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Guaranteed Shareholder Loans and Thin Capitalization

Ideally, a revenue system should apportion the tax burden according to economic realities. Legal fictions may, however, interfere with the concept of economic reality. One example is corporate law. While there are innumerable decisions establishing the corporation as a separate entity, economically it is nothing more than a conglomerate group of individuals. And when this legal fiction is employed in the closely held corporation, irreconcilable results are to be expected.

Where widely held corporations are involved, the vast majority of cases recognize any debt instrument as genuine; but, at the other extreme where a corporation is closely held, and the debt is held in proportion to the equity interests, uncertainty prevails as to whether the debt is actually debt or equity. Corporations, however, are separate legal entities: be they owned by one indi-
vidual or by several thousand; and if a widely held corporation may finance a part of its operation by debt, then to keep the corporate fiction intact, a closely held corporation should be able to finance a part of its operation by debt. Thus, the problem is one of determining, for the closely held corporation, how much of the capital structure can safety be denominated as debt.

There are non-tax reasons for using debt in the corporate financial structure. Leverage may enable one to increase his return on the invested capital; and in the event of a corporate failure, where the shareholder is also a creditor, he will share proportionally with all other creditors as to his corporate debt; whereas he will receive nothing in return for his equity contribution until after all the creditors have first been paid.

One tax advantage arising out of the corporate fiction is that the shareholder can sell appreciated assets to his corporation. He pays a capital gains tax on the profits of the sale, but his corporation gets a stepped-up basis for depreciation. By this method the taxpayer can realize what would have been ordinary income at a capital gains rate. Also, the sale could be reported under the installment sales provisions since the sale price is usually paid over an extended period of time.

The cost of attempting to sell appreciated assets to the corporation and failing may be high. If the Commissioner is successful in bringing the transfer within section 351 of the Internal Revenue Code of 1954, through the theory of thin capitalization, the assets would retain their original basis and the corporation would owe tax dollars for the over-depreciation. The transfer would be a contribution to capital; the repayment of principal would be considered constructive dividends and as such would be income to the shareholder; the interest payments deducted by the corporation would be disallowed; and since the determination may not take place for a number of years, the tax deficiency could be enormous. Even worse, if the statute of limitations has expired as to the year of the transfer, the shareholder may not be able to recover the taxes paid on the alleged capital gain.

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1 But in Int. Rev. Code of 1954, § 1239, a gain on a sale of depreciable property between a shareholder who owns more than 80% of the stock and his corporation is ordinary income. Thus, the sale is only effective if the shareholder owns less than 80%.

Over a decade ago it was said that shareholder guaranteed loans would wholly eliminate the problem of thin capitalization. It was felt that the shareholder should, instead of lending his own money to the corporation, borrow from a third party and guarantee the loan. The guaranteed loan would lessen the tax advantage somewhat, but if it would eliminate the threat of thin capitalization, it would be well worth the additional cost. Recently this feeling of security has waned.

Originally, shareholder guaranteed loans were somewhat successful. They were used as a means of converting losses on loans to corporations from nonbusiness bad debts (short term capital loss) into ordinary loss in a transaction entered into for profit. In the cases of Pollak v. Commissioner, Edwards v. Allen and Cudlip v. Commissioner the shareholder was attempting to get a business bad debt deduction for a guaranty that became bad. The shareholders in these cases were not confronted with the question of whether the loss was fully deductible as incurred in a transaction entered into for profit.

The Commissioner lost all three of these cases. In reading them it must be questioned why the Commissioner did not pose the question of thin capitalization. In the Pollak case the shareholder had an original capital contribution of $20,000. The bank notes less than two years later totaled $200,000 and were endorsed by the shareholder and another. The shareholder guaranteed the notes a few months before the corporation went bankrupt. He was allowed an ordinary loss deduction. The Commissioner's entire attack was based on the fact that the guaranty constituted a loss sustained from a statutory non-business bad debt. It would seem

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4 It should be noted that there are ordinarily two instances in which the shareholder guaranteed loan is utilized: (1) a corporation launched with inadequate capital borrows from a third party, such loans being guaranteed by the shareholder; (2) a newly organized corporation issues a nominal amount of stock and an excessive amount of notes which are guaranteed by the shareholder. In this second type of situation the section 351 problem is present in addition to the question of interest deductions and repayment of principal. For analytical purposes the issue will be considered as the same for both instances—Will the shareholder guaranteed loan eliminate a thin capitalization attack?

5 INT. REV. CODE of 1939, § 23 (e) now INT. REV. CODE of 1954, § 165 (c) (2).

6 Pollak v. Commissioner, 209 F.2d 57 (3rd Cir. 1954).

7 Edwards v. Allen, 216 F.2d 794 (5th Cir. 1954).

8 Cudlip v. Commissioner, 220 F.2d 565 (6th Cir. 1955).
that the Commissioner could have also attacked the transaction on the basis of thin capitalization by attempting to show that the real substance of the arrangement was a shareholder contribution to the corporation and any loss would be a capital loss. The 10:1 ratio of debt to equity would have been an indication that this was in substance a shareholder contribution.

In the *Edwards* case the court again upheld the loss on guaranteed shareholder loan as ordinary; and, the Commissioner in a questionable debt-equity structure never mentioned thin incorporation.

In *Cudlip*, the taxpayer and 2 others, who together held more than 75% of the stock, guaranteed a $90,000 loan to the corporation which had a capital contribution of only $5,000. In the Tax Court the Commissioner again centered his entire argument on the question of a bad debt loss. No mention was made concerning the thinness of a corporation with an 18:1 debt to equity ratio. On appeal the Commissioner's argument of nonbusiness bad debt was rejected. This dissenting judge, however, interpreted the situation differently. His analysis was as follows: At the time the taxpayer's corporation was organized it had commitments requiring expenditures of $85,000 during its first three years of existence. Yet its capital contribution consisted of only $5,000. Obviously more risk capital was required. If the taxpayer had made the necessary additional investment in any of the conventional forms—stock or a loan—his loss would have been a capital loss. But because he happened to, instead, risk his money by guaranteeing the corporation's bank loans, the court allowed him an ordinary loss. Yet from the taxpayer's viewpoint the situation was exactly the same as if he had borrowed the money himself and then lent it to the corporation.10

The Supreme Court of the United States in *Putnam v. Commissioner*11 overruled the ordinary loss argument for the shareholder guaranteed loans by stating that Congress intended for this type of loss to be a nonbusiness bad debt (capital loss). The court utilized the dissent's reasoning in *Cudlip* and concluded: "There is no real or economic difference between the loss of an investment

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9 Id.
10 Id. at 572.
made in the form of a direct loan to a corporation and one made indirectly in the form of a guaranteed bank loan."\textsuperscript{12}

One author believes this statement could be extended to the following: There is no real or economic difference between a direct loan, which is treated as a contribution to capital because the corporation is too thin, and a loan made indirectly by guaranteeing the corporation’s notes.\textsuperscript{13} This type of policy would put guaranteed shareholder loans under the same type of attack as direct shareholder loans — thin capitalization.

\textit{Putnam} was decided in 1956. Until 1965 there were no cases which challenged the shareholder guaranteed loan on the basis of thin capitalization. In 1965 the case of \textit{Murphy Logging Co. v. United States}\textsuperscript{14} was first adjudicated. In this case three partners organized a corporation capitalized at $1,500 and transferred partnership equipment valued at $238,150 to the corporation. The equipment was paid for out of a $240,000 loan by a bank to the corporation. The loan was guaranteed by the partners. In the partnership return for 1959 the partners reported a long term capital gain on the sale of the equipment in the amount of $209,735. The Commissioner treated the transfer as a non-taxable exchange under the provisions of section 351 of the Internal Revenue Code of 1954, reduced the claimed depreciation charges, and disallowed the interest deductions.

Two important factors were mentioned by the District Court. First the court stated that both thin capitalization and lack of an arm’s length transaction raise questions as to whether the substance is the same as the form, even though neither in itself is needed to make the transaction valid. Secondly, it was noted that the new corporation did not comply with the traditional debt formalities. The court concluded that the real substance of the transaction was a capital contribution of equipment by the brothers to the corporation and a loan by the bank to the individuals. The District Court was overruled on appeal. But, the decision of the District Court is important in that it indicates that the guaranteed loan situation is subject to the thin capitalization doctrine; and the analysis of the

\textsuperscript{12} Id. at 92-93
\textsuperscript{14} 239 F. Supp. 794 (D. Ore. 1965), rev’d, 378 F.2d 222 (9th Cir. 1967).
District Court further indicates that the guaranteed loan situation will be examined through the use of the traditional factors used in deciding thin capitalization cases.

The traditional factors which courts have cited as indicia of a thinly capitalized corporation are: form, debt to equity ratio, pro rata holding, core asset and risk of the business, business purpose, and the arm's length transaction.

These factors will be presented as interpreted by the courts, followed by a discussion of their applicability to the guaranteed loan situation.

I. Form

The form of the debt is mentioned in almost every thin capitalization case, yet it is often overlooked by the taxpayer. If the corporation and shareholder-creditor act as if the alleged debt instrument is other than what it purports to be, it casts doubt upon the true character of the transaction.\(^{15}\)

Some aspects of form are the designation in minutes, records, instruments, and other corporation records that there is a debt with a fixed maturity date and a reasonable interest cost. Also, there should be no rights to participate in the management, the debt should not be subordinated and it should be legally transferrable.\(^{16}\)

After the formalities are established it is essential to comply with them. If interest payments are not made on time\(^{17}\) or principal repayments are not made at maturity\(^{18}\) the courts in using hindsight may infer that no debt was in fact intended. Typical is the case that begins with the statement, "In form the instruments are clearly debt."\(^{19}\) The form and the following through will not always win the battle, but at least the contest is not decided before it begins.

II. Debt to Equity Ratio

At one time a high debt to equity ratio raised a strong, almost insurmountable inference that the amount paid in was a contribu-
tion to capital. Even then, however, most courts felt that thinness alone was not a sufficient basis for treating alleged debt as equity.

It appears as if now, while a high debt to equity ratio raises the suspicion of the court, it is only one more factor to consider. In many instances the taxpayer has been able to maintain the debt in the face of an extremely high debt to equity ratio. One method by which this factor has been offset has been by the showing of goodwill.

The exact point of safety is difficult to determine. Courts have found alleged debt to be equity even with very low ratios. It would appear though, that a high ratio is still harmful while a low ratio does not do the taxpayer much good until it gets below 4:1, and there is a substantial amount of equity capital.

### III. Pro Rata Holding

When it appears that the shareholders hold the debt approximately in proportion to their equity holdings, there is again a strong inference that the so called loans are risk capital. On the other hand a sharply disproportionate ratio between ownership of stock and debt will go far to overcome such factors as a high debt to equity ratio as there is much less reason to question the bona fides of the debtor-creditors relationship; but the absence of pro

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20 Isidor Dobkin, 15 T.C. 31, 33 (1950), aff'd per curiam, 192 F.2d 392 (2d Cir. 1951); Sam Schnitzer, 13 T.C. 43, 62 (1949), aff'd per curiam, 183 F.2d 70 (9th Cir. 1950), cert. denied, 340 U.S. 911 (1951).

21 Colony, Inc., 25 T.C. 30, 42 (1950), aff'd per curiam on other grounds, 244 F.2d 75 (6th Cir. 1957), rev'd on other grounds, 357 U.S. 28 (1958).


23 Charles E. Curry, 43 T.C. 667 (1965) (Ratio 30:1); see also J. I. Morgan, Inc., 30 T.C. 881 (1958), rev'd 272 F.2d 936 (9th Cir. 1959) (ratio 50:1); Sun Properties v. United States, 220 F.2d 171 (5th Cir. 1955) (ratio 41,000:1); Ainslee Perraull, 25 T.C. 439 (1955) (ratio 1013:1).


26 See generally Goldstein, Corporate Indebtedness to Shareholders: 'Thin Capitalization' and Related Problems, 16 Tax L. Rev. 1, 20 (1960) where the author states that because the ratio of debt to equity after the recapitalization in Talbot Mills, 326 U.S. 521 (1946), was 4:1, many courts and commentators seemed to feel that in the judgment of the Supreme Court, 4:1 was not clearly inadequate.


rata holding of debt and equity, in itself, does not insure taxpayer success.\textsuperscript{30}

The logic behind the pro rata holding argument is that the less shares the debtor holds the more he tends to think like a creditor; he will be less willing to subordinate his debt, and more willing to foreclose upon a default than, for example, a sole shareholder who is also a creditor.

Family holdings of different amounts do not make the situation any less proportionate. The court may merely consider the family as a unit.\textsuperscript{31}

The first three factors—form, debt to equity ratio and pro rata holding are relatively easy to prove, and as such are obvious grounds upon which the Commissioner can attack a thin capitalization situation. Usually though, it takes more than a factual showing of the corporate structure to convince the court that there was a sham transaction as indicated by a typical statement made in \textit{Estate of Miller v. Commissioner}:\textsuperscript{32}

We know of no rule which permits the Commissioner to dictate what portion of a corporation's operations should be provided for by equity financing rather than by debt. Such a statement would seem to intimate that the corporation with a high debt to equity ratio held proportionately will not be invalid per se. There is a further test of economic reality. Courts, to test the economic reality, have applied such theories as core asset and risk of the business, business purpose, and arm's length transaction.

\textbf{IV. Core Asset and Risk of the Business}

A theory advanced in many cases is that of the core asset or risk of the business. This theory provides that if certain dollars are used to purchase assets which constitute the basis of the company, these dollars should be considered equity.

\textsuperscript{30} Colony, Inc., 26 T.C. 30, 43 (1956), \textit{aff'd per curiam on other grounds}, 244 F.2d 75 (6th Cir. 1957), \textit{rev'd on other grounds}, 357 U.S. 28 (1958). The court said that a disproportionate holding of amounts among shareholders was of no greater weight than disproportionate amounts among common and preferred shareholders.


\textsuperscript{32} 239 F.2d 729, 734 (9th Cir. 1956).
In *Schnitzer* advances to a corporation were, as found by the court, invested in the corporation's permanent assets (organization and plant). As such the advances had been placed "at the risk of the business," and were considered risk capital, and, therefore, they could not be considered debt. In another case, advances for working capital were deemed to be at the risk of the business and therefore equity. Furthermore whenever an advancement could be intended as venture capital, it was placed at the risk of the business especially if it was in proportion to stockholdings.

This concept has not escaped criticism. For whatever a corporation's assets — plant, equipment, inventory, cash and the like — they are at the risk of the business in that unpaid creditors may seize them. Then, too, it is difficult to single out the specific money used to purchase the so-called "risk" assets from that used to purchase the "non-risk" assets.

V. BUSINESS PURPOSE

In *Gregory v. Helvering* the court in analyzing a reorganization stated that if the motive of taxation was discarded, there would simply be an transaction with no business or corporate purpose. The "business purpose" test was then later used in determining if advances should be treated as loans. The presence of a valid business purpose would strengthen the taxpayer's position; the lack of it would indicate a sham or meaningless transaction.

The business purpose test has lost some of its former influence as some courts have made statements to the effect that the taxpayer is entitled to arrange his affairs to minimize his taxes and this in itself would be a valid business purpose.

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33 Sam Schnitzer, 13 T.C. 43, 61 (1949).
34 Isidor Dobkin, 15 T.C. 31 (1950), *aff'd per curiam*, 192 F.2d 392 (2d Cir. 1951).
37 293 U.S. 465, 469 (1934).
The business purpose test was specifically rejected in *Nassau Lens Co.* but it continues to be mentioned in almost all thin capitalization decisions and if a business purpose is present, it may still help to overcome other harmful factors.

VI. Arm's Length Transaction

Another test commonly mentioned is the presence of, or lack of, an arm's length transaction. In *Nassau Lens* the court said that traditional factors were important only as evidence whether the taxpayer could and would be repaid in accordance with substantial economic reality and arm's length transactions.

Perhaps a test such as this would lend more certainty to the debt versus equity area. The taxpayer would have to show that there was a reasonable expectancy that the loan would be repaid in accordance with terms consistent with those prevailing in the general community. The fundamental question would be the same as corporate management asks itself in considering debt — how much money could be borrowed with the assurance that the corporation could continue to service its debts and still repay the loan without risking insolvency. This approach has the theoretical advantage of equating the debt structure of closely held corporations with corporations which are widely held; the difference being that in widely held corporations management makes the total debt decision whereas in closely held corporations the ultimate decision would rest with the courts.

As should be obvious by now, the aspect of thinness cannot be tied down to anything concise. The decisions go in all directions. Nor can the situation be alleviated by consulting beforehand with the Internal Revenue Service. The service will not issue rulings on what will constitute stock or securities where part of the consideration received by the transferors consists of bonds, debentures, or notes, which, when compared to the capital stock of the

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41 J. I. Morgan, Inc., 30 T.C. 881, 890 (1958) *rev'd* 272 F.2d 936 (9th Cir. 1959). The 50:1 ratio of debt to equity was partially overcome in the tax court by the business purpose of the transaction which was to retain former employees.
44 This conclusion was also reached in Rockler, *Transfers to Controlled Corporations: Considerations of Thinness and Multiplicity*, 39 Taxes 1078, 1084 (1961).
corporation, gives rise to the question of a "thin corporation".\textsuperscript{45} Neither will the service ordinarily issue rulings on transfers to controlled corporations where part of the consideration received by the transferors consists of bond, debentures or any other evidences of indebtedness of the transferee\textsuperscript{46}; nor whether advances to "thin corporations" constitute loans or are equity investments.\textsuperscript{47} The question still remains as to whether shareholder guaranteed loans will eliminate the thin capitalization attack. The answer must, in light of the District Court decision of the Murphy Logging Co. case,\textsuperscript{48} the Fors Farms, Inc.\textsuperscript{49} case and comments by persons in the tax area,\textsuperscript{50} be in the negative. However, the Commissioner has yet to win a case in this area, and the guaranteed loan in light of the traditional factors cited by the courts, offers a greater insulation against a thin capitalization attack than the direct shareholder loan.

The guaranteed loan will usually have all the formal characteristics of debt\textsuperscript{51} since there is a third party who is looking out for his own interests. He will not tolerate late interest or extended principal payments, and being in the lending business, the traditional debt formalities will normally be carried out.

For the government to prove its case in a guaranteed loan situation, it must show that the shareholders were the constructive borrowers and the constructive contributors of the loan proceeds to the corporation and that each corporation payment of interest and principal is therefore constructively for the account of the shareholder.\textsuperscript{52} If the debt is not an actual sham the pro rata holding will not be present without employing the previous constructive fictions.

Trying to prove that the money lent by a bank went to the "risk of the business" and therefore equity would involve some contradictions since the theory presumes that no lender would place his

\textsuperscript{46} Id. at 951.
\textsuperscript{48} 239 F. Supp. 794 (D. Oregon 1965), rev'd, 378 F.2d 222 (9th Cir. 1967).
\textsuperscript{50} Hickman, The Thin Corporation: Another Look at an Old Disease, 44 TAXES 883, 889 (1966).
\textsuperscript{51} In the Murphy Logging case, the lower court mentioned specifically that some of the formal characteristics of a loan were missing.
\textsuperscript{52} Aarons, Debt v. Equity: Special Hazards in Setting Up the Corporate Capital Structure, 23 J. TAXATION 194, 195 (1965).
money at the risk of the business which is what actually happened. The theory the government will probably use, as was used in the Murphy Logging case, will be that there is a lack of an arm's length transaction. The Murphy Logging case actually decided nothing in this area since on appeal the court found that the goodwill was enough to prevent the corporation from being thinly capitalized,\textsuperscript{53} and thus removed the necessity of finding an arm's length transaction.

The question of an arm's length transaction, especially in the face of the shareholder's personal guarantee, must depend on the intention of the bank (or any other lender). If the bank is looking to the corporation for payment, then there is an arm's length transaction; this would not be so if the bank is really looking to the individual shareholders through their personal guarantee.\textsuperscript{54}

The proof of the bank's intention is made difficult for the reason that the bank will want to insure its debt as best it can, and the better insurance the bank gets, the worse the chances of the transaction surviving the Commissioner's attack. If the bank succeeds in requiring the shareholder to pledge his personal assets as part of the guarantee, then surely it appears on the surface as if the bank is not depending on the corporation for the repayment.

From the point of view of the taxpayer he is better off if he can persuade the bank to forget the guarantee altogether, and if this is not possible at least avoid pledging any private assets. It would be even better to pledge the corporate assets, for then the taxpayer could point to the security as proof that the bank was looking to the corporation for repayment.\textsuperscript{55}

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\textsuperscript{53} In the Murphy Logging case the appeal court found goodwill whereas the lower court found exactly the opposite—no goodwill.

\textsuperscript{54} In the Murphy Logging case the lower court did not believe the banker's testimony that he was looking to the corporation for repayment.

\textsuperscript{55} Hickman, \textit{The Thin Corporation: Another Look at an Old Disease}, 44 Taxes 883, 891 (1966).