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USING A "DUMMY" CORPORATE BORROWER
CREATES USURY AND TAX DIFFICULTIES

by Glenn A. Portman

Since the late 1960's the American economy has experienced a tight money market during which the pressures exerted by inflation have steadily increased the interest rate. Many businessmen have found that in this tight money market state usury laws¹ which set low ceilings upon the maximum interest rate which lenders may legally charge individual borrowers have the effect of preventing them from financing their ventures. The businessman operating in a non-corporate form is thus confronted with a dilemma whenever a tight money market dictates that lenders will not make commercial loans to individuals. For corporate borrowers Texas² and many other states³ have statutes which deny the defense of usury to corporations. If the businessman forms a corporation to utilize such a corporate exception statute, the corporation will probably be able to attract a willing lender due to the higher interest rate which may legally be charged. But a prevailing question has been whether the courts will sanction a lender's requiring a borrower to incorporate as a condition for a commercial loan.

Businessmen who have chosen to operate their commercial enterprises in non-corporate forms have frequently operated as partnerships or sole proprietorships because of the tax treatment available to such entities. This has been especially true of real estate ventures. If a corporation is interposed between businessmen and their business operations the corporation will be recognized as a taxable entity, with the consequence that the conduit tax treatment available to partnerships will be denied the incorporated businessman. The device of a corporate agent being employed to serve both the purpose of borrowing money and retaining the advantages of conduit tax treatment has thus evolved.⁴ However, requirements and vague standards

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¹ See, e.g., 19C FLA. STAT. ANN. § 687.02 (1966) (maximum permissible rate of 10%); 5 MD. ANN. CODE art. 49, § 3 (Supp. 1973) (maximum permissible rate under written contract of 8%); N.J. REV. STAT. § 31:1-1 (Supp. 1973) (maximum rate varies between 6% and 8% as set by regulation of the commissioner of banking); N.Y. GEN. OBLIG. LAW § 5-501 (McKinney Supp. 1973) (maximum rate of 6% unless otherwise prescribed by the banking board); TEX. REV. CIV. STAT. ANN. art. 5069-1.02 (1971) (maximum rate of 10%).

² See TEX. REV. CIV. STAT. ANN. art. 1302-2.09 (Supp. 1974). This statute by its terms denies corporations, their successors, guarantors, and assigns the defense of usury for loans exceeding a principal amount of $5,000. However, a maximum rate of 1½% per month or 18% per year is imposed so that corporations can assert the usury defense if they are charged interest which exceeds the maximum limit.

³ See, e.g., 19C FLA. STAT. ANN. § 687.02 (1966) (maximum interest rate of 15% imposed upon loans to corporations); GA. CODE ANN. § 57-118 (1971) (corporations organized for pecuniary gain may agree in writing to any interest rate for loans exceeding the principal amount of $2,500); 2B MD. ANN. CODE art. 23, § 125 (1973) (no maximum rate for corporations); N.J. REV. STAT. § 31:1-6 (1963) (no maximum rate imposed); N.Y. GEN. OBLIG. LAW § 5-521 (McKinney 1964); WASH. REV. CODE A. § 19.52.080 (Supp. 1972) (loans over $100,000).

promulgated by the courts have left the feasibility of such an agency conceptual approach open to question. The scope of this Comment is to discuss the interpretation of state statutes which deny the defense of usury to corporations, and to compare the approaches taken by state courts to solve the problems created by lenders or borrowers who deliberately rely upon the exception statute to avoid general usury restrictions on interest for loans to individuals. Also discussed are the tax problems created by the formation of a corporation to satisfy state laws exempting corporations from the usury laws.

I. A SHORT REVIEW OF USURY

From early time, attempts have been made to regulate charges for the use of money through controlled interest rates.5 The antagonism of the Judao-Christian heritage to the exaction of usury, the taking of too great a charge for the use of money, is founded in Biblical tradition, a tradition carried into the Middle Ages, when religious considerations were given great weight and Biblical prohibitions against usury taken literally.6 This attitude of medieval men towards charges for the use of money did not, however, long survive the rise of the modern commercial and industrial nations. As the industrial state evolved, enterprising men, motivated by the pursuit of profits and a higher standard of living, found the use of interest and credit powerful economic tools in the development of a stable economy. Perhaps unfortunately, the American colonies adopted the English pattern and enacted usury statutes regulating interest rates at a time prior to the widespread commercial use of interest and credit in the major financial markets.7 European nations,8 commencing with England9 in 1854, departed from the historical pattern and repealed their general usury laws, so that for over a century European nations have proceeded upon the theory that money and interest rates are subject to market fluctuations caused by the economic laws of supply and demand within the money markets.10 The retention of usury

5. See Benfield, Money, Mortgages, and Migraine—The Usury Headache, 19 CASE W. RES. L. REV. 819, 822-23 (1968). Professor Benfield points out that the use of credit transactions probably commenced about the time of the first loan and that as a consequence primitive societies attempted to regulate the amount of interest charged to borrowers by imposing a maximum ceiling on the interest rate. Both the Code of Hammurabi and Roman law imposed legal restrictions upon the interest rate, although there is considerable evidence that the legal restrictions were frequently violated. Id.


7. Id. at 51-53.


9. Usury Law Repeal Act, 17 & 18 Vict., c. 90 (1854). See also Merriman & Hanks, supra note 8, at 17, where the authors explained that the present English system for controlling the taking of excess interest is to empower equity courts by the Money-lenders Act of 1900, 63 & 64 Vict., c. 51 § 1(1), to set aside interest charges which are unconscionable.

10. Professor Benfield has denominated four factors which determine the market rate of interest for a loan. The four factors are: (1) the cost of money as reflected by the prime interest rate, (2) the cost to the lender of administering the loan, (3) the risk assumed by the lender because of the possibility that the borrower may default, and (4) the competition to the lender in the marketplace. See Benfield, supra note 5, at 826-30.
laws in the United States has been cogently criticized as ignoring the realities of a functioning money market.\textsuperscript{11} The primary reason for the retention of usury laws in America seems to be the favorable attitude which persons unfamiliar with the financial markets exhibit towards the concept of usury penalties. This attitude is attributable to the fact that the usury laws are commonly associated with the protection of the small consumer-borrower.\textsuperscript{12}

\textit{Coverage and Elements of Modern Usury Statutes.} The impression that the usury laws protect consumer-borrowers is in large part illusory. It has been estimated that less than half of the borrowing in the United States falls within the coverage of the usury laws due to statutory exceptions which permit loans at higher interest rates for specified purposes.\textsuperscript{13} The exceptions from the general usury laws which permit the charging of a higher rate of interest include small consumer loans, time-price sales, installment loans, and industrial loans, most of which directly affect the consumer rather than the commercial borrower.\textsuperscript{14} In fact, the exceptions to the general usury law have so eroded the sanction of usury that only home mortgages and some commercial lending remain within the ambit of the usury statutes.\textsuperscript{15}

Traditionally the offense of usury has been defined as consisting of the following elements: (1) an agreement to lend money or money's worth, (2) the borrower's obligation to repay absolutely and not contingently, (3) the taking of a larger compensation for the loan than is permitted by the usury statutes, and (4) an intention to take usury.\textsuperscript{16} The modern usury statutes embodying these elements seem to have either one of two goals. Either the usury statute attempts to fix the price of money by dictating a very low interest ceiling, six percent being the least, or else the statute is designed to set a maximum limit for conscionable loans.\textsuperscript{17}

\textbf{II. THE CORPORATE EXCEPTION TO THE USURY LAWS}

The corporate exception to the usury law has evolved from the policy judgments of many legislatures that corporations should not be entitled to plead the defense of usury. The first enactment denying the defense of usury to a corporation, specifically the Bank of England, was passed by Parliament in 1716.\textsuperscript{18} The American experience with statutes denying the de-

\textsuperscript{11} \textit{Id.} at 820. Benfield argues that state governments do not attempt to fix the price of goods and by analogy there is no reason to regulate the money market by fixing the price of credit through the device of controlling the interest rate; such regulation is said to ignore the economic functioning of the money market, which is analogous to the functioning of the commodity markets.

\textsuperscript{12} \textit{Id.} at 821. Although Professor Benfield favors the repeal of state usury laws in the commercial lending situation, he would substitute legislation for the specific protection of consumer and small business borrowers in the form of the Uniform Consumer Credit Code. \textit{Id.} at 820-21.

\textsuperscript{13} \textit{Id.} at 820-22.


\textsuperscript{15} \textit{See Benfield, supra} note 5, at 840-43, 852-58.


\textsuperscript{17} \textit{See Benfield, supra} note 5, at 831-33.

\textsuperscript{18} The Statute of 3 Geo. 1, c. 8, § 39 (1716). \textit{See also Comment, supra} note 6, at 54.
fense of usury to corporations commenced in 1850 with a New York statute. The passage of this New York statute was the direct result of the decision in *Dry Dock Bank v. American Life Insurance & Trust Co.* in which the judicial enforcement of the usury law enabled a New York banking corporation to avoid $250,000 of its obligations. The commercial and business community convinced the Legislature of New York to respond in that same year with a statute denying the defense of usury to corporations.

The rationale for denying the defense of usury to corporations is that, unlike the situation between lender and the consumer oriented "necessitous" borrower whose borrowing is motivated by the need for life's essentials, the corporation may negotiate loans from the standpoint of an equal to the lender and, therefore, does not need the special protection of usury laws. The fact that corporate borrowing is for corporate purposes and that the risk of loss is distributed among stockholders protected by limited liability may also partly explain the rationale for the corporate exception statutes; loss occasioned by the payment of usurious interest would not have the direct effect on a stockholder that it would have upon an individual borrower.

Also, there is an understandable impression that economic growth is encouraged by permitting corporations freer access to financing, since lenders will be more willing to risk their money with the incentive of a higher rate of return.

Judicial interpretation of the corporate exception statutes has tended to be liberal, the corporate exception being viewed as a return to the situation at common law where there was no usury offense. The corporate exception statutes have been broadly applied not only to deny corporations the usury defense but also to prevent affirmative or equitable actions by corporations against lenders based upon allegations of usury.

A more crucial question is whether the corporate exception statute repeals the usury law as to corporations or merely denies them the usury defense. The consequence of interpreting the statute as repealing the usury law as to corporations is to deny the defense of usury to persons collaterally liable on corporate obligations. Although early cases interpreted the statute as merely removing the defense of usury from the corporation and permitting collateral-liable persons to assert the usury defense, subsequent cases have broadened the application of the exception statute to prevent affirmative or equitable actions by corporations against lenders based upon allegations of usury.

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20. 3 N.Y. 344 (Ct. App. 1850). In the *Dry Dock Bank* decision a banking corporation was permitted to assert the usury defense against a lending institution which had financed the bank enabling it to reopen after being placed in receivership.
22. See Sparkman & McLean Co. v. Govan Inv. Trust, 78 Wash. 2d 584, 478 P.2d 232 (1971). The Supreme Court of Washington noted that the legislature in enacting an exception statute to the usury laws could be justified in concluding that corporations do not need the protection of the usury laws.
23. See Carozza v. Federal Fin. & Credit Co., 149 Md. 223, 131 A. 332 (1925). This reasoning, that corporate stockholders are protected by limited liability, does not always hold true because lenders often require a personal guarantee or surety on the loan. Such guarantors are secondarily liable on the corporation's obligations and, by the majority rule, are also denied the usury defense along with the corporation.
ally liable persons to assert the usury defense, it is presently universally accepted that all persons collaterally liable on corporate obligations are included within the coverage of the corporate exception statutes. As a result, the defense of usury is denied to individual guarantors, sureties, trustees in bankruptcy, junior mortgagees, and the indorsers of corporate obligations.

**Potential Usury Abuses Through Corporate Exception Statutes.** In situations where astute businessmen incorporate and subsequently approach a lending institution there is no conflict between usury laws and the corporate exception statutes. The parties to such a loan may agree upon an interest rate which is greater than that permissible for loans to individuals. Such a transaction falls squarely within the letter and purposes of the corporate exception statutes. However, during a tight money market when interest rates are rising, the situation becomes more complicated when an individual approaches a lender and agrees upon the formation of a corporation to circumvent the usury law by means of the corporate exception statute. In such situations as when the individual who incorporated resists collection or foreclosure, the courts must decide whether the loan was illegally made to an individual borrower with a corporation merely interposed as a disguise, or whether the loan was legally made to a corporation.

In several early cases the New York courts demonstrated a willingness to pierce the corporate veil and find that the loan was in reality made to an individual borrower. But the great depression, starting with the 1929 crash in the stock market, marked a change in the attitude of the New York courts. During the depression, when the great concern was supporting businesses, courts, as part of that effort, encouraged lenders to risk their funds upon business ventures. One result was that the New York courts became highly reluctant to pierce the corporate veil when a loan was made to a corporation. The leading case in New York from the depression era is Jenkins v. Moyse, in which the New York Court of Appeals held that so long

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25. See, e.g., Market Bank v. Smith, 16 F. Cas. 757 (No. 9090) (D. Wis. 1858) (accommodation indorsers not barred by exception statute from asserting usury defense).


27. See, e.g., Anam Realty Corp. v. Delancey Garage, Inc., 190 App. Div. 745, 180 N.Y.S. 297 (1923); First Nat'l Bank v. American Near East & Black Sea Line, Inc., 119 Misc. 650, 197 N.Y.S. 856 (Sup. Ct. 1922); Arona Holding Corp. v. West Twenty-Fifth St. Realty Corp., 198 N.Y.S. 660 (City Ct. 1922). These cases examined the use of the corporate exception statute from the standpoint of a question of fact as to whether a loan had been made to an individual or to a corporation.

28. 254 N.Y. 319, 172 N.E. 521 (1930). In Jenkins an individual borrower approached a lender for a loan and was refused, the lender stating that loans were only available to corporations. Thus, the lender in Jenkins avoided the usury problem by refusing a loan to an individual. This is, however, a mere formal distinction because
as the lender did not make the loan to an individual, the lender could suggest that a corporation be formed to borrow the needed funds. In speaking to the issue of whether allowing the borrower and lender deliberately to utilize the corporate exception statute was circumventing the law, the court stated that "[t]he [usury] law has not been evaded but has been followed meticulously in order to accomplish a result which all parties desired and which the law does not forbid." Thus, the framework in New York for the use of the corporate exception has evolved to permit the parties to deal with each other in such a manner as to circumvent the effects of the usury laws through the intentional use of the corporate exception statute. Later New York cases have solidified the concept that a corporation may be deliberately formed for the sole purpose of avoiding the usury laws.

While the corporate exception is premised upon an arm's-length bargain resulting from a negotiated loan between lender and corporation, not all borrowers who seek the advantage of the corporate exception are businessmen, nor are they necessarily familiar with credit transactions. The Legislature of New York found it necessary to amend its corporate exception statute in 1956 to reinstate the usury defense for corporations whose sole asset was a one- or two-family dwelling upon which a mortgage had been executed within six months of the corporation's organization. The amendment was deemed necessary since a number of lenders were requiring home owners to incorporate in order to obtain home mortgage loans, thereby enabling the lenders to exact high interest charges on the loan. The fact that the legislature found it necessary to amend the statute in New York further indicates that the New York courts were permitting the parties to a loan deliberately

the lender need only refuse to loan money to the individual applicant and then suggest incorporation so that the lender may loan to a corporation.

29. 172 N.E. at 522.

The New York rule that the lender may suggest incorporation to the borrower has been adopted in Maryland upon the basis of an estoppel theory which prevents the incorporating borrower from ignoring his own corporation. See Rabinowich v. Eleisberg, 159 Md. 655, 152 A. 437 (1930).

31. See Comment, Incorporation To Avoid the Usury Laws, 68 COLUM. L. REV. 1390, 1391 (1968). This Comment noted that it is relatively simple for anyone to incorporate and that persons other than experienced businessmen may seek the advantages of the exception statute. However, this article hypothesized that requiring borrowers to incorporate for the benefit of the lender may be a feasible commercial practice.

32. See N.Y. GEN. OBLIG. LAW § 5-521(2) (McKinney 1964).
33. See Note, The Corporate Device as a Cover for Usury—Amendment to New York General Business Law Section 374—Corporations Prohibited from Interposing the Defense of Usury, 24 FORDHAM L. REV. 715 (1956). This Note concluded that the amendment did not offer sufficient protection to borrowers for the reason that its scope was too narrow. Id. at 721.

The problem which this amendment attempted to correct still exists, for at least one lender has circumvented the amendment with the probable cooperation of his borrower by the mechanism of having the borrower personally guarantee the loan to the shell corporation and secure the guarantee by a mortgage instead of transferring the borrower's home to the corporation. See Brint v. Ellin Express Co., 51 Misc. 2d 796, 273 N.Y.S.2d 860 (Sup. Ct. 1966), aff'd, 28 App. Div. 2d 825, 282 N.Y.S.2d 450 (1967).
to circumvent the general usury laws through the corporate exception statute.

In New York, where the courts have followed the doctrine of *Jenkins* by sanctioning the deliberate use of the corporate exception to avoid the effect of the general usury law, one commentator has noted a trend in recent decisions towards limiting the availability of the corporate exception statute to those situations where there is a business purpose for the loan.34 Certainly when a business purpose for the borrower's seeking a loan is clear, there are strong reasons for applying the corporate exception statute. A business purpose in this context distinguishes between loans sought for use in commercial enterprises as compared with those sought for individual or personal uses. The existence of a clear business purpose for seeking a loan seems to be strong evidence in the lender's favor that the loan was actually made to the corporation. The manner in which a lender agrees to make a loan remains of primary importance when the courts seek to determine whether or not to pierce the corporate veil to find a loan to an individual; so long as the lender refused to make a loan to an individual the corporate exception statute will be applied, and the fact that a valid business purpose exists for the loan seems to be merely additional evidence favoring the lender and not an absolute requirement of the New York courts.35

The Question-of-Fact Jurisdictions. The courts of other states have taken a less formalistic view and have attempted to determine whether a loan was actually made to an individual or to a corporation. The New Jersey courts opened the door to ignoring the corporate entity in *Gelber v. Kugel's Tavern, Inc.*,36 a case which illustrates potential abuses which can occur if a lender forces a commercially inexperienced individual to incorporate. In *Gelber* a lender agreed to make a loan to an individual provided that he incorporate, which the borrower subsequently did. Upon the corporation's default on the note the court permitted the individual to whom the loan had been made in fact to assert the usury defense, holding that it was a question of fact, to be determined by the jury, whether or not the loan was actually made to the corporation, or to the individual with the corporation merely interposed as a device to conceal usury.37 The difficulty with the approach adopted in *Gelber* is that the result is difficult to predict.38 Therefore, in such a situation where after-the-fact testimony will be determinative of the

34. See Comment, supra note 31, at 1393.
36. 10 N.J. 191, 89 A.2d 654 (1952). In *Gelber* a father wishing to give his son a business stake in his brother's tavern borrowed a total of $29,000 to purchase the interest and to refinance the original loan three times. Shockingly, of the $29,000 borrowed by the father the lender exacted $7,200 as a bonus for making the loan.
37. 89 A.2d at 656.
38. The lender in *Gelber* testified that he told the father that no loans would be made to individuals, but, that in response to the father's inquiry whether loans were available to corporations he gave an affirmative answer. The borrower's testimony, on the other hand, was to the effect that the lender offered him a loan only if he incorporated, and this was the view which the jury adopted. *Id.* at 657.
issue, lenders must act with caution. While requiring lenders to proceed with care may be good public policy, if the effect of such a view of the corporate exception is to stagnate the available supply of money for corporate loans, especially those for new start-up ventures, then the economic consequences could be harmful.

New Jersey has continued to conceive the issue as one of fact, the question being whether the loan was made to an individual or to a corporation, so that in appropriate cases the court may ignore the corporate entity when it appears that the lender has over-reached his borrower. In cases in which the lender has been informed of the non-business reasons for the loan, the corporate veil has been pierced and the incorporating borrower permitted to defend on the ground of usury, the corporate exception statute being held inapplicable. But where there is a finding that the lender refused a loan to an individual and the individual subsequently created a corporation, that corporation has been denied the defense of usury, the corporate exception statute being held to apply. This would seem proper, otherwise an impossible burden of proof would be placed upon lenders to determine the motivation underlying the incorporation. So long as the applicant for a loan is a presently existing corporation, the lender should be permitted to make that corporation a loan without fear that someone may later challenge the corporation's identity on the ground that its incorporators intended to evade the usury law.

The New Jersey courts have not been hostile to a straight-forward use of the corporate exception to avoid limitations on interest. Monmouth Capital Corp. v. Holmdel Village Shops, Inc. demonstrates that the New Jersey courts will apply the exception statute when an experienced borrower deliberately uses the statute to obtain a loan. In that case a contractor with substantial experience needed funds to complete a small shopping center. Unable to obtain a loan as an individual, he consulted his attorney and a real estate specialist. Subsequently, his attorney formed a corporation for him which successfully obtained a loan at a higher interest rate. Upon de-

39. See In re Greenberg, 21 N.J. 213, 121 A.2d 520 (1956). This case demonstrates the attitude of the courts when there is a clear case of overreaching by a lender. Greenberg was a disciplinary proceeding in which the Supreme Court of New Jersey suspended an attorney for a year because while the attorney was forming a "dummy" corporation to comply with the corporate exception statute he was involved in a conflict of interests. The lawyer, employed by the lender, not only gave the borrower, an aged and inexperienced woman, the impression that he was working for her benefit but he also failed to advise her to seek independent legal advice about the proposed incorporation. The New Jersey Supreme Court took a very dim view of this attorney's role in failing to inform the borrower that the reason behind incorporation was to take advantage of the corporate exception statute in order to avoid the usury laws for the lender's benefit.

40. See Lesser v. Strubbe, 56 N.J. Super. 274, 152 A.2d 409 (1959), rev'd on other grounds, 67 N.J. Super. 537, 171 A.2d 114 (App. Div. 1961), aff'd per curiam, 39 N.J. 90, 187 A.2d 705 (1963). The rule which seems to emerge in the question of fact jurisdictions is that lenders should know, or pretend to know, as little as possible about the borrower's motive for seeking a loan. Lenders in such states will probably only agree to make loans to corporations formed prior to their request for financing.


fault and foreclosure, the contractor sought to assert the usury defense, urging that his corporation be ignored as a mere device to avoid the usury law. The court rejected the usury defense by applying the corporate exception statute, emphasizing the business purpose for the loan and the fact that the borrower was advised by counsel, which fact negated the possibility of overreaching by the lender. The court also considered the fact that the corporation had functioned as an entity by paying real estate taxes, entering into leases, and adopting proper corporate resolutions.43

The Florida courts likewise have approached the issue of incorporation to avoid the usury law as a question of fact. Where the lender has agreed to make a loan to an individual upon the condition that he incorporate, the courts have pierced the corporate veil and permitted the individual borrower to assert the usury defense.44 But if the loan was in fact made to a corporation, the corporate exception statute is applied even though the borrower created the corporation for the purpose of avoiding the usury law.45 So also, where the corporation has been in existence for several years prior to the loan the corporate exception has been applied.46

The leading case interpreting the Florida law is *Tel Service Co. v. General Capital Corp.*47 The trial court in that case found that the lender had required a partnership to incorporate before a loan would be made. The trial court held that the corporate veil should be pierced and the partnership permitted to assert the usury defense. The Florida Supreme Court, however, reversed on the ground that the mere fact that the lender required incorporation was insufficient to prove that the loan was in fact made to the partners as individuals, in light of the fact that the loan agreement was between businessmen in a business setting. The court emphasized the problem of proving that the loan was in fact made to the partners as individuals, and indicated that the standard of proof required in order to support such a finding would be strict.48 As a result of this decision it seems apparent that lenders in Florida will have a freer hand to suggest incorporation to businessmen for the purpose of commercial loans payable in Florida.

The Arizona courts recently considered, but regrettably confused, this area of the law. The opinion of the Arizona Court of Appeals in *Ganga-*

43. *Id.* at 36-37. This court expressed the fear that if the corporate exception statute was not applied then every corporate borrower starting a new business venture would attempt to pierce its corporate veil in an effort to assert the usury defense and avoid its obligations. *Id.* at 39.
44. *See* *Gilbert v. Doris R. Corp.*, 111 So. 2d 682 (Fla. App. 1959), *cert. denied*, 119 So. 2d 792 (Fla. 1960). This court criticized the incorporation device to avoid the usury law on the ground that the device may aggravate the problem of the necessitous borrower being taken advantage of by a lender. This court pointed out that although the usury law is aimed at preventing abuses by lenders against needy borrowers, the corporate exception statute in the instance of an inexperienced borrower not only compels him to incorporate to avoid the usury law but also adds the cost of incorporation which places him *pro tanto* further behind financially. *Id.* at 685.
45. *See* *Holland v. Gross*, 89 So. 2d 255 (Fla. 1956).
46. *See* *Rosenhouse v. Kimbrig*, 147 So. 2d 354 (Fla. App. 1962). The fact that the borrowing corporation had been in existence for some time prior to the loan is strong evidence in support of a lender's contention that a loan was intended by all parties to be made to the corporation.
47. 227 So. 2d 667 (Fla. 1969).
48. *Id.* at 668-70.
dean v. Flori Investment Co.\textsuperscript{49} clearly indicated that that court considered a corporation formed by an individual borrower for the purpose of taking a loan in the corporation's name to be formed for a valid reason, where a valid business purpose for seeking the loan existed. The individual in Gangadean had urged the court to ignore his corporation, formed merely two days prior to the loan, as a device to avoid the usury law, and hold that the loan was in fact made to him individually.\textsuperscript{50} The Arizona Court of Appeals nevertheless held that it was permissible for a borrower to incorporate when there existed a valid business purpose for incorporation, and that seeking a loan for business reasons was such a valid purpose.\textsuperscript{51}

The Arizona Supreme Court's opinion upon the appeal in Gangadean\textsuperscript{52} specifically stated, however, that since the issue of the corporation's being formed solely as a "dummy" to enable the lender to make a loan to an individual was not raised the court would express no opinion on that issue.\textsuperscript{53} This statement seems at odds with the Arizona Court of Appeals opinion, which indicates that the individual behind the corporate borrower was arguing that a loan had been made to him individually.\textsuperscript{54} The Supreme Court of Arizona proceeded to hold that the corporate exception statute should be applied in this case to deny the corporation the usury defense because the evidence supported the finding that the loan was to the corporation. The evidence which was found to be conclusive was that the loan documents were in the corporate name, that the borrower caused the lender to believe that the corporation was in existence prior to the loan, and that there was a clear business purpose for the corporation's borrowing.\textsuperscript{55}

\textit{A Trend Toward Expanding the Corporate Exception Statutes.} A few states in recent years have modified their corporate exception statutes in an attempt to alleviate some of the inherent problems of this area. The corporate exception statute in Georgia\textsuperscript{56} is particularly well worded to solve the potential problem of inexperienced borrowers incorporating to avoid the usury law. Georgia's statute provides a standard which applies the corporate exception statute only if the corporation is organized for pecuniary gain. Although there has been no case on point in Georgia interpreting the statutory pecuniary gain standard, in Reynolds v. Service Loan & Finance Co.\textsuperscript{57} an appellate court noted that in that case there was no issue of a subterfuge through incorporation to shield a loan to an individual.\textsuperscript{58} When the issue arises in a Georgia court the statutory language will provide a concrete

\begin{enumerate}
\item \textsuperscript{49} 11 Ariz. App. 512, 466 P.2d 63 (1970).
\item \textsuperscript{50} 466 P.2d at 65, 67.
\item \textsuperscript{51} Id. at 68.
\item \textsuperscript{52} 107 Ariz. 245, 474 P.2d 1006 (1970) (en banc).
\item \textsuperscript{53} 474 P.2d at 1007.
\item \textsuperscript{54} See note 50 supra, and accompanying text.
\item \textsuperscript{55} 474 P.2d at 1008.
\item \textsuperscript{56} See GA. CODE ANN. 57-118 (1971).
\item \textsuperscript{57} 116 Ga. App. 740, 158 S.E.2d 309 (1967). This case adopted the majority rule that the guarantor of a corporate note is within the coverage of the corporate exception statute and is denied the usury defense along with the corporation.
\item \textsuperscript{58} In this case the court stated that there was no possibility that the corporation was a device to shield a loan to an individual since the corporation involved had been actively conducting business for three years prior to the loan. 158 S.E.2d at 311.
\end{enumerate}
guideline by which to resolve the issue of whether the corporation was formed and the loan obtained with a corporate business purpose in mind. It would be most difficult to shield loans to individuals or for individuals to borrow for personal use if there were a requirement for a demonstrable business reason for the loan. However, such a standard if adopted could place a heavy burden upon lenders to demonstrate that legitimate business purposes exist for corporate loans.

Indiana amended its corporate exception statute in 1969 to include partnerships, limited partnerships, joint ventures, and trusts within the class of business enterprises which are denied the defense of usury. Almost immediately the Indiana courts were called upon to consider the availability for use by individuals of the amended exception statute. In *Havens v. Woodfill* a husband and wife, after consultation with a lender, executed a partnership agreement, a joint venture agreement, and a trust agreement. Each of these business entities borrowed one hundred dollars at an interest rate in excess of the permissible rate for loans to individuals. Shortly after the loans were made, declaratory judgment actions were commenced to have the loans declared usurious on the ground that the partnership, joint venture, and trust agreements were mere shams to enable individuals to obtain loans by avoiding the usury law. The lender argued that the parties should be permitted to structure their transactions in such a manner as to take advantage of the expended exception statute in a manner analogous to the *Jenkins* rule in New York. The Indiana Court of Appeals rejected the lender's argument and held that the loans were in fact made to individuals, and thus were usurious. The court was of the opinion that the partnership, joint venture, and trust agreements should not be used to circumvent the usury law, and emphatically refused to recognize the three agreements on the grounds that to do so would have effectively repealed the usury law. To the court the form in which the parties cast their transaction was not controlling; rather it looked to the substance of what they attempted to accomplish. The Indiana Legislature subsequently resolved the problem by repealing all usury laws in that state.

The State of Washington also recently amended its corporate exception law along similar lines, providing that the defense of usury is denied to corporations, Massachusetts trusts, associations, limited partnerships, persons...
engaged in the business of lending money, and persons developing and improving real estate if the amount of the loan exceeds one hundred thousand dollars.\(^6\) Although this statute has been interpreted only twice,\(^6\) it is significant that the Supreme Court of Washington considered one of the legislative reasons for the exception statute to be the fact that businesses, regardless of form, do not need the protection of the usury laws. With reference to real estate developers that court stated: "It is equally reasonable to assume that those engaged in the development and improvement of real estate, expecting high risks and high returns, should be familiar with financial operations and money's worth."\(^6\) Georgia has a statute\(^6\) similar to the Washington statute except that the Georgia statute is broader in that it permits any person, person being defined to include any individual or business entity, to agree in writing to pay any interest rate on loans exceeding one hundred thousand dollars.

It would seem that the trend of these statutes is to allow the businessman to seek financing at his own risk in the marketplace, regardless of the form in which he chooses to operate his business. State usury law restrictions are disadvantageous to businessmen seeking financing in a tight money market. But the states which have recognized this fact and enacted corporate exception statutes have not gone far enough; exceptions should be made for all businessmen, with the only qualification being that the loan be made for a valid business purpose.

III. WHICH INTERPRETATION FOR TEXAS

In Texas a long history of experimentation with usury provisions has culminated in the basis pattern of a constitutional provision and a series of regulatory statutes.\(^6\) The Texas Constitution dictates the broad rule that in the absence of legislation fixing maximum rates of interest all contracts for more than ten percent straight interest per year are usurious.\(^6\) The Texas Consumer Credit Code contains the traditional elements of usury, definition of interest, and retains the constitution's suggested ten percent limit as the


\(^{68}\) In 1869 the Texas Legislature repealed the usury laws and in the constitution of the same year the legislature was prohibited from enacting usury laws. The constitution enacted in 1876 provided for a usury ceiling of 12\% and this was lowered to the present level of 10\% by the constitution adopted in 1891. See Pearce & Williams, \textit{supra} note 16, at 235.


The legislature shall have authority to classify loans and lenders, license and regulate lenders, define interest and fix maximum rates of interest; provided, however, in the absence of legislation fixing maximum rates of interest all contracts for a greater rate of interest than ten per centum (10\%) per annum shall be deemed usurious; provided, further, that in contracts where no rate of interest is agreed upon, the rate shall not exceed six per centum (6\%) per annum.
maximum permissible legal interest rate for individual loans.\textsuperscript{70}

The Texas corporate exception statute\textsuperscript{71} is by its terms designed to deny the defense of usury for loans exceeding five thousand dollars to non-charitable and non-religious corporations when the interest rate does not exceed one and one-half percent per month, or eighteen percent per year. Recognizing that a potential abuse existed, the legislature prudently provided the eighteen percent per year limit above which a corporation would not be denied the usury defense. This statute makes the corporate form of enterprise an attractive option for lenders and borrowers when the interest rate approaches the maximum permissible interest rate of ten percent on loans to individuals. The corporation has in effect a higher interest ceiling which enables negotiation over a broader spectrum for commercial loans in a tight money market. Realistically, the corporate exception should be conceived in functional terms as a privilege for the corporate form of enterprise, that privilege being the ability to negotiate financing in a tight money market when others are unable to attract business loans.\textsuperscript{72} The higher interest rate paid by the corporation is a recognition of the risk factor which a lender assumes when a loan is consummated to finance a business venture. In the normal situation the corporation through its officers will have a complete understanding of the loan terms and long range cost, and most importantly, the corporation does not merely accept the loan, but rather it negotiates with lenders selected by the corporation with a knowledge of the reputation of the lender and the market conditions, so that the resultant loan is an arm's-length transaction. The business corporation also tends to view the loan as a means of long-term financing which is figured as a cost of doing business.

The Texas courts have not yet faced a situation in which it was necessary to interpret the Texas corporate exception statute\textsuperscript{73} in the context of its

\begin{itemize}
\item \textsuperscript{70} TEX. REV. CIV. STAT. ANN. art. 5069-1.02 (1971).
\item \textsuperscript{71} Id. art. 1302-2.09 (Supp. 1974):
\begin{quote}
Authority of certain corporations to borrow money
Notwithstanding any other provision of law, corporations, domestic or foreign, may agree to and stipulate for any rate of interest as such corporation may determine, not to exceed one and one-half percent (1½%) per month, on any bond, note, debt, contract or other obligation of such corporation under which the original principal amount is Five Thousand Dollars ($5,000) or more, or on any series of advances of money pursuant thereto if the aggregate of sums advanced or originally proposed to be advanced shall exceed Five Thousand Dollars ($5,000), or on any extension or renewal thereof, and in such instances, the claim or defense of usury by such corporation, its successors, guarantors, assigns or anyone on its behalf is prohibited; however, nothing contained herein shall prevent any charitable or religious corporation from asserting the claim or interposing the defense of usury in any action or proceeding.
\end{quote}
\item \textsuperscript{72} See Hershman, Usury and the Tight Mortgage Market, 22 Bus. Law. 333 (1967). Hershman suggested that the economic effect of a low interest ceiling, such as in the states having a 6% limit, is that lenders employ their funds in states having a higher ceiling, thus depleting the money supply for credit in the low ceiling states.
\item \textsuperscript{73} See Pearce & Williams, supra note 16, at 254, where they note that there is a question as to whether the Texas corporate exception will be interpreted as constitutionally permissible legislation fixing a maximum rate of interest. Although the constitutionality of the Texas corporate exception statute has been questioned so far, it would seem that the express wording of the constitution would permit the exception law in Texas. See also 759 Riverside Ave, Inc. v. Martin, 109 Fla. 473, 147 So. 848
availability for use by individuals to circumvent the general usury law. They have, however, given substance to the corporate exception statute by considering related issues on three occasions. On the first occasion a court of civil appeals merely determined that the corporate exception was not retroactive and applied only to loans made after the effective date. In the second case, Sud v. Morris, the Beaumont court of civil appeals implied that the corporate exception statute applied to loans made within Texas and denied the usury defense to Texas corporations. The court found it unnecessary to interpret the statute to reach its holding that when an individual and a corporation are co-obligors upon a usurious note the individual is not denied the defense of usury, even though the corporation is denied the defense by an exception statute. In Texas Tool Traders v. W.E. Grace Manufacturing Co., the third reported case involving article 1302-2.09, the Texas corporate exception statute, the Dallas court of civil appeals held that the usury penalties of article 5069-1.06 should be applied to a violation of the terms of article 1302-2.09 whenever the effective rate of interest exceeded the eighteen percent per year maximum permissible interest charge to a corporation. According to the Dallas court of civil appeals article 5069-1.02 legislates an interest rate of ten percent per year unless otherwise provided and that article 1302-2.09 otherwise provided for a rate ceiling of eighteen percent for loans to corporations.

Deliberate Incorporation to Avoid the Texas Usury Law. If the interpretation of Texas Tool Traders is followed, it would seem that the Texas corporate exception will be enforced, in which event, sooner or later, a Texas court will be confronted with a situation where someone has deliberately incorporated to avoid the usury laws applicable to individuals.

A Texas court approaching this problem would have a choice between two basically different approaches. It could adopt the Jenkins rule of New York sanctioning the deliberate use of the corporate exception to avoid the usury law, or it could align with one of the question-of-fact jurisdictions. Although both approaches produce the same result when a loan is made to an individual, that of permitting the usury defense, the two concepts are dissimilar thereafter. The Jenkins rule permits lenders to refuse loans to in-


76. 488 S.W.2d 498 (Tex. Civ. App.—Dallas 1972), error granted.
77. See TEX. REV. CIV. STAT. ANN. art. 5069-1.06 (1971). This article, in § 1, provides usury penalties of forfeiture of twice the amount of interest charged plus reasonable attorney fees, but makes an exception for accidental errors. Section 2 provides that the principal of the loan shall be forfeited when the interest charge exceeds double the amount of interest allowed by law. Section 3 provides a four-year statute of limitations from the date when the usurious charge was collected.
78. 488 S.W.2d at 502.
dividends but then suggest that a corporation be created to receive the loan formally and act as the borrower. The second approach, as used in the question-of-fact jurisdictions, requires that lenders refuse all usurious loans to individuals, including situations where a corporation is interposed. Naturally, lenders in jurisdictions following the question-of-fact concept can make loans to corporations; the problems arise where the lender has knowledge that the loan is not for a corporate purpose or that the corporation is merely a strawman created by an individual. If the lender makes a loan in such a situation it is possible that the question of fact will be resolved against him and the loan considered to have been made to the individual, in which case the defense of usury would be available to the lender's detriment. In order to decide which approach is more beneficial the Texas courts should give consideration to the reasons underlying the two approaches. The reasons for the first approach are that the letter of the law denies the usury defense to corporate borrowers, and that the parties to a loan should be able to negotiate and organize their transactions in the manner they find most beneficial. The second approach is based on the court's desire to prevent abuse of the exception statute by lenders who may overreach their borrowers by forcing them to incorporate. The courts adopt a question-of-fact approach to determine if the loan was really made to an individual or to a corporation, thus finding in substance rather than form whether the corporate exception statute was violated.

It is submitted that the Texas courts should follow the philosophy of the Jenkins case, in that the approach which allows the parties to incorporate deliberately to avoid the effects of the usury law is the more practical. The corporate exception enables corporations to obtain loans for business expansion, and avoiding the usury law in a tight money market is a valid business consideration to the businessman who is seeking financing. However, since there is always the possibility that either an inexperienced borrower may attempt to use, or an overreaching lender may attempt to misuse, the corporate exception statute, it is suggested that two possible remedies exist, each of which complements the other. First, the courts should recognize only corporations organized for pecuniary gain, as in the Georgia statute, as eligible for inclusion under the exception statute. Secondly, since the form in which one does business is frequently merely a formal distinction, the legislature should amend and expand the corporate exception statutes to include other business forms, similar to the amendments to the Indiana and Washington statutes.

IV. TAX DIFFICULTIES WITH CORPORATION CREATED TO AVOID USURY LAWS

The Problem. With the present state of the usury laws, a partnership or proprietorship virtually may be forced by economic conditions to choose the

79. See notes 36-55 supra, and accompanying text.
80. See Merriman & Hanks, supra note 8, at 12. These authors believe that businessmen should not have to choose their form of business because of the usury laws, since other considerations are more important.
corporate form of enterprise in those states which have an exception statute to the usury laws limited to corporations. One possible disadvantage of incorporation is the double tax which falls upon the corporation and the shareholder.81 The businessman operating as a proprietor or in partnership may well prefer the conduit tax treatment of the partnership to the corporate tax, and may have in fact chosen the partnership specifically for the tax treatment it affords.82 The dilemma of whether or not to incorporate to avoid usury laws is especially critical in real estate development operations, since real estate developers prefer to operate in partnership form to secure the favorable flow-through of the tax attributes of specified deductions for interest and depreciation.83 A partnership which incorporates to take advantage of the corporate exception statutes because of a need to obtain financing may desire to retain the conduit tax treatment available to the partnership but not the corporation. Through careful tax planning it is possible that the incorporating partnership or proprietorship may achieve both objectives.

Whenever a corporation is organized to receive a conveyance of the legal title, while the equitable title remains in its incorporators, the courts have been willing to ignore the corporation for tax purposes.84 However, when the least indication of a business activity on the legal title-holding corporation’s part has been demonstrated, the courts have invariably taxed the corporation as a separate and viable entity. The cases indicate that any activity other than holding bare legal title is sufficient to trigger taxability of the corporation.85 A solution to the problem of forming a corporation to avoid the usury law and attempting to retain conduit tax treatment is not offered by ignoring the corporation for tax purposes, since the corporation must act as the borrower and become primarily liable on the loan. If the corporation borrows and executes promissory notes, the tax consequence is that it will be recognized as a taxable entity as it is demonstrating some business

81. *See B. Bittker, Federal Income Taxation of Corporations and Shareholders* ¶ 1.03 (1971). The double taxation occurs because the corporation is first taxed upon its income and then the shareholders are taxed upon corporate distributions to them in their capacity as shareholders.


83. *Id. §§ 163, 167. See also Merriman & Hanks, supra note 8, at 11. It should be noted that the subchapter S, small corporation election is generally unavailable to real estate developers due to the restriction of that option to corporations which receive less than 20% of their business income from passive investments such as rent. Int. Rev. Code of 1954, § 1382(e)(5).

84. *See Shaw Constr. Co. v. Commissioner, 323 F.2d 316 (9th Cir. 1963); United States v. Brager Bldg. & Land Corp., 124 F.2d 349 (4th Cir. 1941).*

85. *See Taylor v. Commissioner, 445 F.2d 455 (1st Cir. 1971) (corporation collected revenue, executed deeds, mortgages, and contracts, and borrowed); Britt v. United States, 431 F.2d 227 (5th Cir. 1970) (corporation was a partner, paid taxes, paid attorney and accountant fees, and entered into all partnership documents as a signing party); Tomlinson v. Miles, 316 F.2d 710 (5th Cir. 1963), cert. denied, 375 U.S. 828 (1963) (corporation acquired land, recorded title, surveyed the land, and sold timber); Hagist Ranch Inc. v. Commissioner, 295 F.2d 351 (7th Cir. 1961) (corporation executed leases and bought and sold property); O'Neill v. Commissioner, 271 F.2d 44 (9th Cir. 1959) (corporation executed notes and mortgages); Skarda v. Commissioner, 250 F.2d 429 (10th Cir. 1957) (corporation received dividends and served purpose of holding title during merger plan); Paymer v. Commissioner, 150 F.2d 334 (2d Cir. 1945) (corporation borrowed and was recognized; but another corporation which merely held bare legal title to land was ignored).*
activities which are the criterion of taxability. The theory of treating a corporation as a passive "dummy" will be given effect for tax purposes, according to the First Circuit, when the corporation "only performed those transactions necessary to the holding and transferring of title." Because borrowing and the execution of debt instruments are functions other than those merely necessary to holding title, it seems that the creation of a corporation to avoid the usury laws will not achieve the desired objective of conduit tax treatment on the basis of ignoring the corporate entity for tax purposes.

Another Approach—The Use of a Corporate Agent. Another approach, that of creating an agency or trust relationship between a corporation holding legal title to property and the equitable title holders appears more promising as a solution towards achieving conduit tax treatment for a partnership which incorporates to avoid the usury laws. The key concept underlying this approach is an analogy to the traditional agency rule that an agent may hold the bare legal title for his principal who holds the equitable or beneficial interest. An agent is properly taxed upon compensation paid him by his principal for services rendered, but not upon income collected by him on behalf of, and distributed to, his principal. To succeed in using an agency approach all incidents of an agency relationship must be present between the agent corporation, whose agency functions are to borrow and hold bare legal title to the property, and the principal who holds equitable title and desires the use of the borrowed funds. The advantage of an agency or trust relationship is that it allows the agent or trustee corporation to perform the ministerial duties which are essential if the corporation is to borrow and execute a mortgage to assure the lender of security.

The historical antecedents for the agency approach originated in Moline Properties, Inc. v. Commissioner, where the United States Supreme Court

86. See Taylor v. Commissioner, 445 F.2d 455, 457 (1st Cir. 1971). The taxpayers who were the shareholders of the corporation which was seeking to be ignored for tax purposes had conducted their business as if the corporation did not exist. Even though the stockholders ignored their corporation the First Circuit taxed the corporation for its minimal business activities.
87. See Tilley, supra note 4.
88. See Kurtz & Kopp, supra note 4, at 648-49.
89. See id. at 647-48, wherein the authors suggest several reasons why the owner of property may wish to have title held by an agent or strawman. These include the limitation of liability of the equitable title holder, the securing of anonymous ownership, the simplification of conveyancing, and the avoidance of title problems on the death of the owner. These authors point out that an individual may serve as a strawman to hold title but that an individual strawman has the disadvantages of creating contract liability against the title he holds, and that he may die, causing title problems, whereas use of a corporation avoids these problems.
90. See Tilley, supra note 4, at 450, where it is said that the agency or trust approach is the only theory possible when the corporation is to be the borrower in order to avoid the usury law, because the activities of the corporation constitute business activities which normally result in the imposition of the corporate tax.
91. 319 U.S. 436 (1943). In this case the Supreme Court enunciated a rather vague test for determining whether a corporation could be considered passive for tax purposes: The doctrine of corporate entity fills a useful purpose in business life.
held that a corporate entity could not be ignored for tax purposes. However, in that case the Court in support of its decision to recognize the corporation as a taxable entity commented that there was neither an agency contract nor the incidents of an agency relationship between the corporation and its sole shareholder.\textsuperscript{92} In a later case, \textit{National Carbide Corp. v. Commissioner},\textsuperscript{93} the Supreme Court set out the test for determining if an agency existed: "If the Corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case. Its business purpose must be the carrying on of the normal duties of an agent."\textsuperscript{94}

The Tax Court in two early cases\textsuperscript{95} established precedents sanctioning this approach when there were specific contracts and corporate resolutions explaining that the corporation was merely holding title as an agent or trustee. Although the Tax Court has been very strict with the passive concept by refusing to ignore corporations whenever there was a showing of any business activity\textsuperscript{96} or business objective for incorporation,\textsuperscript{97} it has on occasion permitted an agency or trust approach. In \textit{Caswal Corp.},\textsuperscript{98} the Tax Court permitted a corporation which was created and acted solely as a trustee to deduct all rental income which it distributed to the beneficiaries of the ex-

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  \item Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.

\textit{Id.} at 438-39.\textsuperscript{92}

\item The Supreme Court noted that the mere fact a corporation existed did not make that corporation the agent of its shareholders.

\item 336 U.S. 422 (1949). In \textit{National Carbide} the Supreme Court considered the contention by a parent corporation that an agency agreement existed between the parent and three of its subsidiaries. The parent corporation's argument was premised upon a contract executed between the parent and the three subsidiaries. This contract provided that in consideration for the parent corporation's investment of capital and management assistance the subsidiaries would pay all but a small fraction of their profits to the parent. The Supreme Court rejected the notion that any agency existed, because there was no proof of a true agency. In the Supreme Court's opinion the contract was consistent and referable to the parent-to-subsidiary relationship, regardless of the agency issue. As a result of the Court's refusal to consider the arrangement an agency, the three subsidiaries were taxed as separate corporate entities. \textit{National Carbide} did not foreclose the possibility of the agency approach, however, for the Supreme Court noted that if a true corporate agent were used it would not be taxed upon the property and income of the principal which it received.

\item \textit{Id.} at 437.\textsuperscript{94}

\item See \textit{Industrial Union Oil Co.}, 5 T.C.M. 879 (1946), holding that a corporation holding legal title was not taxable on income from oil leases, and \textit{Worth S.S. Corp.}, 7 T.C. 654 (1946), holding that a corporation which operated a ship as legal title holder for a joint venture was not taxable on the income collected for the beneficial owners. This result was accomplished by the use of a joint venture agreement, an operation agreement, and a declaration of trust.

\item See \textit{Perry R. Bass}, 50 T.C. 595 (1968) (corporation signed contracts and made investments). \textit{But see,} \textit{Bartell Hotel Co.}, 32 T.C. 311 (1959) (corporation holding title to hotel operated by other corporation not taxed on hotel earnings).

\item See \textit{Sam Siegel}, 45 T.C. 566 (1966) (corporation formed for the bona fide business purpose of obtaining limited liability for a risky foreign investment).

\item 19 T.C.M. 757 (1960). See also \textit{K-C Land Co.}, 19 T.C.M. 183 (1960). In this case the Tax Court held a similar trust agreement effective to prevent the imposition of a tax upon the income collected by the corporate trustee on behalf of its beneficial owners engaged in a joint venture.
press trust. Further, the activities of the corporation were holding bare legal title, managing the property in trust, collecting the rents on the trust property, and distributing the income to the beneficiaries. To the Tax Court these activities were consistent with the trust relationship and did not evidence business activity that would indicate that the corporation was acting on behalf of itself, rather than as trustee.

Although these early cases suggest that an agency or trust theory may permit a corporation to perform ministerial functions and still, as in the example of an individual agent, have the income it collects on behalf of its principal taxed to the beneficial owners, there remain substantial difficulties for the taxpayer seeking to create an agent corporation.

*Carver v. United States*\(^9\) indicated that a proper agency approach is feasible. In that case an attorney employed a shell corporation to aid his clients and to further some of his own enterprises. The Commissioner sought to tax the corporate entity for those transactions which had been conducted on behalf of the attorney as the sole owner of the corporation. The Commissioner did not challenge the use of the corporation as an agent for the attorney’s clients. The transaction in *Carver* involved a situation in which the attorney and one of his clients, acting together as joint venturers, borrowed money to purchase realty, the title to which they nominally placed in the corporation for holding purposes. Twenty years later when the land was sold and the corporation liquidated the Court of Claims refused to impose the corporate tax on the gain from the sale of the land because, although the attorney was the sole owner of the corporation, the relationship between the third party to the transaction, the attorney’s client, and the corporation was clearly that of principal and agent.\(^{10}\) Because of the agency relationship, the Court of Claims permitted the taxpayer attorney to include the gain on the sale of the land in this particular transaction on his individual tax return and not the corporation’s return. Thus, the attorney was allowed to treat the corporation as his agent because the evidence that the corporation had acted in a similar manner for an independent third party tended to prove the existence of a true agency relationship.

The Court of Claims continued to utilize the *Carver* mode of analysis in the recent case of *Harrison Property Management Co. v. United States*,\(^{11}\) in which three partners incorporated a management company to hold bare legal title to oil leases for the purpose of providing efficient management in the event of the death of one of the partners. The stockholders of the corporation, the three partners, attempted to arrange their transaction to qualify the corporation as an agent by limiting the activities which it could undertake and requiring unanimous approval of all three directors, also the three partners, for most corporate actions. The partners also executed an

\(^{9}\) 412 F.2d 233 (Ct. Cl. 1969).

\(^{10}\) Id. at 240.

\(^{11}\) 475 F.2d 623 (Ct. Cl. 1973). The Court of Claims first noted that the corporation could not be treated as a passive entity which could be ignored for tax purposes because it was organized for business convenience and it performed business activities in executing leases, selling produce, entering lawsuits, and holding stockholder meetings.
agreement which recited that the corporation was organized solely to manage and hold title to property. The Court of Claims rejected the contention that this arrangement was sufficient to establish the corporation as a mere corporate agent for tax purposes. Instead of considering the purported agency contract to be controlling for tax purposes the court sought to find evidence of the substance of an agency.\(^{102}\) In an attempt to find the substance of an agency relationship the court inquired into whether the agency contract was an arm's-length bargain between the corporation and the three stockholders, the partners who also held the beneficial interest. Two criteria were considered significant in this inquiry; first, would the agent-corporation have made the contract if not owned by the stockholder-beneficial owners, and second, would the stockholder-beneficial owners have made the contract if the corporate agent were not under their control.\(^{103}\) The Court of Claims pointed to the Carver case as an instance where these criteria were satisfied.

In Carver the corporation acted on behalf of an independent third party in the same manner as it did for its sole owner. By acting for the independent third party, the corporation demonstrated that its relationship with its owner was actually that of agency, and not merely dependent upon ownership and control by the owner-principal. In reaching its decision that the management company was not a true corporate agent and therefore taxable on its receipts, the court noted that the criterion of whether the corporation and the beneficial owner would have executed the agency contract in the absence of ownership by the beneficial owners of the corporation had to be answered in the negative.

To satisfy the requirements of the criteria enunciated in Harrison Property Management Co. it is evident that the corporation should not appear to function solely because it is owned by the principal. Convincing evidence that the corporate agent is independent of its principal must be available to demonstrate that it is in fact an agent. In theory, the more independent the nominee corporation is of the principal-owners, the greater the likelihood that the agency relationship will be recognized as controlling. One of the factors that indicates the existency of a true agency relationship is the adequacy of the consideration received by the agent corporation in return for the performance of the ministerial acts of an agent. Thus, a mere nominal fee paid to the corporation by the principals suggests that the corporation is not a true agent. But if the corporation receives a fee which includes its costs plus a profit element, then there is stronger evidence that a true agency exists since the corporation would be operating like any other business agent, receiving a commission for services rendered. Another critical factor in establishing an agency relationship is that there should be a very specific agency contract between the principals and the agent corporation.

\(^{102}\) Id. at 629 n.3. The court questioned whether the language of the contract actually established a formal agency.

\(^{103}\) Id. at 627-28. The court considered significant the facts that the corporation was organized solely to serve its stockholders, that the corporation needed the unanimous consent of all three director-stockholders to take most corporate action, and that the relation between corporation and beneficial owners was dependent upon the beneficial owners being the sole stockholders.
setting forth in detail all the normal incidents of an agency, including the
power of the principal to terminate the agency at any time by demanding
a reconveyance of the legal title. The agent-corporation should be restricted
through its articles of incorporation and bylaws to the performance of minis-
terial acts consistent with an agency relationship in order to demonstrate that
the agent corporation is not, in fact, engaging in business for itself. If per-
psons other than the principals owned and managed the agent corporation
in consideration for the commission paid the corporation, this would seem
even more convincing evidence of a true agency. Thus, the agent corpora-
tion's actions would not be directly controlled by the principals, and yet the
principals would be protected by their agency contract permitting a revoca-
tion of the agency upon demand for a reconveyance of legal title. 104

Taxpayer Mistakes to Avoid. In planning the organization of an agent cor-
poration some consideration should be given to the fact that the corporation
should appear to be an agent from its inception. The Tax Court has found
that corporations, which taxpayers claim to be agents, are not in fact agents
because they were organized with an intent to conduct business. Actual
business activity should be kept to an absolute minimum of ministerial acts
which would not lead to a finding that the corporation was operating as a
business corporation.

In the recent Tax Court case of *David F. Bolger* 105 a series of financing
corporations, formed in order to obtain maximum financing by avoiding the
usury law by stockholders who would eventually receive title to real estate
acquired by the corporations, were recognized as taxable entities. The
transactions in which these ten financing corporations played a significant
role were factually complex. Each corporation purchased a building and
then leased it to some business firm on a long-term net lease basis. The
corporations then obtained loans from institutional lenders to pay for the
purchased buildings. Each loan was obtained by the execution of the cor-
poration's mortgage notes and an assignment of the long-term net lease.
The corporations agreed with the lender that they would conduct no business
other than the leasing of the purchased property and that they would con-
tinue to exist during the term of the mortgage notes bought by the lender.
The shareholders of the corporation then entered into an assumption agree-
ment with the corporations by which the corporations agreed to convey the

104. *See* Tilley, *supra* note 4, at 451-53, for a complete list of suggestions about
forming the agent corporation. Tilley noted that the most difficult problem is forming
the agent corporation so that there is adequate proof of an agency relationship.

noted that, aside from the issue of an agency, the business activity of each corporation
in purchasing property, executing mortgages, making and assigning leases, and borrow-
ing money through the sale of its corporate obligations were sufficient to require recog-
nition of the corporation as an entity for tax purposes.
land to the shareholders, who agreed in turn to assume all obligations under the lease and mortgage but without becoming personally liable on the mortgage.

The result of this carefully conceived financing scheme was that the shareholders, the taxpayers in the suit, received legal title to the properties, which were encumbered by a lease and a mortgage, without making a cash investment. On the issue of whether an agency relationship existed between the stockholders and the straw financing corporations, the Tax Court noted that in only two of the ten corporation's documents was there language indicative of an agency. Since the taxpayer asserted that none of the corporations should be recognized for tax purposes, the Tax Court rejected the agency contention because of the lack of proof of an agency. Bolger should reinforce the suggestion made earlier that all corporate documents be drafted to indicate specifically and affirmatively the existence of an agency, and that there should be an agency contract between the corporation and the principals.

**Potential Conflict Between Usury Laws and the Agent-Borrower.** The Bolger case highlighted an area of potential conflict between the agency approach in tax law and the usury law interpretations of the corporate exception statutes under state law. The Tax Court in Bolger stated that "[t]he existence of an agency relationship would have been self-defeating in that it would have seriously endangered, if not prevented, the achievement of those objectives which, in large part, gave rise to the use of the corporations, namely, the avoidance of restrictions under State laws." The restrictions referred to by the Tax Court were the usury laws. The taxpayer in Bolger was a resident of New Jersey which follows the question-of-fact approach to the usury law. By the question-of-fact interpretation the lender is exposed to the risk that an individual will be permitted to assert the usury defense and ignore his corporation if the lender had knowledge at the time the loan was made that the loan was to an individual. It is clear from Bolger that the lending institutions which financed these transactions probably knew of all steps in the entire transaction, although a lender would be wise to pretend ignorance of any transactions between a corporate borrower and its shareholders. It is most unfortunate that the Tax Court did not elaborate on its statement that the use of the agency approach would destroy the transaction from the viewpoint of the state usury laws.

**Harmonizing Usury Law and the Corporate Agent Approach.** In those jurisdictions which permit the deliberate use of the corporate exception statute to avoid the usury law there should be no problem if the lender knows that the corporate borrower is an agent. However, the agency approach could be subject to substantial risks in those states which do not permit the deliberate use of the corporate exception. If the lender has knowledge of the borrower's individual identity, it would furnish the grounds for a court to pierce

106. Id. at 766 n.3.
107. Id. at 766.
the corporation's veil and permit the usury defense on the theory that the
loan was in fact to an individual.\textsuperscript{108}

As a matter of business functioning in the practical rather than the legal
sense it should be irrelevant whether or not the lender knows that the corpo-
rate-borrower is merely an agent. But cautious legal planning designed
to assure the lender that the borrower will not be able to pierce its corporate
veil and assert the usury defense should include the consideration that in
a state following the question-of-fact approach to the corporate usury excep-
tion the lender should know as little as possible about the dealings between
the corporate-borrower and its shareholders. This consideration would dic-
tate to the cautious lender that he abort an incompletely negotiated loan to
a corporate borrower if that borrower volunteered the information that there
was an agency relationship between itself and its shareholders.

An alternative solution which may be safer from the usury standpoint,
although it may occasion more effort and expenses, is for the borrower to
seek a loan in another state by employing the applicable rules of the con-
flict of laws to obtain an advantage under that state's law.\textsuperscript{109} A borrower
considering such a conflicts approach would have to select a state where
there was a favorable advantage over his own state's usury law, and locate
an agreeable lender in that state. But this would not be difficult. A bor-
rower could have his choice of several states which have no usury law at
all,\textsuperscript{110} or a state which has enacted an expanded usury exception statute,\textsuperscript{111}
or a state which has a corporate exception statute and courts following the
Jenkins rule of New York. For the Texas borrower there is recent prece-
dent indicating that this conflicts approach is feasible. In \textit{Securities Invest-
ment Co. v. Finance Acceptance Corp.}\textsuperscript{112} the Houston court of civil appeals
held that the Missouri law would be applied as between a Missouri lender
and a Texas corporate borrower where the contract between them was exe-
cuted in Missouri, the contract specified the Missouri law, the lender had
no office in Texas, and the receivables securing the loan were forwarded
to the lender's place of business in Missouri.\textsuperscript{113} The Houston court of civil
appeals also held that under Texas' conflict of laws rules a reasonable rela-
tion between the contract and the law of Missouri existed, thereby requiring
the application of the law of Missouri's corporate exception statute, which
denied the Texas corporate borrower a cause of action for recovery of usury
penalties in the absence of the payment of the principal and interest on the
loan.\textsuperscript{114}

\section*{V. Conclusion}

The general usury law can make borrowing money difficult for the busi-

\begin{footnotesize}
\textsuperscript{108} See notes 36-55 supra, and accompanying text.
\textsuperscript{109} See Comment, supra note 31, at 395-97, for a review of the rules which suggest
that the conflict of laws approach will be effective if the documents are well drawn.
\textsuperscript{110} Maine, Massachusetts, and Indiana presently have no usury laws.
\textsuperscript{111} See, e.g., the Washington and Georgia statutes at notes 64, 67 supra, and ac-
companying text.
\textsuperscript{112} 474 S.W.2d 261 (Tex. Civ. App.—Houston [1st Dist.] 1971), \textit{error ref. n.r.e.}
\textsuperscript{113} \textit{Id.} at 272.
\textsuperscript{114} \textit{Id.} at 271.
\end{footnotesize}
nessman when there exists a tight money market in which interest rates approach the legal maximum under state law. In those states which have enacted corporate exception statutes, the businessman has a viable option to incorporate and thus become a more attractive borrower to lenders. The corporate exception statutes, however, should be broadened to include other forms of business enterprises; choice of the form of business should not be circumscribed by state usury laws. In normal commercial situations courts have had no difficulty in giving effect to corporate exception statutes because either the corporate borrower was in existence at the time when the loan was contracted or else the corporation involved clearly borrowed for a business reason. Problems have arisen only when the corporate exception statute has been abused, particularly when a lender has required a commercially inexperienced individual to incorporate as a condition to securing a loan. To avoid such abuse, which would render usury laws a nullity, the law distinguishes in the first instance between loans made to corporations and loans made to individuals. Some states allow the participants to a loan transaction to discuss openly the use of the corporate exception statute, whereas in states which adopt the question-of-fact approach the lender is subject to the risk that the usury defense may be entertained if the lender knows that an individual is deliberately employing the corporate exception statute to obtain a loan. As between these two approaches the former is preferable as being the more realistic and practical. It permits businessmen to organize their transactions upon the basis of business considerations rather than upon the basis of the usury law.

When forming a corporation to avoid the adverse effects of state usury laws the prospective borrower should consider carefully the tax consequences which will result from creating such a corporation. If the businessman can advantageously operate from the corporate form then no unusual tax complications are likely to occur. However, if the businessman is in the limited category of persons, such as real estate developers, who find that the conduit tax treatment of partnerships is especially advantageous then great care must be taken to assure continued conduit treatment. An agency relationship appears to be the best approach available as a mechanism to achieve conduit tax treatment for the individual who creates a corporation as a means of employing a corporate exception statute to avoid the effects of the usury law. If this corporation is in fact an agent there is no reason that it should not be taxed as one, thus causing income collected on behalf of its principals to be taxed to the principal under the conduit tax treatment of principals and their agents.

Unfortunately, at the present time, uniformity between results of state usury law requirements and the tax consequences of the formation of a corporation to avoid state usury laws does not exist. This lack of clarity could be solved by specific Treasury regulations or rulings which would enable practitioners in this area to proceed with certainty, or at least reasonable guidance. Perhaps the simplest and most direct solution to the entire problem
would be for state legislatures to repeal all usury laws. However, a similar result could be achieved by a more modest change occasioned by broadening the scope of corporate exception statutes by amendment to include all bona fide business entities. In states which have amended their exception statutes to include many business entities the tax law and the usury law are in accord; the businessman need not change his business form to satisfy a limited exception statute and, thus, the tax consequence of his choice of business organization remains unaffected.