

# William & Mary Law Review

---

Volume 9 (1967-1968)  
Issue 4

Article 12

---

May 1968

## New Dimensions to the Thin Corporation

Waller H. Horsley

Follow this and additional works at: <https://scholarship.law.wm.edu/wmlr>



Part of the [Tax Law Commons](#)

---

### Repository Citation

Waller H. Horsley, *New Dimensions to the Thin Corporation*, 9 Wm. & Mary L. Rev. 1066 (1968),  
<https://scholarship.law.wm.edu/wmlr/vol9/iss4/12>

Copyright c 1968 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.

<https://scholarship.law.wm.edu/wmlr>

# NEW DIMENSIONS TO THE THIN CORPORATION

WALLER H. HORSLEY\*

Since the advent of corporate taxation, stockholders have attempted to take down current earnings and ultimately recover their investment free of the double tax imposed on dividend distributions. The use of debt in a corporation's capital structure is ideally suited for such purposes—the interest distributed is not taxable to the corporation, and principal curtailments on a loan are nontaxable to the stockholder-creditor.<sup>1</sup> Purely on the basis of its tax aspects, therefore, consideration of the use of debt in a corporation's capital structure has become part of the standard checkoff list upon incorporating or making further contributions to a corporation.

Over the years, principles of tax law have evolved to temper purely tax avoidance schemes with the heat of a judicially imposed business purpose. The tests imposed in this area have now passed through the eras of the hybrid instrument<sup>2</sup> and ratio judging<sup>3</sup> and into an era of subjective sniffing in an effort to determine the true bona fides or substantial economic reality of the corporation's debt structure.<sup>4</sup>

Left with a subjective, facts-and-circumstances test for determining the legitimacy of stockholder debt, the courts in recent years have developed new approaches for resolving the basic issue, expanded significantly the area of tainted debt, and laid the groundwork for a number of harmful side effects after the stockholder debt has been reclassified. It is the purpose of this article to point out certain of these new dimensions to the traditional thinly capitalized corporation.

---

\* Member, Virginia Bar. B.A., 1953, LL.B., 1959, University of Virginia. Partner, Hunton, Williams, Gay, Powell & Gibson, Richmond, Virginia. Formerly Lecturer in Taxation, University of Virginia Law School.

1. A creditor may have a tax to pay if the basis of the debt is less than the principal amounts received. One of the more frequently overlooked areas here is the required allocation of asset basis in incorporations and other § 351 transfers. See I.R.C. § 358. For example, if assets worth \$100,000 but with a basis of \$60,000 are transferred to a controlled corporation in exchange for \$40,000 in stock and \$60,000 in securities, the securities take a basis of only \$36,000 (i.e., 60% of \$60,000) so that a \$24,000 gain would be realized on their sale or retirement.

2. See *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946).

3. See, e.g., Caplin, *The Caloric Count of a Thin Incorporation*, N.Y.U. 17TH INST. ON FED. TAX. 771 (1959).

4. *Gilbert v. Commissioner*, 248 F.2d 399 (2d Cir. 1957), cert. denied, 359 U.S. 1002 (1959); *Gooding Amusement Co. v. Commissioner*, 236 F.2d 159 (6th Cir. 1956), cert. denied, 352 U.S. 1031 (1957).

## A NEW APPROACH: "ESSENTIAL OPERATING ASSETS"

Fully aside from tax considerations, a businessman is often persuaded to incorporate his sole proprietorship or partnership and thereby obtain a limit to his personal liability for the subsequent debts and obligations of the business. This fundamental attribute of the corporate business form is undoubtedly the most compelling reason for its use. The use of debt in a corporation's capital structure further aids a stockholder in his desire to limit his losses by allowing him to share with other creditors of equal rank.

Every business today is financed at least in part by borrowed funds. It is hard for a businessman to understand, therefore, why anyone would raise an objection to his wanting to limit his risk to so much, and only so much, of his own investment.

Often a factor of almost conclusive importance in the thin capitalization determination is the availability of credit from established financial institutions, such as banks and insurance companies. Few will contend that borrowing from a stockholder is improper in a case where such borrowing was available from the professional community upon the same terms and conditions (and without the stockholder's endorsement or guaranty). Nevertheless, the courts today are tending to find that the transfer of assets essential to the conduct of the business points to a permanent investment in the risk of the business rather than a temporary loan, with the result that any stockholder debt with respect to such assets is deemed to be equity ("at the risk of the business") rather than debt.

In one of the first decisions to emphasize this feature, the court did not say that this was a conclusive factor, but announced as follows:

We think the nature of the assets, and their continued necessity to the running of the business are relevant considerations in determining the intent of the parties in making the transfer, to be taken together with the other evidence of lack of realistic expectation of payment in cash when due according to the face of the note, and that the notes were extended when they became due.<sup>5</sup>

Other courts have since required stockholders to invest as equity amounts at least to a level necessary to purchase the corporation's "core assets and get its business underway."<sup>6</sup>

5. *Brake & Electric Sales Corp. v. United States*, 287 F.2d 426, 428 (1st Cir. 1961).

6. *See J. S. Biritz Construction Co. v. Commissioner*, — F.2d —, 20 AFTR2d 5891

If this line of reasoning is carried to its ultimate limit, the only form of legitimate stockholder debt recognized by the courts will be debt incurred for expansion purposes. Clearly such a result would be an unrealistic intrusion into legitimate business decisions. The better rule would be to look for a substantial capital investment dedicated to the business,<sup>7</sup> and then apply as necessary other tests to delve into the stockholder's intent to be a true creditor of his corporation.

#### EXTENSION OF THE TAINT: GUARANTEED LOANS

If a corporation borrows money from a bank or other financial institution, the interest paid becomes a true expense to the stockholder owners (i.e., it is paid to others), but the stockholder has effectively limited his investment in the corporation and avoided the problems of recovering his investment after the venture proves profitable. Thus, one of the important tax advantages of the thinly capitalized corporation can often be obtained through a bank loan personally endorsed or guaranteed by the stockholders.

In *Murphy Logging Co. v. United States*,<sup>8</sup> the taxpayers organized a corporation with \$1,500 in capital stock and proceeded to sell to it some \$240,000 of machinery and equipment (stepping up the basis for depreciation in the days before recapture). The new corporation borrowed this purchase price from a local bank, and the stockholders personally guaranteed the corporation's loan. Reversing the district court's holding that the transaction involved an indirect loan to the corporation by its stockholders, the Ninth Circuit recently refused to hold the thin capitalization doctrine applicable to this transaction.

A somewhat similar approach to a corporation's guaranteed debt was attempted by the Commissioner in *Ackerson v. United States*,<sup>9</sup> with the

---

(8th Cir. 1967); *Wood Preserving Corp. v. United States*, 347 F.2d 117 (4th Cir. 1965). *But see* Charles D. Vantress, 23 CCH TAX CT. MEM. 711 (1964).

7. In *Brake & Electric Sales Corp.*, 287 F.2d 426 (1st Cir. 1961) the stockholders took \$20,000 in stock and \$90,000 in notes, and there was testimony that the stock was worth \$210,000 on incorporation after taking goodwill into account. In *Wood Preserving Corp.*, 347 F.2d 117 (4th Cir. 1965) \$25,000 was taken in stock, and \$130,000 was reflected in an open account. Both of these would appear to represent a substantial equity commitment.

8. 378 F.2d 222 (9th Cir. 1967).

9. — F. Supp. —, 20 AFTR2d 5616 (W.D. Ky. 1967). *Accord*, *Fors Farms, Inc. v. United States*, — F. Supp. —, 17 AFTR2d 222 (W.D. Wash. 1965). *See generally* Hickman, *The Thin Corporation: Another Look at an Old Disease*, 44 TAXES 883, 889-91 (1966).

same result. There the stockholders had caused their corporation to purchase a business, paying \$20,000 in cash and \$100,000 by the corporation's note personally guaranteed by the stockholders. Subsequently the corporation's note was refinanced through the bank, and the personal guarantees were continued. The Commissioner took the position that payments on the corporation's notes represented dividends to the stockholder/guarantors. The district court would have none of it.

The opinions in both of these cases emphasized that there were substantial unreflected assets which would lend additional value to the capital stock of the corporation. This emphasis has caused concern that the courts were making a basic determination that the corporations were not thinly capitalized—a conclusion that would considerably dilute the standing of these cases as authority for the proposition that a guaranteed loan from an independent financial institution is safe from a thin capitalization attack.

#### EXTENSION OF THE TAINT: LOANS FROM NONSTOCKHOLDERS

Taking a step beyond the indirect stockholder loan, the Commissioner has attacked loans by nonstockholders where no personal liability of the stockholders of record is involved. Initially, these cases involved a family member or dominant employee serving as lender to the corporation, but the rule has now been extended to otherwise completely independent parties.

In *The Motel Co. v. Commissioner*,<sup>10</sup> the sole stockholder put up \$10,000 in cash and his father loaned the corporation \$100,000 for the purchase of the motel. The father's loan was a third mortgage, ten-year note which remained in continuous default as to principal payments. Although acknowledging that the father was not a stockholder of record, the Second Circuit affirmed the Tax Court's finding that the father's note represented a capital investment, emphasizing the close family relationship, the use of the money for the purchase of the corporation's principal income-producing asset, the 25-to-1 debt to equity ratio, and the unlikelihood of an outsider lending \$100,000 to the corporation at that time on a third mortgage. The court concluded that the father's advance was "a contribution to risk capital, not merely a risky-loan."<sup>11</sup>

The Sixth Circuit reached a similar conclusion in *Foresun, Inc. v.*

---

10. 340 F.2d 445 (2d Cir. 1965).

11. *Id.* at 446.

*Commissioner*.<sup>12</sup> There the mother purported to sell to the children's corporations certain real estate for \$25,000 in cash and a note for \$200,000 secured by a second mortgage. Again, no principal payments were made on this note. The court affirmed the Tax Court's conclusion that the mother was really "a preferred stockholder, not a creditor."<sup>13</sup>

Departing from the close family relation category is the case of *Merlo Builders, Inc.*<sup>14</sup> There a substantial loan was obtained from the stockholders' attorney and the attorney's business partner. The attorney was found to have given the stockholder advice concerning corporate matters, but he was not an officer or director of the corporation; further, his business partner did not directly participate in any of the transactions involved. The attorney did not at any time have a right or option to buy stock, nor was there any understanding between the stockholders and the attorney that the attorney would ever have a stock interest in any of the companies. Nevertheless, the Tax Court felt that the "substance" of the transactions made both the attorney and his business partner stockholders in the corporation.

Treating nonstockholders as stockholders,<sup>15</sup> however, can be tricky business. Imagine counsel's concern when he learns that his corporate client suddenly has an issue of preferred stock, the limitations and preferences of which are not set forth in the corporation's charter as required by law; or else he has additional shares of common stock which have received, without authorization by the corporation's board of directors, dividends on a non pro-rata basis and perhaps impairing the corporation's capital and resulting in personal liability for the directors. Hopefully, individual stockholders would not be encouraged to adopt the Commissioner's findings and attempt to readjust the situation for corporate law purposes, too. If such were the case, conceivably corporate authority for actions authorized by directors elected with notice only to the shareholders of record would have to be ratified or sustained on a de facto basis.

#### HARMFUL SIDE EFFECTS: THE NATURE OF RECLASSIFIED DEBT

Assuming stockholder (or nonstockholder) loans (or guaranteed

---

12. 348 F.2d 1006 (6th Cir. 1965).

13. *Id.* at 1008.

14. 23 CCH TAX CT. MEM. 185 (1964).

15. To the same effect are *Burr Oaks Corp.*, 43 T.C. 635 (1965), where brothers and wives were involved, and *Old Dominion Plywood Corp.*, 25 CCH TAX CT. MEM. 678 (1966), where a sister corporation was the lender.

loans) are disqualified as debt, what are they? Do we disregard the written instrument requiring payment of a sum certain at a fixed and determinable time and place and deem the note a mere contribution to capital; or do we call it a preferred stock, a second class of participating stock, or something else?

Congress expressly declined to attempt any definition of the term "stock" when enacting the Internal Revenue Code of 1954.<sup>16</sup> Reclassified debt has heretofore been described loosely in the decisions, perhaps most often as a contribution to capital on the theory that an instrument deemed not valid as what it purports to be should not be deemed valid for any purpose.<sup>17</sup> But new pressures are now being exerted here, and it is almost impossible to deny the status of nonstockholder debt as a second class of stock when reclassified as an equity investment.

### 1. *Subchapter S Qualification*

In the Small Business Tax Revision Act of 1958, Congress defined "equity capital," for purposes of the special treatment of losses on small business stock, to include all stockholder debt.<sup>18</sup> Subsequently, the Treasury Department issued its regulations concerning the stock classification of electing small business corporations (Subchapter S), stating that, if an instrument purporting to be debt was actually stock, it would constitute a second class of stock and disqualify a Subchapter S election.<sup>19</sup> Even though it was apparent that Congress had not intended to eliminate all stockholder debt in Subchapter S corporations,<sup>20</sup> tax practitioners became very leary of the prospects.

In the first test of the Treasury's regulation, the Tax Court<sup>21</sup> and a district court<sup>22</sup> acknowledged, if not accepted, the second class of stock

---

16. See S. Rep. No. 1622, 83d Cong., 2d Sess. 42 (1954). See generally, *Carlberg v. United States*, 281 F.2d 507 (8th Cir. 1960).

17. See, e.g., *Gilbert v. Commissioner*, 248 F.2d 399, 409 (2d Cir. 1957) (concurring opinion), *cert. denied*, 359 U.S. 1002 (1959). But see *Pocatello Coca-Cola Bottling Co. v. United States*, 139 F. Supp. 912, 916 (E.D. Idaho 1956) (deemed a preferred stock).

18. INT. REV. CODE OF 1954 § 1244(c) (2).

19. Regs. § 1.1371-1(g) (1966).

20. See INT. REV. CODE OF 1954 § 1376(b) (2) which expressly refers to stockholder indebtedness in establishing rules for basis adjustments for net operating losses. The Tax Court will not allow a stockholder to increase his basis here for any corporate debts which he has merely guaranteed. *William H. Perry*, 47 T.C. 159 (1966).

21. *Catalina Homes, Inc.*, 23 CCH TAX CT. MEM. 1361 (1964).

22. *Henderson v. United States*, 245 F. Supp. 782 (D. Ala. 1965).

interpretation. Where the issue was brought more clearly into focus in the Tax Court, however, it was conceded that pro-rata stockholder debt did not constitute a second class of stock but merely an additional contribution to capital by the stockholders.<sup>23</sup>

The Treasury Department has now conceded the issue in *W. C. Gamman*<sup>24</sup> by amending its regulations to provide that, "if such purported debt obligations are owned solely by the owners of the nominal stock of the corporation in substantially the same proportion as they own such nominal stock, such purported debt obligations will be treated as contributions to capital rather than a second class of stock."<sup>25</sup> The new regulation, however, makes it quite explicit that the Commissioner will make a "new determination" if a non pro-rata transaction involving the purported obligation results in a change in the stockholders' percentage of stock or purported debt. The Commissioner has already made two such attempts, both of which failed.<sup>26</sup>

Actually, there seems to be very little reason to apply thin capitalization concepts to a Subchapter S corporation since the design of the Subchapter S election specifically eliminates the double tax which the interest deduction and tax-free recovery of investment seek to avoid. As for corporations only lately electing Subchapter S treatment, the present statutory treatment on withdrawals of pre-Subchapter S accumulated earnings and profits should be protection enough without disqualifying the current election.

## 2. *Problems of Control*

Taking a cue from the Subchapter S cases reviewed above, it is not hard to project new areas which will add another dimension to the harmful thin capitalization side effects. Throughout the Internal Revenue Code, there are numerous tax consequences which attach to taxpayers or events which stand in certain control relationships.

In some of these areas, the taxpayer may find himself urging that stockholder debt is in fact an equity investment and should be treated

---

23. *W. C. Gamman*, 46 T.C. 1 (1966) (en banc).

24. *Id.*

25. Regs. § 1.1371-1(g) (1966).

26. In *Lewis Bldg. and Supplies, Inc.*, 25 CCH TAX CT. MEM. 844 (1966) there was only a slight disproportion of debt, but in *August F. Nielsen Co.*, 27 CCH TAX CT. MEM. 44 (1968), the notes at the time of the Subchapter S election had been curtailed unequally so that one stockholder held \$5,000 in unpaid principal to the other's \$10,000.



as stock.<sup>27</sup> For example, in the personal holding company area, three individuals holding \$25,000 in stock have urged that a bank's note for \$625,000 be considered as stock, so that more than 50% in value of the outstanding stock of the corporation would be held by a nonindividual and the corporation could avoid personal holding company status.<sup>28</sup>

Generally, however, a reclassification of stockholder debt may serve to work against the taxpayer's best interest. This could be true in the personal holding company area, where the debt is held by certain of the individuals who would not otherwise be classified as owning, in the aggregate, over 50% in value of the corporation's stock. Here also, reclassified stockholder debt may jeopardize the percentages necessary to avoid treatment of copyright royalties, amounts received as compensation for the use of property by a shareholder, and amounts received under personal service contracts as personal holding company income.<sup>29</sup>

A number of Code sections depart from a percentage-of-stock value when determining a control relationship. These include:

§ 267, dealing with the disallowance of losses and certain unpaid expenses and interest as between a corporation and a person owning, or deemed to own, more than 50% in value of its outstanding stock;

§ 269, disallowing deductions or credits to a person acquiring at least 50% in value of the stock of a corporation for principally tax avoidance purposes;

§ 303, allowing a redemption to pay funeral and administrative expenses and death taxes, but, where more than two corporations are involved, denying such treatment if the other stockholders hold 25% or more of the aggregate value of the stock of either corporation;

§ 304, classifying a purchase of stock as a redemption through a related corporation upon a finding of at least 50% ownership in value of the stock of both corporations;

§ 318(a)(2)(C), providing a reattribution of stock ownership to or from a corporation based on a holding of 50% or more in value of its stock;

---

27. Such seemingly inconsistent positions have heretofore been urged by taxpayers in noncontrol situations, such as to avoid taxable gain in a § 351 transfer where the stockholder debt is in the form of notes rather than securities. In *Campbell v. Carter Foundation Production Co.*, 322 F.2d 827 (5th Cir. 1963), the taxpayer was allowed to classify certain installment notes as debt for interest payment purposes and as equity securities for carryover of basis for depreciation purposes.

28. *Washmont Corp. v. Hendricksen*, 137 F.2d 306 (9th Cir. 1943).

29. INT. REV. CODE OF 1954 § 543(a)(4), (6), (7).

§ 341(e)(1), applying stricter rules for exemption from collapsible corporation treatment to stockholders owning more than 5% or 20% in value of the corporation's stock;

§ 382(a)(1), denying a loss corporation the continued use of its net operating loss carryover after a change in its business and an increase of 50% in value of its stock ownership;

§ 1235, denying capital gains on the sale of a patent where the sale is made to a person owning 25% or more of the transferor's stock;

§ 1239, denying capital gains on a sale of depreciable property by a stockholder to his corporation if he is deemed to own more than 80% in value of its outstanding stock; and

§ 1551, causing a disallowance of the corporate surtax exemption and accumulated earnings credit where there is an 80% in value control relationship.

Of the foregoing sections, the disallowance of the use of a net operating loss carryover under § 382(a)(1) would seem to be an area particularly vulnerable to attack. In the typical § 382(a) situation, the new owners almost certainly can be expected to place additional debt in the loss corporation's capital structure. It would be indeed anomalous if the thin capitalization doctrine were to be applied to deny a net operating loss carryover even in the context of a legitimate rehabilitation program consistent with the intent of Congress to encourage, by means of such a deduction, further attempts to salvage a losing business.

### 3. *A Separate Class of Stock*

Also in this unexplored area fall many of the basic corporate transactions which rely upon a § 368(c) approach to the definition of control, requiring ownership of 80% of each class of stock. If the second class of stock theory prevails, as originally promulgated under the Subchapter S regulations and at least to some extent reserved in the *Gamman* case, a number of basic evolutions will be jeopardized:

Under § 165(g)(3), a corporation will be denied ordinary loss treatment for worthless securities in an affiliated corporation if it is not deemed to own directly at least 95% of each class of its stock.

Under § 351, even though an initial incorporation can aggregate all the transferors as a group for control purposes, a subsequent transfer to the corporation by a purported 80% stockholder (or stockholder group) may not qualify for tax-free treatment unless he (or they) also hold

80% of the stockholder (or nonstockholder) debt to be reclassified as a second class of stock.

Under the spin-off rules of § 355, no tax-free distribution of stock in a subsidiary will be allowed unless the parent corporation also can be deemed to own 80% of the thin debt if deemed a second class of stock.

Under a B reorganization,<sup>30</sup> the acquiring corporation must obtain not only 80% of the acknowledged classes of stock but also 80% of any reclassified stockholder (or nonstockholder) debt, or the entire reorganization will fail.

#### 4. *A Preferred or Common Stock*

Finally, there are areas in which the classification of thin debt as a second class of stock must be refined further in order to determine whether such stock is a preferred or common stock.<sup>31</sup> Such instances include:

Disqualification of a substantially disproportionate redemption under § 302(b)(2), resulting from a failure to meet the 80% test, if the stockholder debt is deemed to be a separate class of common stock, but not if it is deemed to be some other class;

Treatment of the redemption of the stockholder debt under § 306 unless it is deemed to be a class of common stock;

Disqualification of a complete liquidation under § 332 if the parent corporation does not own at least 80% of each class of stock except nonvoting stock which is limited and preferred as to dividends;

Disqualification of a step-up in basis under § 334(b)(2) if the acquiring corporation does not own at least 80% of each class of stock except nonvoting stock which is limited and preferred as to dividends;

Disqualification under the affiliation test of § 1504(a) for filing consolidated returns (also applicable to the dividends received deduction under § 243) unless the reclassified stockholder debt is deemed to be a class of stock which is nonvoting and limited and preferred as to dividends.

---

30. To a lesser extent such a thin classification can jeopardize an A or C reorganization involving a transfer of assets to a subsidiary if the control required by § 368(a)(2)(C) is not met.

31. Under the liquidation sections, if the Commissioner can transpose his theory to State corporate law, the plan of liquidation has not been adopted if the reclassified debt has not been given notice and an opportunity to vote as a separate class.

## HARMFUL SIDE EFFECTS: COMPLETE TERMINATIONS

The Commissioner's "domino theory" can apply in other areas, so that the corporation's loss of the interest deduction or dividend taxation on a recovered investment are not the only risks to be run.

One of the dominoes that may fall with the classification of an instrument as equity rather than debt is an otherwise timely liquidation under § 337. Under that section, the tax-free sale by the corporation of assets pursuant to a plan of complete liquidation is conditioned upon the distribution of all the assets of the corporation within twelve months after the adoption of the plan, although the corporation may retain sufficient assets to meet contingent liabilities and the claims of its creditors. The regulations here are explicit: "no amount may be set aside to meet claims of shareholders with respect to their stock."<sup>32</sup> Finding stockholder debt to be in fact equity capital, the Tax Court has disqualified a § 337 liquidation when assets were retained beyond the twelve-month period to satisfy the purported debt.<sup>33</sup> The increasing prevalence of findings of thin debt in the hands of nonstockholders in such cases should cause even greater concern.

A similar result will follow in other cases where tax results flow from the completion of a plan of final liquidation.<sup>34</sup> More significantly, a stock redemption attempting to qualify under § 302(b)(3) as a complete termination of interest could similarly be disqualified.

## CONCLUSION

Other areas may also bear the brunt of the unfortunate results which accrue from a reclassification of stockholder debt to equity. The foregoing should be enough, however, to concern any tax practitioner, and to cause him to look above the net worth section and scan the entire right hand side of the corporate balance sheet.

The courts in recent times have shown a remarkable tendency in this area to disregard most of the basic concepts of corporate law governing the issuance of stock. Little comfort can be taken today in the hope that the Commissioner will not be able to persuade the courts at some further point, based on a set of facts carefully chosen for such purpose, to extend the dimensions of the thin capitalization doctrine into all of these areas.

---

32. Regs. § 1.337-2(b).

33. *John Town, Inc.*, 46 T.C. 107 (1966), *aff'd* — F.2d — (7th Cir. 1967).

34. *E.g.*, INT. REV. CODE OF 1954 §§ 332, 333.