would receive a substantial portion of the assets on the liquidation, assets contributed by the provider of capital, even though the skills person has yet to make a real contribution to the business.

Nonvoting, nonparticipating, redeemable, cumulative preferred stock issued to the provider of capital might be the perfect solution for this situation. It would be issued to the party providing the only capital. Since it would be nonvoting and nonparticipating, it would not disturb the basic business bargain that provides for equality in the control and the growth of the business. The cumulative dividend preference would entitle the party providing the money to a senior return for the use of his capital, analogous to the compensation paid for the shareholder providing the special skills or the promise of future services. The liquidation preference would allow the entrepreneur offering the capital to pull out the assets he contributed in the event of an early liquidation. The corporation ultimately would redeem the preferred stock eventually insuring that each entrepreneur would have a 50% stake in the business. If the parties so desired, the amount of the dividends paid on the preferred and its redemption price could be pegged at an amount that would let the preferred stockholder recoup all (or a part) of his extra capital contribution. Second, preferred stock can be useful in transferring control of a close corporation to a younger generation. For example, if a shareholder wishes to pass control of the corporation to his children, but to retain securities representing substantially all of the full present value of the business, he may recapitalize the corporation, creating and retaining a new class of nonvoting preferred stock and giving the voting common to the children. In this manner, the parent retains most of the present value of the corporation while control and future appreciation in the corporation's value accrues to the children. At the parent's death, the corporation might redeem

523. See W. Cary & M. Eisenberg, supra note 7, at 114.
524. Herwitz, supra note 522, at 1098, 1119. See generally e.g., W. Cary & M. Eisenberg, supra note 7, at 114; R. Deer, Lawyer's Basic Corporate Practice Manual 26 (1978).
the preferred in a section 303 redemption without altering control.\textsuperscript{525} Alternatively, if the parent wishes to retain control, but to pass the economic value of the business to his child, he can convey the preferred to the children and retain the common stock until his death. Similar arrangements can be made to pass either control or an economic interest to key employees.\textsuperscript{526}

From the corporation's viewpoint, preferred stock, especially if held by outsiders, has some non-tax advantages over debt. First, unlike debt, preferred stock generally does not carry a fixed obligation from the corporation to the stockholder. If the corporation is in financial trouble, it can withhold the payment of dividends. Unlike a debtholder, the preferred stockholder ordinarily lacks the power to either compel payments or to force the corporation into bankruptcy.\textsuperscript{527} This benefit, however, is offset by a corresponding burden, discussed below, when the preferred is held by common stockholders. Second, putative lenders, e.g., banks, are wary of balance sheets heavily laden with debt. In contrast to debt, preferred stock strengthens the balance sheet by decreasing the debt to equity ratio, thereby making the corporation a more attractive borrower to outsiders.\textsuperscript{528}

\textsuperscript{525} See F. O'Neal, supra note 8, at § 2.15.

\textsuperscript{526} See id.

\textsuperscript{527} See generally id.; Organizing Corporate and Other Business Enterprises, supra note 13, at § 8.06.

\textsuperscript{528} See generally 1 Z. Cavitch, supra note 1, at § 2.21[2]; F. O'Neal, supra note 8, at § 2.15; Organizing Corporate and Other Business Enterprises, supra note 13, at § 8.06.

This difference between preferred stock and debt is often illusory for securities held proportionately by common stockholders in close corporations. While such holders technically have the power to compel payment on debt or to force the defaulting corporation into bankruptcy, either a lawsuit to enforce the debt or a corporate bankruptcy is inimical to their interests as common stockholders. Accordingly, they are likely to waive a default on the debt by the corporation and not insist on payment until the corporation is healthy enough to be able to afford it. The result is exactly the same as when, as directors, they decide on behalf of the corporation to make the corporation withhold payments of dividends to themselves as preferred stockholders.

This advantage of preferred stock over debt may be tempered somewhat by the inclination of sophisticated lenders like banks to require shareholder-creditors to subordinate their claims as creditors to the claims of the bank as a precondition for a bank loan. 1 Z. Cavitch, supra note 1, at § 2.21[2].

Another advantage of preferred stock often mentioned by commentators is that the issuance of preferred shares permits the corporation to raise money from trustees, institutions, and other conservative investors who either will not or cannot purchase common shares. See, e.g., F. O'Neal, supra note 8, at § 2.15. With the disintegration of much of the regulatory prohibitions on investments by such investors, one might question whether this particular advantage still exists.
Since preferred stock does not place a fixed obligation on the corporation, there is a tremendous downside when the preferred stock is to be held by the common stockholders. The preferred stockholder, unlike the debt holder, must wait in line in a corporate bankruptcy for all creditors to be paid in full before he can be paid even his liquidation preference. The preferred shareholders' position in bankruptcy, though superior to the common stockholders', is inferior to debt and is an enormous deterrent to the use of preferred stock in a close corporation. This is especially so since there is often nothing left in bankruptcy for the stockholders whether preferred or common. Thus, if the common stockholders have the choice between making their corporation issue themselves debt or preferred stock, the superior position of debt over preferred stock in bankruptcy is likely to tip the scales in favor of the debt.\textsuperscript{529}

As with all planning devices, preferred stock offers a mix of good and bad tax consequences. First for the bad. The subchapter S election is limited to corporations with no more than one class of stock.\textsuperscript{530} If the corporation already has issued a class of preferred stock, it is ineligible for a subchapter Selection. If a corporation has previously elected subchapter S treatment, the issuance of preferred stock results in an automatic termination of subchapter S status.\textsuperscript{531}

Additionally, if the choice for the planner is between corporate debt and preferred stock, the debt is often more advantageous for the reasons discussed earlier in this text, e.g., the double tax on the corporate earnings distributed as dividends. Moreover, if, as often is the case, the preferred is issued proportionately to the common

\textsuperscript{529} If the owners of the business must look to a sophisticated outside creditor like a bank for credit, however, this advantage of debt over preferred stock may again be somewhat illusory. The bank probably will require the shareholder-creditors to subordinate their claims in favor of those of the bank, thereby placing the shareholders' claims in a position similar to that of preferred stockholders anyway.


\textsuperscript{531} Id. §§ 1361(b)(1)(D), 1362(d)(2)(A) (1987).

Congress eliminated another detriment of preferred stock prior to 1984. Only "common" stock was eligible for the special treatment accorded by section 1244. The Tax Reform Act of 1984 deleted the word "common" from section 1244(c)(1) so that section 1244 now applies to preferred as well as to common stock. See id. § 1244(c)(1) (1987).
stockholders with a view to a redemption at a future date, the re-
demption, if proportionate (as it often is), will be treated as a section
301 distribution.532 Furthermore, while subchapter S often enables
the shareholders of close corporations to avoid the double taxation
problem, as mentioned above, it is not available to a corporation
with preferred stock.

Now for the good. Nonvoting preferred can be used to spread
the ownership of a business among the various members of a family
and thereby shift some of the business income to those in the lower
tax brackets without permitting them to participate in the control
of the business.533 Also, if the corporation has no earnings and prof-
its when the preferred stock is issued, it cannot be considered tainted
section 306 stock534 that would produce ordinary income on a sub-
sequent sale535 or redemption536 under the section 306 preferred stock
bail-out rules. Since a corporation has no earnings and profits at
the time of incorporation, it has sometimes been suggested that close
corporations issue preferred stock at this point to preserve the op-
portunities for a later preferred stock bail-out.537 Though a later
preferred stock bail-out is not an impossibility, it is not highly prob-
able either. For one thing, the common stockholders are likely to

532. See Randolph v. Commissioner, 76 F.2d 472 (8th Cir.), cert. denied sub nom. Randolph
See also F. O'Neal, supra note 8, at § 2.05.

If the common shareholders do not hold preferred stock in proportion to their common stock,
redemption of the preferred probably will not be deemed a dividend. See Himmel v. Commissioner,
338 F.2d 815 (2d. Cir. 1964).

The government has posited that redemption of all preferred stock is not equivalent to a dividend,
if no proportional relationship or pattern of stock ownership exists between the holders of preferred
note 8, at § 2.15 n.4.

The government now considers the result in Himmel to be incorrect because after the redemption
of the preferred stock the redeemed shareholder still retained voting control of the corporation, see
Rev. Rul. 85-106, 1985-2 C.B. 116. Congress decided to retain the "not essentially equivalent to a
dividend" language of § 302(b)(1) in the 1954 Code to allow exchange treatment for a partial re-
demption of preferred stock held by a stockholder who holds only preferred stock.

533. F. O'Neal, supra note 8, at § 2.15.
536. See id. § 306(a)(2) (1987) (redemption of section 301 stock treated as a section 301 dis-
bution).
537. See, e.g., F. O'Neal, supra note 8, at § 2.15.
encounter problems in finding someone willing to buy the preferred stock, since, in a close corporation, a nonvoting equity interest normally is not a very attractive investment for an outsider. If the preferred is not section 306 stock, and, instead of a sale to an outsider, the plan is for the corporation to redeem the preferred stock while it is still in the hands of the issuees, the redemption might fail all of the section 302(b) tests and still produce ordinary income.

IX. CONVERTIBLE SECURITIES

A conversion right is another planning device that can be used to distribute risk, control, and participation among the investors in a closely-held corporation. A security is convertible when it entitles its holder to surrender it to the issuing corporation in exchange for a security of another type or class of that corporation. Usually, the conversion is from a senior security to common stock of the issuer.\footnote{538} Attractive to the investor, a convertible senior security provides the best aspects of a senior security and common stock.\footnote{539} As a senior security, it offers a fixed rate of return and a hedge against insolvency. Since it is convertible to common stock, it offers the holder the right to participate in future growth. In the context of closely-held corporations, a convertible senior security is sometimes the only form of investment that is sufficiently alluring to attract capital from a reluctant, outsider investor.\footnote{540} Additionally; even if the senior security is already marketable, the conversion privilege adds to its


A revenue ruling offers an illustration of common stock that is convertible into preferred. All of the common stock of a corporation was owned by its employees. The articles of incorporation required the shareholders to convert their common into preferred upon their retirement. The purpose of the conversion privilege was to eliminate common stock ownership by retiring employees and to reduce the cash expenditures by the corporation that otherwise would be required if the corporation redeemed the common stock of all retiring employees for cash. See Rev. Rul. 72-238, 1977-2 C.B. 115, 116.

539. The only things lacking in a convertible senior security are participation and voting rights, and the holder can obtain these by converting to common stock.

540. See generally Fleischer & Cary, supra note 538, at 474-75.
“speculative charm” and thus may increase its selling price.\textsuperscript{541} Convertible securities trigger variegated tax consequences. The most important are discussed below.

A. Tax Consequences of the Conversion.

It is an axiom of tax law that an exchange of property is a fully taxable event, unless specifically excepted from the requirement of recognition by the Code. Yet it is well-settled that the act of converting a convertible debt security to stock of the issuing corporation is not a taxable event to the holder of the security,\textsuperscript{542} notwithstanding that this type of exchange is nowhere mentioned in the Code. As with most nonrecognition exchanges, the converter takes a substituted basis in the newly received stock, i.e., same basis that he had in the prior held security.\textsuperscript{543} He also tacks his holding period in the debt on to the stock.\textsuperscript{544} The most widely accepted rationale for the nonrecognition treatment is that the conversion is an open transaction. The holder is merely exercising a right granted him by the underlying security and has yet to dispose of that security.\textsuperscript{545} Recognition of gain or loss thus awaits a taxable disposition of the stock.

Nonrecognition treatment is also accorded a shareholder who converts his stock into another class of stock of the same corporation.\textsuperscript{546} While conceptually the open transaction theory seems as appropriate for convertible stock as it is for convertible debt, the most frequently offered justification for treating the conversion of stock into another class of stock as a nonrecognition event is that

\textsuperscript{541} F. O'Neal, \textit{supra} note 8, at § 3.36.


\textsuperscript{543} See, e.g., Rev. Rul. 72-265, 1972-1 C.B. 222, 223.


\textsuperscript{545} See, e.g., B. Bittker & J. Eustice, \textit{supra} note 27, at ¶ 4.06; Fleischer & Cary, \textit{supra} note 538, at 477-78.

The conversion of debt into stock of a different corporation is a taxable event, however. \textit{See}, e.g., Estate of Timken v. Commissioner, 47 B.T.A. 494 (1942), \textit{aff’d on other issues}, 141 F.2d 625 (6th Cir. 1944); Rev. Rul. 69-135, 1969-1 C.B. 198.

it is a tax-free recapitalization, i.e., an "E" reorganization. Bringing these conversion exchanges under the reorganization umbrella, of course, requires the importation of all of the paraphernalia of the reorganization regime. For example, to constitute a reorganization, the conversion exchange must be pursuant to a plan of reorganization and for a proper business purpose. Generally, these requirements are not likely to cause problems, unless the conversion is clearly a sham designed to extract earnings and profits from a profitable corporation. The provision in the articles of incorporation creating the conversion privilege probably ought to satisfy the plan of reorganization requirement, and a revenue ruling found that a desire to simplify the capital structure of the corporation sufficed as an acceptable business purpose for a conversion of preferred into a common stock. Moreover, a corporation almost always has a definitive business reason for issuing convertible stock since it facilitates the raising of capital.

The conversion of convertible stock is a nontaxable event to the issuing corporation. The governing section is 1032(a), which provides that a corporation has neither a gain nor a loss when it issues its own stock in return for money or other property. The regulations state that the nonrecognition rule of section 1032(a) applies when the corporation issues its own stock to acquire some of its own shares. The issuance of its own shares upon the holder's surrender of the convertible stock fits neatly within the rule mentioned in the regulation.

Also, prior to 1984, the act of converting convertible debt into stock of the issuing corporation was not a taxable event to the is-

---

549. See Fleischer & Cary, supra note 538, at 484.
551. Fleischer & Cary, supra note 538, at 484.
553. Treas. Reg. § 1.1032-1(b) (1987). The corporation need not issue previously unissued shares for section 1032(a) to apply in this (or any other) context. Section 1032(a) applies even when the corporation is issuing treasury stock.
This rule on convertible debt was part of a larger rule that a corporation did not recognize income when it issued stock to cancel its own indebtedness. TRA of 1984, however, reversed the larger rule by adding a subsection 108(e)(10)(A) to the Code: Subsection 108(e)(10)(A) requires a corporation issuing stock in cancellation of its own indebtedness with an amount of money equal to the fair market value of the stock. As a result, a corporation has discharge of indebtedness income to the extent that the principal of the debt exceeds the value of the stock. According to the legislative history, this rule applies where the principal amount of a corporate debt is discharged by reason of the exercise of a conversion right by the holder of the debt. Thus, a corporation thereafter will have income on conversion of a convertible debt into stock to the extent the principal of the debt discharged exceeds the fair market value of the stock. Of course, the holder of debt is unlikely to convert when the stock to be received in the conversion is worth less than the principal of the debt. This new income recognition rule does not apply to convertible debt issued prior to June 7, 1984. The conversion of such convertible debt falls under the old rule that the act of converting convertible debt to stock does not produce any income, gain, or loss to the issuing corporation.

B. Bond Premiums.

A conversion feature drastically affects the tax treatment of bond premiums. For example, a bondholder cannot take an amortization deduction for any part of a bond premium attributable to a conversion feature in the bond, though the holder can deduct any part of the premium attributable to other features of the bond, e.g., a

---


555. See, e.g., Motor Mart Trust, 156 F.2d 122; Revenue Provisions, supra note 168, at 167; Eustice, supra note 554; Fleischer, supra note 538, at 497.

556. See supra note 49.


higher than market interest rate. This and other bond premium issues, including those involving convertibility, are discussed later in this paper.

C. Original Issue Discount.

For purposes of the original issue discount rules, a convertible debt’s issue price includes a premium paid to the issuing corporation for the conversion privilege. Accordingly, the conversion premium produces neither an original issue discount interest deduction for the corporation nor original issue discount interest income for the holder. It is well settled that the issuing corporation may amortize original issue discount on convertible debt so long as the debt is outstanding. The discount is deductible until the time of conversion. Upon conversion, however, the corporation loses the right to deduct any unamortized discount, either as a loss in the conversion year or as an expense in a later year. The reasoning is that as long as interest payments are being made, adjustments for the discount (or premium) must be made where the interest rate does not reflect the true yield of the bonds. Upon conversion of the debt into stock, the obligation to pay both the interest and the discount ceases, and, hence, the justification for the deduction disappears.

It seems plausible that under the tax benefit rule, the corporation should be made to include the previously deducted discount in its income during the conversion year, since the corporation has taken a deduction on the assumption it ultimately would pay the discount on retirement of the debt and, due to the conversion, it never will pay that discount. However, no cases have been found to support

561. See, e.g., Chock Full O’Nuts Corp., 322 F. Supp. 772.
564. Fleischer & Cary, supra note 538, at 509-12.
this argument. Perhaps, new section 108(e)(10)(A), discussed above, subsumes the question by providing a general principle for the issuance of stock to cancel corporate indebtedness, i.e., the corporation has discharge of indebtedness income to the extent that the principal of the debt exceeds the value of the stock.\textsuperscript{565}

\addcontentsline{toc}{section}{X. Bond Premiums and Related Issues}

A bond sells at a premium when the amount required to be paid by the issuing corporation at maturity or upon call is less than the taxpayer's purchase price. The bond premium is the amount of the taxpayer's cost that exceeds the face value or value of the bond. While there are a variety of reasons for a bond selling at a premium (or at a discount, for that matter),\textsuperscript{566} often the reason is that the interest rate on the bond exceeds the yield on similar securities in the marketplace. In that situation, the premium is the extra cost that the purchaser must pay to acquire the higher than market rate of interest. When a taxpayer purchases a bond at a premium, the actual rate of interest, thus, is not a true reflection of the bond's yield, but represents, in part, a return of the premium. Since the bondholder pays more than the face value of the bond, he will not recover his purchase price in full upon retirement.\textsuperscript{567} Accordingly, the tax law conceivably could have taken a hands-off approach and have made the bond purchaser wait until retirement and take a loss then.\textsuperscript{568} Instead, section 171 of the Code allows a taxpayer to amortize the premium by deducting it over the life of the bond.\textsuperscript{569} The amortization deduction is designed to give "a better yearly approximation of the 'true' interest income earned by the bondholder."\textsuperscript{570}

\begin{flushleft}
\textsuperscript{566} For a list of reasons for debt discount or premium, see Fleischer & Cary, \textit{supra} note 538, at 499 n.119.
\textsuperscript{567} See, e.g., National Can Corp. v. United States, 687 F.2d 1107, 1113 (7th Cir. 1982); Fried, \textit{Taxation of Securities Transactions}, in \textit{11B BUSINESS ORGANIZATIONS} § 17.02[5][a] (1987); Fleischer & Cary, \textit{supra} note 538, at 504.
\textsuperscript{568} National Can Corp., 687 F.2d at 1113.
\textsuperscript{569} I.R.C. § 171 (1987). If the bond is callable, the amortizable bond premium is computed by subtracting the greater of the price due on maturity or on the earlier call date from the taxpayer's basis in the bond. \textit{Id.} at § 171(b)(1)(A), (B) (1987).
\textsuperscript{570} National Can Corp., 687 F.2d at 1113.
\end{flushleft}
A conversion privilege is such an attractive feature for a bond that it, too, often results in the bond selling at a premium.\textsuperscript{571} Section 171 expressly states, however, that a bondholder cannot take an amortization deduction for any part of a bond premium attributable to the conversion feature of the bond.\textsuperscript{572} The rationale for the exclusion is that a bondholder who has paid a premium to acquire an unexercised conversion right in effect has bought an option to buy the stock of the issuer. The value of the conversion right is, therefore, unconnected to the differential between the bond's and the market rate of interest. Unlike the higher-than-market rate of interest, the conversion feature does not produce a distorted picture of the bondholder's interest income. Accordingly, the amortization deduction for the bond premium is not needed as an offset to reflect the bond's effective interest rate.\textsuperscript{573} Yet the fact that a bond is convertible does not, in itself, prevent the application of section 171.\textsuperscript{574} A convertible bond is within the scope of section 171, if the option to convert rests with the holder.\textsuperscript{575} The bondholder must prove, however, that at least part of the premium is attributable to a feature other than the conversion privilege, e.g., a higher-than-market rate of interest. In other words, he must be able to allocate the premium between the conversion feature and the high interest rate.\textsuperscript{576}

Bond premium is included in a holder's basis, since it represents a part of his cost in purchasing the bond. He must reduce his basis in the bond, however, by the amounts of his bond premium amortization deductions.\textsuperscript{577}

\textsuperscript{571} See, e.g., Fleischer & Cary, supra note 538, at 499 n.119.
\textsuperscript{573} See, e.g., National Can Corp., 687 F.2d at 1113; Honeywell, Inc. v. Commissioner, 87 T.C. 624 (1987).
\textsuperscript{575} See id.
\textsuperscript{576} See id. The bondholder ascertains the value of the conversion feature by referring to the "assumed" price at which the bond minus the conversion feature, would be purchased on the open-market and then by subtracting that "assumed" price from his cost in purchasing the bond. He ascertains the assumed price of the bond without the conversion feature by comparing the yields on bonds with similar character, not having the conversion feature, as sold on the open market. \textit{Id}.

For a case denying amortization deductions on bond premiums attributable to a conversion feature, \textit{See National Can Corp., 687} F.2d 1107.

If a bondholder converts his bond into common stock before fully amortizing the part of the bond premium not attributable to the conversion feature, he loses the right to take a deduction for the part of the bond premium that is unamortized at the date of conversion. The unamortized bond premium is considered part of the taxpayer's basis in the stock received by exercise of the conversion right, and any future gain or loss will be recognized upon disposition of that stock. The bondholder is not required to recapture the premium that he has already deducted since it represents his cost in acquiring the higher rate of interest which interest he has already taken into income. When a convertible debt is redeemed prior to maturity, the holder can deduct, in the year of the redemption, the part of the unamortized bond premium that is not attributable to the conversion right.

A corporation realizes no income, gain, or loss when it issues bonds at face value. When it issues bonds at premium, the premium, excluding any part attributable to a conversion privilege, is income to the corporation, though the corporation prorates the premium over the life of the bond instead of including it all in income in the issue year. This requirement that the premium be included annually in income on a prorated basis is based on the notion that the issuing corporation is entitled to deduct only its effective rate of interest on its debt obligations, which is computed by subtracting the premium paid to the corporation for the higher interest rate, prorated annually, from the higher interest rate. The prorated inclusion of the premium in income serves as an offset to the higher than market interest deduction, thereby in effect reducing the amount of the interest deduction each year to the effective interest rate paid
by the corporation. It is also thought that a corporation should be able to exclude from its income any bond premium that has yet to be amortized at the time of a conversion, whether or not the un-amortized premium is attributable to a conversion feature. This thought is based on the presumed applicability of section 1032(a), which exempts a corporation from recognized income, gain, or loss when it receives property in exchange for its stock. Upon conversion, the unamortized bond premium is deemed to be part of the stock's issue price.\textsuperscript{585}

When a corporation retires a bond at maturity, it ordinarily will not have income, gain, or loss even if the bonds were originally issued at a premium or a discount. This is because the issuing corporation already will have amortized any premium or discount over the life of the bond, treating the premium as income\textsuperscript{586} and deducting the discount.\textsuperscript{587} Special rules are required, however, for redemptions or repurchases of bonds prior to maturity. When a corporation pays more than the issue price\textsuperscript{588} to redeem or repurchase,\textsuperscript{589} for example, the indenture for an issue of redeemable bonds typically requires the issuing corporation to pay a call premium for redemptions prior to maturity. Subject to an exception contained in section 249, the call premiums are deductible expenses to the corporation.\textsuperscript{590} Section 249 disallows a corporate deduction for any part of a call premium attributable to the conversion feature of convertible debt.\textsuperscript{591} It allows the corporation to deduct a "normal call premium," which is defined as "an amount equal to a normal call premium on a non-

\textsuperscript{585} See, e.g., B. Bittker & J. Eustice, supra note 27, at ¶ 4.06; Fleischer & Cary, supra note 538, at 500-02.

\textsuperscript{586} Treas. Reg. § 1.61-12(c)(2) (1987). See Fried, supra note 567, at § 17.05[1].

\textsuperscript{587} Treas. Reg. § 1.163-3(a)(1) (1987). See Fried, supra note 567, at § 17.05[1].

\textsuperscript{588} Actually, "issue price" is misleading in this context for bonds issued at either a discount or a premium. For bonds that were issued at a premium, the excess of the redemption (or repurchase) price over the issue price minus any bond premium included in the corporation's income prior to repurchase is the amount deductible as an expense in the year of redemption (or repurchase). For bonds issued at a discount, the excess of the redemption (or repurchase) price over the issue price plus any discount deducted by the corporation prior to redemption (or repurchase) is the corporation's deductible expense in the redemption (or repurchase) year. Fried, supra note 567, at § 17.05[1].

\textsuperscript{589} Treas. Reg. § 1.163-3(c)(1) (1987).

\textsuperscript{590} Id.

\textsuperscript{591} I.R.C. § 249(a) (1987).
convertible obligation which is comparable to the convertible obligation.\textsuperscript{592}

In other words, the corporation is entitled to deduct only that part of the premium attributable to factors other than the conversion privilege. The effect is to allow a deduction on the portion of the premium representing an additional interest expense, but to disallow a deduction on that part of the premium analogous to an amount paid in a capital transaction.\textsuperscript{593}

XI. Leases

Closely-held corporations and their shareholders can gain both non-tax and tax advantages by making the shareholders purchase business property in their own name and then lease it to the corporation rather than contribute it as capital or transfer it in exchange for stock.

The primary non-tax advantage is simple. The leasing arrangement protects the shareholder against a bankruptcy of the business. The crucial point is that the shareholders retain title to the business property. The closely-held corporation never takes title to it, and it never becomes subject to attachment by creditors of the corporation or a trustee in bankruptcy acting in their behalf. Of course, both state courts and bankruptcy courts have substantial equitable powers to invalidate fraudulent conveyances, voidable preferences, or other fraudulent schemes involving shareholders and closely held corporations. And courts have used these powers to characterize payments of rents to shareholders as fraudulent conveyances or voidable pre-


Section 249 legislatively institutes the position of the Internal Revenue Service, taken in Rev. Rul. 67-409, 1967-2 C.B. 62, that an excess premium does not constitute a cost of borrowing money and hence should not be deductible as interest. See J. Chomme, supra note 127, at § 74 n.89.

For cases denying the deductibility of premiums reflecting conversion features, see, e.g., National Can Corp., 687 F.2d 1107; Roberts & Porter, Inc. v. Commissioner, 307 F.2d 745 (7th Cir. 1962) (superseded by statute as stated in National Can Corp.); AMP, Inc. v. United States, 476 F.2d 1351 (Ct. Cl. 1973), cert. denied, 417 U.S. 930 (1974); Chock Full O’Nuts Corp., 322 F. Supp. 772; Honeywell, Inc., 87 T.C. 624; Hunt Foods & Indus. v. Commissioner, 57 T.C. 633 (1972), aff’d, 496 F.2d 532 (9th Cir. 1974).
ferences. One would think that a trustee in bankruptcy at one time or another also would have advanced a thin incorporation or inadequate capitalization argument against these shareholder leases. This would be especially true when the term of the lease equals or approaches the useful life of the leased assets. The transaction then closely parallels a sale of the property by the shareholders with the shareholders retaining a security interest in the property, a transaction that perhaps could be recharacterized as a contribution to capital or as a payment in exchange for stock, resulting in a subordination of the claims of the shareholder-seller to those of external creditors. Given the close parallel between the sale and lease transactions, one would think that at some point a trustee in bankruptcy might succeed in convincing a court to treat a lease or sale as a contribution to capital or a transfer of property in exchange for stock. Surprisingly, so far there seems to be no reported bankruptcy law cases confronting this argument.

Leases provide multiple tax advantages. Generally, the shareholder-lessee must include the rental payments in gross income, but he is entitled to the tax advantages of ownership of business property i.e., depreciation or cost recovery deductions, formerly


595. Several Subchapter S cases have focused on the lease v. sale issue. In these cases, generally the Service has argued that the corporation is a lessor rather than a seller of property. Accordingly, payments to it were passive investment income, thereby endangering the corporation’s status as an S corporation. See e.g., Van Elten v. Commissioner, 623 F.2d 622 (9th Cir. 1980). See generally J. EUSTICE & J. KUNTZ, FEDERAL INCOME TAXATION OF S CORPORATIONS, ¶ 5.04[2][b] n.144 (rev. ed. 1985) (and cases cited therein). See also In re Beker Indus., 69 Bankr. 937 (S.D.N.Y. 1987) (“lease” of property was held to be a “conditional sale”); Johnson v. Commissioner, 21 T.C.M. (CCH) 1126 (1962) (“lease” of property held to be a “sale”); Colonial Leasing Co. v. Larson Bros. Constr. Co., 731 P.2d 483 (Utah 1986) (“lease” of property held to be a “disguised sale”). Cf. Footpress Corp. v. Strickland, 242 Ga. 686, 251 S.E.2d 278 (1978). For a general discussion on lease financing, see Gant, Illusion In Lease Financing, 37 HARV. BUS. REV. 121 (1959).


598. Warren, supra note 596, at 1610.
the investment tax credit, and interest expense deductions. Indeed, the shareholders might even have the option of transferring several of these advantages (the depreciation and investment tax credit) to the corporation. Moreover, the corporation is entitled to deduct reasonable rent paid to the shareholders as an ordinary and necessary business expense under section 162(a)(3). Thus, although the rent payments are income to the shareholder, the deduction for the corporation allows the taxpayers to avoid the double tax of corporate earnings at the corporate level. This is an important advantage of leasing over equity financing. As with all transactions between shareholders and their closely-held corporations, the Internal Revenue Service sometimes has challenged the taxpayers' characterization of various aspects of lease transactions as a true lease. The Service has been particularly active in seeking to reduce corporate deductions for rent, by arguing that the corporation can deduct only reasonable rent payments and that payments in excess of a reasonable rent are disguised section 301 distributions to the shareholders.

The Service sometimes has also been unwilling to accept the taxpayers' characterization of a transaction as a lease, arguing that the transaction should be considered a sale rather than a lease. If the transaction is recharacterized as a sale, the shareholder-seller must recognize a gain or a loss unless the transaction fits under the non-recognition rule of section 351. If the lease is recast as a sale, the depreciation or cost recovery deductions and any available investment credits are shifted from the shareholder to the corporation. The corporation may also be entitled to an interest deduction under

599. See, e.g., Cook, supra note 596; Fink, supra note 596; Warren, supra note 596.
600. See, e.g., Warren, supra note 596, at 1610.
602. See, e.g., Sparks Nugget, Inc. v. Commissioner, 458 F.2d 631 (9th Cir. 1972), cert. denied sub nom. Graves v. Commissioner, 410 U.S. 928 (1973); Fairmount Park Raceway, Inc. v. Commissioner, 327 F.2d 780 (7th Cir. 1964); Armstrong Co. v. Commissioner, 188 F.2d 531 (5th Cir. 1951); Limericks, Inc. v. Commissioner, 165 F.2d 483 (5th Cir. 1948).
the imputed interest rules. Unfortunately, the corporation often has too little income to actually benefit from the deductions and credits which it unwittingly has acquired. The harm is to the shareholder-lessee who undoubtedly has enough income to make fruitful use of the transferred tax benefits.

The worst case would be a recharacterization of the lease transaction as a contribution to capital or a payment in exchange for stock. In that situation, the shareholder-lessee would lose all the tax benefits associated with owning business property such as depreciation deductions. Both the shareholder-lessee and the corporation would suffer all the tax disadvantages associated with equity including treatment of the rental payments as section 301 distributions. So far, fortunately, and perhaps surprisingly, the government seems not yet to have tried to recast a purported lease as a payment for stock or a contribution to capital.

XII. STOCK TRANSFER RESTRICTIONS

A change in the mix of individuals entitled either to manage the affairs of the business or to participate in profits has presented recurrent problems for close corporations. Shareholders have sought to avoid these problems through restrictions on the issuance and transfer of their shares. Indeed, stock transfer restrictions are amongst the cornerstones in sound planning for close corporations.

More specifically, there are three basic reasons for imposing transfer restrictions on the stock of close corporations. The first is the retention of the right to choose one's own business associates. As in the partnership, a personal element is crucial in the make-up and management of a closely held corporation. Because there is frequently an identity in closely held corporations between shareholders and management, the success or failure of the venture depends ultimately on the quality of the shareholders. For example,

604. See Walthall, supra note 596.
605. The text on stock transfer restrictions condenses some materials from two earlier articles by the author. See Rands, Closely Held Corporations: Restrictions on Stock Transfers, 84 CoM. L.J. 461 (1979) [hereinafter Rands Stock Transfers]; Rands, Tax Consequences, supra note 257.
606. See Rands, Stock Transfers, supra note 605, at 462.
607. See id. at 462.
when all of the shareholders participate in the business, it might be wise to use a transfer restriction to avoid substitution of a nonactive shareholder (frequently an heir) for one of the present shareholders, a situation that frequently generates friction between old and new shareholders.  

The second reason for transfer restrictions is to provide a method for shareholders, particularly minority shareholders, to recoup their investment upon divestment of their shares. Since often there is no market for minority shares in a closely held corporation, a withdrawing shareholder (or the heirs of a deceased shareholder) might receive nothing absent a buy-sell agreement compelling the others in the enterprise to purchase the stock at a fair price. Therefore, planners often recommend a buy-sell agreement to assure each shareholder of a market for his shares upon his withdrawal or upon his death.

The third reason for transfer restrictions is to assure compliance with the requirements of statutes that provide special treatment for closely held corporations. For example, the parties may desire to restrict stock transfers to ensure that the transferee will not disqualify the corporation from eligibility under Subchapter S of the Internal Revenue Code.

The tax consequences of stock transfer restrictions naturally depend on the terms of the restriction and the choices made by the parties.  


The reasons for the stock transfer restriction may be quite specific. They include: (1) a desire to keep share ownership within the family, see, e.g., Fayard v. Fayard, 293 So. 2d 421 (Miss. 1974); (2) to prevent interference or control by competitors, see, e.g., Mason v. Mallard Tel. Co., 213 Iowa 1076, 240 N.W. 671 (1932); (3) prevent a small group of shareholders from obtaining absolute control, see Campbell v. Campbell, 198 Kan. 181, 422 P.2d 932 (1967); and (4) encourage employees to stay with the business by requiring them to sell stock in the close corporation at a low price upon termination of employment. See, e.g., Harker v.Ralston Purina Co., 45 F.2d 929 (7th Cir. 1930), cert. denied, 284 U.S. 619 (1931) (Missouri law). See Note, Close Corporation Stock Repurchase Agreements, 11 W. Res. L. Rev. 278, 279 (1960). See generally Rands, Stock Transfers, supra note 605, at 462-463.

609. See, e.g., Hornstein, Stockholders' Agreements in the Closely Held Corporation, 59 Yale L.J. 1040, 1049 (1950); Rands, Stock Transfers, supra note 605, at 463.


611. Nanfito, 341 F. Supp. at 246 n.5; Rands, Stock Transfers, supra note 605, at 463.
parties to the restriction. Enforcement of a stock transfer restriction may result in a transfer of stock to an outsider, a transfer to other shareholders, a redemption by the corporation, or no transfer of the stock at all.\footnote{612} When the operation of the restriction results in a sale of stock by the withdrawing shareholder to other shareholders, the tax consequences usually are straightforward. The sale results in recognition of a capital gain or loss to the selling shareholder, though, in the case of a loss, section 267 will deny a deduction if the purchaser is a “related” taxpayer.\footnote{613} The buying shareholder, of course, realizes neither gain nor loss, unless he uses property other than cash. If he uses cash only, the purchaser’s adjusted basis in the stock will be the amount of cash he pays for the stock.\footnote{614}

If operation of the transfer restriction results in a redemption, the tax consequences are more complex. The redeemed shareholder recognizes a capital gain or loss, as he would if he sells his stock—but only if the redemption meets one of the tests described in section 302(b).\footnote{615} If the redemption meets none of the section 302(b) tests, the redemption proceeds are treated like section 301 distributions,\footnote{616} i.e., dividends and ordinary income to the extent of the corporation’s earnings and profits.\footnote{617} The section 302(b)(3) test, which requires a redemption of all the stock owned by the selling shareholder, is ordinarily satisfied, because the selling shareholder usually desires to sell all of his shares and, at least under most buy-sell restrictions, is usually required to do so. Restrictions seldom allow the corporation or the continuing shareholders to buy only a part of the shares offered to them.\footnote{618} For less than complete redemptions, the section

\footnote{612} For a full discussion of the permutations in the enforcement of stock transfer restrictions, see Rands, Tax Consequences, supra note 257, at 450.

\footnote{613} Section 267 denies a deduction for a loss from the sale of property between specified related persons. Related persons include, amongst others, an individual’s brothers, sisters, spouse, ancestors and lineal descendants. I.R.C. § 267(a)(1), (b)(1), (c)(2), (4) (1987). Related party rules, like those contained in section 267, often have an adverse impact on close corporations, which, by their nature, commonly have related parties as shareholders.

\footnote{614} See id. § 1012 (1987).

\footnote{615} Id. § 302(a), (b) (1987). For a full discussion of section 302 and its impact on stock transfer restrictions, see generally Rands, Tax Consequences, supra note 257, at 451-55.

\footnote{616} Id. § 302(d) (1987).

\footnote{617} Id. §§ 301(c)(1), 316(a) (1987).

\footnote{618} Rands, Tax Consequences, supra note 257, at 452.
318 attribution rules, which make the redeemed shareholder the constructive owner of stock owned by other family members, stand as formidable barriers to exchange treatment for a redeemed shareholder in a family-owned corporation. Moreover, if, pursuant to the stock transfer restriction, a subsidiary acquires stock of a parent or a shareholder sells a stock to a related corporation, the special redemption rules of section 304 will be triggered.

Ordinarily, the corporation recognizes neither a gain nor a loss from the enforcement of a stock transfer restriction. When the resulting transaction is a sale of stock, the corporation is not involved in the transaction at all. Corporate assets and liabilities are not affected, and the corporation usually has no legal interest in the identity of its shareholders. When the resulting transaction is a cash redemption, the corporation again has no gain, loss or deduction. The corporation is likely to recognize a gain, however, if it uses appreciated property-in-kind to pay for a redemption, but this potential income tax liability has dissuaded most companies from using anything other than cash to fund redemptions.

Stock transfer restrictions can generate a host of other issues. One potential problem is constructive dividend treatment for non-redeemed shareholders. The vortex of this controversy has been the disproportionate redemption. At one time the Internal Revenue Service contended that when the redemption of another's stock increased the value of the non-redeemed shareholders' stock, that enhanced value constituted a constructive dividend. After a series of

---

619. See I.R.C. §§ 302(c)(1), 318(a)(1) (1987). The attribution rules apply to complete redemptions, too, but section 302(c)(2) allows the completely redeemed shareholder to be free of the family attribution rules by meeting three conditions, one of which is that he must retain no interest of the corporation after the redemption other than that of a creditor. Id. at § 302(c)(2)(i) (1987).

For an unfortunate example of a redeemed shareholder keeping a minor position with the corporation, see Levin v. Commissioner, 385 F.2d 521 (2d Cir. 1967).

For illustrations of the impact of the attribution rules on less than complete redemptions in family corporations, see Rands, Tax Consequences, supra note 257, at 453-54.


621. Rands, Tax Consequences, supra note 257, at 455.


624. Rands, Tax Consequences, supra note 257, at 455.

625. For a full discussion, see generally Rands, Tax Consequences, supra note 257, at 456-58.
courthouse defeats, however, the Service at last conceded on this issue. The remaining problem area, one which lawyers can avoid, is the transfer restriction that requires the continuing shareholders purchase the stock of the withdrawing shareholder. If the corporation redeems the stock the payment discharges a personal obligation of the non-redeemed shareholder and is a constructive distribution to him. The key to avoiding a constructive distribution treatment, therefore, is to place the primary obligation to buy shares of the withdrawing shareholder in the corporation itself. The continuing shareholders can even guarantee the payment of the redemption price by the corporation without risking constructive distribution treatment.

Stock transfer restrictions also can have accumulated earnings tax implications. The recurring issue in tax litigation has been whether the need to accumulate funds to pay for the redemption of stock of a closely held corporation constitutes a "reasonable need of the business," thereby pretermitting imposition of the accumulated earnings tax. The problem is that many redemptions satisfy both shareholder and corporate objectives. A prime example is the buy-sell restriction requiring a corporation to redeem stock at a fair price on the death or termination of employment of a shareholder. Since the restriction is triggered by end of employment, the redemption disenfranchises shareholders who may harbor ill will against the company, perhaps because the corporation fired them or because they have gone to work for a competitor. Obviously, in these cir-

626. See, e.g., Niederkrome v. Commissioner, 266 F.2d 238 (9th Cir. 1958); Holsey v. Commissioner, 258 F.2d 865 (3d Cir. 1958); Wall v. United States, 164 F.2d 462 (4th Cir. 1947); Bennett v. Commissioner, 58 T.C. 381 (1972); Ciaio v. Commissioner, 47 T.C. 447 (1967).
629. Rands, Tax Consequences, supra note 257, at 458.
630. The nonredeemed shareholder receives a constructive distribution only if he is subject to an "existing primary and unconditional obligation" to make the payment himself. When he guarantees the corporate obligation to redeem the stock, he is only secondarily liable. Rev. Rul. 69-608, 1969-2 C.B. 43.
631. For a discussion of stock transfer restrictions and the accumulated earnings tax, see generally McFadden, The Accumulated Earnings Tax Accumulations To Finance Stock Redemptions, 58 TAXES 719 (1980); Rands, Tax Consequences, supra note 257, at 461-63.
cumstances, accumulations to fund such redemptions are part of a plan serving a corporate objective. Such a buy-sell agreement, however, also serves the primarily personal objective, discussed above, of enabling a withdrawing shareholder (or his heirs) to recoup at least part of his investment upon divestment of his shares. This tension between corporate and personal objectives is highlighted by a group of decisions involving friction between various shareholder groups. Courts have found a corporate objective when a redemption eliminates a strident and dissident minority shareholder group, breaks a deadlock or is in lieu of sale of stock to an outsider who wishes to alter the corporation’s current policies. Since internal strife disrupts the efficient operation of the business, these redemptions serve a corporate objective in freeing or protecting the corporation from internal conflict.

The key issue, though, (and it’s one that’s not fully developed) is whether accumulations to fund a possible redemption satisfy a corporate objective in the absence of present shareholder strife. Perhaps, they should, and at least one case has so held. Because the success of close corporations depends on the identity of the shareholders, and because the jurisprudence is replete with bitter contests between old and new shareholders in fights following the death or withdrawal of one of the original shareholders and substitution of a new one, accumulations to fund stock transfer restrictions that give remaining shareholders the right to reject proposed new share-


633. See, e.g., Mountain State Steel Foundries, 284 F.2d at 744.

634. See, e.g., Farmers & Merchants Inv. Co., 29 T.C.M. (CCH) 705.


636. Rands, Tax Consequences, supra note 257, at 462.

637. Hooper, Inc. v. United States, 539 F.2d 176 (Ct. Cl. 1976). In Hooper, the corporation had a “preexisting policy that ownership and control of the business should, if possible, be confined to those who managed it. . . .” Id. at 1289. The court concluded that accumulation of earnings to buy out a withdrawing shareholder served a business need. Id. Unfortunately, Hooper is weak precedent because the court offered no reasons for its conclusions. Instead it merely cited to earlier cases, both of which involved redemptions carried out to resolve shareholder conflict. Furthermore, the court did not even cite, much less try to distinguish, several contrary cases. Rands, Tax Consequences, supra note 257, at 463.
holders ought to be considered sufficiently connected with the well-being of the corporation and within the reasonable needs of the business. At least four cases, however, have found redemptions to be for personal and not corporate purposes.

To insulate itself as much as possible from the accumulated earnings tax liability, the corporation should document its reason for the stock transfer restriction: a desire to foster an orderly continuation of the business following the death or withdrawal of one of its shareholders.

Stock transfer restrictions also affect the value of the underlying shares and are among the factors that must be considered any time the shares are valued for tax purposes. Restrictions that limit the investment decisions available to the shareholder, especially the right of the shareholder to sell to the highest offeror, tend to diminish the value of the underlying stock. A few restrictions, on the other hand, enhance the value of the stock. For example, a restriction might assure the continuity of ownership or management, or, in the case of a buy-sell restriction, create a market for the stock of a close corporation that otherwise might not have existed.

XIII. Special Problems of the S Corporation

The S corporation is an especially desirable choice of business organization for many closely held businesses. Unlike general partners, its shareholders have a shield of limited liability. Unlike limited partners, the shareholders are not constrained from managing the business affairs of their enterprise. If the business loses money, the

638. Rands, Tax Consequences, supra note 257, at 462-63.
640. Rands, Tax Consequences, supra note 257, at 463.
642. See, e.g., Worcester County Trust Co. v. Commissioner, 134 F.2d 578, 582. (1st Cir. 1943).
S corporation, unlike the C corporation, passes the losses through to the shareholders, who, with some limitations, can deduct them on their individual income tax returns. Even the flow through of income to the S corporation shareholder generally is good, now that the highest marginal tax rate for non-corporate taxpayers (28%) is lower than the rate for C corporations (34%). However, the heightened desirability of the S corporation election requires an increased scrutiny of capital structure and related issues.

A. Limitations on Shareholders.

Unfortunately, the 1986 Code contains all of the old 1954 Code eligibility requirements for S corporations. Accordingly, to be eligible for S corporation status, the corporation must:

(i) be a domestic corporation;
(ii) have no more than 35 shareholders;
(iii) not have another corporation, a partnership or a non-qualifying trust as a shareholder; and
(iv) not have a non-resident alien as a shareholder. 644

Yet, while any restrictions on the number or types of investors that a business can have might inhibit capital formation for that business, new closely held ventures are not likely to encounter problems with the S corporation limitations. As a matter of fact, the founders probably would be delighted to find more than 35 investors, including some nonresident aliens and numerous partnerships and corporations dying to put capital into the venture. If, at the beginning of the venture, the founders did run afoul of the S restrictions, they would probably choose a limited partnership as their form of business organization. The more likely problem is apt to occur several years down the road when, for example, a co-founder might die and bequeath his stock in the S corporation to an ineligible shareholder. The obvious preventative measure is to use stock transfer restrictions that prevent the stock from falling into the hands of ineligible shareholders.

B. Classes of Stock.

Subsection 1361(b)(1)(D) pronounces broadly that an S corporation can have no more than one class of stock.\(^{645}\) One needs to read on, however, because, a later subsection, 1361(c)(4), casually mentions that "differences in voting rights among the shares of common stock shall not be treated as resulting in more than one class of stock."\(^{646}\) Each share, however, must be "identical as to the rights of holders in the profits and of the assets of the corporation."\(^{647}\)

What Congress is saying, in a long-winded way, is that an S corporation cannot have preferred stock. It cannot have stock that has varied dividend or liquidation rights. An S corporation must use common stock only, though it can have more than one class of common stock with varying voting rights. It can even have non-voting common stock. Also, the Service has opined that stock transfer restrictions do not create a second class of stock, provided that the restriction does not affect the shareholders' economic rights in the corporation.\(^{648}\)

Is prohibition against preferred stock wise tax policy? Probably not. A primary advantage of the partnership form over S corporations is the ability of the partners to allocate specific items of partnership income or deduction to each of the partners by contract, provided the allocation has substantial economic effect.\(^{649}\) S corporation shareholders, unfortunately, are not allowed to alter contractually the reporting of their pro rata share of each corporate tax item.\(^{650}\) This difference in tax treatment between partnerships and S corporations undercuts the basic thrust of the Subchapter S Revision Act of 1982, which was to provide parity in treatment of the two forms of business organizations.\(^{651}\) The new Code could have

---

646. Id. § 1361(c)(4) (1987).
650. J. Eustice, BITTKER & EUSTICE'S FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 6.02 (2d ed. cum. supp. 1987); S. Lind, S. Schwarz, D. Lathrope & J. Rosenberg, supra note 453.
651. J. Eustice, supra note 650.
achieved something akin to parity by allowing S corporations to issue preferred stock. Moreover, the justification for the one class of stock restriction—the need to maintain simplicity in allocating income or loss—seems outmoded in a computer age, particularly as the allocations would be no more difficult to make for S corporation shareholders than for partners.\(^{652}\)

Can the shareholders of the S corporation circumvent the prohibition against preferred stock? Yes, at least partially. Since they control the decision-making process for the corporation, they can cause the corporation to enter into any one of innumerable transactions with the shareholders to whom they wish to grant a prior claim on earnings. For example, the corporation can lease property from that shareholder. Or it could hire that shareholder as an employee or consultant. Of course, these incestuous transactions are fecund areas for litigation with the Service, which might contest their bona fides. The would-be preferred stockholder, of course, can take corporate debt rather than stock, a topic discussed in the following materials.

C. Debt of the S Corporation.

1. Uses of debt by S corporations.

The issuance of corporate debt by an S corporation has the same non-tax advantages and disadvantages of corporate debt issued by C corporations—a hedge against bankruptcy when issued to the S corporation shareholders or leverage when issued to nonshareholders. Most importantly for the S corporation, however, the owners of the enterprise can use debt to serve the same functions that preferred stock serves for the C corporation. For example, if part of the business bargain is to provide a senior return of income to one of the shareholders, the S corporation can use debt, but not preferred stock (due to the one class of stock limitation) to accomplish that objective.

\(^{652}\) J. Eustice, supra note 29.
2. Tax consequences of S corporation debt.

The basic tax consequence for the S corporation itself is that the S corporation takes an interest expense deduction for interest paid to the debtholder when computing its nonseparately computed income or loss for the year. Interest payments received by the debtholder, of course, are ordinary income. If the shareholders hold the debt proportionately, this tax treatment of the interest component is scarcely of crucial importance because it works out as a wash. The interest expense deduction by the S corporation reduces the net amount of nonseparately-stated income that is passed through and taxed to the shareholders, but those same shareholders pick up that same amount as interest income. Any payments on S corporation debt that exceed a holder's basis are treated by the holder under the same rules that apply to the holders of C corporation debt. Thus, a payment on principal of the debt is a tax-free return of capital up to the investor's basis in the debt. Principal payments in excess of the investor's basis in the debt is treated as a capital gain, unless the original issue discount or market discount rules require that payment on principal above basis is to be treated as interest income.

One of the key features of S corporation debt issued to a shareholder is its impact on the deductibility of losses that are passed through to the shareholders. Subchapter S limits a shareholder's deduction to his basis in his shares and in debt owed to him by the corporation.\(^6\)\(^5\)\(^3\) Unfortunately, unlike a partner who can add his proportionate share of the partnership's liability to his basis in his partnership interest, an S corporation shareholder is not entitled to add liabilities incurred by the entity to his basis in his stock or in his debt.\(^6\)\(^5\)\(^4\)

Because the shareholder's basis in a highly leveraged enterprise, e.g., most real estate ventures, often is too low to absorb all the corporate deductions and losses,\(^6\)\(^5\)\(^5\) the S corporation has not served

---


\(^6\)\(^5\)\(^4\) See id. § 752(a) (1987); Reg. § 1.752-1(e) (1987). See generally Friedman, Choosing Between Corporate and Partnership Entities for Real Property Depends on Its Use, 11 Tax'N FOR LAW. 366, 367-68 (1983); Kanter, To Elect or Not To Elect Subchapter S That Is A Question, 60 Taxes 882, 884 (1982); Rands, supra note 1, at 88.

\(^6\)\(^5\)\(^5\) Id.
as a popular device for tax sheltered investments, which typically rely on nonrecourse financing. Moreover, the shareholder’s basis in the stock does not include corporate debt owed to third parties even though that debt is guaranteed by the shareholder. The S corporation shareholder may be able to circumvent this disadvantage by insisting that the loan be made personally to him. He can then turn over the proceeds of the loan to the corporation either as a capital contribution or as a loan from him to the corporation. Either way he increases the amount of loss deductions that can be passed through to him, because he has increased his basis in either his shares or in debt owed to him by the corporation. In that instance, however, the shareholder loses the advantage of limited liability, which is one of the primary reasons for using both an S corporation and nonrecourse financing. Still, for parties that have already decided on an S corporation, the issuance of debt by the corporation to the shareholders is apt to be a wise choice, because a shareholder aggregates his basis in the S corporation debt with his basis in his stock when computing the cap on the deductibility of losses and deductions that his S corporation passes through to him.

3. Debt reclassified as stock: A second class of stock?

If a purported debt instrument is reclassified as stock for tax purposes, is it the second class of stock that renders the issuing corporation ineligible for S corporation status? Once a frequent battleground between the Service and the private sector, the Sub-

657. See, e.g., Perry v. Commissioner, 47 T.C. 159 (1966), aff’d, 392 F.2d 458 (8th Cir. 1968).
658. See generally Rands, supra note 1, at 88-89.
659. Prior to 1966, the regulations treated any purported debt reclassified as stock as a second class of stock, thereby rendering the corporation ineligible for S corporation status. T.D. 6432, 1960-1 C.B. 317, 24 Fed. Reg. 10294 (Dec. 19, 1959); Plumb, supra note 28, at 391. Eventually, the Tax Court rejected this analysis. In its opinion where the debt was substantially proportionate to stock, the reclassified debt probably would constitute contributions to capital. Gamman v. Commissioner, 46 T.C. 1, 9 (1966). After that courtroom defeat, the Service acquiesced, but only partially. According to amended regulations, the debt would not be treated as a second class of stock, if the stockholders held the debt in substantially the same proportion as they owned the stock. Then the debt was to be treated as a contribution to capital rather than a second class of stock. Unwilling to give up easily, the amended regulation posited that any changes in the proportionate interests of the stock and the debt might result in a creation of a second class of stock. The private sector again attacked the regulations, and again, the Tax Court declared them invalid. See Stinnett v. Commissioner, 54 T.C. 221 (1970). See also Portage Plastics Co., 301 F. Supp. 684.
chapter S Revision Act of 1982\textsuperscript{660} sought to end the carnage by adding a "safe harbor" rule to the Code. According to subsection 1361(c)(5), a debt that qualifies as "straight debt" is not to be treated as a second class of stock for purposes of applying Subchapter S' one class of stock limitation.\textsuperscript{661} The definition of "straight debt" is relatively easy to understand and to meet: (A) the debt must be in writing and include an unconditional promise to pay on demand or on a specified date a certain sum in money; (B) the interest rate and interest payment schedule must not be contingent either on the corporation's profits or the borrower's discretion; and (C) the holder of the debt must be a taxpayer who would be eligible to be an S corporation stockholder,\textsuperscript{662} e.g., the debtholder cannot be a non-resident alien. Presumably, debt issued with nondetachable warrants to buy stock would be treated as convertible and would take the debt outside the straight debt safe harbor.\textsuperscript{663} That the interest rate is pegged to the prime rate or a similar factor not related to the debtor corporation does not disqualify the instrument from fitting within the safe harbor.\textsuperscript{664}

Congress anticipated that straight debt instruments would be treated as debt under Subchapter S so that no corporate income or loss would be allocated to the instruments. The payments on the instruments would be includable in the income of the holder and deductible by the corporation, as per regular income tax rules.\textsuperscript{665}

Shareholder-held S corporation debt outside the straight debt safe harbor should be classified according to the usual class law classification principles.\textsuperscript{666} However, it is difficult to say why any S corporation would use debt that does not satisfy the straight debt safe harbor, because it is so easy to comply with safe harbor requirements.

\textsuperscript{661} I.R.C. § 1361(c)(5) (1987).
\textsuperscript{662} Id. § 1361(c)(5)(B) (1987).
\textsuperscript{663} Id. § 1361(c)(5)(B)(ii) provides that "there is no convertibility (directly or indirectly) into stock." (emphasis added). The word "indirectly" would seem to encompass debt issued with nondetachable warrants to buy stock.
\textsuperscript{665} Id.
\textsuperscript{666} Id.
XIV. Conclusion

How does one conclude a paper on the capital structure of the closely-held corporation in the federal tax laws? A summary would be redundant. The paper is not a latent argumentative brief that would use the conclusion as a final parrying thrust. Perhaps, the one thing left to do is to conjecture for a moment on what the future might hold.

The predominant issue is the future of the distinctive tax treatment accorded debt and equity. Does it make sense to tax them differently? At some point tax policy-makers are finally likely to tackle that issue in depth. Perhaps, the distinctive tax treatment makes little sense. Taxpayers are investing in a corporation, whether the piece of paper they receive is labeled debt or stock or some hybrid in between. They invest in the hope of gaining some economic advantage, no matter which of the two labels is used. Whether the investment is classified as debt or equity, often it is expected to provide the investor with a regular return of interest or dividends. In either case, that's the fee paid for using the investor's money. Whether it issues stock or debt, the corporation is acquiring cash and other assets to use in its business. Moreover, as the failures of the courts, the Treasury and Congress show, it is impossible to devise sensible and predictable guideposts for separating what is debt and what is equity. Yet, our current tax system insists on encouraging the use of debt. Maybe in the United States there is too much debt, both public and private, corporate and personal, and it ought not to be further encouraged by our tax system. Certainly, some people think that it should not. So why not eliminate the tax distinction between debt and equity? Some undoubtedly will want to do that.

How would the distinction between debt and equity be eliminated? One way would be to attack the debt side. The basic change in the tax code probably would be to eliminate the corporate debtor's interest expense deduction. Dividends and interest are alike in that they constitute the payment of a fee to an investor for the use of funds. If dividends are not deductible, why should interest be? Congress already has made inroads on the deductibility of interest, imposing, for example, a cap on the deductibility of investment
interest\textsuperscript{667} and disallowing the deduction for “personal interest,”\textsuperscript{668} e.g., consumer interest paid on credit cards. It could complete the progression by eliminating the interest expense deduction altogether.

At the opposite pole from the elimination of the interest expense deduction would be the elimination of the double tax on distributed corporate income or property. Indeed, in the past innumerable proposals have been made to “integrate” the individual and corporate income taxes. While an infinite number of permutations exist, Congress is likely to consider two primary methods of integration. The first is to eliminate the tax at the entity level by extending the pass-through regime of partnerships and S corporations to all corporations. All corporations would be tax-reporting but not tax paying entities. They would pass the income tax consequences from their operations through to the shareholders who then would report those consequences on their own personal income tax returns. Perhaps, the most appealing aspect of the pass-through models is our extensive experience with them, thirty years with S corporations and even longer with partnerships. A model is already in place. Additionally, in the marketplace, the private sector has been developing its own model—master limited partnerships. (One writer calls them the new generation of ad hoc, self-help integration.\textsuperscript{669}) Congress probably would make the corporation withhold a percentage of dividends distributed. The shareholder would be provided with a form similar to a W-2 and would take a credit for the tax withheld by the corporation.

A less dramatic form of integration would be to allow a dividend-paid deduction for the corporation. Alternatively, shareholders could be allowed a full or partial dividend exclusion (like that contained in former section 116(a)). However, either of these two proposals would probably generate vigorous public and political opposition, regardless that firm economic data can be used to support either.\textsuperscript{670}

\textsuperscript{668} See id. § 163(h) (1987).
\textsuperscript{669} See Canello, Corporate Tax Integration: By Design or By Default, 35 Tax Notes 999 (1987); Leonard, A Pragmatic View of Corporate Integration, 35 Tax Notes 889, 895 (1987).
\textsuperscript{670} Leonard, supra note 669, at 895.
Retention of the status quo or further incursions against the interest expense deduction are more palatable politically.