Worthlessness, Debt-Equity, and Related Problems

William Natbony

Follow this and additional works at: https://repository.uchastings.edu/hastings_law_journal

Part of the Law Commons

Recommended Citation
Available at: https://repository.uchastings.edu/hastings_law_journal/vol32/iss6/1

This Article is brought to you for free and open access by the Law Journals at UC Hastings Scholarship Repository. It has been accepted for inclusion in Hastings Law Journal by an authorized editor of UC Hastings Scholarship Repository.
# Worthlessness, Debt-Equity, and Related Problems

## Table of Contents

I. Statutory Overview: Worthless Securities and Bad Debts ........................................ 1409  
   A. Allowance ........................................................................................................ 1409  
   B. Characterization ............................................................................................. 1414  
   C. Securities and Debts: Differences and Similarities .................................... 1420  
II. Ascertaining Worthlessness ................................................................................ 1422  
   A. Burdens of Proof ............................................................................................. 1426  
      1. Preliminary Burdens .................................................................................. 1428  
      2. Insolvency ................................................................................................... 1431  
   B. Identifiable Event ............................................................................................ 1435  
      1. Bankruptcy and Receivership ..................................................................... 1437  
      2. Reorganization and Foreclosure .............................................................. 1438  
      3. Revocation of Corporate Charter ............................................................. 1440  
      4. Continuation versus Cessation of Business, Liquidation, and Sale of Assets .................................................................................. 1441  
      5. Absence of a Market for Stock .................................................................... 1444  
      6. "Identifiable Events" ................................................................................... 1445  
   C. Irrevocable Insolvency—The Exceptional Case ............................................. 1446  
      1. Going Concern Value .................................................................................. 1448  
D. Subsequent Events .............................................................................................. 1449  
E. Inconsistent Actions ............................................................................................ 1449  
III. Judicial and Regulatory Distinctions Between Debt and Equity ................. 1452  
   A. Distinctions Between Debt and Equity ......................................................... 1454  
   B. Section 385 ..................................................................................................... 1455  
   C. Scope of the Section 385 Regulations ............................................................ 1459  
   D. The Judicial Approach .................................................................................... 1462  
      1. Factors of Hindsight—Form ....................................................................... 1463  
      2. Factors of Hindsight—Intent ...................................................................... 1466  
      3. Factors of Hindsight—Economic Factors .................................................. 1470  
      4. Factors of Foresight—Midstream Transformations ................................... 1472  
      5. Factors of Foresight—Failure to Enforce on Default ................................ 1475  
      6. Factors of Foresight—Advances Continuing After Insolvency .................. 1477  
      7. Factors of Foresight—Accrual of Interest After Insolvency ....................... 1480  
      8. Effect of Equity Characterization ............................................................... 1483  
E. Section 385 Regulations—Post December 31, 1981 Interests ....................... 1486  
   1. Fair Market Value ............................................................................................ 1490  
   2. Reasonable Rate of Interest ........................................................................... 1492  
   3. Non-Shareholder Instruments ....................................................................... 1494  
      a. Hybrid Instruments .................................................................................... 1495  
   4. Shareholder Obligations .................................................................................. 1499  
      a. Bifurcation Rules ....................................................................................... 1499  
      b. "Safe Harbor" ............................................................................................. 1503  
   6. Definitions ...................................................................................................... 1504  
      a. Proportionality ............................................................................................. 1506
7. Proportional Equity Factors ........................................ 1512
   a. Hybrid Instruments ........................................ 1512
   b. Instruments not Issued for Money .......................... 1513
   c. Excessive Debt ............................................. 1515
   d. Change in Terms ............................................. 1516
   e. Payment History ............................................ 1516
   f. Instruments Payable on Demand ............................. 1517
8. Shareholder Obligations Not Evidenced by an Instrument ...... 1518
9. Preferred Stock .................................................. 1521
F. Comments, Criticisms, and Comparisons ............................. 1523
   1. Guaranteed Loans .......................................... 1525
   2. Advances Continuing After Insolvency ..................... 1526
   3. Accrual of Interest After Insolvency ..................... 1527
   4. Reform ..................................................... 1527
IV. Related Issues ................................................................ 1528
A. An Introduction to Consolidated Return Requirements Relating to Worthlessness ............................................. 1528
B. Administrative Requirements ...................................... 1530
V. Conclusion ................................................................... 1532
Worthlessness, Debt-Equity, and Related Problems

By William Natbony

It is a maxim of business that an investment is never made with the expectation of loss; few investments are made with even a suspicion that less than the original outlay will be returned. This perhaps explains the frequency of tax litigation on the issue of loss allowance: with little belief in downside risk, many investors are unprepared to document the context of a loss, having eschewed the legal counseling necessary to plan properly for all contingencies. Financial disaster thus often leaves investors unable to establish a current loss deduction.

Recognizing that capital formation and economic growth require speculation, Congress enacted tax provisions to mitigate investor loss. The provisions relevant to this discussion concern two investment loss categories: securities and debts. Preferential treatment is accorded losses of either kind sustained in a business context, especially in the area of intercorporate investment, in which the stakes often are highest.

* J.D., 1975, New York University School of Law; L.L.M., 1976, New York University School of Law.
† This paper was prepared while the author was on the faculty of St. Louis University School of Law. The author extends his grateful appreciation to his friend and colleague, Sandy Sarasohn, for his continuous support and guidance, and to Kim Sindel for her valuable assistance in the preparation of this Article. Copyright © 1981, William Natbony. All rights reserved.


2. I.R.C. § 165. All references and citations to sections in this Article are to sections of the Internal Revenue Code of 1954, as amended to the date of publication, unless otherwise indicated. All references and citations to regulations are to Treasury Regulations under the Internal Revenue Code of 1954, as amended to the date of publication, unless otherwise indicated.

3. Id. § 166.

Generally, a loss deduction is allowed when “sustained.” Most often a loss is sustained when the loss property is sold or is otherwise disposed of. When there is no sale or other disposition of stock or indebtedness, however, planning and ascertaining the timing of a loss deduction is more complex, with the stakes higher and the tax benefits more significant. Deductibility hinges on whether the stock or debt in issue is “worthless,” a factual determination turning on administrative and judicial reaction to corroborative facts and to the degree of insolvency. An awareness of the judicial yardsticks for determining worthlessness is essential to defining the issues and to planning for the deduction.

Even an allowable deduction for worthlessness may not be beneficial, however, if characterized unfavorably. An allowable loss is either capital or ordinary. Ordinary losses are fully deductible by both individuals and corporations. Corporate capital losses, on the other hand, are deductible only against capital gains. As corporate taxpayers rarely engage in capital gain transactions, corporate capital losses are often useless.

Loss deductions are also affected by events occurring after the apparent date of worthlessness. A seemingly allowable loss, deductible against ordinary income, may be dissipated by subsequent conduct that is either inconsistent with worthlessness or counterproductive to peripheral tax benefits. Awareness of and attention to postworthlessness conduct is thus fundamental to planning the loss deduction.

Moreover, the tax distinctions between debt and equity play an important role in that they may affect both the timing and the allowability of a worthlessness deduction. A debt obligation recharacterized as an equity interest may lose priority and become worthless at a date earlier than that expected by the taxpayer, thus possibly allowing the statute of limitations on deductibility to run. On the other hand, junior debt that is treated as debt for tax pur-

7. See notes 69-76 & accompanying text infra.
9. See id. §§ 65, 1222. See also id. § 1231.
10. Id. § 1211(a). Individuals’ capital losses may be deducted only to the extent allowed by I.R.C. § 1211(b).
11. But see id. § 1231.
12. But see id. § 1212(a) (corporate capital losses may be of some use because of the eight-year period of carryback and carryover).
poses may become worthless at a date later than that expected by the taxpayer if senior debt is recharacterized as equity.\textsuperscript{13}

The development of a loss deduction, from the initial warning of financial deterioration to the date of worthlessness and eventual liquidation of the investment, proceeds through an integrated series of transactions studded with opportunity, yet fraught with danger. This Article sets forth the opportunities and the dangers of developing a loss deduction by tracing the requirements for establishing the amount, character, and timing of deductions for worthless securities and bad debt losses. The focus throughout is on affiliated corporation\textsuperscript{14} problems, although the discussion has broader application. The Article reviews the relevant statutes and voluminous case law, examines current standards for determining worthlessness, and explores planning opportunities. When judicial construction proves confusing, the Article attempts to synthesize a rule of law consistent with the statutes and with legislative intent.

\textbf{Statutory Overview: Worthless Securities and Bad Debts}

\textbf{Allowance}

Section 165(a) provides that \textquotedblleft[t]here shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.\textquotedblright\textsuperscript{15} A deductible loss is \textquotedblleft sustained\textquotedblright when there is a closed and completed transaction, as in a sale or other disposition, or when the loss has been fixed by one or more identifiable events, as in a determination of worthlessness.\textsuperscript{16} Section 165(b) limits the amount of deduction to the property's adjusted basis for loss.\textsuperscript{17}

\begin{itemize}
  \item \textsuperscript{13} See text accompanying notes 89-92 infra.
  \item \textsuperscript{14} For the definition of affiliated corporation, see notes 48-50 & accompanying text infra.
  \item \textsuperscript{15} Also deductible are net operating loss carrybacks and carryovers, I.R.C. § 172, and capital loss carrybacks and carryovers, id. § 1212(a). With respect to the year in which the deduction is allowed, see Rev. Rul. 74-80, 1974-1 C.B. 117 (when stocks purchased on deferred payment under negotiable note, deduction in year of payment, not year of worthlessness).
  \item \textsuperscript{16} Treas. Reg. § 1.165-1(d). It is necessary to ascertain worthlessness in order to obtain a deduction under I.R.C. §§ 165(g), 166, and 832(c)(6). \textit{See also} id. §§ 80, 172(h), 582, 593(c), 595(a), 1212(a)(2), 1351, 6511(d). \textit{Cf.} I.R.C: § 1244 (loss on small business stock treated as ordinary loss, but only when held continuously by taxpayer since issuance).
  \item \textsuperscript{17} Adjusted basis is determined in accordance with I.R.C. § 1011. \textit{See} Charles H.
If a loss arises from indebtedness, the requirement that the loss be "sustained" is relaxed under section 166. Indeed, bad debts may be deducted even if worthless only in part. While section 166(a)(1) repeats the general rule that business debts becoming wholly worthless within the taxable year will be allowed, section 166(a)(2) allows a deduction, at the Secretary's discretion, for partially worthless business debts charged off by the taxpayer during the taxable year. A taxpayer is not required, however, to make a charge-off in the year in which a business debt becomes partially worthless. If partial worthlessness continues, the charge-off and deduction may be taken in any subsequent tax year, but

Allen v. Commissioner, 26 T.C.M. 493 (1967) (taxpayer was denied a worthlessness deduction for failure to establish his basis in the stock).

18. I.R.C. § 166(a)(2).

19. Treas. Reg. § 1.166-3(a)(2)(iii) provides: "Before a taxpayer may deduct a debt in part, he must be able to demonstrate to the satisfaction of the district director the amount thereof which is worthless and the part thereof which has been charged off." See Wilson Bros. & Co. v. Commissioner, 124 F.2d 606, 609-610 (9th Cir. 1941); Sika Chem. Corp. v. Commissioner, 64 T.C. 856, 863 (1975) ("[I]t is the taxpayer's burden to introduce evidence which establishes that in the year the partial worthlessness was claimed, the amount of such worthlessness could be predicted with 'reasonable certainty.'"); Trinco Indus., Inc. v. Commissioner, 22 T.C. 959, 965 (1954); First Nat'l Bank of Los Angeles v. Commissioner, 6 B.T.A. 850, 859-60 (1927).

20. The charge-off requirement is satisfied by accounting entries on the taxpayer's books and records. See Findley v. Commissioner, 25 T.C. 311 (1955), aff'd per curiam, 236 F.2d 959 (3d Cir. 1956); Houghton & Dutton Co. v. Commissioner, 26 B.T.A. 52 (1932); Meyer v. Commissioner, 16 B.T.A. 1239, 1241 (1929). The actual charge-off entries for partially worthless business debts may be made after the close of the taxable year, but must occur prior to the filing of the return. See Hamlen v. Welch, 166 F.2d 413 (1st Cir. 1940). Cf. Colorado County Fed. Sav. & Loan Ass'n v. Commissioner, 36 T.C. 1167 (1961), aff'd per curiam, 309 F.2d 751 (5th Cir. 1962) (entries to reserve for bad debts must be made prior to filing return).

21. See Ardela, Inc. v. Commissioner, 28 T.C.M. 470, 473 (1969) (that petitioners received less than the face amount of the indebtedness did not necessarily prove that the balance was uncollectible). Cf. Bullard v. United States, 146 F.2d 386, 388 (2d Cir. 1944) (taxpayer not entitled to a deduction of part of purchase price of shares when no identifiable event occurred during taxable year to establish worthlessness, and corporation remained in business); Walter H. Goodrich & Co. v. Commissioner, 40 B.T.A. 960, 963 (1939) (disallowance of deduction of part of a reserve for bad debts, consisting of loans to an affiliate, held not arbitrary when during the taxable year the taxpayer continued to make advances and affiliate had large and growing sales). See also I.R.C. § 1038 (reacquisition of real property, as in the foreclosure of a purchase money mortgage, will preclude a finding of complete or partial worthlessness).

22. See Treas. Reg. § 1.166-3(a). This affords the taxpayer some opportunity to select the year in which to claim a bad debt deduction. Furthermore, in lieu of the specific deduction charge-off method allowed under I.R.C. § 166(a), a taxpayer engaged in a trade or business can elect to deduct a reasonable addition to a reserve for bad debts pursuant to I.R.C. § 166(c). The issue of what constitutes a reasonable addition to a reserve for bad debts is a
no deduction is allowed after the tax year in which complete worthlessness occurs. The Secretary's disallowance of a deduction for partial worthlessness will not be disturbed by the courts unless it is plainly arbitrary or unreasonable. If a deduction is properly disallowed in the year in which part of the debt is charged off, a deduction still may be allowed in a later year.

The amount of deduction for worthless indebtedness is limited to the adjusted basis for loss determined under section 1011. Hence, the debt must arise from the debtor's capital. Thus, worthless debts arising from unpaid wages, fees, interest, rents, and similar items cannot be deducted unless previously included in income.

A worthless debt that is evidenced by a "security" will not be deductible under section 166, but may be deductible under section 165(a). "Securities" are defined in section 165(g)(2) as corporate stock and the right to receive corporate stock, and corporate debt evidenced by a note with interest coupons or in registered form. Moreover, indebtedness, even though not evidenced by a security, will still fall outside of section 166 if it is not "bona fide." The Treasury Regulations provide that "[a] bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of

question of fact to be determined in the light of circumstances existing at the close of the taxable year. Treas. Reg. § 1.166-4(b)(1). See Black Motor Co. v. Commissioner, 41 B.T.A. 300 (1940), aff'd, 125 F.2d 977 (6th Cir. 1942). If the Commissioner disapproves an addition, the taxpayer has the burden of establishing reasonableness. See Dixie Furniture Co. v. Commissioner, 390 F.2d 139 (8th Cir. 1968).

23. See Treas. Reg. § 1.166-3(b).

24. In Austin Co., Inc. v. Commissioner, 71 T.C. 955 (1979) (acq.), the Tax Court stated: "[The Commissioner] may not ignore the soundly exercised business judgment of a taxpayer's officers in determining partial worthlessness. Such judgment is relevant in evaluating the reasonableness of [the Commissioner's] exercise of discretion granted him by section 166(a)(2). Thus, if management's business judgment is supported by facts establishing partial worthlessness, [the Commissioner's] exercise of discretion will be overturned." Id. at 971-72 (citation omitted). See also Wilson Bros. & Co. v. Commissioner, 124 F.2d 606, 609 (9th Cir. 1941); Portland Mfg. Co. v. Commissioner, 56 T.C. 58, 73 (1971), aff'd, 75-1 U.S.T.C. ¶ 9449 (9th Cir. 1975) (a deduction cannot be denied when the facts clearly show the extent of partial worthlessness); Findley v. Commissioner, 25 T.C. 311, 318 (1955), aff'd per curiam, 236 F.2d 959 (3d Cir. 1956); Estate of Harris Fahnestock v. Commissioner, 2 T.C. 756, 759 (1943).

25. Treas. Reg. § 1.166-3(a). See also id. § 1.166-3(b).

26. I.R.C. § 166(b); Treas. Reg. § 1.166-1(d).

27. Treas. Reg. § 1.166-1(e).

28. I.R.C. § 166(e); Treas. Reg. § 1.166-1(g).

29. I.R.C. § 166(g).
money. A gift or contribution to capital shall not be considered a debt for purposes of section 166.\textsuperscript{30} The validity of a purported debt will turn on whether the rights of the taxpayer are those of a shareholder or a creditor.\textsuperscript{31}

An exception to the “sustained” language of section 165 that allows a deduction only for “wholly worthless” losses may be argued for partially worthless securities.\textsuperscript{32} To uphold this argument, it is necessary to equate partially worthless business debt losses\textsuperscript{33} with partially worthless business security losses.\textsuperscript{34} Although “a bond, debenture, note, or certificate, or other evidence of indebtedness . . . with interest coupons or in registered form”\textsuperscript{35} does not, for most tax purposes, differ from indebtedness without interest coupons or in nonregistered form, the latter are deductible as partial bad debt losses within the meaning of section 166, while the former are deductible only when “sustained” within the meaning of section 165(a).

Historically, except in the case of a disposition, a loss has been deemed sustained when complete worthlessness occurs.\textsuperscript{36} This rule, however, does not strictly follow from the tax concept of loss realization. “Sustained” is a hybrid accounting term. It does not mean “accrued,” because all the events need not occur to fix the date of loss.\textsuperscript{37} Similarly, it does not mean “paid,” because there need not be a disposition. Sustained may be reasonably defined as “some identifiable event [which] fixes the actual . . . loss and the amount thereof.”\textsuperscript{38} This definition permits a loss deduction for a business security that has become “wholly worthless in part,” that is, that

\begin{itemize}
  \item \textsuperscript{30} Treas. Reg. § 1.166-1(c).
  \item \textsuperscript{31} A significant and comprehensive analysis of this area is found in Plumb, The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal, 26 Tax L. Rev. 369 (1971) [hereinafter cited as Plumb]. The debt-equity classification issue is discussed at notes 259-702 & accompanying text infra.
  \item \textsuperscript{32} Two other exceptions are statutory. Section 166(a)(2) allows a deduction for partially worthless debts. Section 166(c) allows a deduction for a reserve for bad debts.
  \item \textsuperscript{33} See I.R.C. § 166(a)(2).
  \item \textsuperscript{34} Some business security losses are treated as ordinary losses under the Corn Products doctrine. Corn Products Ref. Co. v. Commissioner, 350 U.S. 46 (1955). See notes 52-61 & accompanying text infra.
  \item \textsuperscript{35} I.R.C. § 165(g)(2)(C).
  \item \textsuperscript{36} See notes 93-258 & accompanying text infra.
  \item \textsuperscript{37} Cf. Amend v. Commissioner, 13 T.C. 178 (1949) (acq.) (doctrine of constructive receipt).
  \item \textsuperscript{38} But see Treas. Reg. § 1.1001-1(c) (1977) (until sale or other disposition of property occurs, there remains the possibility that the taxpayer may recoup the adjusted basis of the property).
\end{itemize}
has had a permanent decline in value.

Treating a loss as sustained when fixed by reasonably ascertainable events would also be consistent with the policy underlying the loss deduction provisions. Assume that stock or registered debentures held by an affiliated parent—"business securities"—decline in value so that only a measurable maximum can be recovered and that the decline is irreversible because the subsidiary has a limited life. If the parent charges off the ascertainably worthless portion of the security, then a loss has been sustained. Conversely, if General Motors stock declines fifty percent in value, the corporation has experienced only a decline in value that may reverse itself, and no shareholder has yet "sustained" a deductible loss even if the shareholder contracts to sell the stock in the next year.

Allowing a business taxpayer the earlier deduction mirrors the business versus nonbusiness distinction of section 166. Under section 166(d), a nonbusiness investment loss is deductible when there occurs either final recovery of a portion or complete worthlessness. A business bad debt loss is deductible under the theory of matching business income and deduction when the indebtedness is not reasonably recoverable.

The suggested definition of "sustained," while reasonable, is not supported by legislative history or judicial precedent. Although Congress has never defined "sustained," it has interpreted section 165(a) to provide that "no deduction whatever is allowable with respect to any loss from partial worthlessness (whether or not charged off within the taxable year) of any security as defined in [section 165(g)(2)]." This section could be interpreted merely to proscribe deductions for a decline in value. No court, however, has so held. Moreover, it is unlikely that a court would find the argument sufficiently overwhelming to reverse over sixty years of tax

39. Cf. Sterling Morton v. Commissioner, 38 B.T.A. 1270 (1938), aff'd, 112 F.2d 320 (7th Cir. 1940) (loss deductible only in year stock becomes worthless).
40. See 875 Park Ave Co. v. Commissioner, 217 F.2d 699 (2d Cir. 1954); Treas. Reg. § 1.165-4(a), -5(f).
41. See Amend v. Commissioner, 13 T.C. 178 (1949) (acq.).
43. See Byerlyte Corp. v. Williams, 170 F. Supp. 48, 59-60 (N.D. Ohio 1958), rev'd on other grounds, 286 F.2d 285 (6th Cir. 1961) (taxpayer unsuccessfully argued that a partial worthlessness loss from affiliate securities should be characterized under I.R.C. § 23(g)(4) (1942) (current version of I.R.C. § 165(g)(3))).
practice. The solution thus appears to lie with Congress.

**Characterization**

Worthlessness losses for which deductions are allowed under sections 165(a) and 166(a) and (c) are characterized as ordinary losses because there is no “sale or exchange.” There are two statutory exceptions, however, within sections 165 and 166.

The first exception is for nonbusiness bad debts, which are characterized under section 166(d) as short-term capital losses subject to the same rules for deductibility as wholly worthless business debts. The second exception is for worthless capital asset securities. Section 165(g)(1) provides: “If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall . . . be treated as a loss from the sale or exchange . . . of a capital asset.” This artificial sale or exchange converts worthless security losses from ordinary to capital losses.

There is, however, an exception to this exception. Section 165(g)(3) provides that, for purposes of section 165(g)(1), securities


45. There are two other relevant I.R.C. sections. Section 1244 characterizes a loss as ordinary up to a maximum of $100,000 if (1) the shareholder is an individual, and (2) the loss involves “section 1244 stock” as defined in § 1244(c). Section 1374 allows net operating losses of a “small business corporation” to flow through to the shareholders of the corporation. A corporation cannot qualify as a “small business corporation” if it has a corporate shareholder. I.R.C. § 1371(a)(2). See also I.R.C. §§ 1373, 1375, 1376.

46. The reserve method may not be used with respect to nonbusiness bad debts. Id. § 166(d)(1)(A).


47. The predecessor of I.R.C. § 165(g)(1) entered the Code as part of the Revenue Act of 1938. Pub. L. No. 75-554, § 23(g)(2), 52 Stat. 447 (codified at I.R.C. § 23(g)(2) (1939)). Its purpose was to equate losses resulting from a worthlessness event with those arising from a sale or exchange; the former were not capital losses, even though the assets involved were “capital assets.” Before 1938, they had been deductible in full from gross income as ordinary losses under the Revenue Act of 1936, Pub. L. No. 74-740, § 23(e)(2), (f), 49 Stat. 1648, the predecessor of I.R.C. § 165(a), (c)(2), because the worthlessness event was conceded not a “sale or exchange.” See Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247 (1941).
in an affiliated domestic corporation will not be treated as capital assets; a loss on the complete worthlessness of affiliate securities will be ordinary. A corporation is treated as "affiliated" if at least eighty percent of each class of stock is owned directly by the taxpayer, and more than ninety percent of the aggregate of its gross receipts for all taxable years has been from active sources.

If the worthless security is a noncapital asset, section 165(g) will not apply. As ordinary loss characterization is preferable, the taxpayer's task is to qualify under section 165(g)(3) or to fall outside the section 165(g)(1) exception by failing to meet the definition of capital asset.

Although "capital asset" is defined in section 1221, the stat-
ute is not exclusive. In *Corn Products Refining Co. v. Commissioner*, the Supreme Court held that property integrally related to the taxpayer's trade or business is not a capital asset. Subsequent cases have treated stock in a corporation as integrally related to the taxpayer's trade or business when held to assure a source of supply, to generate business, to expand into a related line of business, or to obtain the services of a research scientist.

The rationale of *Corn Products* and its progeny is that property held as an integral, operating component of the taxpayer's business is not a capital asset. This reasoning has been extended beyond "traditional" *Corn Products* assets to include corporate stock purchased to acquire a vertically or horizontally integrated subsidiary. In reaching a *Corn Products* result, the courts have explicitly looked through the corporate shell to discern the integrated operations of a single enterprise. Raising substance over form, the courts have held that the representative stock was a non-capital asset in light of the business nature and the parent's use of

---

54. Id. at 51.
57. See Schlumberger Technology Corp. v. United States, 443 F.2d 1115 (5th Cir. 1971).
the underlying operating assets.\textsuperscript{61}

To the extent a security is a \textit{Corn Products} asset, section 165(g) will not apply. Accordingly, losses, whether arising from worthlessness or from disposition, will be ordinary. The "integrity" argument, however, has been taken one step further. One commentator has advocated that "section 165(g)(3) and the Code as an ‘organic whole’ reflect a policy that business enterprises, regardless of their form of corporate organization, and whether or not they file consolidated returns, be treated alike with respect to investments in subsidiary businesses."\textsuperscript{62} Affiliated corporations should be "‘considered closely enough related, in effect, to treat them as one operating business.’"\textsuperscript{63} Support for this argument was extracted from the legislative history of section 165(g)(3), which equates the tax treatment of worthless affiliate securities with that of a consolidated group.\textsuperscript{64} The result of this proposal would be to ignore corporate entities that are eighty percent or more owned by a parent corporation or related group.\textsuperscript{65}

This proposal, if given effect, would mean that a parent would no longer need to argue that common stock in a subsidiary is a \textit{Corn Products} asset. Assets, including securities, held by the subsidiary would be section 1231 property, inasmuch as the corporate entity of the subsidiary would be ignored.\textsuperscript{66} Section 165(g)(3) would thus be surplusage because property losses, whether partial or complete, would fall within section 1231.\textsuperscript{67} Moreover, the consol-

\textsuperscript{61.} See John J. Grier Co. v. United States, 328 F.2d 163, 165 (7th Cir. 1964); Union Pac. R.R. v. United States, 524 F.2d 1343, 1357-59 (Ct. Cl. 1975), cert. denied, 429 U.S. 827 (1976); Pittsburgh Reflector Co. v. Commissioner, 27 T.C.M. 377, 379 (1968). \textit{See also} Schlumberger Technology Corp. v. United States, 443 F.2d 1115, 1121-22 (5th Cir. 1971); Chemplast, Inc. v. Commissioner, 60 T.C. 623, 630-33 (1973), aff’d, 506 F.2d 1050 (3d Cir. 1974).


\textsuperscript{65.} Cf. Miller, \textit{The Nominee Conundrum: The Live Dummy is Dead, but the Dead Dummy Should Live}, 34 Tax L. Rev. 213 (1979) (distinguishing between the disregard and nominee corporation theories).

\textsuperscript{66.} Cf. Javaras, supra note 59 (controlled corporate subsidiaries carrying on part of group’s business should produce ordinary loss when their securities sell at a loss).

\textsuperscript{67.} In enacting the predecessor of I.R.C. § 165(g)(1) (I.R.C. § 23(g)(2) (1939)), the
idated return and dividends received deduction provisions would be unnecessary, because the related group of corporations would be treated as one taxpayer.

Although Congress to some extent intended to equate affiliate with consolidated securities losses, section 165(g)(3) does so only when there is complete worthlessness and when the business is not "passive." The consolidated return provisions contain no such restrictions. Section 165(g)(3) allows an ordinary loss for affiliate securities only if they are wholly worthless. Although the result advocated above may be an equitable simplification of the tax law, a simplification of such magnitude is a matter for legislative, not judicial, relief.

Attention to the language used by Congress, however, reveals a view of consolidated returns that has been overlooked. "[A] parent and subsidiary corporation may file consolidated returns and to this extent the corporate entity is ignored." "In the case where the securities of the [consolidated] subsidiary company become worthless . . . the loss, in effect, is regarded as a loss of part of the . . . "

Senate Finance Committee included an exception for securities held by a corporation: "If any securities . . . become worthless during the taxable year and are capital assets, the loss resulting therefrom shall, in the case of a taxpayer other than a corporation, . . . be considered as a loss from the sale or exchange . . . of capital assets." (Emphasis added). The Senate Finance Committee stated that losses from worthless securities incurred by corporations "are customarily a part of their ordinary business expense and should be treated as such." S. REP. No. 1567, 75th Cong., 3d Sess. 13-14 (1938), reprinted in 1939-1 C.B. (pt. 2) 779, 789. The House Ways and Means Committee did not consider this amendment, see H.R. REP. No. 1860, 75th Cong., 3d Sess. 18-19 (1938), reprinted in 1939-1 C.B. (pt. 2) 728, 740-41, and the Conference Committee deleted it without explanation. H.R. REP. No. 2330, 75th Cong., 3d Sess. 35 (1938), reprinted in 1939-1 C.B. (pt. 2) 817, 819. It is not clear from the legislative history whether Congress deleted the exception because it believed that affiliate "securities" might not be I.R.C. § 165(g)(2) securities.


70. The argument against the sanctity of the corporate form was rejected by the Supreme Court in Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438-39 (1943) (citations omitted): "Whether the purpose [of incorporating] 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." See generally B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 1.05 (4th ed. 1979) (hereinafter cited as BITTKER & EUSTICE); Barr, A Threat to the Lifeless Corporate Skeleton: Disregarding the Corporate Entity, 51 TAXES 555 (1973); Miller, The Nominee CoMundrum: The Live Dummy is Dead, but the Dead Dummy Should Live, 34 TAX L. REV. 213 (1979).

business of the parent corporation rather than as a loss on an investment." The congressional belief apparently is that, whether a loss is partial or complete, a consolidated parent would be entitled to characterize the loss according to the underlying assets, normally section 1221(1) or section 1231(b) property.

The belief is theoretically justified. The underlying principle of the consolidated return provisions is that the affiliated group is taxed on its consolidated taxable income, representing the results of its dealings with the outside world after elimination of intragroup gain and loss. Congress enacted the consolidated group provisions in an effort to provide electing corporate groups with the same benefits allowed single corporations with multiple operating divisions. The Treasury Regulations under section 1502 attempt to achieve this result.

An operating subsidiary within an affiliated group filing consolidated returns is, by definition, part of the parent’s trade or business. In effect, the subsidiary’s gains, losses, deductions, depreciation, and characterizations are those of the parent. This is “in keeping with the theory that the consolidated group is a single taxable enterprise and that only its dealings with outsiders have genuine significance.” As such, the stock of an operating subsidiary is akin to any other asset of an operating division, and gain or loss ought to be characterized by reference to the underlying business assets.


73. See generally Bittker & Eustice, supra note 70, ¶ 15.01-24. Cf. Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945) (gain or loss from sale of going business by individual is determined by character of gain or loss from sale of separate assets of the business).

74. But see, e.g., I.R.C. § 542(b); Treas. Reg. § 1.1502-13.


76. Unfortunately, the section 1502 regulations generally do not carry the corporate-division rationale to this logical conclusion. But see Treas. Reg. § 1.537-3(b) (for accumulated earnings tax purposes, the business of an 80 percent subsidiary is the business of its parent). Only one lower court has considered this issue. See United States v. Manor Care, Inc., 490 F. Supp. 355, 358 (D. Md. 1980) (court refused to disregard the corporate entity). Cf. Rev. Rul. 59-395, 1959-2 C.B. 475 (setting forth the Service’s position on the effect of Libson Shops v. Koehler, 353 U.S. 382 (1957), on carrybacks and carryovers under the 1939 Code); In re Chrome Plate, Inc., 614 F.2d 990 (5th Cir. 1980) (corporate entity not automatically disregarded in context of § 334(b)(2) when consolidated returns were filed). Nevertheless, the result follows because consolidated subsidiaries are by definition an integral part of a single corporate enterprise. See Javaras, supra note 59, at 780-92; note 707 infra.
Securities and Debts: Differences and Similarities

Both section 165(a) and section 166 allow a deduction for worthlessness, use section 1011 basis for determining loss, and differentiate between investment and business losses. There are, however, two major distinctions, aside from the obvious one between security and debt, that warrant comment.

One difference has already been discussed. Section 166 permits a deduction for partially worthless business debts, while section 165(a) requires that a security become wholly worthless. A second difference involves the timing of the worthlessness deduction. Section 165(g)(1) provides that the loss resulting from a capital asset that becomes worthless during the taxable year will be treated as a loss from a sale or exchange "on the last day of the taxable year." This will sometimes convert, to the taxpayer's detriment, short-term into long-term capital loss. Moreover, if the taxpayer is a corporation, the computation of earnings and profits may be affected. Section 165(g)(1) has no application, however, to noncapital assets and affiliate securities. These losses are recognized on the date of worthlessness.

Section 166 has no artificial provision for determining the date of loss. No timing provision is necessary because the holding period is irrelevant to debt loss characterization. If the loss arises from a business bad debt, the loss will be ordinary because it did not derive from a sale or exchange. If the loss arises from a nonbusiness bad debt, section 166(d) prescribes artificial short-term capital loss treatment regardless of the holding period.

Section 165(a) and (g) and section 166 require that the prop-

77. See notes 15-25 & accompanying text supra.
78. See I.R.C. §§ 1202, 1211, 1212, 1222.
79. See Treas. Reg. § 1.312-7(b)(1) (earnings and profits include the excess of capital losses over capital gains, nondeductible by virtue of I.R.C. § 1211), Treas. Reg. § 1.316-2(b) (last sentence) and Rev. Rul. 74-164, 1974-1 C.B. 74, 75 (situation 4). It is not clear whether an I.R.C. § 165(g)(1) loss is "realized" on the date of worthlessness or on the last day of the taxable year for purposes of earmarking earnings and profits on midyear distributions. The proper answer should be that the date of worthlessness, if provable, is the date the loss is realized; earnings and profits computations are not governed by artificial "recognition" provisions. If the last day of the taxable year were the correct computation date, the result would be an earnings and profits computation different from that under an I.R.C. § 165(a)-Corn Products loss. See note 53 & accompanying text supra. See I.R.C. § 165(g)(1) ("treated as" language). This issue may be further complicated by a change in the effective tax rate. See I.R.C. § 21.
80. There are no estimated tax issues. See I.R.C. §§ 6015, 6154.
WORTHLESSNESS, DEBT-EQUITY

July 1981

property "become worthless" within the taxable year. It is unclear whether "worthless" means the same thing for purposes of security losses and debt losses. A basic tenet of statutory construction is that, absent explicit contrary congressional intent, words mean the same in one section of a statute as they mean in another. Congress expressed no intent to ascribe different meanings to "worthless" in the securities and debt contexts. Moreover, commentators addressing this question have either assumed or affirmatively represented congruity. Courts have imposed the same test for worthlessness under section 165 as under section 166.

"Worthlessness" means destitute of worth, of no value or use. A loss for tax purposes therefore should occur when a security or a debt ceases to be an asset of the taxpayer, that is, when there is a "constructive disposition" sufficient to achieve the status of a "realization" event, or when the loss becomes "closed and completed" in the annual accounting sense. Such a definition would include losses from both securities and indebtedness.

The inquiry does not end here, however, for there are obvious problems in equating the worthlessness of the extremes, common stock and secured debentures. The quantum, though not the quality, of proof will differ. Worthlessness of a corporation's common stock may precede that of its preferred stock; worthlessness of its preferred stock may precede that of its subordinated debentures; worthlessness of its subordinated debentures may precede that of

81. Sections 165(g) and 166(a) contain another difference worth comment—a drafting inconsistency. Section 165(g)(1) provides: "If any security . . . becomes worthless during the taxable year . . . ." Section 166(a) states: "There shall be allowed as a deduction any debt which becomes worthless within the taxable year." (Emphasis added.) The author can discern no reason, save carelessness, for this drafting distinction.


84. See SURREY, WARREN, MCDANIEL & AULT, FEDERAL INCOME TAXATION 387 (1972) ("The standard in section 166, 'becomes worthless,' is the same as in section 165(g) respecting securities, and hence the cases thereunder as to when a security becomes worthless are applicable to bad debt situations . . . .").


86. See Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 186 (1934).


88. See Treas. Reg. § 1.165-1(b).
its senior debt; and worthlessness of its senior debt may precede that of its secured obligations. At each level of worthlessness, "insolvency" and "potential value" have different meanings. As indebtedness has priority over equity capital, the worthlessness of corporate stock will normally precede that of corporate debt.

Ascertaining Worthlessness

Over the years, the courts have addressed numerous taxpayer claims for loss deductions arising from imprudent investments. Frequently, the contested issue concerned the validity of the claim, that is, whether a loss was actually suffered. More often, however, the contest centered on the timing of the loss deduction. Resolving the latter issue has posed the thornier problem for the courts because, while the question of whether a loss was suffered depends upon the taxpayer's proof of adjusted basis and amount realized, the question of when a loss deduction may be allowed depends upon when the loss was "sustained."

In the worthlessness context, whether a loss was sustained is a question of fact. Although yardsticks for measuring value exist, a judge's reaction to corroborative evidence and to the degree of insolvency will be determinative in all cases but those of dissolution and continued profitability.

Early cases indicate a de novo approach to most fact patterns,

89. See Mahler v. Commissioner, 119 F.2d 869, 873 (2d Cir.), cert. denied, 314 U.S. 660 (1941); Brandtjen & Kluge, Inc. v. Commissioner, 34 T.C. 416, 444-45 (1960) (in order for senior debt to become worthless, there must be no value remaining in the corporation); Jones v. Commissioner, 29 B.T.A. 928 (1934) (common stock may become worthless even while there remains a chance of some recovery on the debt or on preferred stock). See generally D. Cowans, BANKRUPTCY LAW AND PRACTICE 302-07 (2d ed. 1978).

90. See notes 135-243 & accompanying text infra.

91. See note 89 supra.

92. In the following discussion of worthlessness, the tests for worthless securities and bad debts are equated. Reference to one assumes reference to the other, with one proviso: the quantum of proof for bad debts is invariably higher than that for worthless securities. Even when a corporation is "insolvent" and its stock worthless, debt will often retain some value.

"Insolvency"—that is, a situation in which claims with a priority over the taxpayer's claims exceed the corporation's assets properly valued—applies to indebtedness as well as to stock. See note 97 & accompanying text infra. Determining whether potential value exists is also a question of degree. The indebtedness at issue may possess potential value even though the equity securities do not, because the corporation is more "insolvent" with respect to its equity securities than with respect to its debts. See notes 135-243 & accompanying text infra. These distinctions are implicit in the cited cases.
with different courts reaching disparate holdings on the same facts. For example, in a series of cases emanating from the business failure of the Middle West Utilities Company, the Second Circuit held that preferred stock became worthless in 1934, the Board of Tax Appeals in two separate cases held that the common and preferred stock did not become worthless and did become worthless in 1932, and the Tax Court held that the common stock did not become worthless until 1938.

In contrast, recent cases have achieved a high degree of theoretical and actual consistency. This consistency is partially a result of experience. It is also the result of the development, over the years, of a yardstick against which courts can measure the evidence supporting a taxpayer's claim.

Perhaps the most important case in the evolution of judicial reaction to worthlessness is Sterling Morton v. Commissioner, a 1938 decision involving a deduction for worthless stock. The taxpayer in Morton had deducted his common stock as worthless in 1932. In support of his claim, the taxpayer relied on the 1932 dissolution and liquidation of the corporation and maintained that those events identifiably signalled the end to any hope that his investment might recover value. The Commissioner determined that the stock had become worthless sometime prior to 1932, contending that on December 31, 1931, the preferred stock liability of $609,000 exceeded both the corporation's book value of $144,896 and its market value of $42,000. As a result, the Commissioner argued that the taxpayer's loss was reasonably ascertainable in 1931 and that the taxpayer had failed to carry his burden of proving that the stock had a potential value prior to the 1932 events.

From an examination of the leading circuit court cases, the Morton court extracted the threshold requirement that "a loss by reason of the worthlessness of stock must be deducted in the year in which the stock becomes worthless and the loss is sustained

---

97. 38 B.T.A. 1270 (1938), aff'd, 112 F.2d 320 (7th Cir. 1940).
98. Id. at 1275-78.
99. Id. at 1275-80.
If there is any reasonable hope that the stock retains some potential for regaining its value through the foreseeable operation of the corporation, then it may not be considered worthless. That hope can be foreclosed by the occurrence of one or more "identifiable events," which are likely to be known immediately by anyone having an interest in the affairs of the corporation. Identifiable events "are important for tax purposes because they limit or destroy the potential value of stock." 101

"If the assets of the corporation exceed its liabilities, the stock has a liquidating value." Even when assets do not exceed liabilities, the stock, "while having no liquidating value, has a potential value and cannot be said to be worthless," if there is "a reasonable hope and expectation" that the situation will reverse sometime in the future. 102 In these situations, the occurrence of an identifiable event will put an end to the hope and expectation of recovery.

Moreover, there are "exceptional cases" in which there can be "no reasonable hope and expectation that a continuation of the business will result in any profit to its stockholders" because the corporation's liabilities greatly exceed its assets, and the nature of its assets and operations make any future turnabout unlikely. 103 In these cases, "the stock, obviously, has no liquidating value, and since the limits of the corporation's future are fixed, the stock, likewise, can presently be said to have no potential value." 104 Hence, when present value and future value both have been extinguished, the prior worthlessness will not be disturbed, even if there occurs in a later year some "identifiable event," such as liquidation or receivership. The subsequent event would not affect the worthlessness of the stock, "for already 'its value had become finally extinct.'" 105

The Morton court found that the facts fell within the "excep-
tional" situation. It summarized the taxpayer's burden:

In cases where the stock has concededly lost any liquidating value in a certain year, but an event occurs in a subsequent year which the taxpayer claims is 'identifiable,' and where the Commissioner of Internal Revenue has determined that stock became worthless in the year in which it lost its liquidating value, then the taxpayer, in order to be entitled to the loss deduction in the latter year, has the burden of proving that, although the stock lost its liquidating value in the prior year, it continued to have a potential value until the occurrence of the event. The taxpayer in Morton failed to carry this burden and, as a consequence, was denied a deduction for worthlessness occurring in a year closed by the statute of limitations.

The Morton case has led other courts to adopt complementary tests for determining the date on which worthlessness can be said to have occurred irrevocably. In the usual case, the taxpayer must show that the corporation is actually insolvent and that its stock has no potential for regaining value because of a lack of existing goodwill or going concern value. Certain types of identifiable events, such as bankruptcy, liquidation, and receivership, can serve as one means of proving the lack of potential value. In these situations, evidence of identifiable events will conclusively determine the date at which worthlessness can be said to have finally occurred. The taxpayer is then able to mark that date as one at which a reasonable person, in the exercise of sound business judgment, could look at the investment and recognize its worthlessness. At this point, there would be no hope that a turnabout could foreseeably occur.

In the "exceptional" case, however, the taxpayer has a greater burden of proof. The stock may have become worthless long before the corporation was willing or able to signal failure by engaging in activities constituting an identifiable event. In fact, in the exceptional case, there may be no "identifiable event" to signal the occurrence of worthlessness. Consequently, the taxpayer must demonstrate irrevocable insolvency by establishing a lack of current liquidating value and by making a factual showing that no foreseeable change would be likely to restore value to the specific assets. The taxpayer in this situation, as illustrated in Morton,

106. 38 B.T.A. at 1279 (citations omitted).
107. Id. at 1279-80.
108. See notes 135-166 & accompanying text infra.
thus has the burden of making a realistic appraisal of all the facts and circumstances. It is unlikely that precedent will be helpful in determining the date on which worthlessness occurred because, as the Seventh Circuit noted in affirming Morton, "each case must stand on its own facts." The "exceptional" case, therefore, offers the taxpayer a greater opportunity to document tribulations. It also creates a greater problem for the taxpayer who eschews accepted standards of record-keeping.

Absent the occurrence of a clear "identifiable event," the taxpayer must exercise care in assessing the existence of potential value. The taxpayer must walk a fine line, following a "rule of reason, avoiding alike the Scyllian role of the 'incorrigible optimist' and the Charybdian character of the 'Stygian pessimist.'"

**Burdens of Proof**

A taxpayer's initial task is to choose the year in which the stock or debt should be deducted as worthless. Although it will not always be clear that an investment has gone sour, the proper procedure is for the taxpayer to report a loss in the earliest year possible. In *Young v. Commissioner,* Augustus Hand, writing for the court, proposed that "the only safe practice, we think, is to claim a loss for the earliest year when it may possibly be allowed and to renew the claim in subsequent years if there is any reasonable chance of its being applicable to the income for those years."

In this way, any challenge by the Commissioner may be met by repeating the claim in future years. The taxpayer's deduction is thus preserved without fear that the year chosen will be foreclosed by the statute of limitations; a court can thereafter determine the proper year of worthlessness.

---

109. 112 F.2d at 321.


111. 123 F.2d 597 (2d Cir. 1941).

112. Id. at 600. Accord Estate of Fuchs v. Commissioner, 413 F.2d 503, 508 (2d Cir. 1969). But cf. Boehm v. Commissioner, 146 F.2d 553 (2d Cir.), aff'd on other grounds, 326 U.S. 287 (1945) (stockholder's derivative action was too speculative to defer worthlessness event founded on receivership and receiver's reports; loss was deductible in earlier year). See also De Loss v. Commissioner, 28 F.2d 803 (2d Cir.), cert. denied, 279 U.S. 840 (1928) (if the statute of limitations has run and the taxpayer's loss deduction is denied because taken in the wrong year, the stock/debt basis will nevertheless be zero for gain purposes).

113. See I.R.C. § 6511(d)(1) (allowing a seven year statute of limitations for claiming a worthlessness deduction). For a discussion of administrative provisions, see notes 719-29 &
A taxpayer nevertheless has the burden of establishing that (a) the stock became worthless, and (b) the worthlessness occurred during the year alleged. This burden involves purely factual issues, and no single factor is given controlling weight. As one court noted, "worthlessness is not determined by an inflexible formula or slide rule calculation, but upon the exercise of sound business judgment." Hence, the courts apply an objective test of reasonableness in assessing the validity of a taxpayer’s judgment of the year of worthlessness.

It might be true, as the court in De Loss v. Commissioner stated, that "it was not possible to say beyond imaginable peradventure that these assets might not be snatched at by some impressionable buyer, who did not share their owner’s estimate of the value. . . . But any such expectation was plainly illusory. . . . [S]o far as human foresight could go, the shares were worthless . . . ." The phrase that recurs throughout the cases is "incorrigible optimist." The courts’ position is that no reasonable taxpayer has any business being one.

accompanying text infra. I.R.C. § 6511(d)(1) is no longer consistent with I.R.C. § 172 as amended by the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 207(a)(1), which increased the loss carryover period from 7 to 15 years. A conforming amendment to § 6511(d)(1) would be appropriate.

114. Welch v. Helvering, 290 U.S. 111 (1933); Mahler v. Commissioner, 119 F.2d 869, 871 (2d Cir.), cert. denied, 314 U.S. 660 (1941); Lincoln Bank & Trust Co. v. Commissioner, 51 F.2d 78 (6th Cir. 1931); Dustin v. Commissioner, 53 T.C. 491, 501 (1969), aff’d, 467 F.2d 47 (9th Cir. 1972). See also Rule 142(a), RULES OF PRACTICE AND PROCEDURE, UNITED STATES TAX COURT (1978) (burden of proof is on petitioner except as otherwise provided by statute or determined by the court).

115. Boehm v. Commissioner, 326 U.S. 287 (1945); Genevov v. United States, 412 F.2d 556 (5th Cir. 1969); Morton v. Commissioner, 112 F.2d 320 (7th Cir. 1940); Jones v. Commissioner, 103 F.2d 681 (9th Cir. 1939); Lincoln v. Commissioner, 24 T.C. 669, 694 (1950), aff’d on other grounds, 242 F.2d 748 (6th Cir. 1957).

116. As it is a question of fact, a worthlessness determination will not be reversed on appeal unless clearly erroneous. E.g., Freeze v. Jones, 156 F.2d 454 (10th Cir. 1946); Leicht v. Commissioner, 137 F.2d 433 (8th Cir. 1943); Libby v. Commissioner, 133 F.2d 203 (3d Cir. 1943); Dunbar v. Commissioner, 119 F.2d 367 (7th Cir. 1941); Foster v. Commissioner, 112 F.2d 109 (1st Cir. 1940); Keeney v. Commissioner, 116 F.2d 401 (2d Cir. 1940); Sacks v. Commissioner, 66 F.2d 308 (4th Cir. 1933); Royal Packing Co. v. Lucas, 38 F.2d 180 (9th Cir. 1930).

Preliminary Burdens

Once the taxpayer has confronted the fact that an investment cannot be recovered and that a tax deduction will be the only solace, the primary task is to support the claim for tax deduction with persuasive evidence. That task is threefold. The taxpayer must first establish a cost or other basis, for it is elementary that a deductible loss cannot exceed basis. The taxpayer must then demonstrate that the particular stock or debt had some value at the end of the prior year or at the beginning of the year in issue. Finally, the taxpayer must document the stock or debt’s loss of all value during the year in which the deduction is claimed.

Establishing a basis for loss is a threshold requirement, yet more than one loss has been denied for failure to substantiate cost or to prove measurable basis. Meticulous record-keeping is necessary to carry this burden of proof. The taxpayer must recognize that the Commissioner and the courts will scrutinize closely any assertions of basis in order to differentiate among initial cost, capital expenses properly depreciable, and business expenses properly deductible. The sloppy bookkeeper, confronted with the burden of proving the elements of a deduction for worthless stock, is harshly penalized for a failure to document this fundamental element.


Moreover, there can be no loss deduction arising from contributions by a shareholder to the capital of a corporation if made when the stock was worthless. Estate of Bogeaus v. Commissioner, 29 T.C.M. 467 (1970); Carter v. Commissioner, 9 T.C.M. 697 (1950), aff’d per curiam, 194 F.2d 537 (6th Cir. 1952). Cf. Barnet S. Milman, Inc. v. Commissioner, 114 F.2d 95 (2d Cir. 1940) (stockholders’ assumption of corporation’s liabilities not “capital contributions” but payment of debts); Shreveport Producing & Ref. Co., Inc. v. Commissioner, 71 F.2d 972 (5th Cir. 1934) (new corporation taking over assets, business, and stock of dissolved corporation may not deduct dissolved corporation’s losses). But see Vreeland v. Commissioner, 31 T.C. 78, 84 (1958) (taxpayer purchased worthless stock in order to facilitate the liquidation of the corporation; purchase price was allowed as a loss on the liquidation of the corporation).

122. See Malmstedt v. Commissioner, 578 F.2d 520, 524 (4th Cir. 1978).

123. Zarnow v. Commissioner, 48 T.C. 213 (1967). See also Gemma v. Commissioner, 46 T.C. 821 (1966) (knowing failure to keep adequate records may result in court’s surmise that fraudulent intent is the reason for the laxness).

Of course, the axe cuts both ways. If the Service fails to supply a valid argument or reasonable authority on its valuation of basis, the court will accept the taxpayer’s contention. See Roosevelt Inv. Corp. v. Commissioner, 45 B.T.A. 440, 454 (1941).
The taxpayer’s second burden of proof is to establish that the stock had some value in the year prior to, or at the beginning of, the one in which a deduction is claimed. Failure to carry this burden will normally result in a total disallowance of the deduction, for, if the taxpayer fails to prove such worth, worthlessness will be presumed, and the statute of limitations will have run on worthlessness occurring in a prior year. One means of establishing prior value is to show a substantial sale or the existence of a free and ready market in the stock or debt in a preceding year or at the beginning of the year in issue. In general, the sale of stock or debt at a nominal price prior to the year of worthlessness will be given effect for tax purposes, but will not establish continuing value. The sale of stock for a nominal consideration in a year subsequent to worthlessness, however, will not be given effect either as a disposition fixing the date of the loss or as evidence of worthlessness. Sales at a nominal price in the year of worthlessness will be disregarded.

These two burdens of proof make it incumbent upon the tax-

In the absence of adequate records, the court is likely to remark with some asperity on the frailty of the taxpayer’s case: “In this state of the record, with no proof of what the stock was worth at the time the contract was made to measure the value of the machinery by, nor of the value of the machinery to measure the value of the stock by, there is no basis in the record for a deduction allowance on this score; indeed, the reasonable deduction from all the evidence is that there was no loss.” Hunt v. Commissioner, 82 F.2d 668, 671 (5th Cir. 1936).


Another threshold requirement is to establish that, whatever the loss, it was not “compensated for by insurance or otherwise.” I.R.C. § 165(a) (emphasis added). The “otherwise” could mean compensation by future consideration or by benefit to a related business. For example, in Santa Anita Consol., Inc. v. Commissioner, 50 T.C. 536 (1968), the Commissioner argued without success that the loss gave rise to goodwill, a nondeductible capital expenditure. Id. at 548 n.2. This argument is not without substance, but it is difficult to conceive of an actual transaction resulting in worthlessness to which this § 165(a) interpretation would apply.

125. Morton v. Commissioner, 38 B.T.A. 1270 (1938), aff’d, 112 F.2d 320 (7th Cir. 1940).


128. E.g., De Loss v. Commissioner, 28 F.2d 803 (2d Cir. 1928), cert. denied, 279 U.S. 840 (1929); Gilbert H. Pearsall, 10 B.T.A. 467 (1928) (acq.).

129. See text accompanying notes 167-247 infra.
payer to present persuasive evidence, substantiated by corporate records, to support the reasonableness of the belief that the stock retained value until the year in issue. The taxpayer cannot ask the court merely to assume value. The taxpayer's opinion of the corporation's financial status is not sufficient to overcome the presumption favoring the Commissioner's determination that the stock was, in fact, worthless in an earlier year. This is so even when, as in *Eagleton v. Commissioner*, the taxpayer is "the chief financial backer of the corporation, a director, owner of fifty percent of the preferred stock . . . , a creditor, and in close touch with those actively conducting the business." The court ruled that because the taxpayer was in a position to support his contention by providing evidence within his control, his failure to provide evidence negated any weight that his testimony might otherwise have been accorded.

The obverse of this evidentiary burden is the taxpayer's third burden, establishing that the stock or debt actually became worthless in the year alleged. It is fundamental that a loss may be deducted only in the year "sustained." That requirement is at the root of the tax benefit conferred by the statute:

A taxpayer should not be permitted to close his eyes to the obvious, and to carry accounts on his books as good when in fact they are worthless, and then deduct them in a year subsequent to the one in which he must be presumed to have ascertained their worthlessness. To do so would enable him to withhold deductions in his less prosperous years, when they would have little effect in reducing his taxes, and then to apply the accumulation at another time to the detriment of the fisc. This would defeat the intent and purpose of the law.

Thus, the taxpayer must find a means of establishing that the loss actually occurred in the year alleged. Courts have become increasingly receptive to numerous types of corroborative evidence in an effort to marshal the available facts and to measure the pattern against an objective standard of reasonableness As more than one court has noted, however, "[t]he rule is clear, only its application is difficult."

---

130. 35 B.T.A. 551 (1937), aff'd, 97 F.2d 62 (8th Cir. 1938).
131. Id. at 556.
132. Id. at 556-57.
133. Avery v. Commissioner, 22 F.2d 6, 7-8 (5th Cir. 1927).
Insolvency

The court in Morton stated what has become the accepted standard for ascertaining worthlessness.\textsuperscript{135} Under the Morton rule, worthlessness determinations are divided into two categories depending upon the degree of insolvency and the appearance of collapse. In the first category, the taxpayer's investment becomes worthless when all hope of recoupment is foreclosed by the occurrence of an "identifiable event." In the second, "exceptional" case, the investor is put on notice, often well before the occurrence of an identifiable event, that there is no reasonable hope or expectation that continuation of business will restore value to the corporation. Each situation presents unique problems in carrying the burden of proof. Nevertheless, both require a threshold determination of present worthlessness, that is, actual insolvency that eliminates any current liquidating value.

Demonstrating insolvency is fundamental to proving worthlessness because a shareholder or junior creditor takes a place in line only after all of the corporation's more senior creditors have queued up.\textsuperscript{136} The mere existence of a discouraging balance sheet, however, does not establish insolvency. A corporation is "insolvent" or not as to each level of creditor or shareholder. A preferred stockholder has fewer senior creditors ahead of him or her than does a common stockholder. Therefore, the corporation may be

\textsuperscript{135} See notes 97-107 & accompanying text supra.

\textsuperscript{136} Thus, a corporate balance sheet showing an excess of liabilities over assets, properly valued, must be the first evidentiary step in demonstrating worthlessness.

Assets "properly valued" are those that can be given a "fair market value," see, e.g., Nelson v. United States, 131 F.2d 301 (8th Cir. 1942)), which is "the price at which a willing buyer and a willing seller would arrive, after negotiation for sale, where neither is acting under compulsion." United States v. Cartwright, 411 U.S. 546, 551 (1973). Accord, Treas. Reg. §§ 1.170A-1(c)(2), 1.385-3(b)(1), § 20.2031-1(b). See Rev. Rul. 66-49, 1966-2 C.B. 1257. The nature of the individual assets is of utmost importance; certain kinds of assets, such as unfinished goods in inventory, Steadman v. Commissioner, 424 F.2d 1, 4 (6th Cir.), cert. denied, 400 U.S. 869 (1970), or goodwill damaged by unlawful acts, see Byrum v. Commissioner, 58 T.C. 731, 734 (1972), will be assessed at lower than book value. See also Austin Co., Inc. v. Commissioner, 71 T.C. 955, 970 (1979) (acq.) (binding contracts fixed liquidating value of corporation); Dustin v. Commissioner, 53 T.C. 491, 496-97 (1969), aff'd, 467 F.2d 47 (9th Cir. 1972) (value of textbooks given nature of publishing business). Book value is of only slight relevance because a court must look to the actual value of the assets item by item. Canaveral International Corp. v. Commissioner, 61 T.C. 520, 545-46 (1974); Dustin v. Commissioner, 53 T.C. 491, 496-97 (1969), aff'd, 467 F.2d 47 (9th Cir. 1972); Richards v. Commissioner, 35 T.C.M. 1709, 1716 (1976). Thus, an authoritative balance sheet showing no remaining equity for stock is "one form of effective evidence, though [it is] not necessarily conclusive . . . ." Mahler v. Commissioner, 119 F.2d 869, 872 (2d Cir. 1941).
“insolvent” as to the common stockholder without being so as to the preferred stockholder. The taxpayer, in presenting a claim, must corroborate the insolvency with extrinsic evidence, for, given the existence of countervailing facts, a court would be “most reluctant to accord controlling weight to balance sheet figures in estimating what amount of its business debts are worthless at the close of a particular year.” Nevertheless, courts in several decisions have accorded probative weight to carefully prepared balance sheets, holding them sufficient to shift to the Commissioner the burden of going forward with the evidence. Moreover, one court in a recent case was willing to overlook the complete absence of records. The court took cognizance of the taxpayer’s position “as a minority shareholder with no firsthand knowledge of the company’s business” and, accepting the taxpayer’s assessment of insolvency “in the light of as complete information as [was] reasonably obtainable,” shifted the burden of going forward to the Commissioner.

As these patterns are the exception, the claimant should amass extrinsic evidence supporting the existence of present worthlessness. Extrinsic evidence may consist of outside appraisals or accountants’ reports. The Service has outlined the acceptable procedure for independent appraisal, including methods for valuing closely-held stock and intangibles. Although the Service has not ruled on accountants’ reports, numerous courts have shown a distaste for “tentative, unaudited, and unverified” assessments, even by professionals. When liquidation will occur over a substantial period of time, it is proper to discount the assets


138. Mahler v. Commissioner, 119 F.2d 869, 872 (2d Cir. 1941); Frazier v. Commissioner, 34 T.C.M. 951, 963 (1975); Edwards v. Commissioner, 39 B.T.A. 735, 737-38 (1939). Cf. Rand v. Commissioner, 40 B.T.A. 233 (1939) (book figures for corporation’s assets, giving substantial value to stock, held of no probative force where other evidence showed stock to have only nominal value in that year).


140. See Borden Mining Co. v. Commissioner, B.T.A.M. (P-H) ¶ 40,597 (1940).


144. E.g., Borden Mining Co. v. Commissioner, 9 B.T.A.M. (P-H) ¶ 40,597 (1940).
by the length and cost of liquidation.\textsuperscript{146}

The recent judicial trend, however, has been to accept evidence of insolvency from sources other than the professional appraiser in a realistic effort to credit information that a reasonable investor might be expected to have or obtain. Hence, evidence of lack of market value has been found acceptable.\textsuperscript{147} Similarly, expert testimony concerning general business conditions and the specific condition of the business under scrutiny has been accorded substantial weight.\textsuperscript{148} Although a court is not bound by such expert testimony, it should be guided by the testimony and may not arbitrarily disregard it unless there is a suspicion of unreliability or countervailing contrary evidence. Courts have thus held testimony by the president of a company,\textsuperscript{149} a company manager,\textsuperscript{150} the last elected secretary-treasurer,\textsuperscript{151} and a court-appointed receiver\textsuperscript{152} to be corroborative of the taxpayer’s allegation of insolvency.

Some courts have accepted testimony by the taxpayer alone.\textsuperscript{153} The weight to be accorded taxpayer testimony, however, depends upon its reasonableness within the context of established facts and upon the taxpayer’s demeanor. In a recent case, the taxpayer’s “equivocal dealings with the stock”—which included a sale to a friend for one dollar, the recovery and use of the same stock as security, the transfer of the identical stock to his father-in-law, and finally the claim of a $1,200 loss on the same stock that had a $3,000 basis—led the court to conclude that the taxpayer had ascribed more value to tax considerations than to the stock

\textsuperscript{146} See, e.g., Forbes v. Hassett, 124 F.2d 925, 929 (1st Cir. 1942).

\textsuperscript{147} See, e.g., Jones v. Commissioner, 29 B.T.A. 928 (1934). See also Thun v. Commissioner, 36 T.C.M. 1517, 1522 (1977) (creditors’ belief in value of stock, that is, their willingness to accept stock for unpaid interest, is relevant in establishing value). But cf. Ginsburg v. Commissioner, 33 T.C.M. 814, 830 (1974) (“the fact that the stock had no ready market does not establish that it had become worthless.”)

\textsuperscript{148} Ansley v. Commissioner, 217 F.2d 252 (3d Cir. 1954); Jones v. Commissioner, 29 B.T.A. 928 (1934).

\textsuperscript{149} Austin Co. v. Commissioner, 71 T.C. 955, 972 (1979) (acq). See also Scifo v. Commissioner, 68 T.C. 714, 726 (1977) (testimony by officers about events and their appraisal of survival). But see Sipprell v. Commissioner, 21 T.C.M. 491, 494 (1962) (opinion of sales manager about assets, because not expressed in specific amounts and unsupported, was not reliable criterion of liquidating value).

\textsuperscript{150} Richards v. Commissioner, 18 T.C.M. 332, 333 (1959).

\textsuperscript{151} See Edwards v. Commissioner, 39 B.T.A. 735, 737-38 (1939) (acq.).

\textsuperscript{152} Jones v. Commissioner, 29 B.T.A. 928, 929-30 (1934).

In looking beyond balance sheet insolvency, one should recognize that a balance sheet is often an inaccurate measure of corporate value because it overlooks contingent assets and liabilities. For example, the value of a corporation includes the value of rights of action against third parties as well as those against the corporation, and such rights must be considered when determining insolvency, though neither possibility is normally reflected in a balance sheet. A court, therefore, will increase the valuation of assets by the possibility, measured by "fair market value," that a corporation's lawsuits may succeed and will increase the valuation of liabilities by the ascertainable value of litigation proposed or pending against the corporation. Expert testimony on the possible outcome of pending litigation is relevant in establishing insolvency.

The probable or possible success of a claim affects potential value as well as asset valuation. Thus, if a corporation institutes an action in which a victory would restore solvency and the corporation "ha[s] more than a reasonable prospect of prevailing," the corporation is not worthless. Probabilities are capable of valuation and therefore enter the insolvency equation. If the prospect of prevailing is only a possibility, however, insolvency is unaffected, although potential value may remain. The same test applies to litigation against the corporation. Mere possibilities, being unmeasurable, do not affect present value, but they may provide a

155. See Burnet v. Logan, 283 U.S. 404 (1931); Brrkfr & Eustic, supra note 70, at 11.03.
157. Cf. Ryan v. Commissioner, 19 B.T.A. 52, 58 (1930) (prospective contract losses based on future contingencies held "purely speculative").
162. Long v. Glenn, 32 A.F.T.R. 1690 (W.D. Ky. 1943), aff'd, 145 F.2d 234 (6th Cir. 1944); Datamation Serv., Inc. v. Commissioner, 35 T.C.M. 1092, 1104 (1976) ("[T]he discovery of the possibility that the corporation might be successfully sued at some time in the future does not nearly rise to the level of an identifiable event finally signalling the worthlessness of the corporation's stock"); Richards v. Commissioner, 35 T.C.M. 1709, 1717 (1976) ("In establishing the worthlessness of stock, pending litigation with the possibility of insolvency in the event of judgment and litigation to recover assets, will not usually be taken into
clue to the corporation’s future.

Establishing that stock has no liquidating value is essential to a taxpayer’s claim. Although the stock of a solvent corporation necessarily has worth,163 the stock of an insolvent corporation is not necessarily worthless.164 Insolvency alone is not sufficient to warrant a finding of worthlessness, for if there is any prospect of a reversal in the fortunes of the corporation, then the stock has potential value and may not be considered worthless.165 Mere pessimism regarding the recoupment of loss is inadequate.166 A court will measure the objective indicia of potential value prior to agreeing with the taxpayer’s assessment of worthlessness. Both factors—current liquidating value and foreseeably re-acquired value—must be absent for the court to fix the loss.

Identifiable Event

Under the rule articulated in Morton, the taxpayer must establish (1) that the corporation is insolvent—that is, it has no liquidating value—and (2) that the corporation has no potential value—that is, some event occurred that destroyed the corporation’s future prospects.167 Neither factor alone is sufficient. Insolvency does not preclude the possibility of potential value;168 the

---

163. See Treas. Reg. § 1.165-4(a). See also Sarris v. Commissioner, 37 T.C.M. 1851-54 (1978) (decline in value of stock, even if not salable because of § 16(b) of the Securities Exchange Act of 1934, does not render stock worthless).

164. E.g., Coleman v. Commissioner, 81 F.2d 455 (10th Cir. 1936); Olds & Whipple, Inc. v. Commissioner, 75 F.2d 272, 275 (2d Cir. 1935) (“The fact that the assets were insufficient to meet the operating liabilities may properly be taken as evidence of worthlessness of stock, but it is not conclusive.”); Burnet v. Imperial Elev. Co., 66 F.2d 643 (8th Cir. 1933); Singer v. Commissioner, 34 T.C.M. 337 (1976), aff’d, 560 F.2d 96 (5th Cir. 1977); Riss v. Commissioner, 56 T.C. 388, 408 (1971), aff’d, 478 F.2d 1160 (6th Cir. 1973); Trinco Indus., Inc. v. Commissioner, 22 T.C. 959, 965 (1954).

165. Morton v. Commissioner, 38 B.T.A. 1270 (1938), aff’d, 112 F.2d 320 (7th Cir. 1940).


167. 38 B.T.A. 1270, 1282 (1938).

168. An anticipated reorganization may show that the corporation has expectations of profit. Lehman v. Commissioner, 129 F.2d 288 (2d Cir. 1942); Sipprell v. Commissioner, 21 T.C.M. 491 (1962); Lindabury v. Commissioner, 9 B.T.A.M. (P-H) ¶ 40,551 (1940), aff’d per curiam, 121 F.2d 446 (3d Cir. 1941); Coleman v. Commissioner, 31 B.T.A. 319 (1934), aff’d, 81 F.2d 455 (10th Cir. 1936). The possibility of a sale of the business similarly may show expectation of profits. Ainsley Corp. v. Commissioner, 22 T.C.M. 889 (1963), rev’d, 332 F.2d 555 (9th Cir. 1964) (on appeal, the Ninth Circuit noted that, although an offer to sell may be evidence of value, in the instant case the corporation had been of no interest to potential
occurrence of some "identifiable event," without the showing of insolvency, does not prove that the stock is without liquidating value.\textsuperscript{169}

A review of the decisions makes it clear that an "identifiable event" is rarely a single occurrence in the normal business life of a corporation.\textsuperscript{170} Rather, it is a series of events culminating in a final determination that there is no reasonable hope that the stock or debt retains potential value.\textsuperscript{171} Such a determination of worthlessness is based on a consideration of all relevant evidence. The taxpayer's conduct and attitude towards the investment are relevant, as is such purely formal evidence as properly kept books, normal business loan procedures, regular board of directors' minutes documenting finances and business reversals, and arm's length dealings with the corporation and third parties.\textsuperscript{172} Evidence presented of adverse business conditions,\textsuperscript{173} deficit operating history,\textsuperscript{174} and fail-

\textsuperscript{169} The Morton court oversimplified the concept of identifiable event by singling out, as examples of identifiable events, the events of "bankruptcy, cessation from doing business, or liquidation, or the appointment of a receiver." 38 B.T.A. 1270, 1278 (1938).

\textsuperscript{170} The appointment of a receiver and the beginning of corporate liquidation is insufficient unless the taxpayer can demonstrate that nothing will be left for the stockholders. Burnett v. Commissioner, 40 B.T.A. 605 (1939) (nonacq.), aff'd on other grounds, 118 F.2d 659 (5th Cir. 1941). Similarly, a mere cessation of business does not in and of itself indicate worthlessness. Rosing v. Corwin, 88 F.2d 415 (2d Cir. 1937).

\textsuperscript{171} Exceptions to this rule exist, however, and include catastrophe, Sika Chem. Corp. v. Commissioner, 64 T.C. 856, 866 (1975) ("Where one makes an advance of funds and subsequently the debtor is forced to drastically curtail its operations due to some disaster, there has been that 'event or . . . change in the financial obligation of the debtor, subsequent to the time when the obligation was created, which adversely affects the debtor's ability to make repayment."); H.W. Findley, 25 T.C. [311, 319 (1955), aff'd per curiam, 236 F.2d 959 (3d Cir. 1956)]; Moffat v. Commissioner, 24 T.C.M. 961 (1965) (permanent flooding of coal mines), seizure of assets, United States v. S.S. White Dental Mfg. Co., 274 U.S. 398 (1927), disappearance of the debtor, Sims v. Commissioner, 10 T.C.M. 608 (1951), appointment of a receiver, see, e.g., Jamieson Associates, Inc. v. Commissioner, 37 B.T.A. 92 (1938), aff'd and rev'd on different issues, 105 F.2d 990 (2d Cir. 1939), cert. denied, 308 U.S. 618 (1939), and resignation or death of a key employee, LeLandais v. Commissioner, 35 T.C.M. 1580 (1976).

\textsuperscript{172} Cf. Olds & Whipple v. Commissioner, 75 F.2d 272 (2d Cir. 1935) (insufficient assets to meet operating liabilities evidential but not conclusive of worthlessness).

\textsuperscript{173} Compare Scifo v. Commissioner, 68 T.C. 726 (1977) (petitioners worked hard and diligently building a business, then lost all their money in improvident investments in other businesses; court was sympathetic and held in petitioners' favor—record-keeping was excellent) with Dustin v. Commissioner, 53 T.C. 491 (1969) (poor record; court held against taxpayers).

\textsuperscript{174} See, e.g., Trowbridge v. United States, 32 F. Supp. 852, 856 (D. Conn. 1938), in which the court stated: "Human nature shrinks from accepting as final the drastic losses inherent in an economic depression believed to be of temporary duration. This is not necessarily the quality of incorrigible optimism sometimes seen. [Citations omitted.] It may
ure to obtain continued financing provide additional support for a finding of worthlessness.\textsuperscript{177}

\textit{Bankruptcy and Receivership}

Although bankruptcy and receivership are two of the events enumerated by the \textit{Morton} court as signalling the end of potential value, a corporation may be worthless long before a bankruptcy petition is filed or a receiver is appointed. Conversely, potential value may exist even though a corporation's liabilities exceed its assets.\textsuperscript{178} The majority of courts have treated bankruptcy adjudications and the appointment of receivers as mere indications of worthlessness not sufficient in themselves to extinguish potential value.\textsuperscript{179} The practice has been to evaluate circumstances surrounding the petition or appointment in order to ascertain whether the event precludes potential corporate recovery. Insolvency is either explicitly found or implicitly assumed.\textsuperscript{180}

The burden of presenting corroborative evidence is on the taxpayer. Facts that courts have found corroborative include seizure of operating assets,\textsuperscript{181} loss of a principal client,\textsuperscript{182} expiration of a

\textsuperscript{175} See, e.g., Royal Packing Co. v. Commissioner, 22 F.2d 536 (9th Cir. 1927); Yeager v. United States, 58-1 U.S.T.C. 1,917 (W.D. Ky. 1957); Richards v. Commissioner, 18 T.C.M. 332 (1959); Camp v. Commissioner, 12 T.C.M. 908 (1953); H. Liebes & Co. v. Commissioner, 23 B.T.A. 787 (1931) (nonacq.); Mayer v. Commissioner, 16 B.T.A. 1239 (1929) (acq.).

\textsuperscript{176} Kirby v. Commissioner, 102 F.2d 115, 116-17 (5th Cir. 1939); Gwynne v. Commissioner, 22 B.T.A. 164, 169-70 (1931) (acq.); Pearsall v. Commissioner, 10 B.T.A. 467, 469, (acq.).

\textsuperscript{177} None of these factors, standing alone, rise to the level of an identifiable event. Anthony P. Miller, Inc. v. Commissioner, 7 T.C. 729, 747 (1946), aff'd in part and rev'd in part, 164 F.2d 268 (3d Cir. 1947), cert. denied, 333 U.S. 861 (1948) ("It has frequently been held that such factors as deficits, operating losses, lack of working funds, poor business conditions, and similar circumstances are insufficient in themselves to establish the worthlessness of stock.").

\textsuperscript{178} Jarvis v. Heiner, 39 F.2d 361 (3d Cir. 1930); Lyon v. United States, 5 F. Supp. 138 (Ct. Cl. 1933); Peter Doelger Brewing Co., Inc. v. Commissioner, 22 B.T.A. 1176 (1931) (acq.).

\textsuperscript{179} E.g., Mahler v. Commissioner, 119 F.2d 869 (2d Cir.), cert. denied, 314 U.S. 861 (1941); A.R. Jones Oil & Operating Co. v. Commissioner, 114 F.2d 642, 646 (10th Cir. 1940). See note 178 supra.

\textsuperscript{180} E.g., Jeffery v. Commissioner, 62 F.2d 661 (6th Cir. 1933).

\textsuperscript{181} E.g., Coosa Land Co. v. Commissioner, 103 F.2d 555 (5th Cir. 1939); Ruud v. Commissioner, 28 T.C.M. 1284 (1969).

refinancing offer, abandonment of attempts to raise needed equity, absence of a market, and inability to obtain shareholder loans. In each of these cases, the subsequent bankruptcy or receivership led to a determination of worthlessness. Each of the corroborative facts was insufficient, in itself, to destroy value identifiably. These facts, in combination with bankruptcy or receivership, however, manifested an end to potential value.

The degree of insolvency is often determinative when a petition for involuntary bankruptcy or for the appointment of a receiver is contested. Thus, one court found that shareholder resistance to the appointment of a receiver was inconsequential when others "were prepared to throw in the sponge." The threatened receivership was sufficient to signal the end of reasonable hope of corporate worth. In another case, a corporation's contest of a petition for involuntary bankruptcy manifested a belief in the existence of potential value, which the court could not find unreasonable in light of the corporation's financial condition.

A petition in bankruptcy or the appointment of a receiver is a portentous event in a corporation's existence. Although the significance of the event must be measured in the context of its occurrence, a substantial body of case law supports the position that insolvency plus bankruptcy or receivership signals the destruction of corporate value. Therefore, a taxpayer, following the Young admonition of claiming a loss deduction in the earliest year possible, would be foolish not to rely on an event that portends trouble, if not disaster, and that may have identifiably destroyed all potential value as well.

Reorganization and Foreclosure

The attitude of a shareholder or creditor towards an ailing

183. Perkins v. Commissioner, 41 B.T.A. 1225, 1230-31 (1940), aff'd, 125 F.2d 150 (6th Cir. 1942).
184. Lambert v. Commissioner, 108 F.2d 624, 625 (10th Cir. 1939).
186. Id.
188. In the absence of countervailing evidence of value, bankruptcy and receivership should be prima facie indications of worthlessness. Coosa Land Co. v. Commissioner, 103 F.2d 555, 556 (5th Cir. 1939).
191. See notes 111-13 & accompanying text supra.
business is often indicative of its value. A creditor's willingness to
derfer a claim or to accept reissued indebtedness or equity in lieu of
repayment is strong evidence of prospective profits. Hence, courts
have held that indebtedness retains value when a creditor accepts
stock in lieu of interest, or as security for new indebtedness.\textsuperscript{192}

Conversely, an unwillingness to accept a composition evinces
substantial creditor doubt concerning the existence of potential
value. If a creditor refuses a compromise and forecloses on essen-
tial assets, the corporation will cease to function and no further
profits or cash flow can be expected to relieve existing insolvency.
In such circumstances, foreclosure is an event that identifiably de-
strys future value.\textsuperscript{193} That event, when coupled with insolvency,
renders the stock, and usually part of the junior debt, worthless.

Reorganization efforts, which in themselves often demonstrate
continued belief in a corporation's ultimate ability to repay obliga-
tions, may be of little significance to unsecured creditors or share-
holders. Senior creditors, on the other hand, in order to salvage
their investments, may agree to a composition arrangement that
destroys the value of junior obligations and stock.\textsuperscript{194} While reor-
ganization may confirm the worthlessness of stock that occurred no
later than, and perhaps prior to, the year in which the plan was
consummated, however, it will not destroy the value of indebted-
ness. To the contrary, reorganization may demonstrate the exis-
tence of potential value.

Reorganization and foreclosure, therefore, while indicators of
worthlessness, do not qualify as identifiable events unless they un-
equivocally signal the end of taxpayer hope and expectation of fu-
ture profit.\textsuperscript{195} Neither reorganization nor foreclosure alone is suffi-

\textsuperscript{192}. \textit{E.g.}, Thun v. Commissioner, 36 T.C.M. 1517, 1522 (1977).
\textsuperscript{193}. Rev. Rul. IT 1697, II-11-942, 1923, \textit{updated and restated}, Rev. Rul. 72-470, 1972-
2 C.B. 100.

\textsuperscript{194}. Thus, stock has been held to be worthless when a shareholder surrendered his
stock and received nothing in return. Summit Drilling Corp. v. Commissioner, 160 F.2d 703
(10th Cir. 1947). Similarly, stock has been held to be worthless when a stockholder ex-
changed his shares for valueless stock and notes. Stearns v. Kavanagh, 41-2 U.S.T.C. $ 9,750
Commissioner, 81 F.2d 455 (10th Cir. 1936) (potential value remained). \textit{Cf.} Brumder v.
United States, 60 F. Supp. 977 (E.D. Wis. 1944) (stock became worthless prior to the
exchange).

\textsuperscript{195}. \textit{See} Mahler v. Commissioner, 199 F.2d 869, 872 (2d Cir.), \textit{cert. denied}, 314 U.S.
660 (1941) ("[T]he mere fact of a receivership or reorganization proceeding is not alone
sufficient to fix the date of worthlessness."); Joyce v. Gentsch, 141 F.2d 891 (6th Cir. 1944);
Miami Beach Bay Shore Co. v. Commissioner, 136 F.2d 408 (6th Cir. 1943); Leicht v. Com-
cient to support a claim of worthlessness. On the other hand, either event, when viewed in the context of the business's devolution, may be persuasive of the reasonableness of the taxpayer's conclusion that he or she has suffered irreparable loss.¹⁹⁵

**Revocation of Corporate Charter**

A corporation has legal existence only if it conforms to statutory requirements. Logically, the revocation, forfeiture, or surrender of a corporate charter is a significant event, for, if the charter is revoked, a corporation is legally dead. Legal death, however, like other events in a corporation's life, does not, in itself, establish worthlessness—insolvency is a prerequisite. Moreover, some courts have found that, even when worthlessness was inevitable, loss of the corporate charter was not the event that signalled its occurrence.¹⁹⁶

Whether revocation of the corporate charter is an "identifiable" event establishing an end to potential value depends upon the context. In one case, the stockholders resolved to surrender the corporate charter and franchises and to liquidate. The court found that the resolution itself was the event that ended the hope of future success. That finding, coupled with a finding of insolvency, led the court to hold that the stock became worthless on the date of the resolution.¹⁹⁷ Similarly, revocation of a charter for delinquent taxes constituted an "identifiable event" when, despite financial setbacks, it was not until revocation that "[it] became known definitely, and for the first time, that the stockholders were to suffer a complete loss."¹⁹⁸ The critical finding was that of knowledge of the company's condition, which identified the revocation as the final extinguishing of value.

In contrast, if state law requires that the disposition of assets after forfeiture be placed under the control of the board of directors, then "the stockholders [do] not become entitled to possession,

---

¹⁹⁵ For a discussion of worthlessness and insolvency in the context of corporate death, see Leicht v. Commissioner, 137 F.2d 433 (8th Cir. 1943); Forbes v. Commissioner, 62 F.2d 571 (4th Cir. 1933); Altschuler v. Commissioner, B.T.A.M. (P-H) ¶ 84,368 (1938).
¹⁹⁶ Leicht v. Commissioner, 137 F.2d 433, 437 (8th Cir. 1943); Christensen v. Commissioner, 28 T.C.M. 594 (1969); Kentucky Farm and Cattle Co. v. Commissioner, 30 T.C. 1355, 1373 (1958).
¹⁹⁷ See Wolf v. Commissioner, 8 B.T.A. 1121, 1124-25 (1927).
¹⁹⁹ Dunbar v. Commissioner, 119 F.2d 367, 369 (7th Cir. 1941). This conclusion was apparently the result of the taxpayer's failure to provide sufficient evidence.
use and control of their pro rata share of the assets... until they [are] distributed by the directors in liquidation.\textsuperscript{200} The stockholders therefore can not know of their loss or claim for deduction until valuation and actual distribution subsequent to revocation of the corporate charter.

Even legal death, therefore, does not reach the level of an identifiable event absent proven insolvency. Moreover, legal death may merely confirm a demise that could reasonably have been identified at an earlier date. Thus, revocation, like bankruptcy, receivership, and foreclosure, is an indication of worthlessness insufficient in itself to establish worthlessness.

\textit{Continuation versus Cessation of Business, Liquidation, and Sale of Assets}

The continuation of business frequently indicates that the corporate stock and debt retain value. Continuation, however, is not conclusive.\textsuperscript{201} Conversely, cessation of business is evidence, but not proof, of worthlessness.\textsuperscript{202} A number of early decisions, however, held that, absent extraordinary circumstances, the continuation of business activities assumes the existence of potential value, and the cessation of business activities affirms the death of corporate value.\textsuperscript{203}

The test of whether the continuation of business is evidence of continuing value was well stated by Judge Learned Hand in \textit{Bulldard v. United States}:\textsuperscript{204}

The corporation did not go out of business, on the contrary it tried to go on... [O]bviusly the corporation was not yet prepared to throw in the sponge. No liquidation was proposed; no

\begin{footnotes}
\item[200] Wolf v. Commissioner, 8 B.T.A. 1121, 1125 (1927).
\item[201] A.R. Jones Oil & Operating Co. v. Commissioner, 114 F.2d 642, 645 (10th Cir. 1940) ("It has been said that continuation in business is evidence of worth and that discontinuance of business indicates worthlessness."); Ruud v. Commissioner, 28 T.C.M. 1284 (1969); Lincoln v. Commissioner, 24 T.C. 669 (1955), aff'd, 242 F.2d 748 (6th Cir. 1957).
\item[202] Eaton v. Commissioner, 143 F.2d 876 (6th Cir. 1944); Jones v. Commissioner, 103 F.2d 679 (9th Cir. 1939); Eagleton v. Commissioner, 97 F.2d 642, 645 (2d Cir. 1937); Royal Packing Co. v. Commissioner, 22 F.2d 536 (9th Cir. 1927); Bancroft v. United States, 33 F. Supp. 225 (Ct. Cl. 1940).
\item[204] 146 F.2d 386 (2d Cir. 1944).
\end{footnotes}
declaration of insolvency made; no receiver appointed; no such "identifiable event" occurred as was necessary to establish the worthlessness of the property . . . . It would be unsafe to say that until a corporate business has been abandoned, there cannot be that "identifiable event" which is necessary in such situations; but at least we can say that, when the business does continue, the circumstances must be exceptional which will induce us to hold that the shares have as yet become worthless. 205

If the continued business is a mere shadow of the corporation's "normal" business activities, there has been an identifiable change in potential value cognizable by both shareholders and creditors. 206 Conversely, value has not been destroyed if a corporation "took steps designed to preserve its viability and chances of success. Aggressive bidding policies [for contracts] were followed . . . in the hope of a market upswing. Merger . . . was undertaken . . . to form the basis for future success." 207 These measures would not have been undertaken without a reasonable prospect of restoring value to the corporation.

Between the extremes of business contraction and business expansion, a line can be found beyond which a court would probably find worthlessness. That line divides a bona fide contraction from business as usual.

The most common bona fide contraction requires, at the least, a plan to sell the assets confirmed by either a contract of sale, 208 a report showing a lack of potential value and detailing a plan for liquidating the business, 209 or a lengthy period of losses. 210 When a decision has been made to liquidate the corporation or to sell its assets pursuant to a bona fide contraction or dissolution, a common paradox occurs. As the corporation by definition is insolvent, worthlessness will be confirmed by the offering plan if the assets are offered at their fair market values. An offering at fair market value, however, will give prospective purchasers a distinct advantage in price negotiations. Yet a court may use an asking price ex-

205. Id. at 388.
208. See Austin Co. v. Commissioner, 71 T.C. 955, 970-71 (1979) (acq.).
210. See Ainsley Corp. v. Commissioner, 332 F.2d 555, 556 (9th Cir. 1964); Industrial Rayon Corp. v. Commissioner, 94 F.2d 383, 384 (6th Cir. 1938); Squier v. Commissioner, 68 F.2d 25, 27 (2d Cir. 1933).
ceeding the assets’ fair market value to refute insolvency or impute a higher value. Although the courts have reasoned that an asking price does not affect actual value,211 given the inherently factual nature of the inquiry, only an exceptional court would not be influenced by an asking price.

Beyond the clear case of a business continuing with a plan of dissolution adopted with formally executed contracts lie those situations in which a corporation adopts a plan of liquidation but does little more during the year of purported worthlessness. If a corporation adopts a plan of liquidation primarily to accelerate the shareholders’ loss deductions, the plan will be ignored by the courts.212 Actual liquidation will normally be sufficient,213 although it is not necessary.214 A plan of liquidation or the commencement of liquidation usually carries substantial weight with a court when insolvency has been proven.215

Similarly, with regard to a sale of assets or of the business, if the corporation is reduced to a shell possessing liabilities in excess of cash, the stock and some or all of the indebtedness are worthless.216 If the board of directors or an authorized officer agrees to a sale of a substantial amount of operating assets, the agreement to terminate operations generally will be an “identifiable event” fixing the year of worthlessness, even if a binding contract is not signed until a subsequent year.217

When there is no actual liquidation, dissolution, or sale of as-

211. The price for which property was offered “could not have represented even a real hope of what they might get, or anything more than a figure at which haggling over a price might begin.” Ainsley Corp. v. Commissioner, 332 F.2d 555, 558 (9th Cir. 1964).

212. “[The] resolution [to liquidate] appears to us to represent no more than a transparent attempt to concoct an identifiable event for tax purposes, and we accordingly disregard it.” Greenberg v. Commissioner, 30 T.C.M. 937, 941 (1971).

213. Glenn v. Courier-Journal Job Printing Co., 127 F.2d 820, 823 (6th Cir. 1942); Nelson v. United States, 131 F.2d 301, 302-04 (8th Cir. 1942); Benjamin v. Commissioner, 70 F.2d 719 (2d Cir. 1934); Burnet v. Imperial Elevator Co., 66 F.2d 643, 644-45 (8th Cir. 1933).

214. Barnet S. Milman, Inc. v. Commissioner, 114 F.2d 95, 96-97 (2d Cir. 1940).

215. Connelly v. Commissioner, 121 F.2d 686 (3d Cir. 1941); Hobby v. Commissioner, 97 F.2d 731 (5th Cir. 1938); Gowen v. Commissioner, 65 F.2d 923 (6th Cir.), cert. denied, 290 U.S. 687 (1933); Forbes v. Commissioner, 62 F.2d 571 (4th Cir. 1933); De Loss v. Commissioner, 28 F.2d 803 (2d Cir. 1928), cert. denied, 279 U.S. 840 (1929).

216. See A. R. Jones Oil & Operating Co. v. Commissioner, 114 F.2d 642, 646 (10th Cir. 1940); Burnet v. Imperial Elevator Co., 66 F.2d 643, 645 (8th Cir. 1933); Dalton v. Bowers, 56 F.2d 16, 19 (2d Cir.), affd, 287 U.S. 404 (1932).

217. Ainsley Corp. v. Commissioner, 332 F.2d 555, 558-59 (9th Cir. 1964), rev’d 22 T.C.M. 889 (1963) (steps taken consistent with definite decision to go out of business, including offer to sell corporate assets, were “identifiable events”).
sets, or often even if one of these events occurs, the taxpayer's intent is the test of deductibility. A court must search the objective record in an effort to discern present value, and then test future value by the existence of the taxpayer's reasonable belief in the viability of the business. If the taxpayer is an "incorrigible optimist," worthlessness will be held to have occurred in a prior year. Conversely, if the taxpayer attempts to accelerate a loss deduction, worthlessness will be held to occur in a subsequent year. Thus, the rule favoring clear and correct record-keeping must be kept in mind, for a taxpayer's veracity is usually measured against the factual record.

Absence of a Market for Stock

An identifiable event manifests the worthlessness of goodwill, the extinction of going concern value, and the destruction of prospects for future profitability. Coupled with insolvency, an identifiable event freezes present worthlessness.

In the absence of an identifiable event, the only means of establishing the worthlessness of common stock is to prove that the corporation was so insolvent that no reasonable purchaser would have discerned the existence of going-concern value. The hypothetical reasonable purchaser must have believed that it would have been easier, and perhaps more profitable, to start anew than to assume the burdens of revitalizing an existing but floundering enterprise. As creditors may eschew foreclosure and shareholder liquidation to preserve the business as a salable entity, however, there may be no suitable event to identify the worthlessness of stock. In


220. See Esposito v. Commissioner, 32 T.C.M. 910, 912 (1973) (a continued belief in the ability of the corporation to turn around did not alter the effect of a prior identifiable event); Gimbel v. Rothensies, 24 F. Supp. 117, 119 (E.D. Pa. 1938).

221. This is an application of the "pig theory," "so named after the Wall Street adage that 'you can make money being a bull, and you can make money being a bear; but you can't make money being a pig.'" Brink & Eustice, supra note 70, ¶ 4.04 at 4-10.


223. See notes 239-243 & accompanying text infra.
such circumstances, absence of a market for the stock can be used to establish identifiable worthlessness.

Evidence of unmarketability, based on facts in existence at an earlier date, may demonstrate that no going-concern value existed at the earlier time. Similarly, proof that no actual market existed for the corporation’s stock shows no going-concern value. The difficulty in establishing the absence of a market is in amassing the evidence. Cases to date have dismissed absence-of-market arguments because the proof presented has been inadequate. The fact that stock has no ready market does not establish that it has become worthless, nor does the fact that no buyer was found establish that no market existed.

Notwithstanding the inability of taxpayers in the litigated cases to establish market worthlessness, absence of a market can be an identifiable event. If exhaustive efforts to find a buyer have been made, with prospectuses mailed to likely buyers and agents, and the replies indicate an industry-wide consensus that the stock lacks even speculative value, an identifiable event has occurred which has destroyed value. Admittedly, the event has been constructed by the taxpayer; that, however, is also true of voluntary bankruptcy, liquidation, and sale of assets. Adequate evidence of absence of a market establishes that an event has occurred that signals the end of stock value.

“Identifiable Events”

A more practical definition of “identifiable event” can be attempted now that the judicial yardsticks have been reviewed. An identifiable event is an occurrence that would make a reasonable taxpayer finally abandon an admittedly improvident investment. Numerous identifiable events would fit into this description, but do not easily fit within the categories discussed up to this point. Pilferage and deterioration of operating equipment demand on

224. See Ainsley Corp. v. Commissioner, 332 F.2d 555, 557-58 (9th Cir. 1964).
225. Stevens Bros. Found., Inc. v. Commissioner, 39 T.C. 93, 124 (1962), modified on other grounds, 324 F.2d 633 (8th Cir. 1963), cert. denied, 376 U.S. 969 (1964) (petitioner's president testified that he attempted to sell stock, but did not explain details such as offering price and methods of offering).
227. See, e.g., First Teachers Inv. Corp. v. Commissioner, 40 T.C.M. 892, 916 (1980).
a loan,\textsuperscript{229} and an attorney's opinion that loans are beyond recoupment\textsuperscript{230} are examples of events that have been held sufficient to establish worthlessness.

A practical definition of identifiable event is necessary for the additional reason that the case law discloses that each event is measured by the overall factual context. No rule defining an "identifiable event" for all purposes can be extracted.\textsuperscript{231}

Apparent from the foregoing analysis is that corroboration is a necessity, but one easily satisfied. If a corporation is in poor financial condition and possibly headed for disaster, it should not hesitate to hire a financial consultant to audit the books and recommend a course of action. Insolvency, if it exists, will thereby be established. Business and tax planning may proceed.

If the consultant believes that the business is salvageable, value exists as of the date of the report. Business options outlined in the report can be pursued. If worthlessness eventually occurs, evidence of value at a fixed date, perhaps the end of the year prior to the loss, is confirmed.

If the consultant recommends sale or liquidation of the business and estimates the proceeds therefrom, potential value can be both measured and destroyed by corporate action evincing a plan to go out of business. If the plan is followed and inconsistent actions are avoided, the insolvency, coupled with the report and the plan, will produce worthlessness.

\begin{flushleft}
\textbf{Irrevocable Insolvency—The Exceptional Case}
\end{flushleft}

The "exceptional" case, in which the liabilities of a corporation greatly exceed its assets, is not at all rare. It arises any time a corporation is heavily insolvent and cannot find or produce an identifiable event. When an irrevocable insolvency exists in which

\begin{flushright}
\textsuperscript{229} Jessup v. Commissioner, 36 T.C.M. 1145, 1149 (1977).
\textsuperscript{230} First Teachers Inv. Corp. v. Commissioner, 40 T.C.M. 892 (1980). If these events may be perceived as peculiar fact patterns and therefore of limited applicability, it is because they are. In fact, refusal of corporate creditors to accept stock as collateral was judged insufficient to render stock worthless, the court perhaps deciding that the event was too subjective. Anthony P. Miller, Inc., v. Commissioner, 7 T.C. 729, 746 (1946), aff'd, 164 F.2d 268 (3d Cir. 1947), cert. denied, 333 U.S. 861 (1948).
\textsuperscript{231} The reader may well think that the discussion has now come full circle: any subjective occurrence may be an identifiable event. This conclusion may be correct, but it misses the mark. The purpose of this analysis has not been to suggest to the taxpayer a method for recharacterizing prior actions, but rather to provide a roadmap for planning current and future transactions.
\end{flushright}
the value of stock or debt has "become finally extinct,"232 the determination of extinction constitutes an identifiable event sufficient to fix the year of worthlessness.233

One need not distinguish between insolvencies that are merely disastrous and those that are irrevocable. "The only safe practice . . . is to claim a loss for the earliest year when it may possibly be allowed . . . ."234 The result is that the wise taxpayer often will deduct the stock, and at least part of the indebtedness,235 in the first year of insolvency. This practice, however, has not yet been approved by the courts.

As the exceptional case will arise only when there occurs no colorable identifiable event such as cessation of business, liquidation, or sale of operating assets, the taxpayer will have to overcome the presumption of potential value inherent in continued operations.236 In such situations, the size of the deficit is critical. For example, in Keeney v. Commissioner,237 the corporation generated cash flow sufficient to service and repay a part of the indebtedness. No profits were realized. The size of the indebtedness nevertheless precluded a finding that the stock could reasonably regain value in the foreseeable future.238

If continued operations produce additional deficits, the taxpayer's burden is lighter, especially if the deficits are foreseen, projected by external sources, and cannot be reversed. On the other hand, if the corporation continues operations on a profitable basis,

---


234. Young v. Commissioner, 123 F.2d 597, 600 (2d Cir. 1941). For a discussion of this case, see notes 111-13 & accompanying text supra.

235. The two deductions run hand-in-hand. See, e.g., Austin Co. v. Commissioner, 71 T.C. 555 (1979) (acq.).

236. See notes 201-222 & accompanying text supra.

237. 116 F.2d 401 (2d Cir. 1940).

238. "While the taxpayer may have hoped by [conducting business] in 1933 to make something over the expenses of the [business] and thereby reduce somewhat the Club's indebtedness to him, there was no reasonable ground for hoping by that [business] or subsequent [business] to liquidate the enormous debt; and only so would the stock become of any value." Id. at 403. Accord, Richards v. Commissioner, 18 T.C.M. 332, 333 (1959); Morton v. Commissioner, 38 B.T.A. 1270, 1278-79 (1938), aff'd, 112 F.2d 320 (7th Cir. 1940).
it is almost impossible for a court, or a potential buyer, to believe that the corporation does not continue to possess value. The only exception to this rule would be in the case of a heavily insolvent corporation with a history of operating losses, poor creditor relationships, and a limited legal life.

**Going-concern Value**

Whether a corporation is irrevocably insolvent frequently turns on whether any goodwill or "going-concern value" remains. The test of going-concern value is made of the corporation as a whole, rather than on an asset-by-asset basis as for insolvency. One court has stated the test as follows:

> We suppose that [for the corporation to possess going-concern value] a purchaser must think that it would be easier, and more readily profitable, to resume former activities at the old stand than to start an entirely new enterprise without the related intangibles.\(^{239}\)

Going-concern value is ascertained by examining the entire operating history of the business to ascertain its goodwill. Would a prudent purchaser in an arms length transaction have regarded the stock in this enterprise as representing any equity at all in this debt-ridden inactive company with its history of several years of uninterrupted and ruinous operating losses?\(^{240}\)

The nature of the business is also a factor. In some businesses, destruction of public confidence may be tantamount to loss of goodwill or going-concern value. Thus, when officers and employees of a brokerage business were indicted for fraud, the resulting destruction of the public's confidence in the corporation, plus a lack of liquidating value, rendered the stock worthless.\(^{241}\) Yet other businesses, such as book publishers, may record losses every year for many years, and then recoup all losses with a single best seller.\(^{242}\)

In these cases of exceptional insolvency, going-concern value fixes worthlessness as long as there is heavy insolvency and lack of liquidating value.\(^{243}\) Lack of going-concern value shows more than

---

239. Ainsley Corp. v. Commissioner, 332 F.2d 555, 557 (9th Cir. 1964).

240. Id.


243. It is the rare corporation that will own assets worth more singly than in an operating business. Note the effect, for example, of unfinished inventory in Steadman v. Com-
the mere absence of a market; it establishes lack of marketability, which is the bellwether of worthlessness.

Subsequent Events

If a taxpayer deducts as worthless an investment that flourishes in later years, or if the taxpayer refrains from deducting it until the passing of an “identifiable event” and the investment becomes hopelessly lost almost immediately, the initial year's determination will not be tainted. Subsequent events are not relevant to a worthlessness inquiry because worthlessness is a factual determination of what a taxpayer could assess in the exercise of sound business judgment, based upon information as complete as was then reasonably obtainable.244

A substantial sale of stock was at one time evidence of value in a prior year.245 Currently, however, a sale of stock subsequent to worthlessness will not serve as evidence of prior value, especially if the sale is of small quantities, at nominal prices, or under extraordinary circumstances.246 As one court stated, “Once it appears from all the surrounding circumstances that a debt has become worthless, we cannot look to subsequent events to determine if a debt in fact became worthless. The possibility of collection is tested by the facts known at that time and not by hindsight.”247

Inconsistent Actions

The decision to abandon an investment by deducting stock or debt as a loss is difficult. Few taxpayers are willing to admit defeat
by deducting the loss in the first year of insolvency or even subsequent to the panic caused by one or more identifiable events. The most common, and the most dangerous, practice of taxpayers is to continue to make advances to the corporation subsequent to insolvency. If the taxpayer takes the position that the corporation's obligations were worthless at the date of insolvency, then any unsecured advances made with the belief that they would not be repaid “are in the nature of gifts [or contributions to capital] and are not deductible as bad debts.”

Moreover, advances made subsequent to insolvency are evidence of the taxpayer's belief in the potential profitability of the corporation and are thus inconsistent with a deduction for worthlessness.

Exceptions to the rule concerning advances continuing subsequent to insolvency do exist, even though “it is difficult to understand how an experienced businessman would continue to finance a business after all reasonable hope and expectation of profits had been abandoned.”

One exception is when advances are made to aid cash flow to recover at least part of the taxpayer's prior loans even though profits are impossible. Similarly, staving off involuntary bankruptcy and a forced sale of assets at bargain prices, or fulfilling the requirements of local law ought to satisfy a court that the continuing advances are not evidence of a profit motive, which would negate a finding of worthlessness.

Continuing shareholder investment is also inconsistent with

248. W.F. Young, Inc. v. Commissioner, 120 F.2d 159, 164 (1st Cir. 1941) (citations omitted). Unsecured advances reduce the corporation's outstanding (book) liabilities and often destroy insolvency. See Midland Distrib., Inc. v. United States, 481 F.2d 730, 734 (5th Cir. 1973) (once notes are characterized as stock, thus preventing an unjustified bad debt deduction, the debt may be classified as stock for the purpose of allocating liquidation assets); Northeastern Consol. Co. v. United States, 406 F.2d 76, 79 (7th Cir.), cert. denied, 395 U.S. 819 (1969) (stock not worthless when debt owed to parent by subsidiary was reclassified as equity); Byerlyte Corp. v. Williams, 170 F. Supp. 48, 59 (N.D. Ohio 1959), rev'd and rem'd, 286 F.2d 285 (6th Cir. 1960) (stock not worthless when loans in excess of $500,000 were reclassified as equity and assets worth less than $150,000 were distributed on liquidation). See also discussion of debt-equity at notes 395-411 & accompanying text infra.


worthlessness. Yet, the fact of continuing investment will not be given weight if the taxpayer becomes an “incorrigible optimist” with respect to the investment. Refusing to make additional contributions to the corporation, however, may be taken as evidence of worthlessness.

Corporate and individual tax returns and financial statements must be consistent with the taxpayer’s determination of worthlessness. A corporation cannot treat shareholder advances as indebtedness, thereby making the corporation insolvent, unless the shareholder treats them similarly on loan applications, on tax returns, and in demand situations. Furthermore, board of directors’ minutes must be consistent with corporate and individual tax returns and financial statements. Representations may be of particular importance when third party purchasers are involved.

What is true of direct shareholder actions is equally true of indirect ones. If a shareholder guarantees the corporation’s obligations to a third party, the guarantee is evidence of the shareholder’s belief in potential value.

It is apparent from the foregoing that choosing the proper year of worthlessness is a matter for forethought and planning. A clear understanding of the meaning of “insolvency” and the concept of “realization” of tax losses is necessary to fix the date of worthlessness. Financially sound decisions can be accomplished only by careful planning and attention to precedent. The confusion in the cases dealing with worthlessness is more apparent than real.

254. See Gimbel v. Rothensies, 24 F. Supp. 117, 119 (E.D. Pa. 1938). If the investment is worthless when made because no profit motive can then exist, the contribution to capital will be a gift and no deduction will be permitted. See generally I.R.C. § 165(c)(2).
257. See the discussion of demand, in text accompanying notes 315-20 infra. See Benjamin v. Commissioner, 70 F.2d 719 (2d Cir. 1934); Forbes v. Commissioner, 62 F.2d 571 (4th Cir. 1933); Darling v. Commissioner, 49 F.2d 111 (4th Cir.), cert. denied, 283 U.S. 866 (1931); Dustin v. Commissioner, 53 T.C. 491, 498 (1969), aff’d, 467 F.2d 47 (9th Cir. 1972). Financial entries writing down indebtedness were held to be some evidence of worthlessness in Lakewood Hospital Association, Inc. v. Commissioner, 38 T.C.M. 499 (1979).
It arises from the countless differing fact patterns, not from the
decisions themselves. The law is settled; only its application to
specific fact patterns is not.

No one element can be singled out as indicative of worthless-
ness. This is especially true when business operations continue. In-
solvency is always a prerequisite to worthlessness, but most deci-
sions result from judicial reaction to several factors and to the
degree of insolvency. In general, the events evidencing these fac-
tors occur over several years, so that those events that occur in a
year prior to the deduction serve as cumulative support for a sub-
sequent worthlessness event, and those events that occur in a year
subsequent to deduction confirm by hindsight the fact that prior
events in fact rendered the stock valueless. Each case stands or
falls on the record as a whole; the substance of the transaction, and
not the form in which it is cast, determines the legal consequences.

Judicial and Regulatory Distinctions Between Debt
and Equity

Shareholders often occupy the dual status of investor and
creditor with respect to their holdings in a corporation. This dual
status frequently arises from an optimistic belief in the eventual
success of the venture and an unwillingness to share that success
with outsiders. The tax benefits of a corporate debt structure also
favor a combination of debt and equity: with few exceptions, the
tax consequences of debt to both shareholders and corporations
are more favorable than those of stock.259

The tax benefits of debt holdings, however, place an added
burden on the creditor-shareholder to establish that advances to a
controlled corporation are loans and not contributions to capital.260
Courts have consistently held that proportional debt-equity hold-
ings invite closer scrutiny, especially in the case of sole sharehold-

259. See generally Brrkkr & Eustice, supra note 70, ch. 4. But see Kaplan v. Com-
260. But see Cornelius v. Commissioner, 494 F.2d 465 (5th Cir. 1974), in which the
taxpayer, to avoid a doubling of income required by the Subchapter S rules, argued that
what had been characterized as indebtedness by the shareholders was actually an equity
investment. The court held that the taxpayer could not argue for an equity contribution
when he had couched the advance in the form of a loan: “[A]lthough a taxpayer’s own docu-
ments are not conclusive, they normally override any conflicting subjective considerations
advanced by that taxpayer.” Id. at 471. See Redwing Carriers, Inc. v. Tomlinson, 399 F.2d
652, 659 n.9 (5th Cir. 1968); Carlton v. United States, 385 F.2d 238 (5th Cir. 1967).
The fact of proportional identity between shareholders and creditors, however, does not, without the presence of additional equity factors, preclude the existence of a bona fide debt, even if a sole shareholder-creditor is involved.

Non-shareholder debt holdings have rarely been challenged, owing to the absence of abuse potential. In most instances, non-shareholder debt arises in an adversarial context in which the focus is on seniority and security rather than on equity participation. The only situation in which unrelated non-shareholder debt does not arise in an adversarial context is in those instances in which an independent creditor acquires a hybrid instrument.

The consequence of equity treatment to an individual seeking a loss deduction is a matter of timing. The loss deduction may be deferred because the security or debt is not wholly worthless. No change in character from capital loss to ordinary loss is possible.

The stakes in a parent-subsidiary context, however, are higher. An intercompany investment invariably consists of a mix of debt and equity. Subsequent to the initial capital investment in core assets, a parent company often characterizes all subsequent outlays, whether formal loans, open account advances, or guarantees of outside indebtedness, as bona fide debt. Problems will arise primarily in the worthlessness context. If the affiliate company is technically insolvent, an identifiable event will eventually occur to confirm ordinary loss treatment under section 165(g)(3). If the

---


262. *See* Treas. Reg. § 1.385-2(a) and (b); Tomlinson v. 1661 Corporation, 377 F.2d 291, 297 (5th Cir. 1967) (citing cases); Litmans Corp. v. United States, 390 F.2d 964, 971 ( Ct. Cl. 1968).

263. Courts have had difficulty in distinguishing between the debt and equity elements of such instruments. *See* In re Indian Lake Estates, Inc., 448 F.2d 574 (5th Cir. 1971); Farley Realty Corp. v. Commissioner, 279 F.2d 701 (2d Cir. 1960); Utility Trailer Mfg. Co. v. United States, 212 F. Supp. 773 (S.D. Cal. 1962); Pottstown Finance Co. v. United States, 73 F. Supp. 1011 (E.D. Pa. 1947); Monon R.R. v. Commissioner, 55 T.C. 345 (1970); Wynnefield Heights, Inc. v. Commissioner, 25 T.C.M. 953 (1966); Talbot Mills v. Commissioner, 3 T.C. 95 (1944), aff’d, 146 F.2d 809 (1st Cir. 1944), aff’d sub nom. John Kelley Co. v. Commissioner, 326 U.S. 521 (1946); John Kelley Co. v. Commissioner, 1 T.C. 457 (1943), rev’d, 146 F.2d 466 (7th Cir. 1944), rev’d, 326 U.S. 521 (1946).


265. Note, however, the annual limitation on capital losses. I.R.C. § 1211. *See also id.*, § 1212(b) (capital loss carryovers). There may, however, be a change from short term capital loss to long term capital loss.

266. *See* text accompanying notes 167-231 supra. Note that Treas. Reg. § 1.385-10 will
intercompany advances are held to be equity, however, there will often be no technical insolvency and no current worthlessness deduction. Moreover, if the affiliate company does not subsequently lose more money, the stock, that is, stock and debt-turned-equity, will not be "wholly worthless" within the meaning of section 165(g)(3). The loss, instead of being ordinary, will thus be capital.

Inasmuch as the alternative corporate tax on capital gains is twenty-eight percent, while the marginal corporate tax rate on ordinary income is forty-six percent, losses that can be offset against ordinary income are more valuable to the corporate taxpayer than are losses that can be offset only against capital gains. As a practical matter, corporations frequently have no capital gains, rendering useless any "deduction" for capital losses. The existence or nonexistence of bona fide intercompany debt therefore takes on added importance.

The Distinctions Between Debt and Equity

The validity of purported debt, whether or not the debt is between related taxpayers, depends on whether the rights of the taxpayer are those of a shareholder or a creditor. In an early case, the Second Circuit stated the distinction:

have no effect on this result if preferred stock is classified as debt. Although what is labelled as preferred stock may be treated as debt, the worthlessness of the common, other preferred, and purported preferred will depend on seniority.

267. But see the discussion of partially worthless securities in text accompanying notes 32-43 supra.

268. Liquidation problems in which no loss is recognized are discussed in text accompanying notes 490-50 infra.

269. Section 1211(a) provides that "[i]n the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges." Section 1212(a)(1) allows unused capital losses to be carried back three years, forward five years, and to be offset against capital gains for those years.

270. But see I.R.C. § 1231, which may characterize net business gains as capital gains. In this regard, a corporate taxpayer should be fully aware of the tax benefits of a wholly worthless stock deduction. In those situations in which it is unclear whether or not a corporation will eventually regain solvency, it may be proper for good money to follow bad if the result will be the corporation's ultimate insolvency. Compare the value of an ordinary loss deduction on stock having a basis of $1,000,000 in which additional advances of $100,000, characterized as loans, are lost in order to render the corporate stock "wholly worthless," with the value of a $900,000 stock loss that is nondeductible because the stock is not "worthless." The only way this result can obtain, however, is if continuing advances to the troubled subsidiary are characterized as debt. This problem is more fully explored in text accompanying notes 395-411 infra.
[The] vital difference between the shareholder and the creditor is that the shareholder is an adventurer in the corporate business; he takes the risk, and profits from success. The creditor, in compensation for not sharing the profits, is to be paid independently of the risk of success, and gets a right to dip into the capital when the payment date arrives.\textsuperscript{272}

In \textit{Gilbert v. Commissioner},\textsuperscript{273} the Second Circuit sought to establish guidelines for review of lower court decisions.

The classic debt is an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof. While some variation from this formula is not fatal to the taxpayer's effort to have the advance treated as a debt for tax purposes . . . , too great a variation will of course preclude such treatment.\textsuperscript{274}

Lower courts generally resolved the debt-equity issue by examining various objective factors such as those listed in \textit{Gilbert}. Few courts, however, agreed on precisely which factors were objective and what weight should be accorded each factor. As a result, most courts created their own indicia in an effort to ascertain the economic reality of the transaction.\textsuperscript{275} More than one commentator has described this "objective" approach as one in which "courts are at liberty to arrive at opposite results on identical facts depending upon their own whim as to which factors they wish to stress."\textsuperscript{276}

\textsuperscript{272} Commissioner v. O.P.P. Holding Corp., 76 F.2d 11, 12 (2d Cir. 1935).
\textsuperscript{273} 248 F.2d 399 (2d Cir. 1957).
\textsuperscript{274} Id. at 402-03 (citations omitted).
\textsuperscript{275} See Holzman, \textit{The Interest-Dividend Guidelines}, 47 TAXES 4 (1969) (discussion of at least 38 factors upon which different courts have relied).

In view of this lack of uniformity, it is not surprising that the decision of the trial judge is a finding of fact that, in most jurisdictions, will be binding on appeal unless "clearly erroneous." See A.R. Lantz Co. v. United States, 424 F.2d 1330, 1334 (9th Cir. 1970); Road Materials, Inc. v. Commissioner, 407 F.2d 1121, 1123-24 (4th Cir. 1969); McSorley's, Inc. v. United States, 323 F.2d 900, 901 (10th Cir. 1963); Diamond Bros. v. Commissioner, 322 F.2d 725, 731 (3d Cir. 1963); Charter Wire, Inc. v. United States, 309 F.2d 878, 880 (7th Cir. 1962), \textit{cert. denied}, 372 U.S. 965 (1963); Brake & Electric Sales Corp. v. United States, 287 F.2d 426, 428 (1st Cir. 1961); \textit{Gilbert v. Commissioner}, 262 F.2d 512, 513 (2d Cir. 1959), \textit{cert. denied}, 359 U.S. 1002 (1959); Gooding Amusement Co. v. Commissioner, 236 F.2d 159, 166 (6th Cir. 1966), \textit{cert. denied}, 352 U.S. 1031 (1957). \textit{See also} United States v. United States Gypsum Co., 333 U.S. 364, 365 (1948); \textit{Fed. R. Civ. P. 52(a)}.

Section 385

With the enactment of section 385 as part of the 1969 Tax Reform Act, it was thought that the debt-equity area would lose some of its uncertainty as the Treasury aggressively implemented the legislative mandate to prescribe regulations. Despite a number of well-reasoned articles urging standards that would have provided debt-equity safe harbors, the Treasury did not act until

278. Section 385 provides:
“(a) AUTHORITY TO PRESCRIBE REGULATIONS - The Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness.
“(b) FACTORS - The regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. The factors so set forth in the regulations may include among other factors:
“(1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money or money's worth, and to pay a fixed rate of interest,
“(2) whether there is subordination to or preference over any indebtedness of the corporation,
“(3) the ratio of debt to equity of the corporation,
“(4) whether there is convertibility into the stock of the corporation, and
“(5) the relationship between holdings of stock in the corporation and holdings of the interest in question.”

280. In 1971, the New York State Bar Association Tax Section recommended that an interest in a corporation be classified as indebtedness if it:
“(1) arose and was paid in the ordinary course of business of both parties; or
“(2) matured in a relatively short period [two years was suggested] and was then paid; or
“(3) met all of the following requirements:
“(i) it took the form of a written unconditional promise to pay a sum certain in money on demand or at a specified date or dates not unreasonably distant with interest at a specified and reasonable rate; and
“(ii) it was not subordinated to trade creditors; and
“(iii) if it was unsecured and was issued to substantial stockholders, the corporation must have had either (a) a ratio of total debt to equity of not more than a specified ratio [a five-to-one ratio was suggested], or (b) projected earnings in excess of a specified multiple [a multiple of three was suggested] of the total interest expense accrued by the corporation; and
“(iv) it carried no right to vote for the election of directors in the absence of default; and
“(v) if it was convertible, the conversion price exceeded the market price at the time of
March, 1980.\textsuperscript{281}

The Proposed Regulations were a creative and workable response to the debt-equity imbroglio. Yet, in large part because of their unsympathetic and unnecessarily harsh treatment of non-shareholder debt, the Proposed Regulations were met by a storm of protest. Criticism was founded on the belief that the Proposals exceeded the congressional mandate, misinterpreted existing judicial thinking, or simply failed to comprehend commercial business practice.\textsuperscript{282} Some of the criticism was well-founded; some was not.\textsuperscript{283}

issuance by a specified margin.”
1971 N.Y.S. Bar Recommendations, supra note 279, at 60, 64-68.
An interest in a corporation would be classified as stock if:
“(1) it was part of a class of obligations held substantially pro rata by substantial stockholders of the obligor or an affiliated corporation; or
“(2) the maturity date was unreasonably distant; or
“(3) it carried a right to vote for the election of directors other than upon the occurrence of a default; or
“(4) it provided neither a specified rate of interest nor a reasonable discount in lieu of interest.”
Id. at 61, 68-70.


282. A brief history of I.R.C. § 385 illustrates some of the problem areas.
Section 385 found its beginnings in the 1969 Tax Reform Act in the Senate Finance Committee as a complement to the House-proposed § 279. Instead of attempting to legislate debt-equity guidelines, the Senate Finance Committee elected to authorize the Treasury to prescribe the appropriate rules for distinguishing debt from equity. S. Rep. No. 552, 91st Cong., 1st Sess. 138 (1969). The five factors enumerated in § 385 were not intended to be exclusive, appropriate in any specific context, or of greater weight than any other indicia. Nor was § 279 intended to have any impact on the § 385 rules. Id. at 138-39.
Congress intended by § 385 to delegate an extremely broad authority to the Treasury to draft rules that determine the tax status of purported debt and equity. The Treasury was authorized to promulgate regulations having legislative, and not merely interpretive force, to provide certainty and predictability, and to reduce administrative and judicial burdens brought about by the case-by-case approach of then-existing law. See notes 275-76 & accompanying text supra. See also Comment, Toward New Modes of Tax Decisionmaking—The Debt-Equity Imbroglio and Dislocations in Tax Lawmaking Responsibility, 83 Harv. L. Rev. 1695, 1706 (1970) (the discretion delegated by Congress “remains essentially unfettered”).


“The legislative history persists in referring to the development of ‘regulatory guidelines’ setting forth ‘factors’ which are to be ‘taken into account.’ Such language suggests that the Regulations were to provide guidelines . . . in making the determinations, and were not
The final Regulations do not remedy all of the problems of the proposals. Numerous areas of ambiguity and controversy remain. In general, instead of adopting a broad approach to eliminate judicial line drawing, the Regulations defer for later consideration a number of threshold definitions. Thus, the effect of the criticisms was to pressure the Treasury into cautiousness. As a consequence, the final Regulations neither apply to all transactions nor provide guidelines in areas in which a degree of certainty, or presumptive certainty, could have been obtained. Notwithstanding

necessarily intended to prescribe binding or conclusive determinations.

"This ambiguity may provoke litigation in the event the Proposed Regulations are adopted in their present form, since they do not essentially take the approach of prescribing any guidelines." Id. at A-7 to A-8.

The threat of this last statement is difficult to comprehend. Is the Report seriously suggesting that the regulatory scheme could be struck down because it provides conclusive, rather than presumptive, rules for differentiating debt from equity? If that is the implication, it is erroneous. The authority delegated is to the extent "necessary or appropriate." The final Regulations accordingly adopt bright-line rules that, except for their greater clarity and ease of administration, do not differ markedly from the approach of the commentators. See note 279 supra.

The Regulations, however, go beyond the congressional mandate in one instance—they do not merely differentiate between debt and equity. Treas. Reg. § 1.385-3, discussed in text accompanying notes 523-44 infra, provides rules for bifurcating certain shareholder instruments into part debt, part contribution to capital, and part debt, part dividend. These rules derive their authority from §§ 301, 1232, 7805. See Treas. Reg. § 1.385-1(c). The Treasury also could have relied on § 305(c). Although these rules could have been placed under other Code provisions, the Treasury correctly decided to define all instruments under the § 385 Regulations. Notwithstanding their location, the part debt-part equity provisions do not have the legislative force that attaches to the other § 385 Regulations; they have the force only of interpretive regulations. See generally Griswold, A Summary of the Regulations Problem, 54 Harv. L. Rev. 398 (1941). This distinction, however, should make no difference; Treas. Reg. § 1.385-3 is far from a "clearly erroneous" interpretation of the Code. For other views of the Proposed Regulations, see Beghe, Redrawing the Lines Between Corporate Debt and Equity Interests: The Proposed Regulations Under Section 385, 58 Taxes 931 (1980) [hereinafter cited as Beghe]; Gershman, Debt-Equity Proposals Provide Guidance But Pose Problems for Small Corporations, 53 J. Tax. 194 (1980); Fike, Proposed Debt-Equity Regulations: Potent New Standards for Characterizing Purported Debt, 7 J. Corp. Tax. 195 (1980).

Substantive criticisms of the Proposed Regulations raised more serious questions. Perhaps the most disturbing issue was the unanticipated effect of the Proposed Regulations on Small Business Investment Company (SBIC) financing. See, e.g., Internal Revenue Service Hearing on the Proposed Regulations Relating to Treatment of Certain Interests as Stock or Indebtedness, testimony of Robert F. Zicarelli, William P. Lane, and Robert Bolle (July 23, 1980). The broad reach of the nominal capital and principal shareholder rules would have effectively eliminated the role of the SBIC. The final Regulations eliminate this problem. See Treas. Reg. § 1.385-6(a)(6) (Exampes (11) and (12)).

284. The new pro-business, anti-regulatory Administration undoubtedly had a similar effect.
these problems, the final Regulations are a significant improvement over existing case law.

Scope of the Section 385 Regulations

The final Regulations apply to instruments\(^2\) and preferred stock\(^2\) issued after December 31, 1981,\(^2\) and to cash advances and guaranteed loans\(^2\) made subsequent to December 31, 1981.\(^2\)

The final Regulations also apply to instruments issued prior to January 1, 1982, the terms of which are changed “sufficiently” subsequent to December 31, 1981 that the change is considered an exchange of instruments, and to “proportional” instruments, the terms of which are changed after December 31, 1981.\(^2\)

The final Regulations are addressed primarily to “instruments,” defined as “any bond, note, debenture, or similar written evidence of an obligation.”\(^2\) If an obligation is unwritten, the rules of sections 1.385-1 through 1.385-6 are inapplicable. Certain unwritten obligations are addressed, however, in Regulation section 1.385-7.\(^2\)

Interests such as bank deposits, insurance policies, claims for wages, and trade accounts payable fall outside the Regu-

---

286. See Treas. Reg. § 1.385-10. See text accompanying notes 688-77 infra.
287. Although the final Regulations under § 385 were to become effective on May 1, 1981, see T.D. 7747, 1981-8 I.R.B. 15 (1981), the Treasury postponed the effective date in order to review comments and consider policy objections. See T.D. 7774, 1981-22 I.R.B. 6.
289. Treas. Reg. § 1.385-1(a). The regulations do not apply to instruments issued pursuant to a bankruptcy reorganization plan filed on or before December 29, 1980 Treas. Reg. § 1.385-1(a)(2)(i), nor to instruments, loans, or preferred stock issued or made pursuant to a written contract that was binding on December 29, 1980 (Treas. Reg. § 1.385-1(a)(2)(ii)).
290. 45 Fed. Reg. at 86,439 (1980). Apparently, the failure to pay interest or principal when due or the fact that the instrument is a demand note bearing an unreasonable rate of interest will not create a “reissuance.” Id.
292. They are also addressed to certain preferred stock that partakes of the attributes of an instrument. See Treas. Reg. § 1.385-6. See text accompanying notes 668-77 infra.
293. Treas. Reg. § 1.385-8(c).
294. See text accompanying notes 648-67 infra.
lations. If an interest or obligation falls outside the scope of the Regulations, it continues to be governed by existing case law without reference to the Regulations.

An "obligation" is "an interest in a corporation that is treated as indebtedness under applicable nontax law." This definition is far from clear. Aside from the difficulties and uncertainties involved in ascertaining "applicable nontax law," this definition omits a significant exception found in Proposed Regulation section 1.385-3(d)(1): "[The term 'instrument'] does not include any evidence of an obligation to make a contingent payment of principal arising from the sale of property to the corporation by an independent creditor . . . ." Thus, if the sole shareholder of X Corporation sold all of his or her stock to Y Corporation for consideration contingent on future profitability, the Proposed Regulations would not have applied to the transaction if the shareholder and Y Corporation were unrelated. The rationales for this exception were the absence of potential for abuse and the burden of enforcing a contrary rule.

The final Regulations contain no such exception and, more surprisingly, do not explain the deletion. One must search the Temporary Regulations under the new installment sales provision to discover that language similar to that deleted from the section 385 Regulations is incorporated into the section 453 Regulations.

295. Treas. Reg. § 1.385-1(b). The Regulations do not define these interests. It would be proper for the Regulations to define "trade accounts payable" in their ordinary business usage: short-term obligations acquired for goods or services arising in the ordinary course of business. See Treas. Reg. § 1.385-6(g)(5)(v), quoted at note 561 infra.

296. Treas. Reg. § 1.385-1(b)(1). To this extent, case law will have a significant and continuing effect on the debt-equity distinction.

297. Treas. Reg. § 1.385-3(d).

298. Absence of abuse potential is predicated upon the adversity of interests between buyer and seller. Cf. Treas. Reg. § 1.385-3(b) (fair market value as price at which a willing buyer and a willing seller would exchange instrument presumes lack of compulsion to buy or sell on either side); Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967) (goodwill vs. covenant not to compete). However, this adversity does not reduce the seller's subsequent participation in the risks and awards of corporate profits. Theoretically, even an "independent creditor" may hold a hybrid instrument that partakes of a predominant equity flavor.

299. Treating an agreement to make a contingent payment of principal as a "hybrid instrument" within the meaning of Treas. Reg. § 1.385-5, discussed in text at notes 505-21 infra, would create enormous valuation problems.

300. A cross-reference in the I.R.C. § 385 Regulations would be appropriate.

The rules of both the § 385 Regulations and the § 453 Temporary Regulations are consistent with the clearly evidenced intent of Congress in the Installment Sales Revision Act of 1980, Pub. L. No. 98-471, § 2(a), that even cases where the sales price is indefinite and no
Temporary Regulation section 15A.453-1(d)(8) provides:

The regulations under Section 385 do not apply to an instrument (as defined in § 1.385-3(c)) providing for a contingent payment of principal (with or without stated interest) issued in connection with a sale or other disposition of property to a corporation if § 1.385-6 (relating to proportionality) does not apply to such instrument (or to a class of instruments which includes such instrument). The proportionality test represents a tradeoff between the opposing principles of allowing contingent sales and treating equity-flavored instruments as stock.

Under Regulation section 1.385-5, a hybrid instrument is defined as an instrument having equity features. An equity feature is the right to convert the instrument into stock or a right to contingent payments other than a call premium. A hybrid instrument is treated as stock, regardless of the person to whom it is issued, if its equity features predominate, that is, if the value of its equity features exceeds fifty percent of its fair market value. Under this standard, an instrument providing for wholly indeterminate payments, such as a percentage of sales or production, would be treated as equity. If the payments were within the range of a stated minimum and maximum, the instrument's treatment as equity would depend on the range of payments and on the value of the instrument. Under Regulation section 1.385-6(c), a hybrid instrument issued to a shareholder would be treated automatically as equity if held in proportion to stock ownership.

The section 453 Temporary Regulations avoid the valuation problems by adopting a bright-line rule. If contingent contractual payments are made to a proportional shareholder, the contract will be treated as an equity interest. If the seller is not a proportional maximum selling price can be determined can qualify for installment reporting.

301. Temp. Treas. Reg. § 15A.453-1(d)(8) (Example (2)) is a holdover from the independent creditor standard of the § 385 Proposed Regulations. It makes no sense in the context of the proportionality rule of the final Regulations; that is, the contingent payment in that Example cannot be treated as an equity interest under the Regulations. In addition, although the examples specify various circumstances in which interest is or is not stated, this will be irrelevant under the approach adopted.

302. For a discussion of Treas. Reg. § 1.385-5, see text accompanying notes 505-21 infra.

303. The valuation question would raise significant problems. It illustrates that there is a practical, as well as a theoretical, incompatibility between §§ 453 and 385.

304. For a discussion of Treas. Reg. § 1.385-6(c), see text accompanying notes 612-14 infra.
shareholder, the contract will not be characterized under the section 385 Regulations. This rule is a marked improvement over the “independent creditor” distinction drawn by the Proposed Regulations, which required valuation under Regulation section 1.385-5 whenever a contingent payment was receivable by a shareholder owning between five percent and fifty percent of the corporation’s stock.

A contingent payment contract will not necessarily be characterized as debt, however, even though not made to a proportional shareholder. Temporary Regulation section 15A.453-1(d)(8) provides that if the instrument is not to be tested under the section 385 Regulations, it “will be treated as stock or indebtedness under applicable principles of law without reference to the regulations under section 385.” Moreover, several courts have denied debt status when the purchase price of property was entirely contingent and payable over a substantial period of time, especially when the property transferred represented core business assets or the corporate purchaser was otherwise minimally capitalized.

The Judicial Approach

The judicial approach to distinguishing debt from equity requires the resolution of three questions: (1) do the formal rights and remedies of the purported creditor correspond with normal creditor protections? (2) did the parties genuinely intend to create a debtor-creditor relationship? (3) was the economic reality of the transaction consistent with the reasonable risks of a creditor?

305. See Treas. Reg. § 1.385-1(b)(1). Temp. Treas. Reg. § 15A.453-1(c)(4) states that “[i]f the agreement neither specifies a maximum selling price nor limits payments to a fixed period, a question arises whether a sale realistically has occurred or whether, in economic effect, payments received are in the nature of rent or royalty income. Arrangements of this sort will be closely scrutinized.” The determination that the arrangement qualifies as a sale takes into account “all of the pertinent facts, including the nature of the property.” Id. Presumably, custom will be of great significance, so that patents and perhaps copyrights, which have traditionally been sold for indeterminant percentage payments, will more likely be accorded sale treatment. This inquiry should be similar to that for differentiating debt from equity, that is, it seeks to ascertain the bona fides of a transaction.

306. See Knollwood Memorial Gardens v. Commissioner, 46 T.C. 764 (1966) (percentage of sales of cemetery lots payable over more than 20 years); Sherwood Memorial Gardens, Inc. v. Commissioner, 42 T.C. 211 (1964), aff’d, 350 F.2d 225 (7th Cir. 1965) (percentage of proceeds from resale of cemetery lots payable over 15 years). But see Kensico v. Commissioner, 96 F.2d 594 (2d Cir. 1938) (exempt cemetery). Cf. Bittker & Eustice, supra note 70, ¶ 3.01, at 3-6 (applicability of I.R.C. § 351 when only securities are received).

The leading cases have listed between eight and sixteen factors to be weighed in determining whether purported debt is to be treated as debt or equity. The Tax Court framed the ultimate inquiry as follows, adopting factors somewhat different from those employed in the leading cases, and relying primarily on the evidentiary factors set out by William Plumb in his seminal article:

"Was there a genuine intention to create a bona fide debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship?" This test has been relied upon in a number of recent cases.

Factors of Hindsight—Form

The formal trappings of a debtor-creditor relationship are usually essential to the creation of valid indebtedness. Courts have frequently overlooked the form of a transaction, however, when the substance has been inconsistent. Five factors generally have

criteria is the fundamental notion that a valid debt, for Federal income tax purposes, exists when there is both a genuine intention that the funds be repaid and also a reasonable expectation based on economic reality that repayment will be made, independent of the success of the venture to which the funds are supplied." Datamation Services, Inc. v. Commissioner, 35 T.C.M. 1092, 1105 (1976).


309. See Plumb, supra note 31, at 271.


313. See, e.g., Tampa & Gulf Coast R.R. v. Commissioner, 56 T.C. 1393 (1971), aff'd per curiam, 469 F.2d 263 (5th Cir. 1972).
been held to bear on form: maturity date, remedies for default, lack of subordination to outside creditors, adequate interest, and provision for repayment.\footnote{314} A fixed or ascertainable maturity date is often perceived as the most important of the formal factors.\footnote{315} Nevertheless, even a demand obligation having no fixed maturity date will be accepted as evidence of bona fide indebtedness because it has a due date within the control of the creditor.\footnote{316} Similarly, open and revolving account advances between related taxpayers\footnote{317} have been upheld because they gave rise to an enforceable debt obligation.\footnote{318} The perceptive taxpayer should recognize, however, that open account advances are more likely to receive judicial sanction if reduced to writing and authorized by appropriate corporate action.\footnote{319}

A factor related to maturity date is the creditor’s ability to compel payment in the event of default. While an agreement to this effect is not strictly necessary, it is helpful, and its omission may be fatal.\footnote{320}

Subordination to general outside creditors is a factor that tends to emphasize equity features.\footnote{321} The majority view is that

---

\footnote{314}{See Estate of Mixon v. United States, 464 F.2d 394, 402-03 (5th Cir. 1972); Plumb, supra note 31, at 411-57.}

\footnote{315}{See, e.g., Wood Preserving Corp. v. United States, 347 F.2d 117, 119 (4th Cir. 1965) (purported debt found to be equity mainly because of the absence of “a fixed or ascertainable debt maturity date”).}

\footnote{316}{Litton Business Systems, Inc. v. United States, 61 T.C. 367, 378 (1973) (acq.).}

\footnote{317}{See notes 334-37 & accompanying text infra.}

\footnote{318}{Byerlite Corp. v. Williams, 286 F.2d 285, 291 (6th Cir. 1960); Rowan v. United States, 219 F.2d 51, 55 (5th Cir. 1955); American Processing & Sales Co. v. United States, 371 F.2d 842, 857 (Ct. Cl. 1967); Irbco Corp. v. Commissioner, 25 T.C.M. 359, 367 (1966); Scotland Mills, Inc. v. Commissioner, 24 T.C.M. 265, 274-75 (1965); Allied Stores Corp. v. Commissioner, 19 T.C.M. 1149, 1155-56, 1162 (1960). Cf. Malone & Hyde, Inc. v. Commissioner, 49 T.C. 575, 577 (1968) (acq.) (parent corporation's advances constituted indebtedness despite lack of formal evidence, absence of interest, lack of security); C.M. Gooch Lumber Sales Co. v. Commissioner, 49 T.C. 649, 655-56 (1968), rem'd for entry of decision in accordance with compromise agreement of the parties, 406 F.2d 290 (6th Cir. 1969) (open account arrangement may be considered indebtedness so long as clearly designed to reflect "mutually offsetting business dealings based on continuing credit and intermittent, but assumed, repayment"). But cf. Alterman Foods, Inc. v. United States, 611 F.2d 866 (Ct. Cl. 1980) ("advances" by subsidiary to parent were dividends).}


\footnote{320}{See United States v. South Georgia Ry., 107 F.2d 3, 5 (5th Cir. 1939).}

\footnote{321}{Subordination to specific creditors will not normally cast doubt on debt that is otherwise bona fide. See, e.g., Liflans Corp. v. United States, 390 F.2d 965, 971-72 (Ct. Cl. 1968). See also P.M. Finance Corp. v. Commissioner, 302 F.2d 786, 789-90 (3d Cir. 1962);
subordination, in and of itself, will not be sufficient to support a finding of de facto equity. Nevertheless, several cases have indicated that subordinated debt between related taxpayers is similar to preferred stock. Consequently, subordination at the time of corporate formation, while perhaps not fatal per se in the majority of jurisdictions, may be fatal in fact.

Provision for the payment of interest is a factor that may readily indicate whether an obligation most nearly resembles debt or equity. For example, interest payable at the discretion of the debtor is similar to a common stock dividend. In addition, interest contingent on earnings is similar to a preferred stock distribution. No interest at all suggests that what was characterized as a loan was actually a contribution to capital. Most cases, however, cannot be easily categorized. Courts focus instead on whether the interest charged was reasonable in light of the perceived risks, that is, whether the interest charged was less than that demanded by outside creditors.

Several courts have had to determine "reasonable" interest in the context of intercompany loans. In general, courts have held that the purported debt is equity when an outsider would not have loaned except at a significantly higher interest rate and the rate paid by the creditor-shareholder on its loans equalled or exceeded that paid by the debtor-subsidiary. Courts more interested in

322 See, e.g., Harlan v. United States, 409 F.2d 904, 907-08 (5th Cir. 1969); Kraft Foods Co. v. Commissioner, 232 F.2d 118, 125-26 (2d Cir. 1956).
323 See, e.g., Commissioner v. Schmoll Fils Associated, 110 F.2d 611, 613 (2d Cir. 1940); Foresun, Inc. v. Commissioner, 41 T.C. 706, 717 (1964), aff'd, 348 F.2d 1006 (6th Cir. 1965). See also Letter Ruling 7906001 (Sept. 30, 1979).
325 See Fin Hay Realty Co. v. United States, 398 F.2d 694, 698 (3d Cir. 1968).
326 See McSorley's, Inc. v. United States, 63-1 U.S.T.C. ¶ 9231 (D. Colo. 1962), aff'd, 323 F.2d 900 (10th Cir. 1963).
327 See McSorley's, Inc. v. United States, 323 F.2d 900, 901 (10th Cir. 1963) (unreasonable for shareholders to charge 4%, without security, when second mortgage financing was available only at 12%); Wagner Electric Corp. v. United States, 75-1 U.S.T.C. ¶ 9471 (Cl. Ct. T.J.D. 1975) (interest was reasonable when paid at a rate 2% above prime); Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367, 378 (acq.) (1973) (interest was reasonable "in light of the prevailing interest rates in the financial community at that time" when it was ¾% above prime and ¾% above that paid by the creditor-shareholder); Motel Corp. v. Commissioner, 64 T.C. 1433, 1438 (1970) (unreasonable for shareholders to charge 5½%
the overall substance, however, have had no trouble finding other factors to be of greater significance, even when the rate of interest was unreasonable.\textsuperscript{328}

**Factors of Hindsight—Intent**

If the parties' intent, as manifested by their overt actions, was to create indebtedness, this intent will be determinative despite the form of the transaction. As intent can change, unless the parties maintain a consistent approach to the treatment of the purported debt, a court may recharacterize the debt as equity.\textsuperscript{329} Furthermore, even without an explicit finding of changed intent, a court will often rely on present actions in finding that there was no initial intent to create a debtor-creditor relationship. Judicial factors that evidence intent in a related taxpayer context include formal documentation, the existence of security, payment history, and voluntary subordination.\textsuperscript{330}

Formal documentation has been given almost controlling weight by some courts.\textsuperscript{331} A valid debt may exist, however, even when no formal debt instrument has been executed.\textsuperscript{332} The validity when outsiders demanded 13 to 14\%; S.P. Realty Co. v. Commissioner, 27 T.C.M. 764, 767 (1968) (no outsider would have loaned at 5\%); 25\%4-58 Creston Corp. v. Commissioner, 40 T.C. 392, 397 (1963) (it was unreasonable for shareholder to charge 10\% when outsiders were asking 18\%); Allied Stores Corp. v. Commissioner, 19 T.C.M. 1149, 1155-56 (1960) (interest was reasonable when it was "normally higher" than that paid by the parent). But see Tomlinson v. 1661 Corp., 377 F.2d 291, 299-300 (5th Cir. 1967) ("That outsiders offer credit only on prohibitive terms does not transmute a stockholder loan into equity capital.").

\textsuperscript{328} See, e.g., Curry v. Commissioner, 43 T.C. 667, 692 (1965).

\textsuperscript{329} See discussion of "Factors of Foresight" in text accompanying notes 366-429 infra.

\textsuperscript{330} See Plumb, supra note 31, at 457-503. An additional factor in gauging intent is the creditor's failure to enforce payment on default. This factor is discussed in text accompanying notes 388-94 infra.

\textsuperscript{331} J.S. Biritz Construction Co. v. Commissioner, 387 F.2d 451, 459 (8th Cir. 1967) (where the transaction was "not a tax-avoidance scheme nor a mere sham or masquerade," the formalities of indebtedness were upheld). Compare Cohen v. Commissioner, 148 F.2d 336, 337 (2d Cir. 1945) (absence of corporate action authorizing creation of the debt) with Ray v. United States, 68-1 U.S.T.C. ¶ 9152 (M.D. Tenn. 1967), aff'd per curiam, 409 F.2d 1322 (6th Cir. 1969) (corporate authorization is unnecessary in a closely held corporation).

\textsuperscript{332} Byerlite Corp. v. Williams, 286 F.2d 285 (6th Cir. 1960); Rowan v. United States, 219 F.2d 51 (5th Cir. 1955); Wilshire & Western Sandwiches, Inc. v. Commissioner, 175 F.2d 718 (9th Cir. 1949); American Processing & Sales Co. v. United States, 371 F.2d 842, 857 (Ct. Cl. 1967) ("formal indicia of indebtedness are merely clues to, but not indisputable proof of, the ultimate fact"); Malone & Hyde, Inc. v. Commissioner, 49 T.C. 575 (1968) (acq.).
of informal debt has been given greater recognition in situations involving affiliated taxpayers, in which other factors justifiably have been given preponderant weight. 333

Courts uniformly have disregarded the absence of formal documentation in cases involving revolving account advances between related entities. 334 The same result should hold for open account advances. 335 The use of "revolving account advances" is a common conglomerate practice in which cash or supplies are continuously advanced to subsidiaries and ongoing repayment is automatically made out of cash flow. This procedure is employed so that the parent, with its higher line of credit and "prime" borrowing ability, can borrow for the needs of all its businesses, thereby permitting the performance of each subsidiary to be measured by factors other than credit-worthiness and the vagaries of local financing.336 The judicial approach of disregarding formal documentation in such cases is therefore proper. The transaction can justifiably be tested by objective economic factors such as rate of interest, voluntary subordination, payment history, conformity with outside creditor practices, and subsequent conduct, 337 because the parent is acting as banker for its subsidiaries and repayment is automatic.

A security interest is often strong evidence that a valid debt was intended. 338 Its absence in transactions between related enti-


335. See American Processing & Sales Co. v. United States, 371 F.2d 842, 854 (Ct. Cl. 1967) ("the open account... was the product of credits and debits resulting from mutually advantageous trading").


337. For a discussion of subsequent conduct, see text accompanying notes 366-429 infra.

ties, however, has not given rise to the negative inference that no debt was intended.

While the absence of taking a security interest on a debt transaction has sometimes been considered as tending to negative a genuine intention to create a debt, the fact that [the taxpayer] had a 100% stock interest in [the debtor-subsidiary] adequately substitutes for an independent security interest, or at least minimizes the importance thereof.339

As a practical matter, it is of little consequence to the creditor-shareholder whether his or her advances are secured or unsecured. Outside creditors either will insist on preference, thereby compelling the taxpayer to subordinate,340 or will accept the credit-worthiness of the debtor corporation. In the latter situation, a shareholder security interest would create no practical difficulties unless it is excessive. The former situation would, of course, prevent such an arrangement. In either situation, the fact of voluntary subordination341 will weigh against debt treatment if subsequent events compel a change in status.342 Thus, a shrewd taxpayer should consider securing intercompany debt at the time the advances are made.

Hindsight into repayment history is a valuable objective method that courts have used to gauge taxpayer intent. Even the best arrangement of facts will be unavailing if the debtor's payments demonstrate a preference for outside creditors, the cash needs of shareholders, or internal growth.343 As courts ascribe substantial weight to objective evidence of repayment,344 a history of

339. Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367, 381 (1973) (acq.). See also J. S. Biritz Construction Co. v. Commissioner, 387 F.2d 451, 459 (8th Cir. 1967); Wilshire & Western Sandwiches, Inc. v. Commissioner, 175 F.2d 718 (9th Cir. 1949); American Processing & Sales Co. v. United States, 371 F.2d 842, 857 (Ct. Cl. 1967); Malone & Hyde, Inc. v. Commissioner, 49 T.C. 575 (1968) (acq.).

340. For a discussion of subordination, see text accompanying notes 321-24 supra.

341. Alternatives to voluntary subordination, however, are available, and include shareholder guarantees and indirect loans secured by the shareholder. These alternatives are explored in text accompanying notes 405-11 infra.

342. See text accompanying notes 350-52 infra. An alternative to subordination is a shareholder guarantee, which has the same effect, but has less judicial stigma. As a result of the promulgation of Treas. Reg. § 1.385-9, however, it is likely that a guarantee would be treated by a court as the equivalent of subordination. See Diamond Bros. Co. v. Commissioner, 322 F.2d 725, 732 (3d Cir. 1963); Heart of Atlanta Motel, Inc. v. United States, 63-1 U.S.T.C. ¶ 9110 (N.D. Ga. 1962).


344. Timely payment of interest may also be important. Compare United States v.'
principal and interest payments will likely be accepted as evidence of debt despite continued advances that increase the year-end balance.\textsuperscript{345} Conglomerates that have adopted the revolving charge account system should be aware that proper record-keeping and awareness of current financing requirements are elements of a bona fide debtor-creditor relationship to be neglected only at great peril.\textsuperscript{346}

Repayment history may be misleading, however. It is possible that a "temporary lull" in payments might be deemphasized by a court more impressed by other factors.\textsuperscript{347} Query the effect of non-payment for a substantial period of time, followed by repayments of interest arrearages, and then by regular and significant interest and principal payments.\textsuperscript{348} Although a reasonable expectation of repayment must have existed at the time the debt was created,\textsuperscript{349} there is no justification for overlooking subsequent events that reaffirm such intent.

Voluntary subordination has not been sufficient in and of itself to support a finding that an equity contribution was originally intended, or to convert admittedly valid debt into an equity advance.\textsuperscript{350} Nevertheless, in many circumstances the effect of subor-

---

\textsuperscript{345} See cases cited in note 344 supra.

\textsuperscript{346} For the proper approach to such an account, see Litton's procedures as outlined in Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367 (1973) (acq.). Note that the court did not consider detrimental the suspension of interest and principal payments after the advances were challenged by the Service. \textit{Id.} at 380 n.9.

\textsuperscript{347} See Britker \& Eustice, supra note 70, ¶ 4.02, at 4-7, at which the authors state that "hybrid instruments that are held to constitute 'stock' should not necessarily be condemned to permanent equity status, although judicial examples of retransformation into indebtedness have yet to be found." The § 385 Regulations take the opposite view, stating that once an instrument or loan is classified as equity, it cannot be reclassified. Treas. Reg. §§ 1.385-4(b), -7(d). See text accompanying notes 468-73 and 648-60 infra.


\textsuperscript{349} Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367, 380 (1973) (acq.).

dination is to relegate prior loans to the status of preferred equity. A number of courts have so held.\textsuperscript{351}

It is difficult to perceive how a trial judge would not be adversely influenced by voluntary subordination. Accordingly, taxpayers should avoid outright subordination by finding means to obtain the same goal.\textsuperscript{352}

Factors of Hindsight—Economic Factors

A court will consider economic factors to determine, by hindsight, whether the shareholder-creditor's advances were placed at the risk of the enterprise,\textsuperscript{353} or whether the reliance on the debtor's ability to pay was reasonable, as shown by the operations of the debtor.\textsuperscript{354} Economic factors include thinness of capital structure, use to which the advances are put, source of repayment, and consistency of actions with that of an independent creditor.\textsuperscript{355}

At one time, courts and commentators sought a magic debt-to-equity ratio that could conclusively identify a debt structure as reasonable or excessive.\textsuperscript{356} The present view is that

\begin{quote}
[thin capitalization . . . is very strong evidence [of an equity interest] where (1) the debt to equity ratio was high to start with, (2) the parties understood that it would likely go higher, and (3) substantial portions of these funds were used for the purchase of capital assets and for meeting expenses needed to commence
\end{quote}

\textsuperscript{(1962).}

\textsuperscript{351} See, e.g., Watson v. Commissioner, 124 F.2d 437, 440 (2d Cir. 1942); Jewell Ridge Coal Corp. v. Commissioner, 21 T.C.M. 1048, 1056 (1962), aff'd, 318 F.2d 695 (4th Cir. 1963).

\textsuperscript{352} For a discussion of practical alternatives, see text accompanying notes 405-11 infra. For a discussion of shareholders acting as guarantors or endorsers, see Lutz, \textit{Capital Formation of Speculative Enterprises}, 34 \textit{Taxes} 420, 423 (1956).

\textsuperscript{353} Nassau Lens Co. v. Commissioner, 308 F.2d 39, 47 (2d Cir. 1962).

\textsuperscript{354} Jewell Ridge Coal Corp. v. Commissioner, 21 T.C.M. 1048, 1055 (1962), aff'd, 318 F.2d 695 (4th Cir. 1963).

\textsuperscript{355} See PLUMB, supra note 31, at 503-38. See also notes 367-429 & accompanying text infra.

The second economic factor is the use to which advances are put. Advances used to purchase core assets resemble a capital investment. Conversely, when advances have been used to finance operations and to generate their own cash flow for repayment, courts generally have ruled in favor of debt treatment. In neither event, however, is the use of advances of sufficient importance to be determinative of a debt-equity issue and this factor probably has received more attention than it deserves.

The source of debtor repayment was at one time considered a factor of importance. This is no longer the case. Nevertheless, if it can be established that an advance was made in contemplation of repayment out of liquidation proceeds, courts will infer that a capital contribution was intended. Courts, however, take a more realistic view of the normal circumstance of repayment out of profits or cash flow, and rely primarily on factors other than source of debtor repayment. The test, therefore, is whether at "the time of the creation of the advance account . . . it was reasonably expected that even without an increase in sales the business would continue to produce sufficient cash flow and profits to adequately service the debt." Another economic factor considered by the courts involves a comparison of the taxpayer's actions with those of a hypothetical independent creditor. "The acid test of the economic reality of a purported debt is whether an unrelated party would have extended

357. United States v. Henderson, 375 F.2d 36, 40 (5th Cir. 1967). The absence of such circumstances, however, would appear to make this factor moot. See Estate of Mixon v. United States, 464 F.2d 394, 408 (5th Cir. 1972). See also Tomlinson v. 1661 Corp., 377 F.2d 291, 299 n.18 (5th Cir. 1967). But see IRC § 385(b)(3). See notes 559-71 & accompanying text infra.

358. Berkowitz v. United States, 411 F.2d 818, 821 (5th Cir. 1969); Wood Preserving Corp. v. United States, 347 F.2d 117, 120 (4th Cir. 1965); McSorley's, Inc. v. United States, 323 F.2d 900, 902 (10th Cir. 1963); Charter Wire, Inc. v. United States, 309 F.2d 878, 880 (7th Cir. 1962), cert. denied, 372 U.S. 965 (1963).

359. E.g., Rowan v. United States, 219 F.2d 51, 54-55 (5th Cir. 1955); Malone & Hyde, Inc. v. Commissioner, 49 T.C. 575, 579 (1968) (acq.).

360. Cf. Estate of Miller v. Commissioner, 229 F.2d 729 (9th Cir. 1956), rev'd, 24 T.C. 923 (1955) (choice of equity or debt financing for portion of corporation's operations varies from corporation to corporation; no particular method of issuance of stock and incurring of indebtedness can be labeled as "normal").


credit in the circumstances." 363 This test is satisfied if "the terms of the advance account were not a patent distortion of what would normally have been available to [the debtor-subsidiary] as independent debt financing, but were reasonably comparable to such debt acquired in an arm's-length transaction." 364 Thus, the burden on the taxpayer is to establish, by documentation or expert testimony, the existence of outside financing standards that do not differ markedly from those that were imposed. 365

Here again, the astute taxpayer may be able to amass invaluable documentation for debt treatment. "Independent standards" are not the utopian measures that the phrase implies, but rather are subjective evaluations of unknowable risks. The taxpayer aware of this task at an early date ordinarily has little difficulty obtaining independent estimates of loan conditions that are "reasonably comparable" to those he or she decides to impose.

Factors of Foresight—Midstream Transformation

An obligation that has been classified as indebtedness at issuance may be reclassified as equity if the creditor's interest is placed at the risk of the enterprise. The section 385 Regulations provide specific situations in which transformation from debt to equity may occur. When the Regulations are not applicable, 366 similar but more subjective rules provided by existing case law have continuing vitality.

Initially, it must be realized that debt characterization is not immutable. Moreover, as one commentator has noted, the debt-equity factors are far from objective standards. 367 Too often a court "refuses to be bound by prior precedents, relies apparently on an internal reaction to the 'propriety' of the transaction, and then assembles a combination of previously enunciated standards to sustain its conclusion." 368 The taxpayer's behavior during a time of

---

363. Plumb, supra note 31, at 530.
366. For a discussion of the scope of the § 385 Regulations, see text accompanying notes 286-306 supra.
368. Id. at 811.
crisis may have a profound effect on a trial judge. Accordingly, once the taxpayer decides to bury the investment and claim a bad debt or worthless stock deduction, he or she should marshal all available resources in an effort to create a fact pattern conducive to a finding of debt.

Substantial precedent exists for treating as equity an advance that, in earlier years, was apparently valid debt, if subsequent actions demonstrate a change of status. Two recent cases illustrate the possibility of a midstream transformation.371 All previous efforts to establish debt may be undone by actions evidencing an intent by the taxpayer to protect his or her status as shareholder.

The courts in Cuyuna Realty Co. v. United States372 and Tampa & Gulf Coast Railroad v. Commissioner373 found the following facts to be of crucial importance in the change of status: (1) the subsidiary accrued an interest deduction although the parent did not accrue interest income;374 (2) the parent gratuitously cancelled the purported debt, but attempted to have the subsidiary make use of the net operating loss carryovers;375 (3) the subsidiary


370. See note 371 infra. See also Bittker & Eustice, supra note 70, ¶ 4.02, at 4-7, in which the authors state that "hybrid instruments that are held to constitute 'stock' should not necessarily be condemned to permanent equity status." Cf. Joseph Lupowitz Sons, Inc. v. Commissioner, 31 T.C.M. 1169, 1174-75 (1972), rev'd, 497 F.2d 862 (3d Cir. 1974) (subsequent actions led to a finding of debt).

371. Tampa & Gulf Coast R.R. v. Commissioner, 469 F.2d 263 (5th Cir. 1972); Cuyuna Realty Co. v. United States, 382 F.2d 298, 302 (Ct. Cl. 1967). Accord, A.R. Lantz Co. v. United States, 283 F. Supp. 164, 170 (C.D. Cal. 1968), aff'd, 424 F.2d 1330 (9th Cir. 1970) ("Surely by 1963 and 1964, and I believe sooner, the character of the advances was that of an [equity] investment."); National Sav. & Trust Co. v. United States, 285 F. Supp. 325, 332 (D.D.C. 1968); Sayles Finishing Plants, Inc. v. United States, 399 F.2d 214, 217, 220-21 (Ct. Cl. 1968) ("Even if the disputed bonds had been valid indebtedness at their inception, subsequent conduct of the parties belie their status as debt in the taxable years here involved."); W.B. Killhour Sons, Inc. v. Commissioner, 32 T.C.M. 855, 862-67 (1973); Hollenbeck v. Commissioner, 50 T.C. 740, 749 (1968), aff'd, 422 F.2d 2 (9th Cir. 1970) ("Whatever character the advances may have had at the time of their making, they had become irrevocably committed to the enterprise by October 28, 1961. They were then equity, and entirely at the risk of the business.").

372. 382 F.2d 298 (Ct. Cl. 1967).

373. 469 F.2d 263 (5th Cir. 1972).

374. 382 F.2d at 300; 469 F.2d at 264. See notes 412-29 & accompanying text infra.

had become hopelessly insolvent at a prior date and there was no reasonable prospect that the advances would be repaid;\textsuperscript{376} (4) the parent failed to force the subsidiary into bankruptcy;\textsuperscript{377} (5) the subsidiary was in arrears in the payment of interest and had made no recent repayments of principal;\textsuperscript{378} (6) the debt-equity ratio had climbed to more than 300 to 1;\textsuperscript{379} (7) income and cash flow were insufficient to make payments on the advances.\textsuperscript{380}

Other courts faced with less extreme facts have not reached the same conclusion. They have bifurcated the advances, holding that those made prior to the date that recovery became hopeless were valid debts and those made subsequent to that date were capital contributions.\textsuperscript{381} The problem remains in discerning at what point a court would be likely to reach the extreme conclusion of midstream transformation.

The threshold question is whether substance and form have been consistent. If it appears that the taxpayer's primary motive was other than to protect his or her advances, a court may rely on the taxpayer's most recent conduct as evidence of a shareholder's intent to maximize profits. Thus, post-insolvency actions will be subjected to intense scrutiny, especially if the taxpayer has structured the transaction to maximize his or her after-tax income. Awareness of this risk is essential. A taxpayer should be content with mere bifurcation if such scrutiny reveals actions inconsistent with a creditor's concern for protecting his or her advances.\textsuperscript{382}

It is difficult to see how a court could find a change of intent if the parties have merely continued advances subsequent to insol-


\textsuperscript{377} 381. See cases cited in note 381 supra.
Continued advances coupled with (1) an unwillingness to make demand for payment, (2) an effort, unaffected by a business rationale, to maximize tax benefits, and (3) the use of cash flow and income to satisfy outside liabilities (that is, de facto subordination), however, would provide a court with adequate support for a finding of de facto equity.

The converse is also true. When the actions of the parties evince an initial intent to create an equity interest, subsequent actions may alter the character of the advances, "recreating" a creditor interest.

A taxpayer whose related corporation has become insolvent would thus do well to order his or her affairs so that a court will find neither an overall intent to create an equity interest nor subsequent actions to support a changed intent. Such ordered behavior may even permit a court to justify a transformation of equity to debt.

Factors of Foresight—Failure to Enforce on Default

In the event of a default, a creditor must decide whether and when to make a demand for repayment. A creditor's failure to enforce its rights upon default will, in general, weigh against the existence of bona fide indebtedness. If refraining from demand is likely to result in a turnaround, making more funds available for debt retirement, no adverse inference will be drawn. Similarly,

383. However, a court may well find that these advances were capital contributions. See notes 395-411 & accompanying text infra. But see Treas. Reg. § 1.385-6(f), discussed in notes 623-29 & accompanying text infra.

384. See notes 389-94 & accompanying text infra. But see Treas. Reg. § 1.385-6(k) and (l), discussed in notes 635-47 & accompanying text infra. The taxpayer should not forget the many cases that have resolved the debt-equity issue in favor of equity treatment by relying on subsequent events to tip the scales, and then assembled "a combination of previously enunciated standards to sustain [the] conclusion." Caplin, The Caloric Count of a Thin Incorporation, 17 N.Y.U. Inst. Fed. Tax. 771, 811 (1959).

385. See text accompanying notes 394-95 infra.

386. See notes 395-96 & accompanying text infra. De facto subordination would clearly be a "change in terms" within the meaning of Treas. Reg. § 1.385-6(j)(2): "subordination (however effected) . . . is ordinarily a substantial change [in terms]." (Emphasis added.)

387. See note 370 & accompanying text supra. But see note 334 & accompanying text supra.


no demand need be made if the purpose of the extension is to obtain a more favorable market for the assets and prompt demand would havoc the corporation.\textsuperscript{390} Indeed, extensions for bona fide business reasons have been sanctioned in numerous cases.\textsuperscript{391}

The taxpayer who has deducted debt as partially worthless, and stock as wholly so, however, walks a fine line. The taxpayer cannot argue the hope for a turnaround without also suggesting that the corporation retains potential value. Potential value, however, belies worthlessness.

The taxpayer therefore must rely on more fundamental reasons for the failure to act. He or she may assert the need to maintain a costly yet necessary source of supply.\textsuperscript{392} The taxpayer may be required or compelled\textsuperscript{393} to maintain the subsidiary as a single unit in order to find a willing buyer.\textsuperscript{394} On the other hand, he or she may merely need time to choose the proper course of action.

A significant problem in circumstances of bona fide extensions is to convince a court in subsequent litigation that the taxpayer’s motives were pure. There is no easy resolution. Tax counsel must press the client for the reason for perpetuating a corporation that is hopelessly insolvent. If perpetuation is for tax incentives alone and not for a business rationale, the taxpayer should be apprised of the risks and urged to follow an alternative course.

A record of the decision-making process must be maintained to establish the business reasons for failure to make demand. Counsel should suggest that a committee be formed to consider alternatives pursuant to a resolution of the board of directors. Minutes documenting the rationale for extension and excusing the delay between worthlessness and demand occasioned by the decisionmaking process will then be available for use in discussions with the Service and before a court. Periodic reassessment is also advisable.

\textsuperscript{390} E.g., Bordo Products Co. v. United States, 476 F.2d 1312, 1325 (Ct. Cl. 1973).

\textsuperscript{391} See, e.g., Liflans Corp. v. United States, 390 F.2d 965, 969 (Ct. Cl. 1968) (capital improvements); Leach Corp. v. Commissioner, 30 T.C. 563, 577 (1958) (war contracts).


\textsuperscript{393} A requirement might exist pursuant to an antitrust divestiture order.

\textsuperscript{394} This might occur when the sum of a corporation’s assets are worth more as a going concern than as individual units.
Factors of Foresight—Advances Continuing After Insolvency

Once a valid business decision is made to forbear demand, the taxpayer must decide whether and in what form additional financial support will be given. The primary consideration in the decision is whether business needs warrant additional capital. Tax considerations, however, should not be overlooked, especially when the tax risks may be effectively minimized by reasonable foresight. Indeed, taxpayers blind to the tax consequences of efforts to avoid financial ruin may manage to prevent one financial calamity only to cause another.

The lowest risk situation is that in which post-insolvency advances are made that generate income and cash flow. Such income will not affect the character of the advances, but will defeat the claim for worthless stock and bad debt losses because potential value likely remains.\textsuperscript{395} This possibility need not concern the taxpayer, because the financial benefits of a revitalized investment will normally outweigh the lost tax refund. Moreover, only timing will be affected if hindsight reveals an improper worthlessness deduction.\textsuperscript{396}

A more problematic situation arises when the advances either maintain the status quo, that is, they neither produce gain nor accelerate loss, or are absorbed as operating expenses with no possibility of recoupment. Advances may not be denied debt status and may not taint prior loans if made with an intent to protect one’s creditor position, either by minimizing losses and thereby avoiding involuntary bankruptcy\textsuperscript{397} or by enabling the corporation to at least break even.\textsuperscript{398} Evidence of such intent, perhaps in the form of projections of corporate performance, must be present at the time the advances are made.\textsuperscript{399}

The decision to continue advances after insolvency can be explained simply. The creditor-shareholder has either a business mo-

---

\textsuperscript{395.} It is possible, however, for the corporation to be so hopelessly insolvent or for potential income to be so insignificant that continuing advances would not defeat a worthlessness claim. See note 398 \textit{infra} and note 248 \textit{supra}.

\textsuperscript{396.} But see notes 719-32 & accompanying text \textit{infra}.

\textsuperscript{397.} This might result, for example, in a sale of assets for less than their real value as a going enterprise.

\textsuperscript{398.} George E. Warren Corp. v. United States, 141 F. Supp. 935, 940 (Ct. Cl. 1956); Old Dominion Plywood Corp. v. Commissioner, 25 T.C.M. 678, 700 (1966).

\textsuperscript{399.} See George E. Warren Corp. v. United States, 141 F. Supp. 935, 940 (Ct. Cl. 1956).
tivation or an interest in revitalizing his or her investment. If the former, justification for ordinary loss treatment can often be found. If the latter, continuing direct advances can produce only disaster, and an alternative course of action ought to be recommended to avoid tax problems.

A creditor-shareholder may nonetheless wish to assume the risks of a midstream transformation or a disallowance of worthlessness deductions in an attempt to protect a substantial investment. After all, absent additional adverse factors, a midstream transformation is remote and a worthlessness deduction merely a matter of timing.

It is universally recognized that an advance made without reasonable expectation of repayment cannot create valid indebtedness. The fact that prior advances have been charged off as worthless constitutes virtually conclusive evidence that such expectation was lacking. In some situations, post-insolvency advances may also taint prior loans, especially if made under similar procedures, such as open or revolving charge accounts. The result can be devastating.

It was once thought that capital contributions could be converted into valid indebtedness by a simple technique: obtain debt financing through an outside lender and then guarantee payment. When payment on the guarantee is demanded and no contribution from the debtor is forthcoming, payment by the guarantor will produce a bad debt deduction.

Courts, however, have been perceptive in following this sleight

---

401. Nevertheless, it must be recognized that insolvency advances lacking a business rationale can never achieve true debt status. The most that can be hoped for is that sufficient dust can be raised to blot out substance, leaving the Service (and the courts) to attempt to follow the transaction's hazy form. At worst, the continuing advances will be treated as capital contributions and as a factor in negating the shareholder's intent to create valid indebtedness.
403. Dodd v. Commissioner, 298 F.2d 570, 578 (4th Cir. 1962); Reading Co. v. Commissioner, 132 F.2d 306, 310 (3d Cir. 1942); Bihlmaier v. Commissioner, 17 T.C. 620, 626 (1951).
405. See Lutz, Capital Formation of Speculative Enterprises, 34 Taxes 423 (1956). The same result would presumably occur for payments made directly by a parent to its subsidiary's creditors.
of hand. "[T]he 'traditional debt-equity principles' which determine whether a direct advance—in the form of a loan—constitutes a loan or a contribution to capital also determine whether an indirect advance—in the form of a loan guarantee—similarly constitutes a loan or a contribution to capital." Moreover, these principles are applied at the time the guarantee is entered into, not at the time the guarantor performs on the obligation. Consequently, a guarantee entered into after the date of insolvency will result in a contribution to capital, or treatment as a separate class of equity, upon performance. This rule, however, does not foreclose the possibility of an ordinary loss deduction for the continuing advances under other statutory provisions. Thus, several avenues of planning are open to taxpayers with the foresight to structure a business rationale for the guarantee, direct advance, or direct payment to a creditor of the subsidiary.

Section 162(a) allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Only those expenses ordinary and necessary to the taxpayer's business and incurred with no intent to seek repayment are deductible under section 162. A section 162 deduction, therefore, is unaffected by worthlessness considerations. Thus, a deduction has been allowed for payments made to protect or promote a taxpayer's business, to protect the taxpayer's position as a creditor, and to protect or preserve a source of supply. It will be impossible to establish a business purpose, how-


408. Payments made to outside creditors at the time the debtor was being liquidated were held to be ordinary and necessary business expenses in Allen v. Commissioner, 283 F.2d 785, 790 (7th Cir. 1960), in which they were made "to protect the reputation and credit standing" of the payer's business. Accord, Frazier v. Commissioner, 34 T.C.M. 961, 963-65 (1975); Santa Anita Consol. v. Commissioner, 50 T.C. 536, 561 (1968) (payment on a guarantee was a business expense motivated by a desire to protect the taxpayer's business reputation and was deductible under I.R.C. § 162).


410. Payments made directly by a parent to its subsidiary were held deductible when
ever, if the taxpayer has taken the position that the “advance” will be repaid. An expectation of repayment is inconsistent with an intent to incur an expense.\textsuperscript{411}

**Factors of Foresight—Accrual of Interest After Insolvency**

The failure to act consistently as debtor and creditor can be strong evidence of an intent to expose an “advance” to equity risk. The evidence of shareholder intent can become decisive when it can be established that the motivation to act was tax avoidance. This may arise when a taxpayer accrues a bad debt loss, in whole or in part,\textsuperscript{412} forbears from demand for repayment, and does not accrue and report as income interest on the liability that its subsidiary is accruing and deducting. This practice reduces the tax burden of the related group and may be interpreted as a tax avoidance scheme.\textsuperscript{413}

---

\textsuperscript{411} Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712, 719-22 (5th Cir. 1972), cert. denied, 409 U.S. 1076 (1972); Datamation Servs., Inc. v. Commissioner, 35 T.C.M. 1092, 1105 (1976).

\textsuperscript{412} When a partially worthless bad debt is charged off, the creditor ceases to accrue interest income on the worthless part, but continues to report as income interest due and owing on the part that may be collected. If interest on the non-charged-off part of the debt is never paid, the amount of the unpaid interest increases the outstanding indebtedness, and may thereby provide an additional cushion of bad debt to prevent the debtor from regaining solvency; thus, it may aid the taxpayer in obtaining an eventual ordinary loss deduction for wholly worthless stock under I.R.C. § 165(g)(3). Determination of proper accrual of interest income is made on the basis of the “reasonable expectancy” of payment (Corn Exch. Bank v. United States, 37 F.2d 34, 34 (2d Cir. 1930))—a question of fact and often conjecture. The charge-off of partial bad debts is discretionary and may constitute some evidence of the reasonable expectation of repayment by the creditor, especially if founded on documented cash flow projections. Because of these two factors, it may often be in the creditor-parent's interest, and within its power, to eschew a present partial bad debt deduction, or claim a smaller one, in favor of a later deduction and a present increase in the outstanding debt.

\textsuperscript{413} Prior to 1981, even if the subsidiary earned no income with which to offset the interest deductions and thereby incurred a net operating loss, the net operating loss carryover could have been availed of by a revitalization with fresh assets. This aspect of the “double deduction” problem is discussed in Nathony, supra note 375. This device has been mostly eliminated by enactment of I.R.C. § 108. But note that the stock-for-debt exception retains vitality. But see I.R.C. § 108(e)(8). It should be noted that the effect of a double deduction also can be obtained by inconsistent accrual when income is available to the subsidiary to offset the deduction.

If the subsidiary's indebtedness is not worthless, income would be accrued by the parent; if the interest is not paid, it is added to the amount of the outstanding debt. Treas.
“Inconsistent” accrual treatment can bear heavily on the validity of purported loans. In *Tampa & Gulf Coast Railroad v. Commissioner*, the Fifth Circuit found this factor to be of overriding importance. Other courts in similar inconsistent accrual situations have found purported debt to be equity without specific reliance on this factor. Nevertheless, it is reasonable to assume that in those cases this factor had a negative impact on the courts’ view of creditor intent.

Cases addressing inconsistent accrual nevertheless provide substantial support for inconsistent accrual treatment, even between related entities. The rule on the accrual of interest income is that an accrual basis creditor need not accrue and report as income “that which is not received during the taxable year and in all probability will not be received within a reasonable time thereafter.” To constitute income, the creditor must have a “reasonable expectancy” of receiving the interest.

The majority rule on the accrual of interest deductions is that interest on bona fide indebtedness is accruable and deductible even “when the financial condition of the corporation is such that there is no reasonable expectancy that it will pay the accrued interest in full.” In *Pearlman v. Commissioner*, however, the Tax Court held that accrual of interest deductions is improper when it is not reasonable to conclude that payment will ever be

---

Reg. §§ 1.166-1(e), -6(a)(2). The interest-cum-debt may thereafter be charged off as a bad debt loss. As the subsidiary’s accrued interest deduction has previously been used either to offset items of income or to contribute to the creation of a net operating loss, it is easy to see how a single deduction has been turned into a double deduction.

414. 469 F.2d 263 (5th Cir. 1972).
415. Id. at 264.
416. See note 371 supra.
419. Rev. Rul. 70-367, 1970-2 C.B. 37. Accord, Fahs v. Martin, 224 F.2d 387, 393 (5th Cir. 1955) (“interest legally owed is deductible by an insolvent accrual basis taxpayer”); Keebey's Inc. v. Paschal, 188 F.2d 113, 115 (8th Cir. 1951); Zimmerman Steel Co. v. Commissioner, 130 F.2d 1011, 1012 (8th Cir. 1942), rev'd 45 B.T.A. 1041, 1045 (1941); Cuyuna Realty Co. v. United States, 382 F.2d 288, 301 (Ct. Cl. 1967); see Panhandle Ref. Co. v. Commissioner, 45 B.T.A. 651, 656 (1941) (examination of the effect of a debtor's precarious financial condition).
420. 4 T.C. 34 (1944), aff'd, 153 F.2d 560 (3d Cir. 1946).
made. Pearlman affirmed the position taken by the Tax Court in Zimmerman Steel Co. v. Commissioner, despite Zimmerman’s reversal by the Eighth Circuit. Other courts have not adopted the Pearlman view, although some acceptance can be found among commentators and in dicta.

A thorny problem is thus presented when the debtor-subsidiary is insolvent and the creditor-parent has taken a bad debt deduction. "Inconsistent" accrual treatment, while perhaps justifiable under precedent, is certain to result in judicial scrutiny, if not censure. Those taxpayers unafraid of scrutiny on the issues of debt-equity and change of intent may attempt the "extra deduction" route. The majority of taxpayers, however, would be better advised to adopt the position taken by the Tax Court in Cohen v. Commissioner and the Fifth Circuit in Tampa & Gulf Coast Railroad. If a bad debt has been charged off as worthless, the debtor-subsidiary should eschew the accrual of interest deductions that stand no reasonable likelihood of payment. Such restraint will permit a position consistent with the non-accrual of interest income by the creditor-parent.

The creditor-parent should make it clear in writing, however, that it in no way intends to release the debtor from its obligation to pay interest or from its underlying obligation on the loan.

421. Id. at 54. See also Rodman v. Commissioner, 32 T.C.M. 1307, 1318 (1973), rev’d in part on other grounds, 542 F.2d 845 (2d Cir. 1976); Cohen v. Commissioner, 21 T.C. 855 (1954) (acq.); Brainard v. Commissioner, 7 T.C. 1180, 1184 (1946), rem’d, 47-2 U.S.T.C. ¶ 9306 (7th Cir. 1947).
422. 45 B.T.A. 1041 (1941), rev’d, 130 F.2d 1011 (8th Cir. 1942).
423. Id.
424. See Mooney Aircraft, Inc. v. United States, 420 F.2d 400, 410 (5th Cir. 1969); Guardian Inv. Corp. v. Phinney, 253 F.2d 326, 334 n.12 (5th Cir. 1958); Holland, Accrual Problems in Tax Accounting, 48 MICH. L. REV. 149, 172-79 (1949).
425. No such problem exists, however, in those situations in which consolidated returns are filed. See Treas. Reg. §§ 1.1502-13(b)(1), -19(b)(2)(iii), -32, -33.
426. 21 T.C. 855 (1954) (acq.).
427. 469 F.2d 263 (6th Cir. 1972), aff’d 56 T.C. 1393 (1971).
428. This position also appears to produce the "proper" tax result, a factor that courts in future cases may find of overpowering importance.
429. A court faced with this situation should rule in favor of consistency. The Eighth Circuit decision in Zimmerman Steel Co. v. Commissioner, 130 F.2d 1011 (8th Cir. 1942), should be overruled. The decision has no rational basis in tax theory and serves no legitimate purpose. Moreover, the Zimmerman Steel line of cases should be overruled to eliminate the possibility of an unwarranted tax windfall in the related taxpayer context. See notes 419-24 & accompanying text supra.
The Effect of Equity Characterization

A finding of de facto equity will preclude a deduction under section 166. Moreover, no worthless stock deduction will be allowed under section 165(g)(3) unless the equity is, in fact, "wholly worthless." Equity securities can become wholly worthless in two situations only: (1) when no assets remain after expenses are paid and outside liabilities are satisfied, or (2) when the debt-turned-equity is characterized as a preferred stock interest and such "preferred stock" absorbs the remaining assets. The former situation presents no difficulty. The latter requires some discussion.

Assume a situation in which a creditor-parent owns all of the stock and holds all of the debt of its subsidiary. The stock has recently become worthless within the meaning of section 165(a). The parent, relying on the validity of its debt, takes a worthless stock deduction for the taxable year in issue. In addition, the parent directs its subsidiary to sell its assets and transfer the cash proceeds in full satisfaction of the intercompany indebtedness in order to avoid the potential problems that an outright sale of the corporation might involve. Thereafter, the corporate entity is dissolved.

If, in subsequent litigation, the purported debt is held to have been a contribution to capital, which increased the parent's stock basis in the subsidiary, then the question arises of the effect to be given the purported "satisfaction of intercompany indebtedness."

---

430. See text accompanying notes 14-15 supra. But see notes 44-76 & accompanying text supra.
431. See text accompanying notes 135-64, supra.
433. Assume one class of common stock, with no preferred stock issued or outstanding.
434. The remaining debt may be cancelled to set the stage for a "double deduction." See Natbony, supra note 375. But see I.R.C. § 108.
435. A sale of stock is not possible if the debt is valid, because a bona fide creditor would not permit the assets that serve as his security to be sold without the proceeds being used to satisfy his obligations. In such circumstances, an independent creditor would be most likely to demand payment and compel a sale of assets. There also may be a contingent liability problem.
436. The corporate shell may be kept alive in order to "revitalize" the subsidiary and thereby make use of its net operating loss carryovers. See Textron, Inc. v. United States, 418 F. Supp. 39 (D.R.I. 1976), aff'd, 561 F.2d 1023 (1st Cir. 1977). But see I.R.C. § 108. It may also be kept alive merely so that state incorporation costs need not be duplicated should there be a future need for a corporate shell.
The Service has prescribed liquidation treatment in such debt-
turned-equity situations. The Service's position finds support in 
Treasury Regulations, which recognize a "status of liquidation" 
"when the corporation ceases to be a going concern and its activi-
ties are merely for the purpose of winding up its affairs, paying its 
debts, and distributing any remaining balance to its shareholders." 
Liquidation treatment in the debt-turned-equity situation is also consistent with the general rule that a distribution on stock 
is treated as a liquidation.

A section 332 liquidation will thus occur when a subsidiary 
distributes cash to its parent "in cancellation or redemption of 
all stock of the dissolved corporation." If the liquidating distribu-
tion is in respect of preferred stock with a liquidation preference 
greater than that of the cash distribution, however, section 332 will 
not apply because not "all stock" was cancelled or redeemed. It 
may be critical, then, to determine whether debt-turned-equity will 
be treated as a contribution to capital or as a preferred class of

437. See Brief for Defendant at 22-23, Wagner Elec. Corp. v. United States, 75-1 U.S. 
T.C. ¶ 9771 (Cl. Cl. T.J.D. 1975).


439. Id. A liquidation may be completed prior to the actual dissolution of the liquidat-
ing corporation. Legal dissolution of the corporation, however, is not required. Id. Amounts 
distributed in complete liquidation of a corporation are treated as full payment in exchange 
for the stock. I.R.C. § 331(a)(1). There is no recognition of gain or loss by an affiliated 
corporation on the receipt of property distributed in complete liquidation of another affiliated 

It is unclear whether Treas. Reg. § 1.331-2(c) is correct in ignoring the transfer of stock. 
If the shareholders intend to maintain their equity in the corporation, it is difficult to see 
why the liquidation rules ought to apply. See Langstaff v. Lucas, 9 F.2d 691 (W.D. Ky. 
1929), aff'd per curiam, 13 F.2d 1022 (2d Cir.), cert. denied, 273 U.S. 721 (1926). Thus, if 
the corporate shell is to be revitalized, the result should be that a distribution is made on 
the stock, producing a dividend to the extent of earnings and profits. (This would result in 
the retention of corporate attributes in the shell and a dividends-received deduction equal 
to the full amount of the distribution. I.R.C. § 243.) Conversely, if an intent exists to wind 
up the corporate existence, the result should be liquidation treatment. It therefore may be 
wise to plan to reuse the corporate shell.

440. Section 332(b) has three requirements: (1) 80% stock ownership; (2) a plan of 
complete liquidation; and (3) the distributions in complete liquidation must occur within a 
three year period. On the specific conditions of § 332(b), see BITTKER & EUSTICE, supra note 
70, at ¶ 11.41.

441. Cash is "property" for purposes of § 332(a); an all-cash distribution falls within 
the purview of a property distribution. Tri-Lakes S.S. Co. v. Commissioner, 146 F.2d 970 
(6th Cir. 1945); International Inv. Corp. v. Commissioner, 11 T.C. 678 (1948), aff'd per curiam, 

442. Commissioner v. Spaulding Bakeries, Inc., 252 F.2d 693, 697 (2d Cir. 1958), aff'd 
27 T.C. 684 (1957) (nonacq.).
Few cases have addressed whether shareholder advances found to constitute equity contributions qualify as a second class of stock. Those few cases are divided on the issue, although a majority holds that the advances are a second class of stock in the nature of a preferred interest. Shareholder intent is the critical inquiry. If the shareholder's intent, as evidenced by overt actions and the economic reality of the transactions, were to create an interest superior to that of a common stockholder, then the advances would be treated as preferred stock. Thus, the closer a taxpayer comes to creating valid indebtedness, the greater the likelihood will be that, in the event debt characterization is denied, a court will characterize the debt-turned-equity as a second class of stock entitled to a preference on liquidation.

The new section 385 Regulations treat all debt-turned-equity as preferred stock “for all purposes of the Internal Revenue Code.” Even though the Regulations have prospective application only, the likely effect of this provision will be judicial adoption of a senior preferred stock rule. The section 385 Regulations notwithstanding, the facts of a particular case may lead a court to conclude that the advances should be treated as a contribution to capital. The result would be no recognition of loss on the liquidating distribution.

---

443. See note 437 supra.
445. This inquiry parallels the inquiry into debt-equity characterization. See notes 272-75 & accompanying text supra.
449. I.R.C. § 332(a). See also I.R.C. § 337(c)(2)(A) (§ 337 nonrecognition will not apply
An advance that is held to be a second class of stock in the nature of a preferred interest, however, will qualify for section 332 treatment if the distribution exceeds the value of the debt-turned-preferred. If the distribution does not exceed the value of the preferred, then the common stock will be wholly worthless within the meaning of section 165(g)(3) and the loss on the preferred stock will fall within the definition of complete liquidation. The character of the loss on the preferred stock will be determined under section 331.450

Section 385 Regulations—Post-December 31, 1981

Interests

All non-hybrid "instruments,"451 that is, "straight debt instruments,"452 are treated generally as debt under the Regulations. Instruments and certain obligations that contain equity features that

if the basis of the property distributed pursuant to § 332 is determined under § 334(b)(1)). Note, however, that if § 332 does not apply because of the existence of debt-turned-preferred stock, § 337 may automatically apply to defeat the recognition of loss incurred by the subsidiary on the sale of assets.

450. Section 331 prescribes artificial exchange treatment for any distribution in a complete liquidation. Thus, the nature of preferred stock as a capital asset or not determines whether the loss is capital or ordinary. The author can suggest two means of obtaining ordinary loss treatment: (1) if the investment is a Corn Products asset, see Corn Prod. Ref. Co. v. Commissioner, 350 U.S. 46 (1955); Midland Distrib., Inc. v. United States, 481 F.2d 730 (5th Cir. 1973); see also Javaras, supra note 59; or (2) if stock is that of an "affiliate," especially an affiliate in a consolidated group. See S. Rep. No. 1530, 91st Cong., 2d Sess. 2 (1970) (affiliates are "closely enough related, in effect, to treat them as one operating business"). The loss under § 165(g)(3) was regarded as "a loss of part of the business of the parent corporation." Id. (referring to the 1971 amendments to I.R.C. § 165(g), Pub. L. No. 91-897, 84 Stat. 2071 (1971)). See Textron, Inc. v. United States, 561 F.2d 1023, 1027 (1st Cir. 1977) (Bowen, J., dissenting). See also Javaras, supra, note 59, at 790-92. See notes 48-50 & accompanying text supra. Although the latter offers a novel approach to the problem, further exploration of this concept is justified, see Javaras, supra note 59 at 790-92; see also notes 44-76 and accompanying text supra, and adoption of such a position before the Service may provide the added measure of government uncertainty to produce a favorable compromise.


452. A "straight debt instrument" is "any instrument other than a hybrid instrument." Treas. Reg. § 1.385-3(f). Treas. Reg. § 1.385-3(e) defines a "hybrid instrument" as "an instrument that is convertible into stock or one (such as an income bond or a participating bond) that provides for any contingent payment to the holder (other than a call premium)."
demonstrate a probability that the holder may act or is acting more like a shareholder than a creditor, on the other hand, are treated as stock.\textsuperscript{453}

Straight debt instruments not held by shareholders are never treated as stock. This sharply departs from the nominal capitalization rules of the Proposed Regulations, which would have treated as equity all instruments issued by a corporation having a debt-to-equity ratio greater than ten to one.\textsuperscript{454} The final Regulations retreat from the position of the Proposed Regulations in order “not [to] interfere with the normal operations of small business investment companies, commercial lenders or other independent creditors.”\textsuperscript{455} The retreat is proper because an independent creditor who, in contrast to the holder of a hybrid instrument, has no contingent equity interest, would be concerned primarily, if not solely, with preserving his or her debt position. Consequently, the independent creditor's intent would be unassailable and there would be no reason to recharacterize his or her interest as equity.

Hybrid instruments,\textsuperscript{456} however, contain the potential for tax abuse, even when held by independent creditors. The potential for abuse is apparent from the nature of the instrument; the conversion or participation in earnings feature makes the holder's interest more than that of a creditor. Thus, the holder will be influenced in his or her treatment of the corporation by the extent of the equity potential. The Regulations address this problem by treating all hybrid instruments having an equity predominance as equity interests,\textsuperscript{457} an equitable result, albeit difficult to administer. Hybrid instruments held proportionally by shareholders necessarily have an equity predominance and thus will always be characterized as equity.\textsuperscript{458}

The Regulations, notwithstanding their approach to non-shareholder instruments, primarily address shareholder abuse. Standards of shareholder intent and measurements of economic substance are pivotal in the determination of whether shareholder obligations will be reclassified as equity.

The primary standard of shareholder intent employed by the

\textsuperscript{453} See notes 522-647 & accompanying text infra.
\textsuperscript{455} 45 Fed. Reg. 86,438 (1980). See Treas. Reg. § 1.385-6(a)(6) (Examples (11), (12)).
\textsuperscript{456} See note 452 supra.
\textsuperscript{457} Treas. Reg. § 1.385-5. See notes 505-21 & accompanying text infra.
\textsuperscript{458} Treas. Reg. § 1.385-6(c). See notes 612-14 & accompanying text infra.
Regulations is proportionality of stockholdings to debtholdings.\textsuperscript{459} This standard, while valid,\textsuperscript{460} is far too narrow, because it overlooks avenues of significant shareholder abuse. A shareholder with an equity interest greater than his or her debt interest may treat the debt as an extension of stock interest. For example, a ten percent shareholder will treat its five percent debt interest as equity as long as the indebtedness is enforced as a class, because the value of ten percent of the outstanding debt exceeds the value of its five percent debt interest. Admittedly, the Regulations cannot address all such situations. On the other hand, to sanction all is equally unacceptable. The Proposed Regulations attempted a middle path by proscribing certain actions by "principal shareholders." Whatever the excesses of such an approach, the final Regulations seemingly approve relationships that invite abuse almost as much as those proportional holdings that are proscribed.\textsuperscript{463}

Proportional holdings, however, are not sufficient in themselves to cause reclassification of an instrument.\textsuperscript{462} Economic substance must also be absent before an instrument is classified as equity.\textsuperscript{463} The Regulations balance the presence of factors that suggest an intent to expose the obligation to shareholder risk with the presence of economic indicators that demonstrate the likelihood that shareholder considerations predominate. This "factor" approach differs little from the proposals advanced by commenta-

\textsuperscript{459} Treas. Reg. § 1.385-6(a). See notes 572-610 & accompanying text infra.

\textsuperscript{460} It is valid because, for example, a 90% shareholder would have little reason to enforce an 80% debtholding, because in any event a substantial portion of the debt will inure to his or her equity in the corporation. To the extent that a shareholder holds a proportional debt interest, his or her creditor concerns are secondary, and should therefore be ignored.

\textsuperscript{461} See notes 572-610 & accompanying text infra.

\textsuperscript{462} The "Supplementary Information" to the final Regulations, 45 Fed. Reg. at 86,440 (1980), suggests that the result could have been otherwise: "Because the characterization of proportionate advances as debt instead of stock is so heavily influenced by tax considerations, one possibility would have been for the section 385 regulations to classify all proportionately-held debt as stock. . . . [T]he final regulations have rejected this approach. Treasury believed it would have been unsound policy in effect to deny corporations access to shareholder capital in the form of indebtedness when loans on the same terms could have been obtained from independent lenders." The Treasury's implication that proportionality alone could be a basis for reclassification is questionable and was properly rejected.

\textsuperscript{463} Economic factors include hybrid holdings, excessive debt, unreasonable interest rate or nonpayment of reasonable interest in a demand instrument, failure to pay principal, exercise due diligence in collection and the instrument provides for, or there is paid, interest at an unreasonable rate, and certain obligations that are not evidenced by an instrument. See Treas. Reg. §§ 1.385-6, -7. See notes 611-67 & accompanying text infra.
tors in the early 1970's. Greater simplicity and conclusiveness is achieved under the Regulations.

The Regulations do not merely define an instrument as debt or equity. They also characterize an instrument as part debt and part equity. Regardless of proportionality, the Regulations require that each shareholder deal with the corporation at arm's length. If the shareholder paid too much for an instrument, the excess is treated as a contribution to capital. If too little was paid, the difference is treated as a section 301 distribution.

This result is theoretically valid because all shareholder dealings with a corporation are subject to abuse and capable of analysis by arm's length standards. Although ascertaining market value is a difficult task, the Regulations' valuation approach will provide shareholder-creditors with an added incentive to conduct their affairs by commercial means using provable commercial standards. Furthermore, this approach offers some opportunity for compromise, which may reduce litigation.

Once an instrument is treated as stock under section 385, it is treated as preferred stock for all purposes of the Internal Revenue Code. "Interest" is treated as a section 301 distribution, and

464. See note 279 supra.
466. See notes 474-83 & accompanying text infra.
467. See 45 Fed. Reg. 18,959 (1980). The pressure for compromise will be increased by the Tax Court's recent admonition that valuation disputes be settled and not litigated. See, e.g., Buffalo Tool & Die Mfg. Co. v. Commissioner, 74 T.C. 441, 451-52 (1980). Not only will this provision reduce litigation, it also will enhance the bargaining positions of examining agents.
468. Treas. Reg. § 1.385-4(c). This will create disclosure problems, for example, in tax-free acquisitions. It may also create unintended consequences under I.R.C. §§ 302(c)(2), 453B (see Rev. Rul. 72-264, 1972-1 C.B. 131, Rev. Rul. 73-423, 1973-2 C.B. 161), 108(e), and 351(d). "Such preferred stock is considered to have the same terms (e.g., voting rights) as the instrument has under applicable local law. Each class of instruments classified as preferred stock is treated as a separate class of preferred stock. . . . [S]ee § 1.992-1(d)(2) for an exception to this rule." Treas. Reg. § 1.385-4(c). One effect of treating each class of "preferred stock" as a separate class would be to terminate an election under Subchapter S. "However, the Treasury has not yet determined whether the corporation will have 'more than one class of stock' within the meaning of section 1371(a)(4) . . . This point will be covered exclusively by § 1.1371-1(h) [which is reserved for this purpose]." 45 Fed. Reg. 86,438, 86,445 (1980). The "more than one class of stock" rule of I.R.C. § 1371(a)(4) "was enacted to avoid difficulties in allocating corporate income and loss among the shareholders . . . and was intended to apply to differences created by corporate action only . . . ." Brrrker & Eustice, supra note 70, ¶ 6.02, at 6-8. See Portage Plastics Co. v. United States, 486 F.2d 632 (7th Cir. 1973); James L. Stinnett, 54 T.C. 221 (1970); T.I.R. 1248 [1973] Fed.
payments of "principal" fall within sections 302-303.

If an instrument is reclassified as stock, the "reclassification" will be treated as an "E" reorganization. No gain or loss is recognized. Once an obligation is classified as equity, however, it remains classified as equity. A change in terms, in subsequent enforcement, or even in ownership has no effect. This treatment is consistent with characterization as an "E" reorganization.

Fair Market Value

The fair market value of an instrument is relevant to two inquiries: (1) in determining whether an instrument issued to a shareholder is part equity (as when issue price exceeds fair market value), or part sections 301 or 305 distribution (as when an instrument is issued at a discount), and (2) in the nonproportional shareholder context, in ascertaining whether a hybrid instrument's equity features predominate over its debt features.

The fair market value of an instrument is "the price at which
it would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of all relevant facts.” In determining price, “[t]he buyer and the seller would be expected to consider the relevant factors affecting the risks of the investment . . . . [m]any of [which] are the same as the factors mentioned in the case law in distinguishing stock from indebtedness.” The fair market value of an instrument may be determined by the relatively simple task of using present value and standard bond tables. Any noncommercial term used by a taxpayer to distort fair market value may be ignored.

The Regulations provide two “rules of convenience” for facilitating the valuation of instruments issued in an arm’s length transaction. First, the fair market value of a straight debt instrument is considered equal to its face if, on the date of issue, the stated rate of interest is “reasonable,” and the consideration paid is equal to the face amount of the instrument. Second, the fair market value conclusively is presumed to equal the issue price if the instrument is registered with the SEC and sold for cash.

These rules are imminently workable. Appraisal should be necessary as a practical matter only for hybrid instruments issued for property or offered in a limited market. Even when appraisal is necessary, a minor difference in valuation usually will not lead to a major difference in tax treatment, because the hybrid instrument rules require only that fifty—or, in certain circumstances, forty-five—percent of an instrument’s value be attributable to its debt features for it to be classified as indebtedness. Moreover, a straight debt instrument will remain classified as debt even if a part is treated as a contribution to capital or affects the amount of a sec-

---


477. 45 Fed. Reg. at 18,959 (1980), which adds: “For an extensive discussion of these factors and the case law, see Plumb . . . .”


480. See note 452 supra.

481. “Reasonable” within the meaning of Treas. Reg. § 1.385-6(e). See notes 484-95 & accompanying text infra. Should “reasonable” rate of interest be ascertained by United States or foreign situs standards?

482. Treas. Reg. § 1.385-3(b)(2)(i).

Reasonable Rate of Interest

The rate of interest on a bona fide debt instrument must be "reasonable." The problem of determining reasonableness is most difficult when a shareholder holds indebtedness. The Regulations define "reasonableness" by providing a flexible general rule with a liberal "rule of convenience" for recourse liabilities.

(1) In general. The annual rate of interest on an instrument issued by a corporation is reasonable if it is within the normal range of rates paid to independent creditors on similar instruments by corporations of the same general size and in the same general industry, geographic location, and financial condition on the date the determination is made.

(2) Rule of convenience. For purposes of the regulations under section 385, an annual rate of interest on an instrument is considered to be reasonable if—

(i) On the date the determination is made, (A) it is equal to the rate in effect under section 6621, the prime rate in effect at any local commercial bank, or a rate determined from time to time by the Secretary taking into consideration the average yield on outstanding marketable obligations of the United States of comparable maturity or (B) it is between any two of the rates

484. See discussion of Treas. Reg. § 1.385-3(a) ("shareholder") at note 523 infra. See discussion of Treas. Reg. § 1.385-6(a) ("proportional shareholder") in text accompanying notes 572-610 infra. See discussion of Treas. Reg. § 1.385-7 (non-"independent creditor") in text accompanying notes 661-67 infra.

485. Treas. Reg. § 1.385-6(e)(3) excludes nonrecourse liabilities from the rule of convenience in order to give effect to the debt-to-equity ratio element.

486. This portion of the regulatory scheme was criticized as being difficult for shareholders to determine at the date of a loan. The Treasury response is intriguing: "These comments, however, fail to recognize that the debt-equity problem is an extraordinarily difficult one. . . . Any attempt to reduce the problem further, to a set of purely mechanical formulas would necessarily result in oversimplification. There is a certain irreducible core of difficulty in making the debt-equity distinction, and some exercise of judgment is ultimately required. The final regulations present this judgment as a relatively straightforward exercise in valuation, and this is quite possibly the most that can be done." 45 Fed. Reg. 86,442 (1980). Reasonable rate of interest depends on weighing the case law factors, such as maturity date, subordination, capitalization. Id. See also Treas. Reg. § 1.385-6(e)(5) (Example 1).

487. "[L]ocal commercial bank" includes any commercial bank at which the issuing corporation ordinarily does business." Treas. Reg. § 1.385-6(e)(4).

488. "It is anticipated that these rates will be published in a revenue procedure. This change allows corporations to use the interest rates on longer term Treasury obligations as safe harbor rates when the prime rate may not be an accurate indicator of long-term interest rates." 45 Fed. Reg. at 86,443 (1980). It appears likely that the Secretary will establish diff-
described in subdivision (A) of this subdivision (i), and
(ii) At the end of the taxable year in which the determination
is made, the debt-to-equity ratio of the issuing corporation is not
greater than 1:1.489

Under the rule of convenience, if a calendar year corporation's
debt-to-equity ratio, measured by the adjusted basis standard of
asset valuation,490 happens to exceed 1:1 at the end of the tax-
payer's taxable year, a loan obtained at the beginning of the year,
for example, at or near the prime rate will subject the corporation
to the heavier burden of proof under Treasury Regulations section
1.385-6(e)(1). Although testing reasonableness on the last day of
the taxable year may be convenient, it is not equitable. A debt-to-
equity ratio has little relevance eleven months after the creation of
an obligation.491 Moreover, this “rule of convenience” may require
the taxpayer to establish and document the reasonableness of a
rate of interest negotiated some time earlier. The rationality of this
provision is questionable. A more equitable “rule of convenience”
definition of “reasonable” would measure the debt-to-equity ratio
as of the date on which the obligation arises. Although this rule
may be difficult to administer, because, for example, depreciation
is more easily computed at year’s end, the added degree of fairness
would more than compensate for the difficulty.492

The requirement of a 1:1 debt-to-equity ratio applies only
when the taxpayer needs a safe harbor. Despite the lack of preci-
sion in the “adjusted basis” aspect of the debt-to-equity ratio defi-
nition493 and the conservative nature of the 1:1 ratio, the only ef-
effect is to compel the taxpayer to meet the heavier evidentiary

489. Treas. Reg. § 1.385-6(e)(3) (footnotes supplied). Treasury adopted the 1:1 debt-
to-equity ratio for two reasons: "First, [a 1:1 ratio] covers a majority of all corporations.
Extensive statistical analysis indicates that more than 55 percent of all corporations filing
tax returns in a recent year and more than 60 percent of all new corporations had debt-to-
equity ratios of less than 1:1. Second, a debt-to-equity ratio of 1:1 is exceptionally high by
debt-to-equity ratio appears to be approximately 0.7:1. See generally RMA Annual State-

490. See text accompanying notes 559-71 infra.

491. The Regulations attempt to mitigate the problem somewhat by factoring in a
corporation's net operating loss for the taxable year. See note 565 infra. While helpful, this
addition does little to further economic substance.

492. If debt is issued at incorporation, the randomness of the end-of-year test can be
eliminated by election of a one-day year.

burden of establishing a commercial rate of interest.494 This burden can be met by comparing the rate with contemporaneous or comparable outside borrowing, or by referring to the interest rate paid by borrowers with superior credit ratings.495 Problems will arise only in those situations in which a corporation has no credit rating and no outside borrowings, which is a circumstance sufficiently fraught with valuation difficulties to warrant seeking shelter in the safe harbor. The increased certainty brought to the debt-equity area by the reliance on reasonable rate of interest and fair market value more than compensates for this inconvenience.

**Non-shareholder Instruments**

“Straight debt instruments”496 issued to “independent creditors” are always treated as debt under the final Regulations.497 An “independent creditor” is a creditor who neither owns stock proportionately in the corporation nor owns five percent or more of the corporation’s stock by application of the attribution rules of section 318(a).498 If a creditor owns five percent or more of the stock, directly or indirectly, the determination of whether the creditor is an “independent creditor” is made from “all relevant facts and circumstances.”499

“Independent creditors” are treated as bona fide lenders because instruments issued to them are not normally open to tax abuse. The terms of the instrument derive from an adversarial agreement: neither party is under an obligation to loan or borrow, and neither derives any direct benefit from issuance aside from the terms of the obligation. Therefore, the theoretical basis for the Regulations’ exclusion of independent creditor instruments is clear. Exactly what an “independent creditor” is or should be,

494. “In view of the fact that the safe harbor rates are, in most cases, below-market rates, the 1:1 safe harbor ratio has not been increased. If this ratio were increased, most corporations would be able to rely upon the regulations to avoid the uncertainty inherent in the factor-oriented approach of the case law and, at the same time, charge below-market interest rates on proportionate debt.” 45 Fed. Reg. at 86,443 (1980).
495. “Moreover, the ways of proving the corporation’s ability to borrow from outside creditors at commercial rates are similar to those of proving the fair market value of a corporation’s assets.” 45 Fed. Reg. at 86,443 (1980).
496. Straight debt instruments are all instruments other than hybrid instruments. See Treas. Reg. § 1.385-3(f). See notes 451-52 supra.
498. Treas. Reg. § 1.385-6(b)(2).
however, is not.

The Regulations’ Examples shed little light on the reasoning of the Treasury. A creditor remains independent if he or she exacts the right to designate a director. A creditor who may appoint even a majority of the directors apparently will remain independent because he or she falls within the safe harbor rule. This result is supportable because the right to manage the corporation is not a right to participate in earnings. The Regulations, however, give no clue whether the right to designate a director is a relevant “fact or circumstance” in the situation of a more than five percent shareholder.

A creditor is not independent if he or she owns, actually or by attribution, five percent or more of the corporation’s stock. Also, a creditor who owns less than five percent of the corporation’s stock is not independent if his or her stock and debt holdings are “substantially proportionate.” The Regulations ought not to apply to non-proportionate stock and debt holdings, even if the creditor is not “independent” by reason of stockholdings exceeding five percent.

Hybrid Instruments

A hybrid instrument issued to a non-“proportional” creditor is treated as stock if, on the date of issuance, the fair market value of the instrument’s equity features predominates. The eq-

500. Treas. Reg. § 1.385-6(b)(4) (Example (3)).
501. See Treas. Reg. § 1.385-6(b)(2).
502. See Treas. Reg. § 1.385-6(b)(4) (Example (1)).
503. See Treas. Reg. § 1.385-6(b)(4) (Example (4)). See also notes 572-610 & accompanying text infra.
504. See notes 681-67 & accompanying text infra. 
505. See note 452 supra.
507. Treas. Reg. § 1.385-5(a). An exception to the predominance standard, permitting the value of the “debt features” to be as low as 45%, is provided if “clear and convincing evidence” shows that on the date of issuance both the issuer and holder reasonably believed that the instrument’s debt features predominated. Treas. Reg. § 1.385-5(c). See Treas. Reg. § 1.385-5(f) (Example (9)). The purpose of this exception is to eliminate the danger that a minor good faith valuation error may result in a major difference in tax consequences. It will require, however, that the issuer and holder rely on expert valuation in order to satisfy the standard of “clear and convincing evidence.” Such good faith reliance, whether the actual value is 45% or even 40%, should be sufficient to serve the policy interests of the Regulations and the problems of commercial business practice. As such, the “minor” difference in valuation should be expanded to reach 40%. The practical effect of not expanding the safe harbor will be simply to compel a court to reach a finding of fact more consistent with the
uity features of an instrument are the right to stock conversion and the right to contingent payments other than a call premium.8

The purpose of the hybrid instrument rules is to treat as stock those instruments that evidence a predominant participation right in the corporation’s earnings and losses. Instruments with a right only to fixed payments of interest and principal do not evidence such a participation right and are accordingly treated as debt.9 If taxpayer’s expert. Because the purpose of the Regulations is to conserve judicial resources, a broader safe harbor would provide the better solution.

508. Treas. Reg. § 1.385-5(b). See also notes 668-77 & accompanying text infra.

509. These are so-called “straight debt-instruments,” defined at note 452 supra. See Treas. Reg. § 1.385-5(e) (Examples (5), (9), (10), (14)); Treas. Reg. § 1.385-5(f) (Example (1)).

Fixed payments of interest and principal are those payments that are “definitely ascertainable” as to rate and sum, respectively, and date, and that cannot be impaired without the holder’s consent. Treas. Reg. § 1.385-5(d)(2)-(3). The holder must have a right to receive principal when due and to receive interest within 90 days of its due date. A payment is “definitely ascertainable” as to date if it is payable on demand or due on ascertainable dates. Treas. Reg. § 1.385-5(d).

Interest and principal are definitely ascertainable if they are irrevocable, or their variability is subject to an uncontrolled external standard. Treas. Reg. § 1.385-5(d)(4)(ii)(B): “A principal sum is not variable simply because it is within the borrower’s control to prepaid all or a portion of the principal sum.” The distinction adopted by the Regulations is that a “date contingency” is not contingent if it is within the borrower’s control.

Nonrecourse debt and recourse debt receive the same treatment under the Regulations. Treas. Reg. § 1.385-5(f) (Example (4)).

An external standard is uncontrolled if it is not subject to the borrower’s control and is not related to the success or failure of the borrower’s business or activities. A payment that is not “fixed” under this formulation may nonetheless be treated as fixed if it is guaranteed by another person Treas. Reg. § 1.385-6(d)(7), or if the contingencies, which, for example, permit impairment without the holder’s consent, are illusory. Treas. Reg. § 1.385-6(d)(6). It is interesting to recognize that some of the rights that are the usual indicia of equity have no effect on a weighing of debt versus equity features, that is, voting rights and subordination are almost irrelevant. See Commissioner v. O.P.P. Holding Co., 76 F.2d 11, 12 (2d Cir. 1935) (subordination increases value of other factors); Plumb, supra note 31, at 447 (voting rights not a decisive factor). Subordination, however, will affect valuation.

The classification of a payment as fixed is not affected by the fact that: “(i) The instrument is issued under an indenture that satisfies the requirements of section 316 of the Trust Indenture Act of 1939 (15 U.S.C. § 77ppp); (ii) A holder’s right to receive interest or principal may be impaired by the operation of the Federal bankruptcy laws (Title 11, U.S.C.), the Railroad Modification Act (47 U.S.C. § 20b), or any similar provision of law; or (iii) A holder’s right to receive interest or principal may be impaired in the event of the insolvency of the issuing corporation (either in the sense that the corporation is not able to pay its debts as they become due or in the sense that its liabilities exceed its assets).” Treas. Reg. § 1.385-5(d)(5).

Debt issued in redemption of stock is often subject to state law limitations. For example, payments of principal and interest cannot be made if the corporation is or would be rendered insolvent. See Herwitz, Installment Repurchase of Stock: Surplus Limitations, 79 Harv. L. Rev. 303 (1965). Treas. Reg. § 1.385-5(d)(5)(iii) treats such an insolvency limita-
neither interest nor principal is "fixed," the instrument is treated as an equity investment. If payment of either principal or interest is not fixed, however, the instrument is not a "straight debt instrument" and must be classified under the Regulations' predominance standard.

The Regulations provide a four-step process for determining predominance. First, the instrument's "fixed" and "contingent" elements are identified. This is a simple all or nothing definitional process. Second, the fair market value of the instrument is determined as a form of subordination that is not a "contingency." See 45 Fed. Reg. 86,438, 86,439-40 (1980). This concept is illustrated in Treas. Reg. § 1.385-5(e) (Example (11)).

However, in Treas. Reg. § 1.385-5(e) (Example (12)), local law provides an additional restriction which the Regulations do treat as a "contingency." In Example (12), nontax law provides that each payment can be made only out of earned surplus. The Example finds that the instrument lacks the right to any fixed payment and is therefore stock. This result would obtain in a number of jurisdictions. See, e.g., CAL. CORP. CODE §§ 500(a), 501 (West 1977); OR. REV. STAT. § 57.035(1)(5) (1979); MODEL BUS. CORP. ACT § 6 (1979). Cf. N.Y. BUS. CORP. LAW. § 613(a) (McKinney 1963) (payments allowed out of "surplus"); see Treas. Reg. § 1.385-10(c) (Example (6)).

The Regulations' treatment of state law earned surplus is theoretically correct; that is, the redeemed shareholder has a continuing equity participation. This would be especially true if the redemption price exceeded fair market value, as it well might in a family corporation context. Payments in a more usual closely held context are merely suspended; they are not wholly contingent. Yet, the line drawn here is exceedingly fine. The rationale for state law earned surplus limitations on redemption payments has no relationship whatsoever to the tax distinctions between debt and equity. The state law concept of "earned surplus" is an historic, balance sheet figure reflecting past earnings. Treas. Reg. § 1.385-5, and Treas. Reg. § 1.385-10, appear to be most concerned with payments out of future earnings, a different concept. More importantly, however, notwithstanding its theoretical validity, the Regulations' standard may be unworkable. A redeemed shareholder in an earned surplus jurisdiction would be unable to waive family attribution, see I.R.C. § 302(c)(2)(A), because his or her instrument is treated as stock for all purposes of the Internal Revenue Code. Treas. Reg. § 1.385-4(c)(1). One consequence, therefore, of treating an earned surplus limitation as a "contingency" would be in a § 318 context, in which dividend treatment under §§ 302(d) and 301 would be mandated without necessarily having "dividend equivalency." A less formalistic distinction than incorporation in an "earned surplus" jurisdiction therefore is appropriate. The Treasury should reconsider its conclusion on this issue. Although the Regulations provide a simple expedient for avoiding the problem—a shareholder guarantee, see Treas. Reg. §§ 1.385-5(d)(7), -10(c) (Example (6))—the jurisdictional earned surplus distinction should not, of itself, support a substantive tax difference. All that is accomplished is the creation of another trap for the unwary.

In this respect, the instrument provides for payments normally associated with preferred stock. See notes 688-95 & accompanying text infra (discussion of preferred stock). See Treas. Reg. § 1.385-5(e) (Examples (8), (12)).

Some theoretical support may exist for a weighing approach in which an "equity feature" may not have a complete equity flavor, e.g., when a payment of interest is not made it will bear interest at a reasonable rate until paid. In the interests of administrative simplicity, the Regulations treat the value of the entire contingency as an equity feature. If an
The "Supplementary Information" to the Regulations assumes that, in most cases, the fair market value of the instrument will be equal to its issue price. This assumption is valid if the instrument is marketed to the public. If the instrument is sold privately, there is no reason not to hold the parties to the form of their transaction. Valuation at issue price compels a valuation of the instrument's debt or equity features to reach a conclusion on predominance.

The Regulations' third step is to value the instrument's "debt features," inasmuch as equity features have no readily ascertainable market value. This valuation will be relatively simple if the corporation has a credit rating—the applicable discount rate for the corporation can be ascertained and present value methods applied. If a corporation does not have an ascertainable credit rating, then prior arm's length borrowing will provide a starting point for valuing the instrument's debt features. If the hybrid instrument is the corporation's first attempt to borrow, the instrument will be held to a more rigorous standard. The parties to a hybrid instrument possessing demonstrable "equity features" therefore will be put to their proof.

The fourth and final step is to compare the value of the instrument's "debt features" to its fair market value. If the difference between the debt features and the fair market value exceeds fifty percent of the instrument's value, the hybrid instrument will be classified as preferred stock. This initial classification is immutable.

allocation to "debt flavor" were permitted, valuation would become an impossible task.

513. 45 Fed. Reg. at 18,959 (1980). The "Explanation of Changes," id. at 86,438, "supplements the 'Supplementary Information' contained in the notice of proposed rulemaking."

514. See Treas. Reg. § 1.385-3(b). The "fair market value" "rules of convenience" are discussed at text accompanying notes 480-83 supra.

515. The "fixed" principal and/or "fixed" interest.

516. The discount rate of a comparable corporation with an established credit rating also could be used.


However, minor differences in the discount rate employed may result in profound valuation effects. Because the discount rate will derive from the same subjective judicial factors that created problems under prior law, the Regulations' approach is not the revolutionary improvement suggested in the Supplementary Information. Cf. Treas. Reg. § 1.1232-3(b)(2)(ii) (1979) (discussing valuation of investment units).

518. But see Treas. Reg. § 1.385-5(c), discussed at note 507 supra.

519. Treas. Reg. § 1.385-5(a) tests the instrument "on the day of issue." See Treas.
There is one exception to this process. A corporation can create two separate interests, lock them together, and thereby avoid predominance and proportional holding analyses. Such locked interests will be treated separately, that is, one as debt, the other as stock. This is a substantial and appropriate concession by the Treasury.

The approach of the Regulations is creative and theoretically sound. Characterization of hybrid instruments has been a difficult judicial task, and the concept of reducing each case to a valuation exercise appears to eliminate a great number of uncertainties. Although the Regulations' approach is not, and could not be, a simple mathematical equation, it comes as close as possible to providing an objective formula for classifying hybrid instruments, while necessarily taking into account the subjective factors intrinsic to a determination of fair market value.

**Shareholder Obligations**

The Regulations are directed primarily at shareholder instruments, the area of greatest abuse. Straight debt instruments issued to shareholders are "ordinarily" classified as debt. Hybrid instruments issued proportionately to shareholders, on the other hand, are always classified as stock.

**Bifurcation Rules**

A debt instrument issued to a shareholder at a premium

Reg. § 1.385-4(b)(1). Unless there is a change in terms sufficiently "substantial" to be considered an exchange of instruments, the § 385 Regulations cannot again apply. See 45 Fed. Reg. 86,439 (1980).

520. Treas. Reg. § 1.385-8(a) states: "[F]or example, if a corporation issues a bond with a nondetachable warrant, the bond and the warrant are treated as two separate interests in the corporation."

521. This rule also appears to be contrary to existing law. See Universal Castings Corp. v. Commissioner, 37 T.C. 107, 115 (1961), aff'd, 303 F.2d 620 (7th Cir. 1962), cited in 45 Fed. Reg. 18,962 (1980).

522. Treas. Reg. § 1.385-2. Instead of defining "ordinarily," the Regulations define the exceptions to debt treatment, leaving the undefined within the ambit of the "ordinary."

will result in a contribution to capital in the amount of the premium.\textsuperscript{525} If the instrument is treated as debt, the face of the instrument exceeds its “issue price,” and the instrument was issued for cash, then the excess of its face amount over its initial fair market value will be treated as “original issue discount” within the meaning of section 1232.\textsuperscript{526} If the issue price exceeds the face amount, then there is original issue premium.\textsuperscript{527} If an instrument issued to a shareholder is treated as preferred stock,\textsuperscript{528} then the excess of its face amount, that is, its redemption price,\textsuperscript{529} over the initial fair market value may result in a deemed dividend on preferred stock during the period prior to the earliest call date.\textsuperscript{530}

112. \textit{But see} White Tool & Mach. Co. v. Commissioner, 41 T.C.M. 116 (1980); R.T. French Co. v. Commissioner, 960 T.C. 836 (1973). Why the Treasury decided that existing law should apply instead of providing regulatory guidelines is unclear and creates potential inconsistencies. There is no requirement, for example, that a court apply family attribution and the regulatory rules in a bargain redemption context, although the failure to do so may result in an inconsistency.

\textsuperscript{524} That is, issue price exceeds fair market value.

\textsuperscript{525} Treas. Reg. § 1.385-3(a)(1). The contribution to capital may be treated as a gift, see note 523 \textit{supra}, compensation, see I.R.C. § 83, or, if the instrument is treated as stock, as a constructive dividend within the meaning of I.R.C. § 305, see note 530 \textit{infra}.

\textsuperscript{526} See I.R.C. § 1232(a)(3)(A) and (E); Treas. Reg. § 1.163-4(a)(1).

If an instrument is issued in exchange for “property,” as defined in § 1232(b)(2), Treas. Reg. § 1.385-3(a) will not apply. This is not made clear by the Regulations, and should be clarified; it is taken for granted in the Supplementary Information, 45 Fed. Reg. at 18,961 (1980). If the instrument is issued proportionately to shareholders, see text accompanying notes 572-610 \textit{infra}, then Treas. Reg. § 1.385-6(d) will apply.

Section 1232 will treat the excessive consideration in a different manner. Although the excess of the issue price over fair market value will be treated as a contribution to capital, the excess of the face amount over initial fair market value will not create original issue discount. This is because issue price is treated as stated redemption price at maturity. I.R.C. § 1232(b)(2). As a result, there will be capital gain at maturity and no ratable income during the term of the obligation. There is a corresponding effect on the corporation’s basis in the property, that is, the corporation’s basis will equal the shareholders’ basis plus any gain recognized.

The inconsistency of application owing to the nature of shareholder consideration is unsupportable. See notes 615-22 & accompanying text \textit{infra}. Although based on a statutory distinction, the Treasury should reconsider the applicability of § 1232 to the debt-equity area.

\textsuperscript{527} See I.R.C. § 171; Treas. Reg. § 1.61-12(c)(2).

\textsuperscript{528} Under Treas. Reg. §§ 1.385-6 or -7. See text accompanying notes 612-13 \textit{infra}.

\textsuperscript{529} See Treas. Reg. § 1.385-4(c)(1)(i).

\textsuperscript{530} Under § 305(b)(4) or (c), there may be a deemed dividend unless and to the extent the preferred stock is immediately redeemable at a reasonable redemption price. See Treas. Reg. § 1.385-4(c)(2) (Example (4)). To prevent application of § 305(b) (i.e., Treas. Reg. § 1.305-5(b)), shareholder instruments should contain an immediate prepayment right, the theory apparently being that a right to immediate redemption does not represent dividend equivalency, but rather a right to participate in growth. The Service’s current ruling
Conversely, if the fair market value of an instrument exceeds its issue price, then the difference between the fair market value and the issue price is treated as a distribution to which section 301 applies.\textsuperscript{531} If face exceeds issue price, section 1232 again will apply; if issue price exceeds face, there will be original issue premium.\textsuperscript{532} If, however, the instrument is treated as stock under other provisions of the section 385 Regulations, then the difference between the fair market value and the issue price will be treated as a distribution to which section 305 applies.\textsuperscript{533}

The bifurcation rules have been much criticized. One commentator has argued that the rules conflict with and partially supersede the rules of Code section 482 and certain treaties that provide safe harbors for intercompany debt within controlled groups. They may also conflict with the imputed interest rules of Code section 483 in cases of disproportionately held shareholder debt issued in payment of property.\textsuperscript{534}

This argument criticizes the lack of consistent arm's length standards in the section 385 Proposed Regulations and in the regulations then in existence under sections 482 and 483. Under the final section 385 Regulations, the problem has been properly reduced to one of administrative procedures: interest will be reasona-
ble if it falls within guidelines established by the Secretary. Presumably, guidelines under the three sections will be integrated. The addition of Treasury Regulation section 1.482-2(a)(4), (5) and (6) and the change of I.R.C. sections 482 and 483 interest rates will further resolve the difficulties in overlapping fact patterns.

Another criticism is that the rules "present a number of opportunities for tax avoidance. For example, foreign corporate investors might exploit the rules to generate excessive discount income that would be deductible by the domestic issuer and exempt from withholding and nontaxable under treaty rules." This criticism, while valid, would be better resolved by treaty than by regulatory change.

The rules have also been criticized for effectively forcing closely held corporations to pay higher interest rates to avoid a finding of contribution to capital and original issue discount. This pressure to pay higher interest rates similarly inhibits salvage loans by shareholders. This criticism has little merit. The rules requiring conformity to higher standards are justified to the extent that shareholder loans are subject to greater abuse. Interest at a commercial market rate is not an overly burdensome standard. Moreover, salvage loans by shareholders often have an equity

536. Treas. Reg. § 1.482-2(a)(5) provides that the I.R.C. § 385 Regulations, supplemented by the original issue discount provisions of I.R.C. § 1232(a)(3) and the bond premium rules of Treas. Reg. § 1.61-12(c)(2), will be applied prior to the I.R.C. § 482 Regulations. Debt may be bifurcated or recharacterized under the I.R.C. § 385 Regulations even if it meets the requirements of § 482, for example, if the interest rate on the debt falls within the safe harbor rule of Treas. Reg. § 1.482-2. If a debt is classified as stock under the § 385 Regulations, the § 482 Regulations will not apply. If interest is imputed under Treas. Reg. § 1.385-3(a) or I.R.C. § 1232(a)(3), it "will be considered an arm's length interest rate for purposes of section 482." See Treas. Reg. § 1.482-2(a)(6).
538. Beghe, supra note 283, at 944.
539. It should be noted, however, that the opportunity for whipsaw is not limited to foreign investors. For example, a corporation may take the position that a premium was paid for an instrument even though the shareholder is taking an inconsistent position.
540. The Treasury believes that the higher commercial rates will be beneficial because they "will enable small businesses to obtain loans from their shareholders at the same rates paid by the largest corporations." 45 Fed. Reg. at 86,443 (1980).
WORTHLESSNESS, DEBT-EQUITY

flavor. If outside creditors would not lend to the corporation, the Regulations are correct in treating the instrument as a partial or a complete contribution to risk capital.

A number of basic policy criticisms constitute a final attack on the rules. These criticisms address the concepts of original issue discount and amortizable premium. While arguably valid, all may be rebutted.

"Safe Harbor"

The "safe harbor" is set out in the Summary at Treasury Regulations section 1.385-2(d). It is not intended to serve as a definition, but rather as an outline of the nonoperative areas of the regulatory scheme.

A "straight debt instrument" will fall within the safe harbor when three conditions are satisfied:

1. **Principal and interest.** The instrument has a fixed maturity date and provides for annual payments of interest at (i) the rate in effect under section 6621, (ii) the prime rate in effect at any local commercial bank, or (iii) a rate determined from time to time by the Secretary taking into consideration the average yield on outstanding marketable obligations of the United States of comparable maturity, or (iv) any rate in between.

2. **Debt-to-equity ratio.** The debt-to-equity ratio of the corpora-

541. See text accompanying notes 402-04 supra.
542. If interest rates would have to be imputed at a noncommercial rate, that is, 30 to 40%, the Treasury decided that the instrument should be reclassified as equity. This is partially accomplished by the "excessive debt" rules of Treas. Reg. § 1.385-6(f). See 45 Fed. Reg. at 86,441 (1980).
543. See Beghe, supra note 283, at 945.
544. These criticisms are founded primarily on concerns about capital formation and the inequity of Treas. Reg. § 1.385-3(a) as a trap for the unwary and the unsophisticated. The capital formation policy evidenced in the Regulations, for example, reduction of capital gain by imputed contribution to capital, or payment of taxes without receipt of cash, is firmly entrenched in the Code, e.g., §§ 305(c), 1232, and cannot be removed absent legislative action. As such, this policy should be consistently applied. The I.R.C. § 385 Regulations do exactly that. Treas. Reg. § 1.385-3(a) functions as a trap only when shareholders attempt tax avoidance, that is, issue noncommercial instruments.
545. Treas. Reg. § 1.385-2(d) states: "This section is merely a summary . . . and is subject in all respects to the more complete rules contained in §§ 1.385-3 through 1.385-10."
546. See note 452 supra.
547. Treas. Reg. § 1.385-2(d). (Footnotes supplied). Several problems created by these positive requirements are explored below in the discussions of defined terms and debt-equity factors.
548. See Treas. Reg. § 1.385-6(f).
549. See Treas. Reg. § 1.385-6(e).
tion does not exceed 1:1. 550

(3) Paid when due. All principal and interest on the instrument are paid when due. 551

The term “safe harbor,” however, is misleading. Although Treasury Regulation section 1.385-1(d) neatly gathers the elements of conclusive safety, it fails to state that the absence of some elements, though not others, may not be fatal to debt treatment. 552 It also omits the significant proviso that the consideration paid for the instrument must equal its face in order to avoid the bifurcation rules of section 1.385-3. 553 Thus, section 1232 may apply to instruments issued as part of an investment unit 554 even though the safe harbor includes the “rule of convenience” requirements for equating the face amount with the fair market value. 555 To this extent, the “safe harbor” is not totally safe. To fail to summarize this requirement is misleading.

The Regulations as drafted have no need of a “safe harbor.” An instrument is classified as indebtedness for all Internal Revenue Code purposes if it falls outside the Regulations’ proscriptions. 556 The Regulations, nevertheless, provide a definition of “safe harbor” that converts the language of the proscribing provisions to a positive statement of debt classification.

Definitions

The cornerstone of the Regulations is a set of definitions that serves as a standard of reasonable conduct. These definitions make important distinctions on the basis of debt-to-equity ratio, fair market value, 557 reasonable rate of interest, 558 and shareholder proportionality.

The Regulations place great reliance on the definition of debt-to-equity ratio to determine the classification of instruments held
by shareholders. A ratio of 1:1 is the maximum permitted in the "rule of convenience" definition of "reasonable rate of interest." Ratios of 10:1 and 3:1 are the primary standard for ascertaining whether a corporation is nominally capitalized. The definition of debt-to-equity ratio, however, does much more than define safe and unsafe harbors; it is a standard integral to the Regulations' scheme.

The definition of "debt-to-equity ratio" is the ratio of the corporation's liabilities to the stockholders' equity. The definition of stockholders' equity, however, departs from accounting theory and substitutes a rule of convenience. Stockholders' equity in a corporation is defined as "the excess of-(i) The adjusted basis of its assets (less reserves for bad debts, if applicable, and other similar asset offsets) over (ii) Its liabilities (including liabilities excluded under paragraph (g)(1)(i) of this section)." In computing stockholders' equity, the adjusted basis of a

559. Treas. Reg. § 1.385-6(e)(2).
561. Treas. Reg. § 1.385-6(g)(1) provides: "The debt-to-equity ratio of a corporation is the ratio that—(i) The corporation's liabilities (excluding trade accounts payable, accrued operating expenses and taxes, and other similar items) bears to (ii) The stockholders' equity."

Trade accounts payable and similar items are omitted from liabilities, "because trade accounts payable vary during the ordinary course of business in a way that is largely beyond the control of shareholders . . . ." 45 Fed. Reg. at 86,443 (1980). Treas. Reg. § 1.385-6(g)(5)(v) provides that "[a] liability is treated in the same manner as a trade account payable if it is—

(A) Incurred under a commercial financing agreement (such as an automobile 'floorplan' agreement) to buy an item of inventory,
(B) Secured by the item, and
(C) Due on (or before) sale of the item."

562. This debt-to-equity rule of convenience will materially affect only the "reasonable rate of interest rule of convenience" for the 1:1 debt-to-equity ratio required thereunder. Treas. Reg. § 1.385-6(e)(2). It cannot impact negatively on "excessive debt" inquiries. See Treas. Reg. § 1.385-6(f)(2).
563. This is for the purpose of equalizing cash and accrual method taxpayers.
564. Treas. Reg. § 1.385-6(g)(2) (emphasis added) (footnotes supplied). See note 561 supra. Debt-to-equity ratio is determined on the last day of the taxable year both for purposes of the reasonable rate of interest rule of convenience, Treas. Reg. § 1.385-6(e)(2)(ii), and the safe harbor rule for excessive debt (Treas. Reg. § 1.385-6(f)(4) (last sentence)).
565. Four adjustments are provided: "(i) In the case of a corporation that uses the cash method of accounting, the adjusted basis of trade accounts receivable shall be deemed to be equal to the face amount of the receivables (less an appropriate reserve for uncollectibles)."

"(ii) In determining the debt-to-equity ratio of a corporation at the end of a taxable year, the stockholders' equity shall be increased by the amount of any net operating loss (determined without regard to sections 1211(a) and 1212) sustained by the corporation dur-
corporation’s assets and the amount of its liabilities are determined by use of the corporation’s normal accounting method. The computation is made without regard to any reclassification under section 385, except that preferred stock treated as debt under section 385 is considered a liability. Moreover, “[t]he debt-to-equity ratio shall be computed without regard to distortions created by a temporary contribution to equity or any similar contrivance.”

The debt-to-equity ratios of members of an affiliated group are computed by treating lower-tier subsidiaries as operating divisions. Thus, a parent is deemed to own a ratable share of its subsidiaries’ assets and to owe a ratable share of its liabilities. Parent-subsidiary investments and liabilities that are duplicative are eliminated.

Proportionality

“Substantial proportionality” between stockholdings and any class of debtholdings is the most important of the Regulations’ definitions. The Regulations are founded on the premise that non-proportionate debt is not easily abused. Consequently, proportioning the taxable year...

“(iii) [Certain bank corporations must make adjustments pursuant to I.R.C. § 279(c)(5)(A).]”
“(iv) [Insurance company insurance reserves are treated as trade accounts payable.]” Treas. Reg. § 1.385-6(g)(5). Subparagraph (ii) is helpful to balance the effect of the Regulations’ end-of-the-taxable-year rule.

The Treasury’s purpose in adopting the adjusted basis standard was simplicity of application. See 45 Fed. Reg. at 18,959 (1980) (“The fair market value of the corporation’s assets, although theoretically a more correct measure than adjusted basis, is not used in determining stockholders’ equity because of the greater difficulty inherent in valuing operating assets.”). The definition, and its various qualifications, is successful in accomplishing that goal. Adjusted basis for tax purposes is an objective figure that is readily ascertainable. “Readily ascertainable” does not mean free of problems. There may be questions of law (such as, based upon the form of acquisition, is basis carried over or computed at cost?) and issues of fact (such as, what is the proper “useful life” of an asset?) The Treasury’s formulation is workable, equitable, and efficient. The problems under the Proposed Regulations have all been corrected. See, e.g., 1980 N.Y.S. Bar Report, supra note 283, at B-8 to B-13.

The Treasury’s purpose in adopting the adjusted basis standard was simplicity of application. See 45 Fed. Reg. at 18,959 (1980) (“The fair market value of the corporation’s assets, although theoretically a more correct measure than adjusted basis, is not used in determining stockholders’ equity because of the greater difficulty inherent in valuing operating assets.”). The definition, and its various qualifications, is successful in accomplishing that goal. Adjusted basis for tax purposes is an objective figure that is readily ascertainable. “Readily ascertainable” does not mean free of problems. There may be questions of law (such as, based upon the form of acquisition, is basis carried over or computed at cost?) and issues of fact (such as, what is the proper “useful life” of an asset?) The Treasury’s formulation is workable, equitable, and efficient. The problems under the Proposed Regulations have all been corrected. See, e.g., 1980 N.Y.S. Bar Report, supra note 283, at B-8 to B-13.
tionality is the linchpin of analysis.

Surprisingly, the Regulations contain only a general description of "proportionality."574 Perhaps more surprising is a statement in the Treasury Explanation that "the definition of proportionality has been clarified to the extent possible."575 Rather than promulgating regulatory guidelines providing measurements of proportionality, the Treasury has stated that it "anticipate[s] that . . . guidelines will be published as a revenue procedure."576 A revenue procedure, however, does not possess the force of either legislative or interpretative regulations.577 For the sake of consistency and ease of administrative and judicial review, the Treasury should have provided regulatory areas of conclusive proportionality and nonproportionality along with a list of factors to be used in deciding cases not within the conclusive areas. This factor approach could have been facilitated, for example, by using a standard deviation approach permitting a disparity of whatever percentage is deemed appropriate.578 The rule of "conclusive proportionality" should have applied in all cases in which eighty percent or more of the shareholders own any portion of any class of debt.579 Finally, a presumptive safe harbor should have been provided for cases in which both stockholdings and debtholdings do not exceed fifty percent.

A rule of "conclusive proportionality" would have the effect of equating the "control" of a corporation with an overriding equity interest.580 At a certain level of ownership, there predominates a

---

574. Treas. Reg. § 1.385-6(a)(2).
575. 45 Fed. Reg. at 86,441 (1980). The impetus for treating only proportionate shareholder debt as subject to abuse was apparently provided by Stone, Debt-Equity Distinctions in the Tax Treatment of the Corporation and Its Shareholders, 42 Tul. L. Rev. 251 (1968), cited in 45 Fed. Reg. at 86,440 (1980). Although the Stone article provides convincing support for treating proportional shareholder debt as similar to an equity interest, it does not provide support for treating nonproportional debt as presumptively valid. In this, the Treasury should not have withdrawn as far as it did. Compare the "principal shareholder" rules of Prop. Treas. Reg. § 1.385-7, 45 Fed. Reg. at 18,969-71 (1980).
577. See generally Griswold, A Summary of the Regulations Problem, 54 Harv. L. Rev. 398 (1941).
578. See, e.g., Letter to Commissioner of Internal Revenue from Robert J. McGee (April 1, 1980).
579. That is, the Regulations should have treated debt owned by certain shareholders as a separate class and, therefore, proportional (subject, of course, to a standard deviation formula).
580. See, e.g., I.R.C. §§ 332, 368(c), 382.
desire to further growth at the cost of subordinating other investments to the risks of the enterprise. Substantial support exists in the Code for an eighty percent definition of "predominance." 581

A presumption based on this high degree of ownership is compelling. It would not reclassify the instrument; rather, it would serve merely to scrutinize the instrument under tests of arm's length dealing.

A presumptive safe harbor also would be appropriate. Shareholders who engage in bona fide business transactions with their corporations would be able to do so in safety. More importantly, the presumptive safe harbor would prescribe an area of theoretical non-abuse; even a fifty percent shareholder would not often sacrifice one-half of his or her debt interest to further his or her equity interests. Exceptions, however, would have to be recognized. For example, if the debtholders must or will act together,582 the creditor-shareholder loses nothing by treating its debtholdings as equity. A case by case analysis, based on factors set forth by the Treasury, would be helpful in these cases.583

Finally, a standard deviation formula can be used to differentiate abusive from non-abusive structures.584 For example, if a forty percent shareholder owns one percent of a class of indebtedness and eleven one percent shareholders own, disproportionately, fifty percent of that class, there is little likelihood that the eleven shareholders would act in concert to give precedence to their equity interests, even though a majority of shareholders own a majority of a class of indebtedness.585 A factor approach would be appropriate in such a case. Conversely, if three shareholders each own twenty-five percent of the stock and twenty-five percent of the debt, no factor approach would be necessary. Their interests

---


582. Debtholders will be compelled to act together if the debt instruments provide, for example, that certain actions to enforce the debt must be agreed to by a majority (or more) of the debtholders. Debtholders will act together by choice if a quid pro quo exists, such as outside business interests or informal indemnification. See Treas. Reg. § 1.385-6(a)(7). See note 590 infra.

583. In the absence of a specific adverse factor, the burden of proof should be shifted to the Commissioner. Cf. I.R.C. § 534 (accumulated earnings tax; reasonable accumulations).

584. The formula would find its greatest use in the context of 50% to 80% proportionality. See text preceding note 595 infra. See also note 579 supra.

585. This appears to be the threshold measure of proportionality. See text accompanying notes 593-610 infra.
would be inextricably intertwined and, hence, "substantially proportionate." 586

In addition to the failure to take a definitive approach, the standard of proportionality under the Regulations is vague. The greater clarity sought by the Treasury is not attained. 587 Indeed, the present language of the Regulations serves only to obfuscate.

Section 1.385-6(a)(2) defines "substantial proportionality" as actual and constructive stock ownership, 588 which, when compared to the holdings of any class of instruments, 589 is proportionate as "determined from all relevant facts and circumstances . . . ." 590 An exception is provided for widely held stock and instruments that are separately traded and readily marketable. 591

---

586. Cf. Treas. Reg. § 1.385-6(a)(6) (Example (2)).
587. See note 575 & accompanying text supra.
588. The rules of § 318(a) are "taken into account"; however, stock owned constructively under § 318(a)(4) (relating to options) "is taken into account [only] to the extent that it is reasonable to expect, at the time of the determination, that the options may be exercised." Treas. Reg. § 1.385-6(a)(2). See 1971 N.Y.S. Bar Report, supra note 283, at 63. Because § 318(a) attribution is only one of the "facts and circumstances" included in determining substantial proportionality, facts negating attribution, such as family hostility, will also weigh in the determination. Compare Robin Haft Trust v. Commissioner, 510 F.2d 43 (1st Cir. 1975), with David Metzger Trust, 76 T.C. 42 (1981). Similarly, close business ties and relationships that almost, but not quite, fall within the attribution rules of § 318 (e.g., in-laws, cousins, siblings) also will be appropriate to a determination of "substantial proportionality." Although these additional elements make a determination of substantial proportionality "fair" and "equitable," they also require a case by case analysis. In this writer's opinion, cross-reference to an existing attribution rule would be more desirable.
589. Two or more classes of instruments may be considered as one, for example, if they are issued pursuant to a plan and holdings will be substantially proportionate after completion of the plan. Treas. Reg. § 1.385-6(a)(4)(i). The application of the step transaction doctrine in this context should be based on the "mutual interdependency" standard, see American Bantam Car Co. v. Commissioner, 11 T.C. 397 (1949), aff'd, 177 F.2d 513 (3d Cir. 1949), cert. denied, 339 U.S. 920 (1950), rather than, for example, the "binding commitment" test. See Commissioner v. Gordon, 391 U.S. 83 (1968). See generally Mintz & Plumb, Step Transactions in Corporate Reorganizations, 12 N.Y.U. Inst. Fed. Tax. 247 (1954). Two classes will also be considered as one if they are treated as a single class and thereby are held in substantial proportion. See Treas. Reg. §§ 1.385-6(a)(6), Examples (13), (14); 1.385-6(a)(4)(ii).

One class will be treated as two if part of the class is treated differently, for example, if interest is paid on one portion but not on the other. Treas. Reg. § 1.385-6(a)(5).
590. Treas. Reg. § 1.385-6(a)(1). If all the facts and circumstances suggest that the terms of an instrument were not fixed at arm's length or not diligently enforced and there are related non-arm's length transactions, then the instrument may be treated as held proportionately, whatever the actual percentages. Treas. Reg. § 1.385-6(a)(7). See Reed v. Commissioner, 242 F.2d 334 (2d Cir. 1957); Broadway Drive-In Theatre, Inc. v. United States, 220 F. Supp. 707 (E.D. Mo. 1963).
dent creditors" are specifically excluded from the definition of proportionality.592

The Examples in the Regulations provide insight into the Treasury's thinking. In Example (5), the indirect ownership of eighty-five percent of a class of debentures by a one hundred percent shareholder was found to be "substantially proportionate,"593 while in two other Examples594 the direct ownership of fifty percent of a class of debentures by a one hundred percent shareholder, and of one hundred percent of a class of debentures by a fifty percent shareholder, was not so found. It would appear from these Examples that a danger exists for a majority of shareholders owing a majority of a class of debt. As a practical matter, however, the spread between fifty percent and eighty-five percent is large. The Regulations provide no clear guidance.595

Two additional Examples are worthy of comment. Example (3)596 states that, if three shareholders each own one-third of the outstanding stock and ten percent of a class of debentures, there is no proportionality. In Example (2),597 in which one hundred percent of the shareholders own ninety percent of the debentures, however, the Treasury views the holdings as proportional. The rationale of Example (2) appears to be that the three shareholders, despite non-pro rata proportionality, would have little reason to treat their debtholdings differently from their stockholdings. A failure to enforce would inure directly to their stockholdings.598 Yet, in Example (3), in which debtholdings among the shareholders are pro rata and a failure to enforce599 would inure proportion-

592. Treas. Reg. § 1.385-6(a)(3)(ii). An "independent creditor" is defined, in part, as one whose holdings of stock and instruments are not proportionate. Treas. Reg. § 1.385-6(b).
593. Treas. Reg. § 1.385-6(a)(6) (Example (5)).
594. See also Treas. Reg. § 1.385-6(a)(6) (Examples (7) and (13)(a)).
595. See also Treas. Reg. § 1.385-6(c)(3) (Example) (where three shareholders owning 50%, 30%, and 20% each hold, respectively, 60%, 25%, and 15% of a single class of debt; held proportional); Treas. Reg. § 1.385-6(a)(6) (Example (2)) (where three shareholders hold 40%, 30%, and 20% of a single class of debt; held proportional); Treas. Reg. § 1.385-6(k)(2) (Example (1)) (where a 100% shareholder owns 80% of the debt; held, proportional).
596. Treas. Reg. § 1.385-6(a)(6) (Example (3)).
597. Id. (Example (2)).
598. See 45 Fed. Reg. at 86,440 (1980) ("if the shareholder elects to receive debt, the allocation of the repayments between principal and interest makes little non-tax difference"). However, if the requirements of the "Deep Rock" doctrine are satisfied, Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1939), a creditor-shareholder will share ratably with outside creditors in insolvency proceedings.
599. For example, nonenforcement because of the shareholders' mutuality of interest.
ately to their stockholdings, the Treasury finds no proportionality.

If interest is not paid by the shareholders or if there is a subordination of shareholder debtholdings, the change in terms will result in treatment of the shareholders' debtholdings as a separate class, and "substantial proportionality" will exist at that point. But the obligation of Example (3) will be free from scrutiny under the Regulations if there is a default and the creditor-shareholders fail to exercise the ordinary diligence of independent creditors, or if the instrument is issued at a time when there is "excessive debt," or if an advance is "payable on demand." Such enhanced opportunity for abuse by taxpayers owning a controlling equity interest and a proportional amount of any class of debt should lead the Treasury to reconsider Example (3). The elimination from the final Regulations of the "principal shareholder" concept outlined in the Proposals does not justify a laissez faire approach to "controlling shareholders."

Example (8) outlines a capital structure in which A owns all the common stock and fifty percent of the senior debentures of Y Corporation. B, unrelated to A, owns the remaining senior debentures and one hundred percent of a class of junior debentures, which are convertible into one hundred shares of Y common stock. The Example states that "it is reasonable to expect that B may ultimately exercise the conversion privilege." Relying on section 1.385-6(a)(2)(ii), the Example finds that the senior debentures are proportionate and the junior debentures are not.

600. See Treas. Reg. § 1.385-6(a)(5) and -6(a)(6) (Examples (13) and (14)).

601. This is so, as long as other members of the class do not act inconsistently. See Treas. Reg. § 1.385-6(b)(3).


603. Cf. Treas. Reg. § 1.385-6(f)(1). These results obtain owing to the requirement that economic substance exist only if there is "proportionality." See 45 Fed. Reg. at 86,440 (1980).

604. See Proposed Treas. Reg. § 1.385-6, 45 Fed. Reg. at 18,969-71 (1980). The Treasury states: "Several comments contended that in most cases there will be a sufficient economic incentive for shareholder-creditors to enforce their rights under debt instruments not held in substantially the same proportion as the corporation's stock. Treasury agrees with these comments." 45 Fed. Reg. at 86,441 (December 31, 1980) (emphasis added). "Most cases" nevertheless leaves substantial room for abuse.

605. See text accompanying notes 580-81 supra.

606. Treas. Reg. § 1.385-6(a)(6) (Example (8)).

607. See note 588 supra.

608. It is important to recognize that the hybrid junior debentures need not have predominant "equity features" in order to conclude that they reasonably "may" be exercised. Therefore, although the junior debentures are treated by the Regulations as valid indebted-
Example (8) differs slightly from its counterpart in the Proposed Regulations.\textsuperscript{609} In the Proposed Regulations, A and B each owned fifty percent of the junior debentures instead of B owning one hundred percent. The Proposed Example concluded that the senior debentures would be treated as substantially proportionate because they would be proportionate on B's exercise of the conversion right under the junior debentures. The Example ignored the fact that, if it is reasonable for B to convert, it would also be reasonable for A to do so, and that such conversion would result in A owning two-thirds of the stock and fifty percent of the debt and B owning one-third of the stock and fifty percent of the debt. It is unclear whether such non-pro rata holdings should be treated as substantially proportionate. The final Regulations retreat from the issue\textsuperscript{610} and from the conversion presumptions of the Proposals.

\textit{Proportional Equity Factors}\textsuperscript{611}

Hybrid Instruments

All hybrid instruments issued "proportionally" to shareholders are treated as preferred stock.\textsuperscript{612} This conclusive rule is proper because of the congruence of interest between proportional hybrid holding and equity participation. The validity of this rule is made

\begin{itemize}
\item \textsuperscript{609} Proposed Treas. Reg. § 1.385-6(a)(8) (Example (8)) at 45 Fed. Reg. at 18,969 (1980).
\item \textsuperscript{610} See note 595 supra. This may presage a reconsideration of what exactly is "substantially proportionate" in a non-pro rata setting, and when an option should be viewed as exercised.
\item \textsuperscript{611} The Treasury states: "When the initial terms of proportionately-held shareholder debt are not arm's length terms, the regulations, where possible, in effect create arm's length terms by adjusting the interest rate. However, when the terms are not arm's length and arm's length terms cannot be created by adjusting the interest rate (e.g., debt issued for property), then the final regulations classify the proportionately-held shareholder debt as stock.

"The final regulations also require shareholders to enforce the terms of proportionate debt according to an arm's length standard." 45 Fed. Reg. at 86,440 (1980).
\item \textsuperscript{612} Treas. Reg. § 1.385-6(c). See the discussions of proportionality, at text accompanying notes 572-610 supra, and reclassification, at text accompanying notes 456-73 supra.
\end{itemize}
clearer by reason of the "locked interest safe harbor," which permits the division of debt and equity features into separate interests.

Instruments Not Issued for Money

An instrument issued proportionately to a shareholder that states an unreasonable rate of interest at date of issue and whose issuance does not give rise to original issue discount under section 1232(a)(3), or amortizable bond premium under Treasury Regulation section 1.61-12(c)(2), will also be classified as stock. There

614. See note 520 & accompanying text supra.
615. See text accompanying notes 572-610 supra.
616. Treas. Reg. § 1.385-6(d). See text accompanying notes 484-95 supra.
617. The Treasury Explanation outlines the parameters and policy of Treas. Reg. § 1.385-6(d) as follows: "First, the original issue discount rules are applicable to certain instruments issued for property (e.g., instruments issued for marketable securities). In such cases, the original issue discount provisions apply and, accordingly, § 1.385-6(d)(1) is not applicable.

"Second, there are certain situations where it may not be clear under present law whether the original issue discount provisions of section 1232 would apply (e.g., an instrument issued as a dividend or as compensation). Section 1.385-6(d)(1) applies in these situations unless section 1232 is found to be applicable. This is in accordance with the policy of the regulations not to classify proportionately-held instruments as stock because they do not bear a reasonable interest rate if the interest rate can be adjusted to an arm's length rate through the creation of original issue discount or premium.

* * *

"Only when it is not possible to adjust the interest rate by creating discount or premium (e.g., debt issued for property) do the regulations classify the entire debt as equity." 45 Fed. Reg. at 86,442 (1980).

618. Treas. Reg. § 1.385-6(d) applies only to instruments "issued" by a corporation, see also Treas. Reg. § 1.385-1(b), and, therefore, does not apply to liabilities assumed or taken subject to (for example, in exchanges under §§ 351 or 1031). Consequently, if A purchases property from B and gives a nonrecourse purchase money mortgage at an unreasonable rate of interest (for example, in return for B's agreement to compensate A by salary or reciprocal purchase) and thereafter transfers the property subject to the mortgage to wholly-owned X Corporation, Treas. Reg. § 1.385-6(d) by its terms will not apply. There is no "contrivance" exception in Treas. Reg. § 1.385-6(d), cf. Treas. Reg. § 1.385-6(a)(7) (non-arms' length transactions); id. § 1.385-6(g)(v)(A) (debt-to-equity ratio computed without regard to distorting contrivances), although the § 385 regulations do not preclude the application of the "substance over form" doctrine. See 45 Fed. Reg. at 18,960 (1980). To be sure, § 357(b) could be applied if, as is proper, avoidance of § 385 is viewed as tax avoidance and a bona fide business purpose is not a defense. When the stepping together of interdependent steps leaves a court with the choice of applying either § 357(b) or § 1.385-6(d), the statutory rule of § 357(b) should take precedence, even though boot under I.R.C. § 357(b) often will be less onerous than reclassification under Treas. Reg. § 1.385-6(d). Cf. I.R.C. §§ 356(d), 368(a), 1031(b), 1031(d). Conversely, if C, the sole shareholder of Y Corporation, sells property to D in whole or partial return for a nonrecourse purchase money mortgage
is an exception for instruments exchanged for an equal or greater amount of indebtedness if both an independent creditor and an independent debtor would have agreed to the exchange.619

The rationale for this provision is that, because Congress decided to provide bifurcation rules only for those items of "property" addressed by section 1232(a)(3) and Treasury Regulation section 1.61-12(c)(2), no other "property" transfers can fragment an instrument into part debt-part equity.620 Section 1.385-3(a) therefore has no application to non-section 1232(a)(3) "property" exchanged by a shareholder for an instrument. The Treasury elected to have the Regulations classify the entire interest as equity, instead of exercising the authority delegated by Congress to provide that all consideration is subject to the bifurcation rules.621 The absence of a policy rationale for treating instruments issued for property differently from instruments issued for cash warrants reconsideration of this rule.622
Excessive Debt

The Regulations treat as stock those instruments that are "substantially proportionate" to stockholdings\textsuperscript{623} and are, in light of the corporation's capital structure, "excessive" when issued.\textsuperscript{624} A corporation's capital structure evinces "excessive" debt if all the terms and conditions of the instrument and the corporation's financial structure would not be satisfactory to an institutional independent creditor.\textsuperscript{625} However, to provide a readily ascertainable yardstick to guide in the planning of a capital structure, the Regulations also define a safe harbor for debt treatment. The corporation's debt will not be treated as excessive if the corporation's debt-to-equity ratio\textsuperscript{626} does not exceed 10:1\textsuperscript{627} and the corporation's "inside debt-to-equity ratio" does not exceed 3:1.\textsuperscript{628}


A bargain sale of "property" by a proportional shareholder who receives in return an instrument will be subject to Treas. Reg. § 1.385-6(d).

Note the opportunity for planning upon incorporation. If cash and property are exchanged for stock and securities, a shareholder should certainly be able to earmark the cash or, if beneficial, the property, as exchanged for the securities. If earmarking is not permissible, perhaps delay in the transfer of cash or property for securities would be sufficient to prevent, for example, pro rata allocation. Again, what is created is a trap for the unsophisticated.

623. See text accompanying notes 572-610 supra.

624. Treas. Reg. § 1.385-6(f).

625. Treas. Reg. § 1.385-6(f)(2). "For this purpose, the corporation's size, industry, geographic location, and financial condition must be taken into account." \textit{Id.} See Plumb, supra note 31, at 610.

An exception is made for instruments issued in exchange for an equal or greater principal amount of indebtedness. The principal amount of indebtedness includes interest accrued but unpaid until the date of the exchange, but only to the extent that such interest is paid with principal in the exchange. Treas. Reg. § 1.385-6(5). \textit{But see Treas. Reg. § 1.385-6(f), discussed at notes 630-34 & accompanying text infra, and Treas. Reg. § 1.385-6(k), discussed at notes 635-43 & accompanying text infra.}

626. Defined in Treas. Reg. § 1.385-6(g). See text accompanying notes 559-71 supra.

627. "Extensive statistical analysis tends to confirm that a ratio in excess of 10:1 is extreme. Nearly 85 percent of all corporations filing tax returns in a recent year and more than 90 percent of all new corporations had debt-to-equity ratios . . . of less than 10:1." 45 Fed. Reg. at 18,962 (1980).

628. Treas. Reg. § 1.385-6(f)(3). A corporation's "inside debt-to-equity ratio" is determined under Treas. Reg. § 1.385-6(g), except that liabilities to "independent creditors" are excluded (except in computing stockholders' equity). Treas. Reg. § 1.385-6(f)(4). The Treasury explains the insertion of the 3:1 inside ratio as follows: "First, the proposed regulations were premised on the assumption that shareholders lending proportionately to their corporations would not create unusually high debt-equity ratios to produce large interest deductions at the corporate level because the interest or discount produced by § 1.385-3 and section 1232 would be taxed currently to the shareholders as ordinary income . . . Several comments pointed out, however, that this deterrent was not present in situations where the
By providing for an independent creditor test, which may be corroborated easily,\textsuperscript{629} the Regulations reach a reasonable compromise between ease of administration and equity. The institutional lender standard, more stringent than the marketplace, and the safe harbor rule, despite its use of an adjusted basis formula for ascertaining stockholders’ equity, will be useful to proportional shareholders in structuring corporate capitalization. The \textit{in terrorem} nature of these rules certainly will reduce the quantity of litigation arising from factual disagreements.

Change in Terms

Voluntary subordination, change in interest rate, even if offset by other changes,\textsuperscript{630} postponement of maturity date, or any other “substantial change” affecting the fair market value of an instrument\textsuperscript{631} held by a proportionate shareholder\textsuperscript{632} results in a reissuance of the instrument on the day the issuer and the holder enter into a binding agreement to make such a change.\textsuperscript{633} The instrument will be evaluated anew under all the Regulations’ tests.\textsuperscript{634}

Payment History

Timely payment of interest and principal retains the same importance in the Regulations that it has been given in the case

shareholders were not paying tax on the interest income (e.g., certain nonresident alien shareholders, taxpayers with large net operating losses, or charitable organizations). . . . This debt would have produced large interest deductions that could have been used to offset tax at the corporate level without being taxed to the shareholders.

    * * *

“The second reason for the inside ratio of 3:1 is to limit the situations where very large amounts of discount will be imputed under \textsection 1.385-3 and section 1232. As a general matter, when the inside ratio exceeds 3:1 and the loans do not satisfy the standard of \textsection 1.385-6(f)(2), the proper interest rates would tend to be so high as to be noncommercial (e.g., as high as 30 to 40 percent).” 45 Fed. Reg. at 86,411 (1980). Commentators generally favored a 3:1 debt-to-equity ratio.

629. For example, it may be corroborated by applying the corporation’s credit rating to commercial lending practices as of the date the instrument is issued.

630. See Treas. Reg. \textsection 1.385-6(j)(4) (Example (2)).

631. Treas. Reg. \textsection 1.385-6(j)(1)(i) and (2). Substitution of collateral and prepayment are not “substantial changes.” \textit{Id.}

632. See text accompanying notes 572-610 supra.

633. Treas. Reg. \textsection 1.385-6(j)(1) and (3). \textit{But see} Treas. Reg. \textsection 1.385-6(d)(3), (f)(5), and (j)(4) (Examples (1) and (3)). “[Section] 1.385-6(j) does not change existing law as to when a change in the terms of an instrument will constitute a taxable exchange of instruments.” 45 Fed. Reg. at 86,443 (1980).

634. Treas. Reg. \textsection 1.385-6(j)(1).
In the context of proportionate shareholder loans, payment history is a decisive factor in the continuing classification of purported debt.

A proportionately held debt instrument will be reclassified as stock if a corporation fails to pay interest when due and the shareholder does not pursue available remedies with the ordinary diligence of an independent creditor. The shareholder must also pursue available remedies if principal remains unpaid ninety days after it is due. Failure to act as would an independent creditor will cause the instrument to be treated as payable on demand. Debt-equity classification will then turn on reasonable rate of interest. There is an exception, however, if the amount of the obligation on which there is a default in principal, plus the amount of "unwritten shareholder obligations," does not exceed $25,000 and the defaulted obligation is repaid within six months of issuance.

Instruments Payable on Demand

Although the absence of a fixed maturity date is no bar to the existence of a bona fide debt, it does create a potential for tax
avoidance. This potential, however, is insufficient to treat proportionately held demand obligations as equity interests without some additional evidence of non-arm's length dealing. Accordingly, the Regulations proscribe only proportionately held instruments that are payable on demand and that provide for an unreasonable rate of interest at issuance, or for any subsequent year.

The purpose of this provision is to ensure that a shareholder's behavior conforms to that of an independent creditor. As there is no fixed maturity date, the bifurcation rules of Treasury Regulation section 1.385-3(a) will not apply to impose original issue discount or amortizable bond premium. Hence, it is required in Treasury Regulation section 1.385-6(l) that interest be fixed and paid at a reasonable rate. The effect of this subsection is to require, consistent with commercial practice, periodic interest rate adjustments on shareholder demand obligations.

**Shareholder Obligations Not Evidenced by an Instrument**

Any cash advance by a non-“independent creditor” will be

---

644. An example of such potential is that the obligation is subject to manipulation at the shareholder-creditor’s discretion. The shareholder may choose to enhance his or her equity participation at the expense of the “indebtedness.” This can be accomplished by a de facto deferral in maturity, which is similar to a failure to enforce. Cf. Treas. Reg. § 1.385-6(j) (change in terms). See text accompanying notes 630-34 supra.

645. See text accompanying notes 572-610 supra.

646. Treas. Reg. § 1.385-6(l)(1). A reasonable rate of interest is defined in Treas. Reg. § 1.385-6(e). See text accompanying notes 484-95 supra.

647. Treas. Reg. § 1.385-6(l)(1) and (2). If an instrument is reclassified as preferred stock, it is treated as stock on the first day of the taxable year during which a reasonable rate of interest was not paid. See note 651 infra. A rate is considered reasonable if it is reasonable as of any day of the taxable year. Id. The effect of this rule is merely to require a December 31 adjustment, payable within 90 days, see note 637 supra, to achieve a reasonable rate of interest, even if the rate is not commercially reasonable. See I.R.C. § 6621. As such, the payable-on-demand provision is a trap for the unwary and the unsophisticated.

648. A “cash advance” is a loan not evidenced by an instrument within six months after the day on which the loan is made. Treas. Reg. § 1.385-7(a)(1)(ii). See note 660 infra. Loans of property fall outside the Regulations and are governed by existing case law. See note 296 & accompanying text supra. The rationale for this is unclear. The Treasury states that “[t]he failure of a corporation to reduce to writing the terms of large cash advances creates doubt as to the tax status of the advances.” 45 Fed. Reg. at 18,962 (1980). But the Treasury apparently finds the situation in which a large amount of cash is used by a shareholder to purchase property and the property is advanced to the shareholder's corporation sufficiently arm’s length to be governed by existing case law, that is, I.R.C. § 1232 and Treas. Reg. § 1.61-12(e)(2). See text accompanying notes 523-30 supra. If it is the Treasury's intent to classify in this way cash and property advances, the intent is premised on a mis-
classified as a contribution to capital if the corporation has "excessive debt" when the loan is made or there is a failure to pay interest on the loan at a reasonable rate during any taxable year. A cash advance repaid within six months will fall outside of this section to the extent that it, plus other cash advances treated as debt, does not exceed $25,000.

This provision reflects a number of substantial changes, and several improvements, over the Proposed Regulation. First, the final Regulation provides a presumption of debt treatment unless certain "equity features" are present. Second, the final Regulation defines "excessive debt" by reference to section 1.385-6(f), while the Proposed Regulation employed a 1:1 debt-to-equity ratio. Third, the final Regulation provides a "retroactive qualification"

correction. Cash and property advances do not provide a basis for distinguishing debt from equity. See note 622 and accompanying text supra.

Moreover, it often is difficult to distinguish between advances of cash and property. Is a certificate of deposit "cash"? Marketable securities? See I.R.C. § 1232(b)(2). Inventory? Services? See note 622 supra.

Such a cash advance will not be classified as preferred stock. The rationale for this classification is unclear, especially if the advance is granted preference under local law, because it undoubtedly would be if evidenced by a writing.

Excessive debt is defined in Treas. Reg. § 1.385-7(c). The loan is reclassified as a contribution to capital on the later of either the first day of the taxable year or the date of the loan. Id. A rate is considered reasonable if it falls within the definition of Treas. Reg. § 1.385-6(e) as of any day of the taxable year. Treas. Reg. § 1.385-7(c). The effect of this provision is merely to require an adjustment on December 31, payable within 90 days, to achieve a reasonable rate of interest, even if the rate is not commercially reasonable. See I.R.C. § 6621. As such, the reclassification rule of Treas. Reg. § 1.385-7(c)(1) has no teeth; it is solely a trap for the unwary. See note 647 supra; Treas. Reg. § 1.385-7(c)(2). For the effects of reclassification, see Treas. Reg. § 1.385-7(d).

Any manner of offset is not considered a repayment. Treas. Reg. § 1.385-7(a)(2)(B)(ii). An offset of intercompany debt, however, should be a "payment" for this purpose. See note 637 supra.

See Treas. Reg. § 1.385-7(e) (Example (3)).

Treas. Reg. § 1.385-7(a)(2). The intent is to except interim seasonal or extraordinary close corporation advances that are de minimus and short-term. Yet, $25,000 may be substantial in a number of contexts and $100,000 de minimis in others, and six months has no relevance to many seasonal businesses. Because of this arbitrariness, this exception will have only limited usefulness. It will apply only rarely to affiliated or large closely held corporations. An alternative would be an exception based on percentage of net worth and seasonal nature of business.


See notes 623-29 & accompanying text supra.

Because of the use of adjusted basis in determining stockholders' equity, the 1:1 debt-to-equity requirement would have operated inequitably.
rule applicable to instruments issued within six months of the making of the loan. The Proposed Regulation was unclear on this point.

The intention of the Treasury in making several other changes was to expand the application of the rules relating to unwritten obligations. Instead of isolating the problem areas and clarifying the broad new definitions of unwritten obligations and independent creditors, the final Regulation, if anything, makes the area less clear.

The primary problem with Treasury Regulation section 1.385-7 lies in its use of the undefined term, “independent creditor.” An “independent creditor” is ascertained by taking “into account... all relevant facts and circumstances.” It is unclear, however, what the relevant facts and circumstances are. The “safe harbor” and the Examples provide some clues, but no answers.

A creditor will be deemed to be independent if he or she owns, directly or indirectly, less than five percent of the corporation’s stock, and if his or her direct and indirect holdings are not “substantially proportionate.” It is not clear, however, in what circumstances a five percent or greater nonproportionate shareholder may be an “independent creditor.” The Treasury Explanation sug-

660. The Treasury Explanation states that “this section would apply to two types of loans: (i) unwritten loans and (ii) loans where the material terms and conditions are contained in a document other than an instrument (e.g., a board of directors’ resolution or an entry on a corporation’s books).” 45 Fed. Reg. at 86,443-44 (1980). This is substantially broader than the Proposed Regulation, which would not have applied to an obligation for which there was written evidence, such as a board of directors’ resolution, i.e., an obligation the material terms of which, such as fixed principal amount, maturity, rate of interest, subordination, were contained in a written document or set of related documents.

It is unclear, moreover, why the Treasury chose to exclude only instruments, and not other writings. If the intent is to discourage self-serving or fraudulent notations, or noncontemporaneous corporate minutes, then it is supportable, if misguided. After all, self-serving, non-contemporaneous instruments could as easily be executed. If there is a theoretical basis for such distinction, it escapes this writer.

663. Treas. Reg. § 1.385-6(b)(4).
664. That is, by I.R.C. § 318(a) attribution, except that stock constructively owned by an unrelated person within the meaning of I.R.C. § 318(a)(4) is not taken into account. Treas. Reg. § 1.385-6(b)(2) and (3).
gests a de minimis standard balanced against all the facts and circumstances, the latter becoming more important as stockholdings increase. The Examples in Treasury Regulation section 1.385-6(b)(4) illustrate the safe harbor rule, but not the definition of independent creditor. In Example (1), individual C owns five percent of the stock of Corporation Y. C falls outside the safe harbor because of its ownership of the Y stock. In Example (2), individual B holds an option to acquire nine percent of the stock of X Corporation. B, also, falls outside the safe harbor. The Examples do not state, however, whether A or B is an "independent creditor." Moreover, neither standards nor examples are provided for ascertaining non-proportional non-independent creditor status. This unnecessarily opaque framework should be clarified by further regulations, such as a set of factors of predominant importance.

**Preferred Stock**

The complement to the hybrid instrument rules of Treasury Regulation section 1.385-5 is Treasury Regulation section 1.385-10, which classifies as an instrument "preferred stock" resembling hybrid debt. Preferred stock will be treated as an instrument if it provides for fixed payments of principal or interest. The reclassified "instrument" will be subjected to the hybrid instrument analysis of Treasury Regulation section 1.385-5 or the proportionality inquiry of section 1.385-6. A narrow safe harbor is carved out for preferred stock when (1) it is labelled preferred stock and treated as such under applicable nontax law, (2) the excess, if any, of the preferred stock's redemption price over its issue price is a reasonable redemption pre-

---

666. 45 Fed. Reg. at 86,444 (1980) states: "Some comments . . . stated that the rules of proposed regulation § 1.385-9 should not apply to shareholders owning de minimis amounts of stock because it appeared unlikely that such shareholders would maintain a casual attitude towards their unwritten loans to the corporation. Other comments pointed out that, taken literally, proposed regulation § 1.385-9 would not apply to unwritten loans between brother-sister corporations wholly-owned by a common parent, an unwarranted result. Treasury agrees with both comments. Therefore, § 1.385-7 will apply to loans made by persons other than independent creditors rather than simply to shareholder loans."

667. Arguably, B holds an option to acquire .9%.

668. Treas. Reg. § 1.385-10(a).

669. See text accompanying notes 505-21 supra.

670. See text accompanying notes 572-610 and 612-14 supra.
mium under Treasury Regulation section 1.305-5,\textsuperscript{671} (3) current dividends are contingent,\textsuperscript{672} (4) the right to receive dividends and redemption payments may not be enforced under applicable non-tax law because the issuing corporation is or would be rendered insolvent or the issuing corporation’s capital would be impaired by such payments,\textsuperscript{673} (5) default in a dividend or redemption payment does not entitle the holder to accelerate redemption payments, and (6) the preferred stock has a term of ten years during which the holder cannot compel redemption.\textsuperscript{674}

The standards used in the safe harbor rule of Treasury Regulation section 1.385-10 have no counterpart in the case law. Although a number of cases addressed “debenture preferred stock,”\textsuperscript{675} few courts held that fixed rights alter the character of that which the parties denominated “preferred stock.” The Regulation is directed at a newer financing device, so-called “sinking fund” preferred stocks. Nevertheless, the safe harbor standards go

\textsuperscript{671} The theoretical rationale for this requirement is unclear. Treas. Reg. § 1.305-5(b) provides that an unreasonable “redemption premium” will be treated as a dividend equivalent under rules analogous to those used in taxing original issue discount. The greater the redemption premium is, the greater the deemed dividend will be. Treas. Reg. § 1.385-10 makes a leap in equating greater redemption premium with debt characteristics. Under this analysis (which apparently follows from the predominance approach of Treas. Reg. § 1.385-5 “discount”) which resembles equity more than debt in many ways, is treated as an important debt feature. See note 628 \textit{supra} (last paragraph). This anomaly aside, there is no magic to the 10% premium safe harbor of Treas. Reg. § 1.305-5(b)(2) adopted in evaluating the bona fides of preferred stock. See generally Note, Discounted Preferred Stock under the New Section 305 Treasury Regulations: On Confusing Debt and Equity, 84 \textit{Yale L.J.} 324 (1974).

\textsuperscript{672} The dividends are contingent, for example, if they are payable only out of earned surplus or unrealized appreciation or at the discretion of the board of directors, but not payable out of capital or capital surplus. See Treas. Reg. § 1.385-10(c) (Examples (2), (5) and (6)). See note 509 \textit{supra}. See also Treas. Reg. § 1.385-5(d)(7).

\textsuperscript{673} That is, the fair market value of the remaining assets of the issuing corporation would be less than the sum of its liabilities and the liquidation value of its other classes of preferred stock that are senior or equal in rank. Treas. Reg. § 1.385-10(b)(4).

\textsuperscript{674} Treas. Reg. § 1.385-10(b). If the preferred stock provides for redemption over a period of years, the term shall be the weighted average life of the issue. Treas. Reg. § 1.385-10(b)(6). See Treas. Reg. § 1.385-10(c) (Example (3)). Practitioners, relying on an analogy between preferred stock and “continuity of interest”-“security” issues, had generally assumed that five years was sufficient. Cf. Rev. Rul. 66-23, 1966-1 C.B. 67 (“Ordinarily, the Service will treat 5 years of unrestricted rights of ownership as a sufficient period for the purpose of satisfying the continuity requirements of a reorganization.”).

beyond necessity and existing precedent. A broader safe harbor would be appropriate.

Preferred stock on which dividends and redemptions may be paid only out of earned surplus or retained earnings, or in the discretion of the board of directors, does not provide for fixed payments in the nature of either principal or interest. Consequently, the Regulations do not apply to such preferred stock.

Subordination to other interests, however, is not considered a contingency under the Regulations. Thus, forms of subordination, such as payment limitations on dividends and redemptions based on insolvency or impairment of capital, do not alter the fixed nature of payments.

Comments, Criticisms, and Comparisons

The Regulations under section 385 are a welcome improvement over debt-equity case law. The emphasis on objective economic standards of fair market value, reasonable rate of interest, and payment history results in a workable and equitable weighing of factors to differentiate debt from equity.

The regulatory flaws are primarily those of scope. Instead of distinguishing between debt and equity in every area of potential abuse, the Regulations defer to section 1232 in the areas of bifurcation, debt-for-property, and unwritten obligations. This deference creates confusion and complexity, and unnecessarily continues the case by case approach of existing law.

The Regulations also fail to address the difficult, but preeminent, definitional problems of “proportionality” and “independent creditor” status. The effect of eschewing regulatory definitions and thereby deferring to existing case law and future Revenue Procedures is to create uncertainty in application and judicial acceptance.

Another problem with the Regulations is that they provide that existing case law is to apply to interests and, presumably, to definitions not addressed by the Regulations, “without reference to
It is to be hoped that this catchphrase characterization of regulatory scope will have little effect. One judge has already applied an analysis based on the Proposed Regulations to a pre-existing fact pattern, and the likelihood is that most judges will seek safety in the clear rules provided by the Treasury. The exceptions, of course, will be in those cases in which the judge’s visceral reaction is otherwise. That is, courts will continue to be result-oriented: When the desired result may be by use of the regulations, a regulatory analysis will be employed; in other cases, there will be reliance on “existing case law.”

An additional criticism of the Regulations is that they complicate the debt-equity inquiry by compelling application of judicial factors to reach regulatory conclusions in any situation in which fair market value is placed in issue. Although this is a valid criticism, the use of the case law factors to reach a factual conclusion is easier than using them to reach a conclusion of law. Unfortunately, the complexity is unavoidable; it is, however, mitigated by a broad rule of convenience.

The Regulations apply only upon the “issuance” of instruments and not upon their purchase. This normally will reflect economic reality because a mere purchase will not usually affect the bona fides of a corporation’s capital structure. The one exception is when a majority of stock and debt is sold at a time of corporate financial stress. The purchased debt in such cases assumes the risk characteristics of equity, with the result that the purchase allocation would have no economic validity. In these situations, the rules of Treasury Regulation sections 1.385-3 and -6(c), (d), and (f) should be made applicable.

The Regulations also fail adequately to address several other
issues not served by existing law: guaranteed loans, advances continuing subsequent to insolvency, and accrual of interest subsequent to insolvency.

Guaranteed Loans

If a shareholder directly or indirectly guarantees a loan made to its corporation, such as by pledging collateral, and existing case law treats the loan as made to the shareholder, "then the shareholder is treated as making a contribution to the capital of the corporation." This rule differs from its counterpart in the Proposed Regulations, which provided that a loan would be treated as made to the shareholder if, at the time of issuance, it was unreasonable to expect that the loan could be enforced against the corporation in accordance with its terms. According to the Treasury, this definition expresses existing law; the "change" in the final Regulations is not substantive, but merely avoids the "confusion" engendered by the proposal. This view of existing law has been criticized as both too tough and too uncertain, as well as an incorrect interpretation of the cases.

Existing case law evaluates a shareholder guarantee by reference to independent creditor standards: at the time the guarantee was executed, would the lender have loaned that amount on those terms to the corporation? If the answer is no, the shareholder is the primary obligor and his or her constructive loan to the corpora-

689. Treas. Reg. § 1.385-9. This section appears to be an interpretative regulation under the authority of § 7805. Thus, it does not have legislative force. "[T]here is] no implication to be drawn from § 1.385-9 as to the tax treatment of international finance companies." 45 Fed. Reg. at 86,444 (1980). See Treas. Reg. § 1.166-9, which retroactively applies the standards of Treas. Reg. § 1.385-9 to losses incurred after December 31, 1975.
691. 45 Fed. Reg. at 86,444 (1980); see id. at 18,962 (1980).
692. See text accompanying notes 406-407 supra. In the Treasury's view, this is a simple exercise in comparisons: were the loans obtained directly by the corporation under similar terms, or, given the corporation's credit rating, would an independent creditor have made a similar loan? Cf. Treas. Reg. § 1.385-5. Courts, however, have had a more difficult time weighing the factors, such as rate of interest, debt-equity ratio, proportionality, remedies on default. See Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir.), cert. denied, 409 U.S. 1076 (1972); Murphy Logging Co v. United States, 239 F. Supp. 794 (D. Or. 1965), rev'd, 378 F.2d 222 (9th Cir. 1967). See also Note, New Thin Incorporation Threat: Repayment of Guaranteed Bank Loans Treated as Dividends, 23 J. Tax. 197 (1965).
tion, because it is not on terms satisfactory to an independent creditor, is classified as equity.\(^{693}\) Payments by the corporation are constructive distributions to the shareholders, which are deemed to pass through them, as principal or interest payments, to the lender.

Under the Treasury’s view, a court might treat the entire debt as an equity interest if, for example, the loan that is guaranteed provides for interest that is two percent below “reasonable.” The court’s only alternative would be to treat the debt as bona fide. The bifurcation rules of Treasury Regulation section 1.385-3(a) would be inapplicable; they have no counterpart in the case law.

The Hobson’s choice presented by the Regulations is unnecessary. The only case cited by the Treasury is *Plantation Patterns, Inc. v. Commissioner*,\(^{694}\) which apparently applied a back-to-back analysis that is different from the approach adopted by the Regulations. It treated the shareholder guarantee as a loan by the lender to the shareholder and by the shareholder to the corporation. The shareholder’s constructive loan was then evaluated under a traditional debt-equity analysis. This is the more equitable view, and should be reconsidered by the Treasury. It would evaluate shareholder guarantees—indirect loans—under the same standards applicable to direct shareholder loans.\(^{695}\)

In addition to considering “existing law” on the debt-equity issue, the Regulations treat the “equity” as a contribution to capital because it is not evidenced by an instrument. However, existing case law would no doubt treat the “equity” as preferred stock if it is given preference under local law. This aspect of Treasury Regulation section 1.385-9 also should be reexamined.

Advances Continuing after Insolvency

The Regulations treat each newly-issued obligation separately. Thus, new advances cannot taint prior years’ advances. The only effect of continuing advances that increase a corporation’s debt-equity ratio, then, will be possible classification of new loans as preferred stock. Continuing advances, however, can also have the

---

695. Note that nonproportional shareholder guarantees may be characterized as capital contributions under Treas. Reg. § 1.385-9, even though direct loans on the same terms are immune from recharacterization under other provisions of the § 385 Regulations.
effect of creating "proportionality." As a consequence, failure to pay a reasonable rate of interest or a default in the payment of principal may convert the entire debt into preferred stock.

Accrual of Interest after Insolvency

The Regulations do not address accrual of interest problems; they provide only that a creditor-shareholder must pursue available remedies if there is nonpayment of interest or principal. Pursuit of those remedies, however, would allow a parent corporation to avail itself of the accrual "double deduction" during the period that remedies were being pursued. This result is unacceptable. A specific proscription against the non-accrual of interest income should be added to the Regulations.

Reform

The Regulations resolve many of the multiple debt-equity classification problems. They do so, however, at tremendous cost. They add another layer of complexity to a legislative system that is already too complex. Moreover, this complexity is added at a level that affects a large number of taxpayers.

The alternative to the section 385 Regulations is not better regulations, but no regulations. This alternative requires that there be no need or opportunity for abuse. A simplification of such magnitude requires a legislative overhaul of striking proportions. The path, however, has been defined by William Plumb's 1971 proposals and the recent ALI Subchapter C Study. Reform is overdue.

---

696. Cf. Treas. Reg. § 1.385-6(a)(6) (Examples (13) and (14)), (k)(2) (Example (2)), (k)(1) ("or the first day on which this section applied to the instrument").


698. See text accompanying notes 412-29 supra.

699. Treas. Reg. § 1.385-6(k) and (l). See text accompanying notes 635-43 supra.

700. See text accompanying notes 412-29 supra.

701. The Regulations should require that in order to comply with the Regulations' requirement that a proportional shareholder react to a default as would an independent creditor, the proportional shareholder must accrue interest income for which an "affiliate" is accruing an interest deduction.

Related Issues

Deductions for worthless stock and bad debt losses are influenced by a number of factors, some of which have been explored. Consideration of the effects of a consolidated return election has been deferred to this point so that the specific benefits and burdens of an election can be explored. Selected administrative requirements for affiliated corporations in the worthlessness context are also examined.\textsuperscript{703}

An Introduction to Consolidated Return Requirements Relating to Worthlessness

The filing of consolidated returns will be beneficial if an affiliated member becomes worthless within the meaning of section 165(g). Deductions for worthless securities will be accelerated because partial deductions are allowed and deductions for bad debts will remain subject to the rules discussed above.

One advantage to the filing of consolidated returns is that losses flow through to the affiliated group.\textsuperscript{704} The basis of the parent's subsidiary stock or stock in the loss affiliate held by other members must be reduced,\textsuperscript{705} however, to the extent that losses are "availed of" by the group\textsuperscript{706} in computing consolidated taxable income. As a result, a consolidated parent will receive the benefit of annual ordinary loss deductions resulting from the gradual decline in value of its investment in the subsidiary rather than awaiting the complete worthlessness of its stock and a single ordinary loss deduction under section 165(g)(3).\textsuperscript{707}

\textsuperscript{703} See notes 719-32 & accompanying text infra.

\textsuperscript{704} Treas. Reg. § 1.1502-11 and -12.

\textsuperscript{705} Treas. Reg. § 1.1502-32(a) and (b)(2). See also Treas. Reg. § 1.1502-11(b).

\textsuperscript{706} The losses are "availed of" by the group either currently or as carryback or carryover deductions.

\textsuperscript{707} This has interesting ramifications in the Corn Products and securities' characterization areas. See text accompanying notes 52-76 supra.

If a parent has a $100 basis in its subsidiary stock, the parent and the subsidiary are members of an affiliated group filing consolidated returns, and the subsidiary generates net operating losses of $99, then the parent in effect receives an ordinary loss deduction of $99 on its stock investment. See Treas. Reg. § 1.1502-11.

Alternatively, if the subsidiary generates losses of only $80, and its assets depreciate in value to $1, then the parent may deduct the $80 flow-through as an ordinary loss. Upon sale of the subsidiary stock for $1, however, the parent apparently is entitled to capital loss treatment only. I.R.C. §§ 1221, 1222. This is so despite the fact that the stock depreciation in both cases results from operating and § 1231 losses. The distinction in the latter situation
Affiliate loss from "intercompany transactions" is deferred until the subsidiary is "disposed of." This deferral encompasses losses from a partially or completely worthless intercompany bad debt, or for a deduction for a reasonable addition to a reserve for intercompany bad debts, and is triggered by the complete worthlessness of stock within the meaning of section 165(g). Deductions for intercompany bad debts or a reserve will therefore be unaffected by the filing of consolidated returns because the worthlessness of stock by definition precedes the worthlessness of indebtedness.

The worthlessness of stock in an affiliated subsidiary would produce the following results: (1) the parent's basis in its subsidiary's stock would be deductible as if the stock were disposed of on the last day of the taxable year; (2) the parent could deduct its intercompany indebtedness either in whole or in part; (3) the parent's basis in its subsidiary's stock would be reduced to zero; and (4) the parent's basis in the intercompany indebtedness would be reduced by the amount deducted.

is that the subsidiary's I.R.C. § 1231 (or I.R.C. § 1221(1)) losses went unrecognized; tax depreciation was not consistent with economic depreciation. The consolidated return regulations treat the affiliated group as "integrally-related" for operating gain and loss; there seems to be no warrant for differentiating bulk termination sales from similar integral tax treatment. Cf. Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945) (gain or loss on sale of business measured and characterized by individual components).

709. Treas. Reg. § 1.1502-14(d). The same rule would apply whether the debt was held to be bona fide indebtedness or preferred equity. Treas. Reg. § 1.1502-19(a)(2)(ii).
711. In addition to the § 165(g) test of worthlessness, Treas. Reg. § 1.1502-19(b)(2)(iv) and (v) provide two alternative objective worthlessness tests. There is a "disposition" if (1) "the Commissioner is satisfied that 10 percent or less of the face amount of any obligation for which the subsidiary is personally liable (primarily or secondarily) is recoverable at maturity by its creditors," or (2) "a member transfers an obligation for which the subsidiary is personally liable (primarily or secondarily) to a nonmember for an amount which is 25 percent of the face amount of such obligation."

If the parent's subsidiary stock basis is zero, or if it has an excess loss account, there would be no I.R.C. § 165(g) loss deduction. A "disposition" would trigger recapture to the extent of an excess loss account, normally as ordinary income. Treas. Reg. § 1.1502-19(a) and (b). The general features of Treas. Reg. §§ 1.1502-19(a) and (b) were held valid in Covil Insulation Co. v. Commissioner, 65 T.C. 364 (1975), and Georgia-Pacific Corp. v. Commissioner, 63 T.C. 790 (1975).
713. Treas. Reg. § 1.1502-14(d)(3)(ii); § 165(a).
For tax years subsequent to the year of worthlessness, if the subsidiary were to generate any net operating losses, these losses would flow through to the affiliated group.\textsuperscript{716} The recognition of loss would trigger a negative basis adjustment in the parent's subsidiary stock basis,\textsuperscript{717} and the parent would recognize income from this excess loss account equal to the net operating loss flow-through. The result is an annual tax wash.\textsuperscript{718}

**Administrative Requirements**

The preceding substantive discussion must be tempered by knowledge of procedural requirements, or careful planning may be compromised by procedural error. A review of all administrative requirements for financially distressed corporations, however, is beyond the scope of this Article.\textsuperscript{719} As such, only those provisions that have unique and important consequences in the worthlessness context are discussed.\textsuperscript{720}

Section 6511(a) states the general rule that a claim for refund shall be filed within three years from the date the return was filed or two years from the date the tax was paid, whichever expires later. A seven-year statute of limitations applies, however, to refund claims relating to a deduction for wholly worthless securities\textsuperscript{721} or wholly worthless debts.\textsuperscript{722} The taxpayer in these circumstances can claim a refund within seven years of the date prescribed by law for filing the return.\textsuperscript{723} The three-year statute of limitations is also relaxed for net operating loss and capital loss carrybacks.\textsuperscript{724} A claim for refund may be made on the return filed for the applicable year.\textsuperscript{725}

A strict three-year limitations period applies to the assessment

\begin{footnotes}
\begin{enumerate}
\item Treas. Reg. § 1.1502-11.
\item Treas. Reg. § 1.1502-32.
\item See generally Beghe, Tax Planning for the Financially Troubled Corporation, 52 Taxes 795 (1974).
\item See I.R.C. §§ 6425(a) and (b), 6655 (estimated tax over and under payments).
\item I.R.C. § 165(g)(3).
\item I.R.C. § 165(a)(1).
\item I.R.C. § 6511(d)(1). See Treas. Reg. § 301.6511(d)-1(c) (the seven-year statute of limitations does not apply to the deductibility of partially worthless debt losses).
\item I.R.C. § 6511(d)(2). See also I.R.C. §§ 1311-1314.
\item I.R.C. § 6402; Treas. Reg. § 301.6402-3. See also I.R.C. §§ 6405, 6406 (claims for refunds exceeding $200,000).
\end{enumerate}
\end{footnotes}
of deficiencies by the Service. Section 6501(a) provides that taxes must be assessed within three years of the date on which the return was filed.

The interplay of sections 6501(a) and 6511(d)(1) is significant. The Service can be foreclosed from assessing a deficiency arising from other items of tax liability when a taxpayer claims a refund for worthless securities or wholly worthless debts after the three-year statute of limitations on assessment has run, but prior to the expiration of the seven-year limitations period on refund of overpayments. This statutory distinction permits the taxpayer to file protective returns in those cases in which an initial refund claim has been disallowed and litigation on the propriety of a worthlessness deduction for that year is pending. Thus, if a refund claim for year one is disallowed, the taxpayer may file suit and, in year six, seven, eight or nine, may file a refund claim for year two based on the same deduction for worthless securities and wholly worthless debts. This practice of filing protective returns would continue either until the last possible year of worthlessness or until the Service or the courts allowed the deduction for a prior year. In this way, the taxpayer can insulate from attack by the Service other potential items of tax liability and also avoid loss of a worthlessness deduction by failure to claim it in the proper year. Moreover, if the subsequent refund claims are disallowed, the taxpayer will be able to consolidate its claims for trial, permitting the trial judge to be the final arbiter of the year of worthlessness.

A taxpayer's quest for the earliest year of tax deduction is

726. See I.R.C. § 6514(b). However, the taxpayer may not recover a refund to the extent that there was no overpayment of tax in the barred year. In Lewis v. Reynolds, 284 U.S. 281 (1932), the Supreme Court held that, although the Commissioner may not credit an overpayment against a barred deficiency for a different taxable year, the Commissioner might do so if the deficiency was for the year for which the taxpayer claims a refund. See also Bull v. United States, 295 U.S. 247 (1935); I.R.C. §§ 1311-1315. The doctrine of equitable recoupment cannot be used to assess a deficiency or reopen a closed year.

727. This assumes that the identifiable event did not occur in a year prior to year one.

728. This assumes refund suits in the same court.

729. See Young v. Commissioner, 123 F.2d 597, 600 (2d Cir. 1941): "[T]he taxpayer is at times in a very difficult position in determining in what year to claim a loss. The only safe practice, we think, is to claim a loss for the earliest year when it may possibly be allowed and to renew the claim in subsequent years if there is any reasonable chance of its being applicable to the income for those years." See generally I.R.C. §§ 7422(a), 6532(a).

730. Also, government money has been used at what, to date, have been favorable rates of interest. I.R.C. § 6621. But see Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 711 (amending § 6621).
endangered by the possibility that a penalty may be imposed. Section 6653(a) states that “[i]f any part of any underpayment . . . is due to negligence or intentional disregard of rules and regulations (but without intent to defraud), there shall be added to the tax a [penalty] equal to 5 percent of the [entire] underpayment.”\textsuperscript{731} This has specific application to a grossly improper claim of worthlessness. It also applies, however, if a separate underpayment on the return was due to negligence or fraud. In such circumstances, the entire underpayment for the year, and not merely that part resulting from negligence or fraud, will be subject to the statutory penalty.\textsuperscript{732} Thus, a taxpayer would be well-advised to scrutinize closely all items on his or her return to avoid the possibility of any underpayment due to negligence or fraud. Particular care is necessary in the case of worthless securities and debt losses, because the proper year for deduction is difficult to ascertain and the deduction is frequently substantial in amount.

**Conclusion**

Planning for tax contingencies begins even before a corporation is organized. A proper mix of common and preferred stock and indebtedness,\textsuperscript{733} use of multiple entities,\textsuperscript{734} and election of tax options\textsuperscript{735} should all be considered prior to formation. The beneficial effect of these planning tools is often dependent upon substantiation. The execution of notes, the adoption of regular board of directors’ and shareholders’ minutes, and the institution of proper accounting procedures set the stage for future deductions. Of course, the efficacy of historical evidence may be destroyed by subsequent inconsistent actions. The converse, however, is also true. Shortsighted planning may be overcome by remedial measures which are properly documented. At no time can the taxpayer assume that an apparently negative result is a foregone conclusion.\textsuperscript{736}

\textsuperscript{731} Section 6653(b) provides for a penalty of 50% of the amount of the underpayment in those cases in which fraud results in any underpayment. A penalty under § 6653 may be imposed in addition to that under § 6651. See also I.R.C. § 6653(a)(2).

\textsuperscript{732} Bianchi v. Commissioner, 66 T.C. 324, 335 (1976), aff’d, 553 F.2d 93 (2d Cir. 1977).

\textsuperscript{733} See generally Bittker & Eustice, note 70 supra, at ¶ 4.02 and ch. 10; I.R.C. § 305.

\textsuperscript{734} See I.R.C. §§ 165(g)(3), 1501-04.

\textsuperscript{735} See I.R.C. §§ 1244, 1371-79, 1501.

\textsuperscript{736} See Wagner Electric Corp. v. United States, 208 Ct. Cl. 1024 (1976), (adopting
This Article focuses on several areas of tax planning, the foremost of which is the establishment and maintenance of the bona fides of indebtedness. Failure to prove valid debt often results in the disallowance of interest deductions, an inability to bail-out earnings, and the deferral and recharacterization of debt and worthless securities' losses, which otherwise might have been characterized as ordinary. The section 385 Regulations provide comprehensive new standards for making the distinction between debt and equity. They are a marked improvement over existing case law. Tax planning for obligations issued after December 31, 1981 can proceed with a large degree of certainty. Pre-1982 debt-equity rules and areas not addressed by the section 385 Regulations, however, remain a muddle. Fortunately, their applicability has been severely limited.

This Article also addresses the requirements for a worthlessness deduction. The test of worthlessness under Sterling Morton v. Commissioner measures the substance of insolvency, not the form of nominal sales or half-hearted marketing efforts. If insolvency is established and proof exists of an inability to restore value, a worthlessness event has occurred. The cases properly turn on evidence of events that extinguish prospects for profitability. Although the Morton test relies on factors that, at the time of worthlessness, may be unknown and unknowable, a reasonable person standard for deductibility nevertheless emerges.

Some question exists, despite judicial adoption of a "wholly worthless" requirement for "sustained," whether a loss may be "sustained" in the parent-subsidiary context when the extent of partial loss becomes fixed by the occurrence of one or more identifiable events. Similarly, the proper characterization of affiliate loss in unclear. An argument can be made in support of ordinary gain and loss treatment for affiliate securities when consolidated returns are filed. Only one court, however, has passed on this issue. The Treasury should resolve these anomalies by promulgating regulations under section 1502 consistent with the concept of treating a consolidated group the same as a single corporate entity with multi-
tiple operating divisions. In the absence of Treasury action, the courts should resolve these anomalies.