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The Debt-Equity Question in the Federal Income Taxation of Corporations: Will New Section 385 Make Tax Planning a Reality?

INTRODUCTION

For many years the corporate tax planner has faced the possibility that what appears to him to be bona fide debt will be seen by the Internal Revenue Service or a federal district court as equity. Despite honest efforts to produce results that will meet with the approval of the Service, by reliance on past Service positions or court decisions, the tax planner is likely to find that his efforts will be challenged and that the court in which his position is litigated will ignore at least some of its own prior conclusions in reaching its decision. While the goal of every tax planner, a clear set of rules to be followed in order to achieve an unassailable result, may not be possible, or even desirable, in the area of corporate debt, yet it should be possible for the Treasury Department to provide criteria for a capital structure that will be relatively safe from attack.

In the Tax Reform Act of 1969¹ Congress provided new section 385 for the purpose of distinguishing debt from equity.² Section 385 delegates virtually unlimited authority to the Secretary of the Treasury or his delegate to define corporate debt and equity by regulations for all purposes of the Internal Revenue Code.³ Section 385(b) states that the regulations to be promulgated for section 385 ". . . shall set forth factors . . ." to be taken into account in determining in a given factual situation whether a debtor-creditor or a corporation-shareholder relationship exists. Section 385(b) then lists five factors which *may* be included in the factors settled upon by the Treasury:

- (1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,

1. Tax Reform Act of 1969, Pub. L. No. 91-172, 82 Stat. 487, *amending* INT. REV. CODE OF 1954 [hereinafter cited as Tax Reform Act].

2. 1969-3 CUM. BULL. 511.

3. INT. REV. CODE OF 1954, § 385(a).

4. *Id.* § 385(b).

- (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 stock of the corporation, and
- (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.⁵

The Senate Report for the Tax Reform Act of 1969 makes it clear that the five factors listed in section 385(b) are not intended to be the only factors included in the regulations or that

. . . with respect to a particular situation, any of these factors must be included in the guidelines, or that any of the factors which are included by statute must necessarily be given any more weight than other factors added by regulations.⁶

The language of the Senate Report seems to authorize whatever standards the Treasury deems proper. But, even with such broad delegation from Congress, the Treasury may find the task of delineating debt and equity ". . . formidable, and perhaps impossible . . ."⁷

Because in the past, there have been no Treasury regulations to assist the corporate planner in providing safe instruments of indebtedness for the corporation, and because the Internal Revenue Service has been unwilling to issue advance rulings concerning whether corporate arrangements are debt or equity,⁸ the federal courts have developed some guidelines to aid them in determining what qualifies as bona fide debt. But, as one commentator has noted:

[t]o look to the case law for guidance is to invite bewilderment. There have been literally hundreds of decisions over a period of about 20 years. . . . You can find a case which supports almost any reasonable argument.⁹

This commentator suggests that in a "really hopeless"¹⁰ case, the best approach is to ask for a district court jury trial because if

. . . you drew a halfway sympathetic judge, you should stand a 50-50 chance, for no twelve ordinary people would ever understand all

5. *Id.*

6. S. REP. No. 91-552, 91st Cong., 1st Sess. 138 (1969) (reprinted at 1969-3 CUM. BULL. 511).

7. Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 577 (1971) [hereinafter cited as Plumb].

8. Rev. Proc. 69-6, 1969-1 CUM. BULL. 396.

9. Hickman, *The Thin Corporation: Another Look at an Old Disease*, 44 TAXES 883, 885 (1966).

10. *Id.*

the double tax involved, and would probably end up flipping a coin.¹¹

That such advice is seriously given and received is evident from a perusal of the cases in the area. That the advice is necessary is an indication of the need for the reform provided for in section 385.

DEBT-EQUITY—AN HISTORICAL PERSPECTIVE

The determination whether an instrument represents debt or equity is important to the corporate issuer because the tax consequences of debt are usually more favorable to the corporation than the tax consequences of equity. Under present tax law, a corporation is permitted to deduct interest paid by it on its debt but it is not allowed a deduction for dividends paid by it on its stock or equity.¹² The Senate Report reflects the congressional concern that the debt-equity question has assumed added importance in recent years because of the increased level of corporate merger activities and the increasing use of debt for such acquisition.¹³ Since the tax consequences of debt make it advantageous for the corporation to finance its activities, to the maximum extent, through debt rather than stock,¹⁴ an unexpected classification as equity may have serious ramifications for the corporation.¹⁵ And, while the government normally seeks to have the questioned instrument classified as equity whereas the corporation and shareholders argue for a debt classification, the roles may be reversed; “. . . and both taxpayers and government may take inconsistent positions in different years, depending on the context in which the issue arises.”¹⁶

The government and the corporate or individual taxpayer most often find themselves litigating the debt-equity question on one of three occasions: (1) on the receipt of the “debt” obligation in exchange for

11. *Id.*

12. 1969-3 CUM. BULL. 510; *see* INT. REV. CODE OF 1954, § 163(a).

13. 1969-3 CUM. BULL. 511.

14. Plumb, *supra* note 7, at 372.

15. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 4.02 (2d ed. 1966) [hereinafter cited as BITTKER & EUSTICE]. For example, if purported debt is found to be a second class of stock, the corporation's Subchapter S election will be ineffective. *See* INT. REV. CODE OF 1954, §§ 1371-79. Other examples of serious side effects occasioned by a finding of equity include: loss of § 337 benefits if assets are retained beyond the twelve-month period to pay off “creditors”; loss of reorganization status if purported debt securities are discharged for cash or other debt instruments; and, conversion of an assumed “purchase transaction” into a tax-free reorganization if debt issued as the consideration is held to constitute stock. *See* BITTKER & EUSTICE, ¶ 4.02, at 4-6 & n.9.

16. *Id.* ¶ 4.02; *see* Zilkha & Sons, Inc., 52 T.C. 607 (1969).

property, raising the issue of recognition of gain or loss to the transferor and basis to the transferee in the typical section 351 situation; (2) during the time when the instrument is outstanding, when the corporation deducts paid or accrued "interest"; and, (3) at maturity of the instrument, when it is characterized by the holder at collection or when it is written off as worthless.¹⁷ Although the debt-equity question is raised in many other situations, this discussion will consider primarily these three situations, in the context of close corporations since it is the close corporation's shareholder who becomes creditor in suspect circumstances.

The essential difference between a shareholder and a creditor of a corporation is that the shareholder is an "... adventurer in the corporate business"¹⁸ He takes the risks and shares in the success. But, the creditor, as compensation for not sharing in the corporate success, is to be paid "... independently of the risk of success; and gets a right to dip into capital when the payment date arrives."¹⁹ The classic definition of debt is very similar to the first factor listed in section 385(b). Debt is

... an unqualified obligation to pay a sum certain at a reasonably close, fixed maturity date along with a fixed percentage of interest payable regardless of the debtor's income or lack thereof.²⁰

The significance of the debt-equity distinction is that the corporation is permitted by the Internal Revenue Code to deduct its cost for the use of money that it will return, because such cost is a business expense.²¹ But, when a corporation pays dividends, it is not incurring a business expense, rather it is distributing profits, and should not be able to deduct any "cost" for so doing.²² As to instruments which are called debt by the holder who is also a shareholder, the Internal Revenue Service will argue that where the risk of repayment is high, the instrument can only be regarded as an evidence of risk capital so that any payment of "interest" to the holder by the corporate debtor is not permitted the usual interest deduction because the congressional policy allows such

17. *Id.*; see Plumb, *supra* note 7, at 372-403 (an exhaustive analysis of variations on these three themes, including cases cited for each variation). The scope of this comment prevents detailed analysis of the multitude of cases decided under these themes.

18. *Id.* at 404; see Commissioner v. O.P.P. Holding Co., 76 F.2d 11 (2d Cir. 1935).

19. Plumb, *supra* note 7, at 404.

20. Gilbert v. Commissioner, 248 F.2d 399, 402 (2d Cir. 1957).

21. See INT. REV. CODE OF 1954, § 163.

22. 248 F.2d at 407.

deductions for bona fide debt costs and not for returns on risk capital.²³ The same policy argument is made to prevent bad debt deductions²⁴ in the case of a loss which is in substance a loss of risk capital labeled as debt.²⁵

In early tax cases, the courts were willing to distinguish debt from equity by looking at the intent of the parties.²⁶ The early decisions looked also for a fixed maturity date at which the holder would have an unconditional right to demand repayment.²⁷ The problem with the use of intent of the parties or a fixed maturity date as the criteria for judging whether an instrument be considered debt or equity is that where the parties are a corporation and its shareholders the expressed intent or the ability to enforce payment at maturity are often formal incidents of the instrument with no real intention to demand a creditor's rights on the part of the shareholders.

So that finally, courts were forced to look beyond the face of the instrument to ascertain "whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or represents a strict debtor-creditor relationship."²⁸

As courts began to understand that the formal characterization of the instruments by the parties involved, even if supported by book entries and formal declarations of intent, should not be allowed to obscure the substance of the transactions,²⁹ they created considerable confusion by generating lists of criteria to be used in making the debt-equity determination.³⁰

These lists of criteria seem to go on in an endless line, with most districts or circuits selecting from a list that one compiler sets at thirty-eight in number³¹ those factors that seem appropriate for the facts at hand. The Fifth Circuit seems to most consistently apply the same set of criteria to the debt-equity question, relying on a list of eleven factors

23. *Id.*

24. See INT. REV. CODE OF 1954, § 166.

25. See *Gilbert v. Commissioner*, 248 F.2d 399 (2d Cir. 1957).

26. See *Commissioner v. Meridian & Thirteenth Realty Co.*, 132 F.2d 182 (7th Cir. 1942) (the court found an intent of the parties not to violate a state statute).

27. See *Commissioner v. H.P. Hood & Sons, Inc.*, 141 F.2d 467 (1st Cir. 1944); *United States v. Title Guaranty & Trust Co.*, 133 F.2d 990 (6th Cir. 1943).

28. Plumb, *supra* note 7, at 406.

29. J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 26.06 (Supp. 1972).

30. Plumb, *supra* note 7, at 407-09.

31. Holzman, *The Interest-Dividend Guidelines*, 47 TAXES 4 (1969).

to be weighed in relation to each new set of facts. The eleven factors are set out in *Monclair, Inc. v. Commissioner*,³² and are referred to and used in almost every subsequent Fifth Circuit case following the *Montclair* decision.³³ But, the same circuit stated that

... each case must be decided on its unique fact situation, and no single test is controlling or decisive in making this determination.³⁴

What this means is that in most instances the government as well as the taxpayer

... are at the very mercy of what some writers have called "whim," or the trial judge's "experience with the wellsprings of human conduct," and "the acuity of [the trial judge's] sense of smell."³⁵

The guidelines developed by courts, however diverse they may be, nonetheless do focus on certain considerations which recur in the cases in this area. In most cases the debt-equity ratio is discussed. This ratio was introduced in the dictum of *John Kelley Co. v. Commissioner*,³⁶ and has been popularized as the "thin capitalization" doctrine.³⁷ The doctrine now means that corporate obligations will not be given debt status when the ratio of debt to equity is so large that shareholder-creditor rights will be worthless in the event of failure of the corporation.³⁸ Thin capitalization is normally associated with close corporations in the determination of the extent to which the money advanced has been put at the risk of the business.³⁹ The history of the debt-equity ratio as a factor in the analysis of close corporations' shareholder ad-

32. 318 F.2d 38, 40 (5th Cir. 1963). The factors listed in *Montclair* are:

- (1) the names given to the certificates evidencing the indebtedness;
- (2) the presence or absence of a maturity date;
- (3) the source of the payments;
- (4) the right to enforce the payment of principal and interest;
- (5) participation in management;
- (6) a status equal to or inferior to that of regular corporate creditors;
- (7) the intent of the parties;
- (8) 'thin' or adequate capitalization;
- (9) identity of interest between creditor and stockholder;
- (10) payment of interest only out of 'dividend' money;
- (11) the ability of the corporation to obtain loans from outside lending institutions.

33. See *Tyler v. Tomlinson*, 414 F.2d 844 (5th Cir. 1969); *Berkowitz v. United States*, 411 F.2d 818 (5th Cir. 1969).

34. 411 F.2d at 820.

35. *Plumb*, *supra* note 7, at 409.

36. 326 U.S. 521 (1946).

37. Stone, *Debt-Equity Distinctions in the Tax Treatment of the Corporation and Its Shareholders*, 42 TUL. L. REV. 251, 255 (1968).

38. *Id.*

39. *Id.* at 256.

vances can be divided into three periods which reflect the attention of the courts on the intent of the parties.⁴⁰ The courts have not applied any mathematical formula to establish a safe debt-equity ratio, and have applied the concept more sparingly in recent years.⁴¹ Some decisions have even referred to the ratio as irrelevant.⁴²

Another guideline used by courts to decide the debt-equity question is the proportionality of the holding of debt and stock. Where debt and stock are held pro rata by shareholders, there is a strong inference that the form debt is really equity.⁴³ The question the court must answer when considering the proportionality of shareholder-creditor holding is whether a shareholder would eliminate his own corporation by demanding his rights as a creditor.⁴⁴ But, holding disproportionate amounts of debt and stock may make the debt valid.⁴⁵

Courts also look to the purpose to which the advance is put in determining whether the advance is debt or equity. If the debt is assumed in order to acquire the assets essential to the corporation, the advance may be seen by the courts as equity because the corporation is held to have been undercapitalized.⁴⁶ When the debt is assumed to acquire unessential assets, courts will generally look to other relevant factors to determine the debt-equity status.⁴⁷

Although intent is not the vital factor it once was in the debt-equity question intent is still weighed by some courts in varying degrees.

Objective intent such as contained in the documentation of an advance of money is generally not to be afforded special weight. It alone cannot be controlling of the debt-equity issue. However, analysis [of the generally accepted criteria], *including* the objective expression of intent, leads to subjective resolution of the ultimate

40. Caplin, *The Caloric Count of Thin Corporations*, 17 N.Y.U. INST. ON FED. TAX. 771, 774 (1959). Caplin sees the history of thin corporation as a tax problem divided into three major periods: 1) pre-1946—a struggle with hybrid securities by searching for the parties' intent as in *Commissioner v. Meridian & Thirteenth Realty Co.*, 132 F.2d 182, 184 (7th Cir. 1942); 2) 1946-1956—reliance on ratios begun by dicta in *John Kelley Co. v. Commissioner*, 326 U.S. 521, 535 (1946); 3) 1956-present—decline of the ratio test which was replaced by a search for substance, with intent reappearing as a major question but with factors outside the instrument gaining in importance as in *Gooding Amusement Co. v. Commissioner*, 236 F.2d 159 (6th Cir. 1956), *cert. denied*, 352 U.S. 1031 (1957).

41. 414 F.2d at 848.

42. *See Byerlite v. Williams*, 286 F.2d 285 (6th Cir. 1960).

43. Plumb, *supra* note 7, at 470; *see Charter Wire, Inc. v. Commissioner*, 309 F.2d 878 (7th Cir. 1962); *Gilbert v. Commissioner*, 248 F.2d 399 (2d Cir. 1957).

44. *Mullin Bldg. Corp. v. Commissioner*, 9 T.C. 350, 355-56 (1947), *aff'd*, 167 F.2d 1001 (3d Cir. 1948).

45. *Charles E. Curry*, 43 T.C. 667 (1965).

46. *Sam Schnitzer*, 13 T.C. 43 (1949), *aff'd*, 183 F.2d 70 (9th Cir. 1950).

47. *J.I. Morgan*, 30 T.C. 881 (1958).

issue: Whether the parties in fact intended the advance to create debt rather than equity.⁴⁸

Courts will look for the creation of a formal creditor-debtor relationship, a written debt instrument, and security for the debt.⁴⁹ Other factors which courts will consider as adverse to the contention that the advance is debt include the subordination of shareholder loans to outsider loans,⁵⁰ the existence of an unduly long maturity date,⁵¹ restrictions on the right to enforce payment,⁵² and the lack of a business motive for incorporating.⁵³

NEW SECTION 385—THE DEVELOPMENT OF A STATUTORY APPROACH TO DEBT-EQUITY

New section 385 gives a fresh opportunity for reconsideration of the difficult questions that have confronted taxpayer, court, and Internal Revenue Service alike when attempting to determine whether an advance to a corporation is equity or true debt.⁵⁴ It is not probable that the regulations which are prepared under the direction of section 385 will provide a mechanical test to be applied formally to yield the answer to the debt-equity question. This would not be in keeping with the congressional intent as reflected in the Internal Revenue Code to treat every corporate distribution to shareholders coming out of earnings and profits to the extent thereof.⁵⁵ Congressional concern for the avoidance of tax through the excessive use of debt securities is also found in the Senate Report on the Tax Reform Act of 1969.⁵⁶ For these reasons, it is to be expected that the section 385 regulations will not effect a policy change in the attitude of the Internal Revenue Service regarding the requirement that shareholder distributions be derived from earnings and profits. Rather the regulations will probably

48. *A.R. Lantz Co. v. United States*, 424 F.2d 1330, 1333-34 (9th Cir. 1970).

49. *Wood Preserving Corp. v. United States*, 347 F.2d 117 (4th Cir. 1965).

50. *Charles I. Huisking & Co.*, 4 T.C. 595 (1945). For a note on voluntary subordination see *Plumb*, *supra* note 7, at 497.

51. *Swoby Corp.*, 9 T.C. 887 (1947).

52. *Green Bay & W.R.R.*, 3 T.C. 372 (1944), *aff'd*, 147 F.2d 585 (5th Cir. 1945).

53. *Gooding Amusement Co. v. Commissioner*, 236 F.2d 159 (6th Cir. 1956). *But see Kraft Foods Co. v. Commissioner*, 232 F.2d 118 (2d Cir. 1956).

54. See New York Bar Ass'n Tax Section Comm. on Reorganization Problems, *Recommendations as to Federal Tax Distinction between Corporate Stock and Indebtedness*, 25 TAX. LAW. 57, 58 (1971) [hereinafter cited as N.Y. State Bar].

55. *Plumb*, *supra* note 7, at 584; see INT. REV. CODE of 1954, §§ 302, 316(a). See also *Gregory v. Helvering*, 293 U.S. 465 (1935).

56. See note 6 *supra*.

“... clarify and regularize . . .”⁵⁷ the standards by which bona fide shareholder debt can be ascertained.⁵⁸

Several commentators have suggested that the proper approach for the Internal Revenue Service to use when formulating the section 385 regulations is to develop a tier system of tests so that a safe harbor can be realized by those who clearly issue or hold debt instruments.⁵⁹ The various safe harbor approaches are sufficiently similar so that the study of one creates an understanding of all. The key to each such proposal is that at either extreme of the debt-equity question lies safe ground wherein the relationship is clearly debt or equity. But, between the extremes lies the gray area wherein

... the ambivalence of the factors causes the principal uncertainty today and where the regulations cannot feasibly provide solutions with mathematical precision.⁶⁰

In the gray area, the regulations will be valuable to the extent that they not merely list factors in much the way that courts now list them but to the extent that the regulations include

... short essays on the significance, if any, to be attached to each factor or combination of factors, putting them in perspective and correcting some aberrant notions that have appeared.⁶¹

Other suggestions for the gray area include developing a series of rebuttable presumptions,⁶² or reliance on revenue rulings to be issued to cover the gray areas.⁶³ The safe harbor, although varied in specifics, has as its goal the protection of the “non-litigious taxpayer” who should be sheltered from the dangers of the “fringe areas” of debt and equity. “Tax law should not compel taxpayers to be adventurous.”⁶⁴

When drafting the new regulations for section 385, several problems will have to be resolved. A decision regarding the retroactivity of the

57. Plumb, *supra* note 7, at 585.

58. *Id.*

59. See BITTKER & EUSTICE, *supra* note 15, ¶ 4.05; Plumb, *supra* note 7, at 586; N.Y. State Bar, *supra* note 54 *passim*.

60. Plumb, *supra* note 7, at 587.

61. *Id.* at 588.

62. N.Y. State Bar, *supra* note 54, at 62. A rebuttable presumption of equity would attach to an interest in a corporation held by a substantial shareholder, for example. The rebuttable presumptions are intended to be evidentiary in effect, and not to have substantive effect.

63. *Id.* It will be helpful to have rulings in the gray area between debt and equity. If the Treasury decides to treat the debt-equity question as one of law, the rulings should be easier to make. See note 105 *supra*, and accompanying textual material.

64. Note, *Toward New Modes of Tax Decisionmaking—The Debt-Equity Imbroglia and Dislocations in the Lawmaking Responsibility*, 83 HARV. L. REV. 1695, 1705 (1970).

regulations will have to be made. It has been suggested that the regulations must be prospective in nature so that taxpayers will not find prior "debt" transactions changed in character.⁶⁵ Other questions concerning debt-equity problems that should be considered by the drafters of the regulations include: whether classification as debt or equity, once made, will be permanent; whether instruments can be classified as part debt and part equity; whether there should be a bias built into the regulations to decide doubtful cases in favor of equity; and, whether the debt-equity question is one of law or fact.⁶⁶

Two of these issues, the question of the permanency of the classification and the question whether the debt-equity determination is a matter of law or fact, are related. These considerations have received less attention from the commentators than the other issues concerning debt versus equity. But, it could make a significant difference in the effect and administration of new section 385 and its regulations to have these questions answered one way or another.

The question of the permanency of the classification of an instrument as debt or equity is really a question of the *res judicata* or collateral estoppel effect to be given in later years to an administrative or judicial determination made in a prior year. Income tax is levied on a yearly basis. Each year is the beginning of a new liability and a separate cause of action.

Thus if a claim of liability or non-liability relating to a particular year is litigated, a judgment on the merits is *res judicata* as to any subsequent proceeding involving the same claim and the same tax year. But if the later proceeding is concerned with a similar or unlike claim relating to a different tax year, the prior judgment acts as a collateral estoppel only as to those matters in the second proceeding which were actually presented and determined in the first suit.⁶⁷

Collateral estoppel thus operates to prevent ". . . redundant litigation of the identical question of the statute's application to the taxpayer's status."⁶⁸ *Commissioner v. Sunnen*⁶⁹ asserted the position that the collateral estoppel effect of a tax decision is to remain only as long as matters which have been decided remain ". . . substantially static, factually

65. N.Y. State Bar, *supra* note 54, at 63; *see* INT. REV. CODE of 1954, § 7805(b).

66. BITTKER & EUSTICE, *supra* note 15, ¶ 4.06.

67. *Commissioner v. Sunnen*, 333 U.S. 591, 598 (1948).

68. *Id.* at 599.

69. 333 U.S. 591 (1948).

and legally.”⁷⁰ *Sunnen* makes it clear that collateral estoppel is not to be applied in tax cases to create “vested rights”⁷¹ in decisions that have become “. . . obsolete or erroneous with time, thereby causing inequities among taxpayers.”⁷²

The Court of Claims has followed the position taken in *Sunnen*. In cases where the collateral estoppel issue is raised, the Court of Claims holds that the court “. . . must inquire for each year whether there is indebtedness.”⁷³ The Court of Claims further adds that as to the debt-equity determination, it is proper for courts to consider the continuing relationship of the parties claiming debtor-creditor status, so that if it becomes apparent with the passage of time that the parties have no intention of maintaining the debtor-creditor relationship, the court may decide to eliminate any tax benefits accruing from the prior debtor-creditor status.⁷⁴

Viewing the collateral estoppel question slightly differently is the Tax Court which gives more consideration to prior determinations in its analysis of a debt-equity issue.⁷⁵ The Tax Court will consider the character given to instruments at creation, but will not give the initial character conclusive weight.⁷⁶ An analysis of the Court of Claims and Tax Court cases in this area will, however, reveal the fact that all the cases were factually similar. In each instance the obligation was kept by the one originally making the advance, who was the litigant in each case.

Contrasted with this factual situation are decisions from several courts of appeals, involving cases in which the obligation was passed to a third party in an arm's length transaction, and the third party became the litigant. For the application of collateral estoppel, this is significant because the party had changed between the prior determination as to

70. *Id.* at 599.

71. *Id.*

72. *Id.* While the taxpayer must not be given vested rights in an outmoded decision, it should be permitted to the taxpayer to have some assurance that his tax planner can rely on past determinations as to the debt-equity question. Whether the debt-equity question can ever be made finally as to any tax problem is improbable because of the shifting factual circumstances on which tax decisions are based. It is not suggested that the debt-equity question should be answered initially and never changed, even though the facts may change. What is suggested is that the new regulations give sufficient guidelines to taxpayers so that they will not inadvertently “plan” themselves into new litigation on an old decision.

73. *Cuyuna Realty Co. v. United States*, 382 F.2d 298, 301 (Ct. Cl. 1968).

74. *Sayles Finishing Plants, Inc. v. United States*, 399 F.2d 214, 217 (Ct. Cl. 1968).

75. *Ruby, Constructive Transubstantiation of Corporate Investments and Its Tax Consequences*, 49 TAXES 666, 668 (1971).

76. *Edwin C. Hollenbeck*, 50 T.C. 740, 748 (1968).

debt-equity and the present action. And, when the party in a debt-equity situation changes, the factors to be weighed and applied necessarily change also. However, the courts of appeals appear to be applying this rule: if the instrument has been determined immediately before transfer to be equity, it will be considered equity after transfer; but, if the instrument has been determined immediately before transfer to be debt, it will be considered debt after transfer.⁷⁷

The effect of these various approaches to the collateral estoppel factor in litigation pertaining to debt-equity status is that taxpayers are treated differently depending on which court hears their case. Thus, there is a recurring theme in the debt-equity area, not only as to the factors to be considered but also as to the collateral estoppel effect of prior determinations, which theme is that taxpayers are not treated equally before the law. Choice of court may not only affect the initial determination as to whether a relationship is one of debtor-creditor or corporation-shareholder, but that determination, once made, may be given differing consideration in later litigation. The regulations for new section 385 should consider the question of collateral estoppel and provide guidelines to be applied by all courts, so that the taxpayer does not suffer from unequal application of the income tax or from unequal treatment once the tax has been applied and is to be litigated.

Closely related to the collateral estoppel question is the question whether the determination as to debt-equity status is one of fact to be found by the trier of fact in the same way it finds all other facts, or whether the debt-equity question is one of law to be determined by the court after all the facts are in.⁷⁸ For many years, it was well-established that the debt-equity question was a question of fact to be decided by the trier of fact.⁷⁹ Perhaps the most often-repeated statement in the debt-equity decisions was the statement that the question is one of fact and that no one factor is controlling.⁸⁰ Because this statement was the basis for each court's analysis of the litigation at hand, another statement often accompanied it: that because each debt-equity case must be decided on its own unique fact situation,⁸¹ therefore, the criteria to be

77. Ruby, *supra* note 75, at 670.

78. *Id.* at 666.

79. See *A.R. Lantz Co. v. United States*, 424 F.2d 1330 (9th Cir. 1970); *Diamond Bros. Co. v. Commissioner*, 322 F.2d 725 (3d Cir. 1963); *Matthiessen v. Commissioner*, 194 F.2d 659 (2d Cir. 1952).

80. See note 79 *supra*; see, e.g., *Austin Village, Inc. v. United States*, 432 F.2d 741 (6th Cir. 1970).

81. See notes 79-80 *supra*; see, e.g., *Turner Tire Co. v. United States*, 344 F. Supp. 634 (M.D. La. 1972).

used varied with the case and no comprehensive set of criteria could be compiled.⁸²

Because the debt-equity question was universally considered to be one of fact, the courts found their powers of review limited. For a time the *Dobson v. Commissioner*⁸³ doctrine was followed to prevent review of Tax Court determinations of fact.⁸⁴ That doctrine led to such absurd results⁸⁵ that the Internal Revenue Code was amended to provide for review of Tax Court decisions ". . . in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury"⁸⁶

After the *Commissioner v. Duberstein*⁸⁷ decision, the courts of appeals began to use the "clearly erroneous" test of that case to limit their review to matters of law, not reversing factual determinations unless the trial courts determination as to debt-equity status was clearly wrong.⁸⁸ Using the *Duberstein* language as a talisman, the courts of appeals continued to apply varying factors and to give varying weights to the factors chosen as they addressed the question whether the trial court had been wrong in its factual determination.⁸⁹ It may be concluded by the objective observer that the chief concern of the courts of appeals was to avoid as much as possible the substantive considerations necessary to a meaningful review of the debt-equity question, instead filling the complex area with factors to fit every need. The question-of-fact language was raised to eliminate the need to consider the economic or policy issues behind the debt-equity confusion. The taxpayer was, indeed, left at the mercy of the trial judge's sense of smell.⁹⁰

To a great extent this is the situation that prevails today. Recently, however, the courts of appeals have begun to differ as to whether the debt-equity question is one of fact or one of law.⁹¹ The questions of fact in a given situation are ". . . those questions which may be decided without reference to any rule or standard prescribed by the state—that

82. See *Florida-Georgia Corp. v. United States*, 331 F. Supp. 36 (M.D. Ga. 1971); *Kingsmill Corp.*, 28 T.C. 330 (1957).

83. 320 U.S. 489 (1943).

84. *Stone*, *supra* note 37, at 254.

85. Compare *John B. Kelley Co. v. Commissioner*, 326 U.S. 521 (1946), with *Talbot Mills v. Commissioner*, 326 U.S. 521 (1946).

86. INT. REV. CODE of 1954, § 7482(a).

87. 363 U.S. 278 (1960).

88. See, e.g., *A.R. Lantz v. United States*, 424 F.2d 1330, 1334 (9th Cir. 1970).

89. See notes 79-82 *supra*.

90. See note 35 *supra*.

91. See *Ruby*, *supra* note 75, at 666; see, e.g., *Berkowitz v. United States*, 411 F.2d 818 (5th Cir. 1969).

is without reference to law."⁹² When facts are in issue, the jury or administrative body can, as the trier of fact, determine their existence without any reference to the consequences that the state may attach to the determination.⁹³ If a question is characterized as one of fact, the court can pretend that it must affirm if the finding of fact is supported by reasonable evidence.⁹⁴ But, if the question is one of law, the court of review cannot avoid its responsibility to determine ". . . whether it is or is not a case for the exercise of the judicial lawmaking power."⁹⁵ This dichotomy is easily stated, but the problem arises in the application of the principle.

The delusive simplicity of the distinction between questions of law and questions of fact has been found a will-of-the-wisp by travellers approaching it from several directions.⁹⁶

Verbal ingenuity easily produces the desired result,⁹⁷ as debt-equity cases attest.

Even in the absence of regulations, the Treasury has been required to provide some definition of debt and equity. Its definition has been to say that the question is one of fact so that the definition is worked anew for each case. But the underlying question of law has remained unanswered: what principle is to be applied to yield the correct result in each case?⁹⁸ "Certainly is of enormous practical desirability . . ."⁹⁹ because of the financial reliance placed on the content of tax rules. It is unreasonable to expect taxpayers to guess at the tax rule which will be applied to their particular case. There must be a consensus to guide courts and the tax administrative agency in their determinations as to the debt-equity question in the various factual situations which form the basis of tax cases. If one principle is not attainable, then at the least,

92. Brown, *Fact and Law in Judicial Review*, 56 HARV. L. REV. 889, 901 (1943).

93. *Id.*

94. Jaffe, *Judicial Review: Question of Law*, 69 HARV. L. REV. 239, 241 (1956).

95. *Id.* In the debt-equity area, this means that the crucial determination is left to the Tax Court and the district courts, largely. When one considers that there are many district courts and that the Tax Court members generally sit alone, it becomes clear that there can be many and varied answers to the debt-equity question. If the question were to be made one of law, the reviewing courts could look de novo at the debt-equity issue in order to impose consistent standards of decision on the lower courts.

96. Isacco, *The Law and the Facts*, 22 COLUM. L. REV. 1 (1922).

97. Paul, *Dobson v. Commissioner: The Strange Ways of Law and Fact*, 57 HARV. L. REV. 753, 812 (1944).

98. Note, *Toward New Modes of Tax Decisionmaking—The Debt-Equity-Imbroglia and Dislocations in the Lawmaking Responsibility*, 83 HARV. L. REV. 1695, 1698 (1970).

99. *Id.* at 1707-08.

the Treasury can provide by regulation an arbitrary set of rules to govern the debt-equity question,¹⁰⁰

. . . for there is nothing wrong in relying on an arbitrary tax rule which is arbitrary precisely because there is no general agreement as to the applicable principle. . . . The real task to draw the lines in such a way that widely shared economic and social goals may be achieved.¹⁰¹

Section 385, in its authorization to the Treasury to write regulations for the debt-equity area, has specifically delegated rulemaking power to the Treasury to provide "legislative" regulations which will be binding on the courts so long as they are within the granted power, issued pursuant to proper procedure, and reasonable.¹⁰²

Thus, section 385 is at once a congressional prod to the Treasury and a warning to the courts: the debt-equity question must be resolved, and it must be resolved through Treasury rulemaking, not adjudication.¹⁰³

If the Treasury will take up the congressional challenge, it can do much to settle the confusion in the debt-equity area. It should establish a tier system so that the safe harbor is held out to the taxpayer wishing to seek its shelter. The safe harbor approach will serve to free those taxpayers, corporate and individual, who want to forego the possible tax advantages of a debt stance in order to be assured of Internal Revenue Service approval of their corporate financial position. The safe harbor has, however, one flaw, which must be considered by the Treasury when it proposes regulations for new section 385. The tier approach will only protect and define those transactions which are clearly debt or equity in their nature. The transactions which compose the bulk of debt-equity cases today are those which would fall into the gray area of the safe harbor approach, and which would, therefore, require litigation even under the tier system. It seems clear, therefore, that the federal courts will still play an important part in the new safe harbor regulations. The Treasury, then, must prepare a comprehensive set of factors to be applied uniformly throughout the federal court system in the litigation of the gray area cases concerning debt-equity matters.

100. *Id.*

101. *Id.*

102. *Id.* at 1704-05.

103. *Id.*

There is a plethora of lists of factors for the Treasury to choose from in preparing its list. Until proposed regulations are circulated, any discussion of the factors to be used to determine the character of transactions in the debt-equity area must be tentative. There are, however, certain factors which seem particularly appropriate for inclusion in the list. Among these are: a fixed and reasonably early maturity date; an unconditional obligation to pay interest and principal; priority of the obligation to all classes of shareholders, even though the obligation may be subordinated to creditors; debtor-corporation earnings or cash-flow sufficient to repay the debt; and identity of the creditors. Creditor identity is important for several reasons. The new regulations should force a far more careful scrutiny of shareholder-creditors than of outsider-creditors because the outsider will normally have the intent, so often alluded to by courts, to act as a creditor and to enforce his creditor's rights even at the expense of the corporation's existence. Further, the shareholders-creditor should be expected to show that his advances are more than pro rata advances made by all the shareholders to bolster the capital of a failing close corporation. It may even be that any pro rata shareholder advance should be given equity status as a matter of course, in order to prevent the courts' having to evaluate intent in those situations where common business sense reveals an intent, albeit unexpressed and couched in formal debt terms, to infuse into a weak corporation the equity necessary to continued operation.¹⁰⁴

Finally, the Treasury should answer the question whether the debt-equity determination is a matter of law or of fact, so that all courts will apply the same quantum of judicial review in the debt-equity area. It should no longer be possible for the Internal Revenue Service to argue in one circuit court that the matter is a question of law, while arguing in another circuit court that the question is one of fact.¹⁰⁵ Nor should it be possible for the Service to change its position on appeal because its

104. Whether intent should be considered at all in making the debt-equity determination is questionable. The intent as expressed by the parties' outward manifestations will almost always be to create a debt relationship. That formal intent will be evidenced by the proper instrument, and whatever other qualifications the particular circuit, or the new regulations, require. The problem is that when the intent must be judged within the confines of a lawsuit, the parties to the suspect transaction, who are probably the close corporation and its shareholder, will already have acted contrary to the expressed formal intent. That contrary action will probably have caused the court action. In such circumstances, the usefulness of intent as a criterion for determining debt-equity recedes to the vanishing point.

105. Compare *Piedmont Minerals Co., Inc. v. United States*, 429 F.2d 560 (4th Cir. 1970), with *Tyler v. Tomlinson*, 414 F.2d 844 (5th Cir. 1969).

position at trial led to an adverse decision.¹⁰⁶ If the Service is precluded from such vacillation, then the taxpayer will at the least know that his attitude toward the matter can be consistent throughout the appellate procedure. It may be that the correct position to be taken by the new regulations is that the question is one of law, thereby allowing the jury to determine what the underlying factual status is and allowing the court to apply the appropriate law to the facts as found. In this way the jury will not have to weigh the factors and tiers to make the debt-equity determination. Rather, the determination will be made by the court which has more experience in weighing the factors and in handling the complex financial and corporate taxation aspects of such cases.

Tax planners should not expect the regulations for section 385 to solve all their problems. In such a convoluted and overworked area of law, it is inevitable that the regulations will fall into some of the traps previously encountered by courts and the Internal Revenue Service. What is essential is that the Treasury thoroughly discuss and weigh every aspect suggested by experience and business realities for inclusion in the new regulations. If it is impossible to make the debt-equity question a simple matter of mechanical tests to be met, it is surely possible to eliminate some of the inequity and confusion that now exists in the area. By adhering to this course, the Treasury will fulfill the intent of Congress and permit section 385 to be the far-reaching solution to the debt-equity chaos that it can be.

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106. See *Austin Village, Inc. v. United States*, 432 F.2d 741 (6th Cir. 1970).