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THE "THIN CORPORATION" PROBLEM

The "thin corporation" problem was annexed to the "curtailment of tax avoidance" structure through dictum in *John Kelley Co. v. Commissioner* when the court stated:

As material amounts of capital were invested in stock, we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessive debt structure.¹

The Commissioner promptly applied this language to corporate financing, thereby causing definite tax consequences.² Since then the abundance of comment on the subject of "thin incorporation" has been exceeded only by the uncertainty in the field. The Commissioner's treatment of thin capitalization leaves the tax consultant unable to use the thinly organized corporation confidently as a tax-planning measure. Because of this confusion Treasury Regulations should be forthcoming³ and one commentator notes that a recent "thin corporation" decision, *Gooding Amusement Co.*,⁴ could well result in "Gooding regulations" similar to the "Clifford regulations" in the short-term trust field.⁵

I. DEFINITION AND ADVANTAGES

A "thin corporation" is one in which the capital is supplied primarily by loans from its operators rather than by stock investment.⁶ This type of financing is particularly advantageous to the corporate taxpayer because it can deduct amounts paid to its shareholders as interest on indebtedness,⁷ whereas the same amounts paid as dividends would not be deductible.⁸ But it is also advantageous to the individual taxpayer as the payment on the principal of the notes is treated as nontaxable return of capital.⁹ The individual taxpayer is further favored with the possibility of a business bad debt deduction.¹⁰ The aforementioned financing is of

¹ 326 U.S. 521, 526 (1946).

² *Swoby Corp.*, 9 T.C. 887 (1947).

³ Anderson, "Thin" Corporate Capitalization, 1957 So. Cal. Tax Inst. 35.

⁴ *Gooding Amusement Co.*, 23 T.C. 408 (1954), aff'd, 236 F.2d 159 (6th Cir. 1956).

⁵ Rabin, The "Clifford Case" of the Thin Corporation, 34 Taxes 282 (1956).

⁶ 2 CCH 1958 Stand. Fed. Tax Rep. para. 2377.277.

⁷ Int. Rev. Code of 1954, § 163(a), Int. Rev. Code of 1939, § 23(b), 53 Stat. 12.

⁸ The corporate saving far outweighs the nominal exclusion allowed the shareholder for dividends received, Int. Rev. Code of 1954, § 116(a), and the credit against his tax, Int. Rev. Code of 1954, § 34(a), particularly in close family-type corporations.

⁹ See Seidman, The Unexpected, Untimely and Uninvited Dividend, 36 Taxes 166 (1958), where the author points out that a tax-neutral loan payment can become a tax-disastrous redemption of stock if the Internal Revenue Service characterizes debt as equity. He suggests that a questionable loan not be repaid until the Internal Revenue Service has passed on the deduction of interest payable on the "loan" by the corporation.

¹⁰ Int. Rev. Code of 1954, §§ 166, 1211, 1212.

dubious value today, however, as the Commissioner constantly characterizes this type of debt as equity.¹¹

II. DEBT-EQUITY RATIO

A major consideration in this area is the perplexing debt-equity ratio. Its ultimate effect is not clearly conveyed by the cases, although many commentators speculate as to its importance. It is definitely one of the factors to be considered in a "thin corporation" problem¹² and perhaps the most important factor. Apparently the Commissioner includes both capital and surplus in "equity" and includes as "debt" all indebtedness with priority equal to or greater than the purported shareholder loans.¹³ The determination of this ratio requires the application of real values in lieu of artificial par or book values.¹⁴ Although very controversial, a ratio of debt to equity of 3½ to 1 or lower seemingly will be upheld.¹⁵ Many commentators believe a 2 to 1 ratio is wiser, being safer and yet still permitting the advantages.¹⁶ Many industries require a higher debt financing because of the very nature of their operations and this fact further prevents the establishment of a definite ratio for all businesses.¹⁷ Possibly the most reliable advice is imparted by the commentators who suggest that the presumably safe 3½ to 1 ratio be used as a rule of thumb and not as an infallible guide.¹⁸

¹¹ Kraft Foods Co., 21 T.C. 513 (1954), rev'd, 232 F.2d 188 (2d Cir. 1956); Gooding Amusement Co., 23 T.C. 408 (1954), aff'd, 236 F.2d 159 (6th Cir. 1956); Estate of Herbert B. Miller, 24 T.C. 923 (1955), rev'd, 239 F.2d 729 (9th Cir. 1956); R. M. Gunn, 25 T.C. 424 (1955), aff'd, 244 F.2d 408 (10th Cir. 1957).

¹² Isidor Dobkin, 15 T.C. 31 (1951), aff'd, 192 F.2d 392 (2d Cir. 1951); Ruspyn Corp., 18 T.C. 769 (1952), acq., 1952-2 Cum. Bull. 3; Estate of Herbert B. Miller, 24 T.C. 923 (1955), rev'd, 239 F.2d 729 (9th Cir. 1956); Schlesinger, *Acceptable Capital Structures: How Thin Is Too Thin?*, 5 U. Fla. L. Rev. 355 (1952).

¹³ Comment, 55 Colum. L. Rev. 1054 (1955). See Sheldon Tauber, 24 T.C. 179 (1955).

¹⁴ Kraft Foods Co., 21 T.C. 513 (1954), rev'd, 232 F.2d 188 (2d Cir. 1956).

¹⁵ This is due to the Commissioner's acquiescence in the case of Ruspyn Corp., 18 T.C. 769 (1952), acq., 1952-2 Cum. Bull. 3, which upheld a 3½ to 1 ratio. See Treusch, *Corporate Distributions and Adjustments: Recent Case Reminders of Some Old Problems Under the New Code*, 32 Taxes 1023 (1954), in which are listed approximately twenty cases holding various corporations to be inadequately capitalized. See also Stanford, *What Is Adequate Capitalization?*, 31 Taxes 231 (1953), which lists thirteen cases involving thin corporations and Schlesinger, *supra* note 12, which contains a chart of thin corporation cases.

¹⁶ Bittker, *Thin Capitalization: Some Current Questions*, 34 Taxes 830 (1956); Poin-dexter, *Thin Corporations*, 35 Taxes 880 (1957); Schlesinger, *supra* note 12.

¹⁷ 2 ALI Fed. Income Tax Stat. § 232 (Feb. 1954 Draft); Anderson, *supra* note 3; Spanbock, Carro, and Katz, *Nourishing the Thin Corporation*, 34 Taxes 687 (1956); H. B. Miller v. Commissioner, 239 F.2d 729 (9th Cir. 1956). See also Greene, *Corporate Organization and Distributions*, 6 J. Taxation 262 (1957), in which it is noted that the ABA Tax Section recommends that the Internal Revenue Code be changed to provide that a 10 to 1 debt-equity ratio will not be too thin.

¹⁸ Kahn, *Incorporating the Going Business: How to Find the Method with the Least Tax Cost*, 6 J. Taxation 72 (1957); Treusch, *supra* note 15.

III. OTHER CONSIDERATIONS

In addition to the apparent necessity of a low debt-equity ratio, it is essential that the instrument evidencing the corporate debt be strictly "debt" in form and not a "hybrid security." It is important to remember, however, that form alone will not ultimately produce the desired result; substance is the controlling factor. But even so, the instruments and all related matter must be form perfect in order to have a "fighting chance." Hence there should be (1) an unconditional obligation to pay a sum certain in money, (2) a definite maturity date, (3) a specific time for the interest payment and the actual payment of interest whether or not there are earnings, (4) no subordination to the claims of other creditors, and (5) correct debt form in the corporate books and all related matter.¹⁹ Also, the shareholder's debt should be disproportionate to his equity interest.²⁰ Relatively recent cases indicate a possible need for a business purpose,²¹ and there has been mention of requiring the introduction of new capital.²² Intent is also essential in this area.²³ The taxpayer's intent is always found so as to support the court's holding, and it often appears that the holding is determined prior to the intent. As pointed out by one commentator, the Tax Court apparently feels free to determine the requisite intent by hindsight.²⁴ The cases state that the "thin corporation" decisions must necessarily be decided on their own facts since, as a practical matter, no two cases are factually alike.²⁵ The preceding paragraph thus points out the essentiality of precise form, a reasonable ratio, and a business purpose if the taxpayer intends to remain out of court or at least have a strong possibility of prevailing if forced into court action.

IV. INCONSISTENCIES

The reasoning of the courts is very inconsistent and vague; perhaps the ultimate outcome of a "thin corporation" decision will

¹⁹ Schlesinger, *supra* note 12; 2 ALI Fed. Income Tax Stat. § 232 (Feb. 1954 Draft); Treusch, *supra* note 15.

²⁰ 1432 Broadway Corp., 4 T.C. 1158 (1945), *aff'd*, 160 F.2d 885 (2d Cir. 1947); Spanbock, Carro, and Katz, *supra* note 17.

²¹ Kraft Foods Co., 21 T.C. 513 (1954), *rev'd*, 232 F.2d 188 (2d Cir. 1956); Gooding Amusement Co., 23 T.C. 408 (1954), *aff'd*, 236 F.2d 159 (6th Cir. 1956); Estate of Herbert B. Miller, 24 T.C. 923 (1955), *rev'd*, 239 F.2d 729 (9th Cir. 1956). See also Treusch, *supra* note 15.

²² Kraft Foods Co., 21 T.C. 513 (1954), *rev'd*, 232 F.2d 188 (2d Cir. 1956), 11 Sw. L.J. 260 (1957).

²³ Estate of Herbert B. Miller, 24 T.C. 923 (1955); Associated Investors, Inc. v. United States, 57-1 CCH U.S.T.C. para. 9396 (1956).

²⁴ Poindexter, *supra* note 16.

²⁵ Gooding Amusement Co. v. Commissioner, 236 F.2d 159 (6th Cir. 1956); Associated Investors, Inc. v. United States, *supra* note 23; Poindexter, *supra* note 16.

depend on the particular circuit in spite of the constant statement that each case depends upon its own facts. An example of the confused reasoning is found in the Tax Court's opinion in the *Gooding* case. The court states at 418:

There is nothing reprehensible in casting one's transactions in such a fashion as to produce the least tax. The courts have often reaffirmed this view [citing authority]. On the other hand, tax avoidance will not be permitted if the transaction or relationship on which such avoidance depends is a "sham" or lacks genuineness.

Later in the same opinion at 421 the court asserts:

The fact the . . . [petitioner] may have had no intention of distributing earnings under the guise of discharging debts is immaterial.

Further at 422 quoting from *McGuire v. Commissioner*:³⁶

'Neither artifice, subterfuge, or bad faith need be present . . . , for as we read the law a taxpayer may well act with the utmost good purpose and without evil intent and yet his transactions may in effect be the equivalent of the distribution of a taxable dividend.'

The above opinion initially indicates that tax avoidance is permissible unless there is "sham," but then states that tax avoidance is disallowed regardless of purpose. This leads to the conclusion that if done for tax avoidance, whether genuine or not, the transaction can be struck down.

Reasoning such as the above and the Tax Court's holdings have aroused courts of appeals and commentators alike.³⁷ In *Estate of Herbert B. Miller*³⁸ the Ninth Circuit averred:

We know of no rule which permits the Commissioner to dictate what portion of a corporation's operations shall be provided for by equity financing rather than by debt.

And in a well-reasoned opinion by the Fifth Circuit it was declared:

It would obviously work an unwarranted interference by the courts in ordinary and perfectly proper business procedures for us to say that there can be established, as a matter of hindsight, a ratio of stockholder-owned debt to the capital of the debtor corporation. No stockholder could safely advance money to strengthen the faltering steps of the corporation . . . if he is faced with the danger of having the Commissioner, with the backing of the courts, say 'he had no right to launch a corporate business without investing in it all the money

³⁶ 84 F.2d 431, 432 (7th Cir. 1936).

³⁷ One commentator envisions: "It might be fair to assume, therefore, that any closed corporation that has borrowed money from its shareholders, whether in the form of bonds or notes or loans, has an excellent chance of ending up in the court." Rabin, The "Clifford Case" of the Thin Corporation, 34 *Taxes* 282, 285 (1956).

³⁸ 239 F.2d 729, 734 (9th Cir. 1956).

it needed, and investing it in the way that is most disadvantageous to himself, both as relates to taxpayer and as to other creditors.²⁹

Disagreement such as the foregoing should accelerate the advent of government regulations.

The Commissioner is perhaps too inclined towards obtaining additional revenue and not sufficiently concerned with the effect his action could have on corporate financing. The court of appeals in the Sixth Circuit stated:

The essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it, so that he may enjoy the chances of *profit*. The creditor, on the other hand, does not intend to take such risks so far as they may be avoided, but merely to lend his capital to others who do intend to take them.³⁰

This is perhaps technically correct. It is not entirely accurate, however, as there are many other considerations involved. An operator, although desiring to retain his stockholder control, will often become technically a creditor so as to take advantage of favorable provisions in the Bankruptcy Act as well as in the Internal Revenue Code.³¹ Conversely, a lender to a corporation often will demand some of the stock so that he can keep abreast of corporate affairs.³²

The Commissioner's treatment of corporate financing has met with disfavor among commentators. One article declares:

Corporations and their stockholders should be entitled to issue whatever classes of securities and in whatever proportions they may choose, within reason, regardless of tax consequences.³³

And, as asserted in the *Tax Fortnightler*:

If the stockholders have a right to advance any amounts to their corporation as true indebtedness, what provision of law limits the amount or ratio of such indebtedness?³⁴

The American Law Institute protests thusly:

Whether there should be a limitation upon the amount of indebtedness held pro rata by shareholders . . . has been the subject of disagreement, but it is our conclusion that there should be no such limitation.³⁵

²⁹ Rowan v. United States, 219 F.2d 51, 55 (5th Cir. 1955).

³⁰ United States v. Title Guarantee & Trust Co., 133 F.2d 990, 993 (6th Cir. 1943).

³¹ Of course, as a practical matter, this is only possible in a closely held corporation.

³² Boughner and Greene, Corporate Organization and Distributions, 5 J. Taxation 147 (1956).

³³ Manley, What To Do About the New Intent Test in Thin Corporations, 5 J. Taxation 379 (1956).

³⁴ 1956 Annual Tax Fortnightler 1346.

³⁵ 2 ALI Fed. Income Tax Stat. § 232. (Feb. 1954 Draft).

It appears that the only semblance of agreement is among the critics, who do not approve of the Commissioner's conduct in thus "piercing the corporate veil." Businessmen undoubtedly desire to finance their interests in such a manner as is most advantageous to them and should be able to do so without adverse tax effects, if within legal and reasonable bounds. Obviously no outside creditor would advance money or goods to a firm that was too thinly capitalized, and therefore he is protected in this sense.

V. FACT V. LAW

The courts of appeals uphold decisions from most administrative bodies if the decisions are supported by "substantial evidence on the whole record," but this rule does not apply to Tax Court decisions. The Internal Revenue Code expressly provides that the courts of appeals have reviewable jurisdiction just as if the decision were rendered by a district court in a civil action without a jury.³⁶ The Federal Rules of Civil Procedure provide that findings of fact rendered by a court without a jury "shall not be set aside unless clearly erroneous."³⁷ If this "clearly erroneous" rule is strictly applied, the problems affronting the taxpayer will surely be multiplied. The Tax Court noticeably backs up the Commissioner as a general rule in these "thin corporation" cases and it is quite possible that the very important criterion—intent—will be considered a question of fact, thereby almost precluding the courts of appeals from reversing the Tax Court.³⁸ As is generally conceded, the courts of appeals can devise ways to circumvent rules and reach almost any conclusion desired, but nevertheless the "clearly erroneous" test can further harass the already frustrated taxpayer.

VI. PROBLEM AIDS

The following discussion is to be prefaced with the caveat that none of these proposed aids are "tried and true" and also with the observation that this writer sees no real merit in any of

³⁶ Int. Rev. Code of 1954, § 7482(a) specifies: "The United States Courts of Appeals shall have exclusive jurisdiction to review the decisions of the Tax Court . . . in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury."

³⁷ Fed. R. Civ. P. 52(a): "In all actions tried upon the facts without a jury . . . the court shall find the facts . . . Findings of fact shall not be set aside unless clearly erroneous . . ."

³⁸ See *Crown Iron Works Co. v. Commissioner*, 245 F.2d 357 (8th Cir. 1957) in which the court affirms, "The question of intent, if at all doubtful either because of a conflict in the evidence or because different inferences reasonably may be drawn from undisputed facts, is a question of fact for the trial court, and only becomes a question of law for a reviewing court if the evidence is all one way as to leave no doubt as to the fact." (Emphasis added.) It is obvious that reasoning such as the above will resolve intent as a question of fact in the majority of the cases.

them as dependable and practically workable solutions. In addition to having all instruments, accounts, entries, etc., strictly "debt" in form, a reasonable ratio, and a business purpose, there are other possible ways to substantiate the taxpayer's position. One often mentioned method is securing the loan, but this is of doubtful value. (Of course *any* further evidence of debt is of some help in this area.) Another aid is the delaying of loans for a period, with the stockholder possibly renting assets to the corporation, taking depreciation, and eventually capital gains;³⁹ while not strictly a thin corporation solution, this is perhaps a good tax-savings device. Of course, the delay itself cannot be expected to ward off the Commissioner. The often proposed solution whereby the shareholder merely guarantees the loan was perhaps fatally dealt with in *Putnam v. Commissioner*⁴⁰ and will not be considered here. Another possible solution is an unconditional sale of the stockholder's debt interest to an unrelated third person. This sale will more than likely take place near maturity as a practical matter.⁴¹ Many other suggestions have been proffered, but this writer fails to see the practical value of any of them. Perhaps the best solutions have been either (1) to avoid the Tax Court⁴² or (2) to be in the proper circuit.⁴³

VII. CONCLUSION

The Fifth Circuit is perhaps presently the best circuit in the eyes of the taxpayer in which to litigate a "thin corporation" problem. This circuit in the *Rowan* case strongly asserted:

It is entirely within the competence of Congress to provide by statute for such ratio if it deems it advisable or necessary within the scheme of Federal Taxation. It is not within our province to do so. Nor would it further the desirable end of certainty in taxes for us to do so.⁴⁴

In accord with this view is one commentator's opinion dealing with the Commissioner's treatment of the debt-equity question:

It is submitted that such changes should be made by statute rather than by courts. Whether the change is accomplished by statute or the courts, it would certainly not be equitable to apply it retroactively

³⁹ Anderson, "Thin" Corporate Capitalization, 1957 So. Calif. Tax Inst. 35.

⁴⁰ 352 U.S. 82 (1956). But see Kanter, Supreme Court Kills Ordinary-Loss Deduction on Guaranteed Loans; Uncertainty Remains, 6 J. Taxation 66 (1957). Also noted in Bittker, *supra* note 16, was the thought that the substance-form theory would at the least cause guaranteed loans to be scrutinized closely by the Commissioner.

⁴¹ Manley, *supra* note 32.

⁴² Poindexter, *supra* note 16.

⁴³ See Rabin, *supra* note 27.

⁴⁴ 219 F.2d 51 (5th Cir. 1955).

in view of the Commissioner's acquiescence in the ratio of debt to equity test.⁴⁵

This writer agrees with the above views but feels that even if regulations or statutes are used in settling the debt-equity ratio the Commissioner may still classify debt as equity by an "intent" test or some other similar test. The only path out of this intricate maze is a Supreme Court decision, Treasury regulations, or an amendment to the Internal Revenue Code, which will cover the entire problem rather than merely the ratio facet.

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⁴⁵ Manley, *supra* note 32.