Tax Factors Affecting Debt-Equity Financing for a New Small Corporation

Theodore M. Garver

Follow this and additional works at: http://scholarlycommons.law.case.edu/caselrev

Part of the Law Commons

Recommended Citation
Available at: http://scholarlycommons.law.case.edu/caselrev/vol17/iss3/17
Closely held corporations often are confronted with unique tax problems. Several complex areas relating to these problems are discussed in the articles in this section. Mr. Theodore M. Garver analyzes the tax advantages and disadvantages of thinning a corporation's financial structure. He notes that thinning is not an advisable procedure in every situation and suggests the use of stockholder guaranteed bank debt as a possible alternative. Mr. Wilton S. Sogg discusses some significant problems which arise during the purchase or sale of a corporation. He specifically considers the tax aspects of good will and covenants not to compete, imputed interest, depreciation recapture and investment credit, and twelve-month liquidations. Mr. Richard Watson concentrates on an area of increasing importance to closely held corporations — the Libson Shops Doctrine. After tracing the development of the doctrine and analyzing its impact on a corporation's net operating loss carryover, the author discusses the Commissioner's recent retreat in this area. He concludes that new opportunities for the use of loss carryovers have been made available by this retreat. Mr. David R. Fullmer concludes this section with a treatment of the tax considerations of employee-shareholder compensation. After setting out the specific limitations on the amount of this compensation, he offers a detailed analysis of the use of non-salary types of compensation. He concludes that the use of these fringe benefits frequently offers an attractive alternative to the corporation which seeks to increase employee-shareholder benefits but, for tax reasons, hesitates to do so by salary raises.

Tax Factors Affecting Debt-Equity Financing for a New Small Corporation

Theodore M. Garver

In the past, lawyers have been inclined to advise clients that, for tax purposes, a new corporation should be financed largely through the issuance of debt securities to stockholders rather than with equity funds. While there are several reasons for this advice, undoubtedly the most important is that if a large portion of the money needed for the operation is loaned to the new corporation and the loan is upheld for tax purposes, profits of the corporation can be distributed to the stockholder-creditors in the form of a repayment of the loan without dividend tax. The tax benefits derived from repaying a loan
as opposed to paying dividends can be very significant—so significant, in fact, that advice to thin a new corporation is often given as a matter of course. In recent years, new decisions and statutes have injected additional considerations which make the choice of financing methods a matter of serious judgment. It is no longer true that thinning is always desirable. On this theme, an examination of the various reasons for thinning in light of present law will be profitable.

I. ADVANTAGES AVAILABLE THROUGH THINNING

A. Nontaxable Withdrawal of Funds

When a debt is repaid, there are normally no tax consequences to either the debtor or creditor. On the other hand, when a dividend is paid, it is taxed as ordinary income to the shareholder without tax effect on the corporation. As has been noted, this distinction is often the primary incentive for thinning.

Unfortunately, it is rarely clear that the desired advantage will be realized. If the debt is sufficiently similar to stock in practical effect, the advantage will not be realized. When the stockholders' interests are directly proportional to their interests as creditors—the normal situation in a thinly capitalized new corporation—it often makes little difference whether their ownership is represented by notes rather than by stock. Consequently, numerous cases have held that what purported to be a debt interest was in reality an equity interest in the corporation. As a result, interest payments are treated as nondeductible dividends, and debt payments are treated as stock redemptions which normally are taxable as dividends.

1 See Schlesinger, "Thin" Incorporations: Income Tax Advantages and Pitfalls, 61 HARV. L. REV. 50, 56 (1947), where the author estimates that in order to achieve the same after-tax effect as a $250,000 repayment of a loan, the corporation's sales would have to be increased by $12,650,000. While the taxpayer is not required to choose the alternative of paying taxable dividends upon which the estimate is based, there is little question that the advantages can be very great.

2 A corporation is generally described as being thin when a substantial portion of its funds are obtained by borrowing rather than as capital. See Schlesinger, supra note 1, at 50.

3 See, e.g., R. C. Owen Co. v. Commissioner, 351 F.2d 410 (6th Cir. 1965); Wood Preserving Corp. v. United States, 347 F.2d 117 (4th Cir. 1965); McSorley's, Inc. v. United States, 323 F.2d 900 (10th Cir. 1963); P. M. Fin. Corp. v. Commissioner, 302 F.2d 786 (3d Cir. 1962); Gooding Amusement Co. v. Commissioner, 236 F.2d 159 (6th Cir. 1956), cert. denied, 352 U.S. 1031 (1957).

4 For an exhaustive compilation of cases, see 4 P-H 1966 FED. TAX SERV. § 13096.

5 See, e.g., Foresun, Inc. v. Commissioner, 348 F.2d 1006 (6th Cir. 1965); Consumers Credit Rural Elec. Co-op Corp. v. Commissioner, 319 F.2d 495 (6th Cir. 1965); Charter Wire, Inc. v. United States, 309 F.2d 878 (7th Cir. 1962).

6 See INT. REV. CODE OF 1954, § 302 [hereinafter cited as CODE §]; Treas. Reg. §
For a period, many lawyers derived considerable comfort from the fact that the ratio of debt to equity of the corporation was reasonable — approximately four to one or less. In 1945, the United States Supreme Court in *Talbot Mills v. Commissioner*\(^7\) stated that such a ratio of debt to equity was not "an obviously excessive debt structure.”\(^8\) Whatever validity debt-equity ratio might once have had in determining whether debt would be held to be stock for tax purposes,\(^9\) it is now clear that a favorable debt-equity ratio has only minor significance. Particularly when the debt is created on incorporation, the courts have had no difficulty in holding even reasonable amounts of debt to be stock. Without attempting to make an exhaustive examination of the case law,\(^10\) this conclusion can be illustrated by two recent cases.

In *Moughan v. Commissioner*,\(^11\) debentures in the face amount of 166,000 dollars and stock worth 150,000 dollars were issued upon the incorporation of a partnership, giving a debt-equity ratio of almost one to one, far below the four to one guideline often cited. In spite of the conservative ratio, the Sixth Circuit upheld the Tax Court’s finding that the 166,000 dollars of debentures represented equity rather than debt capital and held that interest paid on the debentures was not deductible to the corporation.

*Charter Wire, Inc. v. United States*\(^12\) also involved notes issued to partners on the incorporation of a partnership. In spite of a very conservative debt to equity ratio of one to three, the court, as in *Moughan*, held that what purported to be debt was a contribution to capital. Both *Moughan* and *Charter Wire* involved other factors, but it is clear, nevertheless, that a favorable debt-equity ratio is far from determinative.

The issue of whether debt actually constitutes equity cannot be decided simply. One court has cited "at least" eleven factors which

---


\(2\) Companion case to John Kelley Co. v. Commissioner, 326 U.S. 521 (1946). It should be noted that, despite the Court’s statement on the debt-equity ratio, the taxpayer in one of these two cases, the *Talbot Mills* case, nevertheless lost, as the Supreme Court upheld the Tax Court’s decisions in both the consolidated cases.

\(3\) Id. at 526.


\(5\) Attempted in 1959 by Professor Caplin. *Ibid.*

\(6\) 329 F.2d 399 (6th Cir. 1964).

\(7\) 309 F.2d 878 (7th Cir. 1962).
should be considered in reaching a final decision. With such an array of different considerations entering into the final decision, it will be an unusual case when a lawyer is able to conclude that there is no substantial danger that the repayment of debt will be taxed as a dividend; but, without some such assurance, few clients will want to attempt to repay the purported debt. If no other advantage is lost by incorporating thin, no harm is done; but where other advantages of stock capitalization are sacrificed in the hope of creating a situation where the debt can be repaid without tax consequences, it becomes difficult to judge when "the game is not worth the candle."

When the time for repayment of the debt is reached, all is not lost even if the conclusion is reached that the risk of dividend treatment is very great. Even if the purported debt is held to be an equity interest, it should be treated as a species of preferred stock. If it was created at the time of incorporation, when there were no earnings and profits, it will not be classified as "section 306 stock." If this is so, there should be no adverse consequences in selling what purports to be a debt obligation to a bank or other investor. When the debt is later repaid, no adverse consequences will result to the investor because he will have completely terminated his interest in the corporation.

In addition to the fact that the benefits involved in extracting funds from the corporation without tax by thinning are often tenuous, it should be pointed out that the creation of a doubtful issue of debt is not the only way to extract funds from the corporation without tax. A far safer and equally effective way to accomplish this purpose is for the individual to retain property that will be used in the business after incorporation and to sell the property to the corporation at a later date. For example, if the business

---

13 O. H. Kruse Grain & Milling Co. v. Commissioner, 279 F.2d 123, 125 (9th Cir. 1960).
14 MONTAIGNE, Book 2, ESSAY, Ch. 17 (1580).
15 Section 306 of the Internal Revenue Code provides generally that the proceeds from the sale or exchange of certain preferred stock issued in a tax-free transaction, such as in a reorganization or as a stock dividend, will constitute ordinary income. Section 306 does not apply, however, if the corporation had no earnings or profits at the time the stock was issued. CODE § 306(c) (2).
16 CODE § 302(b) (3). Where only partial payment of the debt is involved, it would seem highly likely that even if the debt were considered stock, the redemption would be held not to be essentially equivalent to a dividend under § 302(b) (1), so that the investor would not be harmed. Both conclusions assume that the investor does not bear any of the relationships to the common stockholders described in § 318(a) of the Internal Revenue Code.
which is to be incorporated will operate in a building owned by the proprietorship, there is no real need to transfer title to the building to the corporation immediately. Instead the building can be rented to the corporation until such time as the company has accumulated enough funds to purchase the building outright. Of course, the gain which can be realized on the sale of depreciable property to a controlled corporation without any ordinary income consequences is limited;\textsuperscript{17} nevertheless, in this manner corporate funds may be extracted essentially without tax with relative safety. While this method may have the same effect as thinning with debt, the Internal Revenue Service has rarely attacked the device unless corporate notes were issued for the property.\textsuperscript{18}

B. The Interest Deduction

Another less important advantage of thinning a new corporation, again assuming the debt is upheld, is that the interest paid on the debt will be deductible to the corporation, thus eliminating the double tax to which dividends are subject. While the same uncertainties inherent in the repayment of debt are also present in the payment of interest, most clients are willing to run the risk of non-deductibility because of the relatively smaller amounts involved. By the same token, the relatively smaller amounts also mean relatively smaller advantages. This, coupled with the fact that the interest will be taxable to the shareholder-creditor, normally makes the interest deduction at most a minor factor in the decision whether to thin a new corporation. Furthermore, the same effect can be achieved either by retaining property and renting it to the corporation or by electing to be taxed as a "tax option corporation."\textsuperscript{19}

C. Accumulated Earnings Tax

Another important factor in deciding whether to thin is the accumulated earnings tax.\textsuperscript{20} This tax, at rates of twenty-seven and one-half per cent and thirty-eight and one-half per cent, is imposed

\textsuperscript{17} CODE §§ 1239, 1250.

\textsuperscript{18} In situations where notes have been given for property, the Internal Revenue Service has shown no hesitancy in challenging such transactions as involving contributions to capital rather than \textit{bona fide} debts. See, e.g., Brake & Elec. Sales Corp. v. United States, 287 F.2d 426 (1st Cir. 1961); Castle Heights, Inc. v. United States, 242 F. Supp. 350 (E.D. Tenn. 1965); Bruce v. Knox, 180 F. Supp. 907 (D. Minn. 1960), appeal dismissed, 289 F.2d 936 (8th Cir. 1961). Payments of interest on such notes are often regarded by the courts as dividends and therefore are not deductible.

\textsuperscript{19} CODE §§ 1371-77.

\textsuperscript{20} CODE § 531.
on corporations accumulating their income beyond the reasonable needs of the business.21 Obviously one prime business need of any corporation is the need to repay its debt. If a corporation can use its earnings, at least temporarily, to repay debt, the earnings will not be accumulated; if the earnings are accumulated to pay a debt in the future, the corporation will achieve a certain amount of immunity from the accumulated earnings tax. Even if there is great uncertainty as to whether the repayment of the debt will be tax-free, the existence of the debt on the balance sheet may provide a substantial argument in defense against the penalty tax. While the fact that the corporation is so thinly capitalized that the debt ought to be treated as equity capital theoretically should invalidate this defense, the Internal Revenue Service seems rarely to have made this argument.22 It should be pointed out that the Commissioner is not helpless in this situation. Accumulation of funds to redeem stock is generally considered an indication that the funds are not needed in the business. There is no reason why this should not be as true for stock that is labeled debt as for any other stock.23 Furthermore, thinning may no longer be as effective in defending against the imposition of the accumulated earnings tax because of the indication in some recent decisions that a corporation which has financing available from friendly sources has need to accumulate less of its earnings for its business than other corporations not so favorably situated.24 Since a shareholder-creditor is undoubtedly a friendly source of financing, a debt owed to him may not be as effective in defending against accumulated earnings tax as was previously thought.

II. FACTORS AGAINST THINNING

A. Tax Option Corporation

One of the most radical innovations in the area of taxation of small corporations is the option given to the corporation to have its

21 CODE §§ 531(1), (2).

22 This argument was made and accepted by the court in Smoot Sand & Gravel Corp. v. Commissioner, 241 F.2d 197, 204 (4th Cir. 1956), cert. denied, 354 U.S. 922 (1957).


24 See, e.g., Helvering v. National Grocery Co., 304 U.S. 282, 294 (1938) where the court said: "Since Kohl was the sole owner of the corporation, the business would have been as well protected against unexpected demands for capital, and assured of capital for the purpose of any possible expansion, by his personal ownership of the securities as by the corporation's owning them." See also Helvering v. Chicago Stock
income taxed directly to the shareholders pro rata without any corporate tax. The effect of the option is to eliminate the double tax and to achieve substantial equivalence to taxation of a partnership. A corporation remaining permanently in the tax option status would have no reason to desire a thin financial structure. Election of the tax option status allows a corporation to freely distribute its earnings without a tax effect. A corporate deduction for interest paid to a stockholder would be meaningless, and the accumulated earnings tax would not be applicable. While these thinning advantages would again be present if the corporation should terminate its tax option election, it is rarely advisable to thin a tax option corporation because the consequences of unsuccessful thinning can be disastrous. Among the requirements for a corporation to qualify as a tax option corporation is a requirement that it have only one class of stock. Nevertheless, debt which is held to be an equity interest has been held to constitute a second class of stock thereby completely invalidating the tax option election, but the Tax Court has recently adopted a contrary view. The result may be a very expensive double tax, a disallowance of substantial deductions to the shareholders for corporate losses, or taxation of capital gains at both ordinary income and capital gain rates. Therefore, in the absence of unusual conditions, a tax option corporation should be capitalized solely with common stock.

B. Section 1244 Stock

Prior to the passage of Section 1244 of the Internal Revenue Code and the subsequent Supreme Court decision in Whipple v. Commissioner, debt financing was somewhat more advantageous.


26 In general, CODE §§ 1371-77 provide that all corporate income or loss is taxed proportionately to the shareholders, which is the way partnership income is taxed. There are differences which will be important in some cases, particularly if the corporation has earnings and profits accumulated either before or after the election is effective or if there have been transfers of stock during the year. See generally Wright, supra note 25.

27 CODE § 1371(a) (4).


than equity financing in the event that the venture failed. Many courts had approved an ordinary deduction as a business bad debt where the facts would support the theory that the stockholder-creditor was in the business of financing small corporations.\(^{31}\) The Supreme Court's decision in the *Whipple* case has eliminated this possibility, unless the taxpayer virtually has the status of a broker. On the other hand, section 1244 now unequivocally allows an ordinary loss, within limits, on the worthlessness or sale of stock which has been qualified as "section 1244 stock." The qualification of stock as "section 1244 stock" is limited to corporations (1) having paid-in capital of 500,000 dollars or less, and (2) paid-in capital and surplus of 1 million dollars or less.\(^{32}\) In addition, the losses entitled to ordinary loss treatment in any one year are limited to 50,000 dollars on a joint return.\(^{33}\) Nevertheless, in many cases section 1244 will be a substantial reason for using stock rather than debt to finance the corporation. Of course this tax advantage must be weighed against the advantage that may accrue to a shareholder-creditor by reason of his creditor's position when the corporation fails. But personal guarantees are so frequent in newly formed corporations that a creditor's position is often unimportant to a shareholder.

C. *Estate Planning*

Less frequently the use of stock rather than debt may offer important estate planning advantages. Sections 303 and 6616 of the Internal Revenue Code, contain valuable statutory benefits available only to estates having assets composed of a sufficient percentage of closely held stock or small business assets.

An estate qualifies under section 303 if more than thirty-five per cent of the gross estate or more than fifty per cent of the taxable estate consists of stock of a single corporation or several seventy-five per cent owned corporations.\(^{34}\) If the requirements are met, the stock can be redeemed by the corporation to provide the estate with sufficient funds to pay death taxes and administration expenses without the redemption being taxed as a dividend. Without the protection of section 303, there is often a substantial danger that


\(^{32}\) Code § 1244(c) (2). It should be noted that the issuance of debt securities to shareholders to keep the capital accounts within these limits will not be effective. *Ibid*.

\(^{33}\) Code § 1244(b).

\(^{34}\) Code §§ 303(b) (2) (A), (B).
any redemption of the stock of an estate will be taxed as a dividend. This is generally true where a family corporation is involved. In many cases a redemption under section 303 can be more valuable to an estate than the opportunity for repayment of debt created through thinning. In any event, the results are sure, and, executors not being a venturesome group, the certainty of even a lesser benefit may mean more than the possibility of a greater one.

Section 6166 provides additional benefits for an estate holding similar percentages of small business assets. Stock in a close corporation (ten or less stockholders) or stock in a corporation in which the decedent owned twenty per cent of the voting stock are small business assets which will help meet the goal, and will increase the benefits if the goal has already been met. If the estate includes the necessary percentages, the executor can elect to pay a portion of the estate tax in ten equal annual installments, without putting up a bond, and at only four per cent interest.

Both of these estate planning advantages are made available only in respect to stock interests. If thinning the corporation would leave a stockholder holding less than the percentages necessary to meet the requirements of sections 303 and 6166, the financial structure ought to be considered in light of the relative advantages of the thinning and the estate planning benefits available.

III. STOCKHOLDER GUARANTEES OF DEBT AS A SUBSTITUTE FOR THINNING

A frequently suggested alternative to thinning a new corporation with direct stockholder debt is to have the new corporation borrow substantial sums from a bank. As a business matter this would always be advisable except that the response of most banks is to require the stockholders to guarantee the corporation’s debt, thus leaving the stockholder with as much at risk as if he had loaned the money directly. Nevertheless, stockholder guarantees have enjoyed considerable popularity for several reasons.

35 CODE § 302.
36 CODE § 318(a).
37 See text accompanying note 33 supra.
38 CODE § 6166(a) permits the deferral as a matter of right. Some confusion has been caused by § 6166(k) (2) which states: "For authority of the Secretary or his delegate to require security in the case of an extension under this Section, see § 6165." Neither § 6165 nor the regulations interpreting it permit the Secretary to require a bond in the case of an extension as a matter of right under § 6166, and none is required in practice. The provision for security in § 6166(k) is applied only to additional extensions of time granted the taxpayer beyond those to which he is entitled as a matter of right. See, e.g., CODE § 6166(h) (3).
For a number of years a principal reason given for the use of stockholder guaranteed bank debt was that courts had held that the satisfaction of a guarantee was an ordinary rather than a capital loss. The theory was that there was no debt which could be classified as a nonbusiness bad debt. However, the Supreme Court destroyed this theory in Putnam v. United States, which held that the guarantor's right to indemnification created a debt even if it was completely without value. Although Putnam seemed to end all hope of an ordinary deduction for guaranteed loans, there has developed in its wake an interesting line of decisions which still extends the ordinary loss result to well-advised taxpayers. These cases unanimously hold that where a taxpayer who has guaranteed a loan to a corporation which is failing pays a third person to assume the obligation of the guarantee, this payment is deductible in full. The theory is the pre-Putnam theory that there is no debt which can be classified as a nonbusiness bad debt. The Putnam result is avoided, because in this situation no indemnification right which can be classified as a debt is created. Under these cases the ordinary loss would seem to be proper without regard to whether the entire payment was used by the third party within a short period in satisfaction of the guarantee obligation, as long as no right of indemnification was created.

In addition to the possibility of ordinary loss deductions, financing through the use of stockholder-guaranteed bank debt will achieve all the advantages of direct thinning with much less uncertainty. Even if the corporation is excessively thin, a payment to a bank has been relatively immune from attack because the shareholder receives nothing which can readily be taxed as a dividend. Unfortunately a district court in Oregon has recently upset this line of reasoning. Murphy Logging Co. v. United States involved a typical small corporation financed to a large extent with bank loans. The bank required the guarantee of the stockholders and, in fact, probably looked primarily to them for payment. The court, in—

39 See, e.g., Cudlip v. Commissioner, 220 F.2d 565 (6th Cir. 1955); Edwards v. Allen, 216 F.2d 794 (5th Cir. 1954); Pollak v. Commissioner, 209 F.2d 57 (3d Cir. 1954).

40 352 U.S. 82 (1957).


42 E. H. Rietzke, supra note 41.

voking the form-over-substance doctrine, held that the real substance of the transaction was a loan by the bank to the stockholders and a subsequent loan by the stockholders to the new corporation. The logical consequence of this holding is that repayment of a bank loan which is guaranteed by stockholders is just as vulnerable to dividend treatment on thin capitalization grounds as a direct loan by the shareholders. Of course, the results under the Murphy theory may be more harsh because, while the shareholders could be taxed as if they had received ordinary dividend income, they would have no funds at all with which to pay the tax.

While the Murphy case stands alone and certainly does not represent settled law, it should not be disregarded. It is very often true in such cases that the bank considers only, or primarily, the credit of the shareholders and that the loan is made in form to the corporation only as an accommodation to the shareholders. Where the facts indicate this situation, a government argument that the real substance of the transaction is a loan to the shareholders and a subsequent loan by them to their corporation has definite support in the long line of substance-over-form cases.

IV. Conclusion

In view of the many different considerations involved, it seems evident that there can be no flat statement that it is best either to thin or not to thin a corporation. Undoubtedly there are many situations where no advantage is surrendered by thinning. If so, nothing is lost by the attempt even if the results are uncertain. There are other situations where a detailed study of all of the facts and circumstances will indicate that a reasonable amount of thinning has a good chance of success, in which case it may be advisable to forego other advantages that may flow from stock capitalization. The point is that each case must be considered on its own facts. Rather than automatically deciding to use as much debt financing as possible, the relative advantages of each type of financing should be carefully considered.

45 In Fars Farms, Inc. v. Commissioner, CCH 1966 STAND. FED. TAX REP. (66-1 U.S. Tax Cas.) § 9206 (W.D. Wash. Jan. 17, 1966), the court seemed to accept the reasoning involved in Murphy, but concluded as a factual matter that the debt was valid.