Business Tax
Prof. Bogdanski
Spring 2026

Study Problems

Problem Set 1

Problem 1.1. Individuals A and B both are and will continue to be in the highest marginal individual tax bracket. They are forming a business that they expect will generate deductible losses of about $300,000 over the next three years and then will turn around and generate income of about $100,000 per year indefinitely. A and B each will "materially participate" in the operation of the business. What form(s) of business organization will produce the most favorable tax results for A and B?

Problem 1.2. Three individuals, R, S, and T, form a limited liability company. Each of the three are equal members of the LLC. How will the LLC be classified for federal income tax purposes, with and without available tax elections?

Problem 1.3. Unless otherwise indicated, Z Corporation ("Z") is a domestic corporation that has 115 shares of voting common stock outstanding. In each of the following alternative situations, determine whether Z is eligible to elect S corporation status:

(a) Z has 99 unrelated individual shareholders, each of whom owns one share of Z stock. The remaining 16 shares are owned by A and his brother, B, as joint tenants with right of survivorship.

(b) Same as (a), above, except that A and B are married to each other and own 10 of the 16 shares as community property. The remaining 6 shares are owned 3 by A as her separate property and 3 by B as his separate property.

(c) In (b) above, assume that the shareholders of Z elected S corporation status. What will be the effect on Z's election if one year later A dies and bequeaths her interest in Z stock to her unrelated butler, X?

(d) Same as (a), above, except that the remaining 16 shares are held by a nonprofit corporation that operates a private high school.

(e) Same as (a), above, except that the remaining 16 shares are held by an irrevocable inter vivos trust that has three related beneficiaries. The trustee is given the power to decide which of the beneficiaries receive the income from the trust. All of the beneficiaries are individuals, and the grantor of the trust retains no interest in it whatsoever. What if the beneficiaries were unrelated to each other and to any of the other shareholders?

(f) Same as (a), above, except that the remaining 16 shares are owned by a revocable trust created by an individual, the income of which is taxed to the grantor under I.R.C. § 671.

(g) Same as (a), above, except that the remaining 16 shares are owned by a testamentary trust under which the surviving spouse has the right to income for her life, with the remainder passing to her children. The trust is a "qualified terminable interest trust" (see IRC § 2056(b)(7)).

(h) One of Z's 115 outstanding shares is owned by a C corporation.

(i) Ninety of Z's 115 outstanding shares are owned by an S corporation.

(j) All of Z's 115 outstanding shares are owned by an S corporation.

(k) All of Z's 115 outstanding shares are owned by a partnership.

(l) Z has 100 shares of Class A voting common stock and 50 shares of Class B nonvoting common stock outstanding. Apart from the differences in voting rights, the two classes of common stock have equal rights with regard to dividends and liquidation distributions. Z also has an authorized but unissued class of nonvoting stock that would be limited and preferred as to dividends. The Class A common stock is owned by four individuals, and the Class B common stock is owned by E and F (a married couple) as tenants-in-common.

(m) All of Z's outstanding shares are held by an individual. Among other things, Z owns a .001% stock interest in Microsoft, a publicly traded corporation; 80% of the stock of a privately held corporation, Privco; and 100% of the stock of another corporation, Subco. Can Privco elect to be an S corporation? Can Subco?

Problem 1.4. X is a "small business corporation" that has been operating for several years as a C corporation. X uses the calendar year for its taxable year. When is its S election effective if it is duly filed –

(a) On March 2, 2026?

(b) On March 22, 2026?

Problem 1.5. Y, a "small business corporation," is formed, and begins its first taxable year, on September 1, 2025. Its taxable year is the calendar year. When is its S election effective if it is duly filed –

(a) On September 1, 2025?

(b) On November 10, 2025?

(c) On November 22, 2025?

(d) On March 2, 2026?

(e) On March 22, 2026?

Problem 1.6. How is a corporation's status as an S corporation terminated? When is a termination of S status effective? Can S status be retroactively reinstated after a termination?

Study Materials for Problem Set 1

IRC §§ 11, 199A, 701, 1361, 1362, 1363, 1366, 7701(a)(3), 7704.

Treas. Regs. §§ 1.1362-6, 301.7701-1, 301.7701-2, 301.7701-3.

Readings in Burke & Friel Casebook

Chapter 1.

Readings in Schwarz & Lathrope Black Letter Outlines

Corporate Tax

Problems 1.1 and 1.2: Chapter II.

Problems 1.3 to 1.6: Chapter XV, Parts A to C.

Partnership Tax (redundant with Corporate Tax for this problem set)

Problems 1.1 and 1.2: Chapter II.

Problems 1.3 to 1.6: Chapter XV, Parts A to C.

Problem Set 2

In each case, except as otherwise noted, assume that X is a business entity with three equal owners, R, S, and T. R, S, and T each contribute $10,000 cash to X to form the entity.

What are the tax consequences to X, R, S, and T of each of the following fact patterns? For R, S, and T, consider the effects on the basis of their ownership interests as well as the amount, character and timing of any income they have. In each case, address each of the following scenarios:

Scenario A. X is a C corporation.

Scenario B. X is an S corporation.

Scenario C. X is a partnership, or an LLC taxed as a partnership.

Problem 2.1. For the first year of its operation, X has a pre-tax operating profit (and taxable income) of $15,000. On the last day of the year, X pays R, S, and T a distribution on equity (that is, a dividend in Scenarios A and B, a partnership distribution in Scenario C) of $2,500 each. What if X's taxable income was all long-term capital gain?

Problem 2.2. Same as Problem 2.1, except that the distributions to R, S, and T are $5,000 each.

Problem 2.3. Same as Problem 2.1, except that the distributions to R, S, and T are $8,000 each.

Problem 2.4. Same as Problem 2.1, except that X makes no distributions on its equity; however, it distributes $5,000 of its pre-tax income to each of R, S, and T as compensation for personal services.

Problem 2.5. For the first year of its operation, X has a pre-tax operating loss of $15,000.

Problem 2.6. For its first year, X's gross income and deductions from operations happen to offset each other exactly. At the end of the year, X distributes Blackacre, a parcel of real estate, one-third each to R, S, and T as tenants in common. The distribution is on equity (that is, a distribution with respect to stock in Scenarios A and B, a partnership distribution in Scenario C). The fair market value of Blackacre at the time of the distribution is $15,000; assume that the value received by the three owners is $5,000 each. X's adjusted basis in Blackacre (which it purchased from a third party a few months earlier) immediately before the distribution is $12,000. (Consider what R, S, and T's basis in Blackacre is.)

Problem 2.7. X, a corporation, is a wholly owned subsidiary of a C corporation, P. P contributes $30,000 in cash to X to form X. P and X do not file a consolidated tax return together. For the first year of its operation, X has a pre-tax operating profit (and taxable income) of $15,000. On the last day of the year, X pays P a dividend of $7,500.

Study Materials for Problem Set 2

Scenario A (C corporations): I.R.C. §§ 11, 162(a)(1), 172, 243, 301, 311, 312, 316(a), 317(a).

Scenario B (S corporations): I.R.C. §§ 1363, 1366, 1367, 1368, 1371.

Scenario C (partnerships): I.R.C. §§ 701, 702, 704, 705, 707(a), 707(c), 731, 732, 733.

Readings in Burke & Friel Casebook

Pages 193–240, 303–310, 323–349.

Readings in Schwarz & Lathrope Black Letter Outlines

Corporate Tax

Chapter VI; Chapter XV, Parts D and E.

Partnership Tax

Chapter IV; Chapter VIII, Part A; Chapter XII, Parts A and B.

Problem Set 3

In each case, assume that X is a business entity with three equal owners, R, S, and T. R, S, and T each contribute $10,000 cash to X to form the entity.

What are the tax consequences to X, R, S, and T of each of the following fact patterns? For R, S, and T, consider the effects on the basis of their ownership interests as well as the amount, character and timing of any income they have. In each case, address *each* of the following scenarios:

Scenario A. X is a C corporation.

Scenario B. X is an S corporation.

Scenario C. X is a partnership, or an LLC taxed as a partnership. Under the partnership agreement or LLC operating agreement, all items of income, deduction, loss and credit are allocated equally among R, S, and T.

In this problem set, we will first discuss all of the problems together as applied to C corporations. We will then discuss all of the problems together in the context of S corporations; finally, we will discuss all of the problems together in the context of partnerships.

Problem 3.1. Shortly after it is formed, X borrows $54,000 from a bank. The loan is a recourse loan; no payments are due until the next year. For the first year of its operation, X has a pre-tax net operating loss of $39,000. X makes no distributions to R, S, or T. For purposes of Scenario C, assume that X is a general partnership.

Problem 3.2. Same as Problem 3.1, except that, in Scenario C, X is a limited partnership; R is the sole general partner; and S and T are the limited partners.

Problem 3.3. Same as Problem 3.1, except that, in Scenario C, X is an LLC.

Problem 3.4. Same as Problem 3.*2*, except that R, S, and T individually guarantee X's obligation to the lender. For purposes of Scenario C, assume that X is a limited partnership; R is the sole general partner; and S and T are the limited partners.

Problem 3.5. Same as Problem 3.1, except that, in addition to contributing $10,000 each in cash for their equity interests in X, the owners (R, S, and T) each lend $10,000 to X.

Problem 3.6. Same as Problem 3.1, except that for the first year of its operations, X has a pre-tax operating profit (before any deduction for interest it paid) of $24,000. X pays $900 of interest and $1200 of principal to the lender.

Study Materials for Problem Set 3

Scenario A (C corporations): I.R.C. §§ 11, 172.

Scenario B (S corporations): I.R.C. §§ 1363, 1366 (especially 1366(d)), 1367, 1371; *Harris v. United States* (below).

Scenario C (partnerships): I.R.C. §§ 702, 704 (especially 704(d)), 705, 752; Treas. Regs. §§ 1.752-1(a), 1.752-2(a), (b), 1.752-3.

Readings in Burke & Friel Casebook

Pages 226–232, 240–245, 602–606.

Readings in Schwarz & Lathrope Black Letter Outlines

Corporate Tax

Chapter III, Part A; Chapter XV, Part D.

Partnership Tax

Chapter IV(B); Chapter VII.

(902 F.2d 439)

**J.H. HARRIS, and William J. Martin, Plaintiffs-Appellants, v.
UNITED STATES of America, Defendant-Appellee.**

United States Court of Appeals, Fifth Circuit.
June 7, 1990.

Appeal from the United States District Court for the Eastern District of Louisiana.

Before JOHNSON, WILLIAMS and GARWOOD, Circuit Judges.

GARWOOD, Circuit Judge:

In this federal income tax refund suit, plaintiffs-appellants, J.H. Harris (Harris) and William J. Martin (Martin), collectively Taxpayers, appeal the district court's summary judgment in favor of defendant-appellee, the United States (Government). We affirm.

Facts and Proceedings Below

In June 1982, Taxpayers contracted with Trans–Lux New Orleans Corporation to purchase for $665,585 cash a New Orleans pornographic theater that they intended to convert into a wedding hall. The Taxpayers' obligations under the contract were conditioned on their being able to secure from a third party a loan for not less than $600,000 repayable in fifteen to twenty years.[1] Shortly before this time, Taxpayers had contacted John Smith (Smith), a real estate loan officer with Hibernia National Bank (Hibernia), to discuss the possibility of obtaining financing for the impending acquisition. Smith orally committed to lend Taxpayers $700,000.[2]

Subsequently, to shield themselves from the potential adverse publicity that could follow from the purchase of the pornographic theater, as well as to limit their personal liability and enhance their chances of qualifying for industrial revenue bonds to finance the theater's renovation, in July 1982 Taxpayers formed Harmar (Harmar), a Louisiana corporation, which elected to be taxed pursuant to Subchapter S of the Internal Revenue Code, to purchase and operate the subject property. Harris and Martin each initially contributed $1,000 to the corporation, receiving its stock in return, and each also loaned Harmar $47,500 to satisfy operating expenses. Harris and Martin were the sole shareholders of Harmar, each owning half of its stock.

The purchase of the theater closed on November 1, 1982, and the theater was conveyed to Harmar on that date. Hibernia furnished the $700,000 necessary to close the transaction.[3] In

[1] As part of the contract, Taxpayers deposited with the seller $32,500, all of which was to be applied to the purchase price. In the event Taxpayers were unable to procure the loan, the purchase contract called for their deposit to be refunded.

[2] Smith asserted in his deposition that he did not know the purpose of the borrowed funds in excess of the purchase price, but he surmised that the money was intended for improvements to the theater. No written loan commitment was ever issued.

[3] As noted, the purchase price was $665,585. Harris testified in his deposition that at closing there was also paid some $10,000 in miscellaneous closing costs and a $35,000 real estate commission, so "the entire $700,000 was accounted for at the closing." It is unclear whether the $32,500 escrow previously deposited by

borrowing the funds necessary to acquire the subject property, Harmar executed two promissory notes payable to Hibernia for $350,000 each, each dated November 1, 1982. One of these notes was secured by a $50,322.09 Hibernia certificate of deposit in Harris' name and another $304,972.49 certificate of deposit in the name of his wholly-owned corporation, Harris Mortgage Corporation. Harmar secured the other note, in accordance with its collateral pledge agreement, by its $3,000,000 note (which was unfunded apart from the $700,000) and its collateral mortgage on the theater, each executed by Harmar in favor of Hibernia and dated November 1, 1982. Under the terms of the collateral pledge agreement executed by Harmar in reference to the $3,000,000 note and mortgage, the mortgage secured "not only" Harmar's $350,000 note to Hibernia, "but also any and every other debts, liabilities and obligations" (other than consumer credit debt) of Harmar to Hibernia whether "due or to become due, or whether such debts, liabilities and obligations" of Harmar "are now existing or will arise in the future." Thus, the collateral mortgage secured the full $700,000 loan from Hibernia. Additionally, Taxpayers each executed personal continuing guarantees of Harmar indebtedness in the amount of $700,000 in favor of Hibernia. Smith testified in his deposition that the transaction was structured so that half the loan, as represented by one of the $350,000 notes, would be primarily secured by the certificates of deposit and the other half, represented by the other $350,000 note, primarily by the mortgage on the property purchased, with the entire amount also secured by Taxpayers' individual guarantees.

On its income tax return for the year ending December 31, 1982, Harmar reported a net operating loss of $104,013. Pursuant to section 1374 of the Internal Revenue Code of 1954,[4] Taxpayers each claimed half of the loss as a deduction on their 1982 individual returns,[5] concluding that their bases in Harmar were in fact greater than Harmar's net operating loss for that year and that they therefore were entitled to deduct the entire loss on their personal returns. On audit, the Internal Revenue Service (IRS) found to the contrary and determined that Harris and Martin each had a basis of $1,000 in his Harmar stock and an adjusted basis in Harmar's indebtedness to each of them as shareholders of $47,500. Pursuant to I.R.C. § 1374(c)(2), the IRS limited Taxpayers' deductions of the net operating loss to what it considered to be their bases in Harmar, $48,500 each. The IRS's disallowance of a portion of the deductions claimed by Taxpayers[6] resulted in additional tax liability, including interest, for Martin of $3,150.58 and for Harris of $1,280. Taxpayers paid the tax in dispute and now appeal the district court's summary judgment dismissing their suit for refund.

Discussion

Taxpayers contend on appeal that in determining the deduction allowable for Harmar's net operating loss, the IRS should have included in Taxpayers' bases in their Harmar stock the full value of the $700,000 Hibernia loan they guaranteed. I.R.C. § 1374 permits a Subchapter S shareholder to deduct from his personal return a proportionate share of his corporation's net operating loss to the extent

---

the Taxpayers with the seller was wholly or partially refunded to them or was credited to Harmar. Harmar's 1982 income tax return shows that as of December 31, 1982, it had land and buildings with an original cost of $674,367.

[4] Except as otherwise indicated, references herein to the Internal Revenue Code (I.R.C.) are to the Internal Revenue Code of 1954. * * * We also observe that the limitations provided in former § 1374(c)(2) by section 2 of the Subchapter S Revision Act of 1982 were subsequently reenacted in § 1366(d)(1). That section is currently in effect.

[5] Harris and Martin claimed deductions for Harmar's loss of $52,006 and $52,007, respectively.

[6] The IRS disallowed $4,506 of Harris' deduction and $4,507 of Martin's.

that the loss does not exceed the sum of the adjusted basis of his Subchapter S corporation stock and any corporate indebtedness to him. *See* section 1374(c)(2) (now section 1366(d)(1)). To arrive at their basis figure, Taxpayers seek to recast the transaction in question. They in essence urge that we disregard the form of the Hibernia loan—one from Hibernia to Harmar—in favor of what Taxpayers consider as the substance of the transaction—a $700,000 loan from Hibernia to them, the $700,000 proceeds of which they then equally contributed to Harmar's capital account. As evidence of their view of the substance of the transaction, Taxpayers point to the deposition testimony of Smith indicating that Hibernia looked primarily to Taxpayers, rather than to Harmar, for repayment of the loan, and they call attention to the $700,000 guarantees they each provided Hibernia as well as the $355,294.58 in certificates of deposit that Harris pledged to Hibernia as part of the November 1, 1982 loan transaction.

In its summary judgment memorandum, the district court declared that *Brown v. Commissioner,* 706 F.2d 755 (6th Cir.1983), was "on all fours" with the instant case and therefore resolved it. In *Brown,* the Sixth Circuit rejected shareholders' substance over form argument in ruling that the shareholders' guarantees of loans to their Subchapter S corporation could not increase their bases in their stock in the corporation unless the shareholders made an economic outlay by satisfying at least a portion of the guaranteed debt. *Id.* at 757. Without such an outlay, the *Brown* court concluded that " 'the substance matched the form' " of the transaction before it. *Id.* at 756. The reasoning of *Brown* was followed by the Fourth Circuit in *Estate of Leavitt v. Commissioner,* 875 F.2d 420 (4th Cir.1989), *aff'g,* 90 T.C. 206 (1988). There, the court, affirming the en banc Tax Court, held that shareholder guarantees of a loan to a Subchapter S corporation did not increase shareholders' stock basis because such guarantees had not "cost" shareholders anything and thus did not constitute an economic outlay. *Leavitt,* 875 F.2d at 422 & n. 9.[7] In reaching this conclusion, the Fourth Circuit affirmed as not clearly erroneous a finding of the Tax Court that the loan, in form as well as in substance, was made to the corporation rather than to the shareholders.[8] *Id.* at 424. The court rejected appellants' suggestion that it employ the debt/equity principles espoused in *Plantation Patterns, Inc. v. Commissioner,* 462 F.2d 712 (5th Cir.1972), in determining whether the shareholders had actually made an economic outlay,[9] instead choosing to employ a debt/equity analysis only after making a finding that an

[7] In reasoning that the shareholders had not increased their stock bases as a result of their guarantees, the court turned to I.R.C. § 1012, which defines basis of property as its cost. *Id.* at 422 n. 9. Cost of property, in turn, is defined in the Treasury Regulations as the "amount paid for such property in cash or other property." 26 C.F.R. § 1.1012–1(a).

[8] The court noted that the loan in question had been made by the bank directly to the corporation, the loan payments were made by the corporation directly to the bank, and neither the corporation nor the shareholders reported the payments as constructive dividends. *Id.*

Under *Leavitt,* the presumption is that the form will control and that presumption will not be surmounted absent the shareholder's satisfying the higher standard applicable to a taxpayer's seeking to disavow the form he selected and recast a transaction. *See* Bowers, *Building Up an S Shareholder's Basis through Loans and Acquisitions,* J. Tax'n S Corp., Fall 1989, at 22, 29.

[9] In *Plantation Patterns,* this Court considered whether a Subchapter C corporation could deduct interest payments made on its debt and whether its shareholders had resulting dividend income. The Court, using a debt/equity analysis, affirmed a Tax Court finding that a corporation's interest payments on debentures were constructive dividends and could not be deducted as interest payments. *Id.* at 723–24.

Subsequent decisions have elaborated on *Plantation Patterns* and identified thirteen factors used to establish whether shareholder advances to a corporation are debt or equity. They are:

"(1) the names given to the certificates evidencing the indebtedness;

economic outlay had occurred.[10] *Leavitt,* 875 F.2d at 427. The *Leavitt* court reasoned that the legislative history of section 1374 limiting the basis of a Subchapter S shareholder to his corporate investment or outlay could not be circumvented through the use of debt/equity principles.[11] *Id.* at 426 & n. 16. *See generally* Bogdanski, *Shareholder Guarantees, Interest Deductions, and S Corporation Stock Basis: The Problems with Putnam,* 13 J. Corp. Tax'n 264, 268–89 (1986).

Taxpayers press this Court to follow the contrary holding of *Selfe v. United States,* 778 F.2d 769 (11th Cir.1985). There, the Eleventh Circuit ruled that a shareholder's guaranty of a Subchapter S corporation loan could result in an increase in equity or debt basis even though the shareholder had not satisfied any portion of the obligation. *Selfe,* 778 F.2d at 775. The court remanded the case to the district court for it to employ debt/equity principles in determining if the loan in question was in substance one to the shareholder rather than to the corporation. *Id.*

The courts have uniformly ruled that a shareholder must make an economic outlay to increase his Subchapter S corporation stock basis. *See Leavitt,* 875 F.2d at 422; *Selfe,* 778 F.2d at 772; *Brown,* 706 F.2d at 756; *Underwood v. Commissioner,* 535 F.2d 309, 311–12 (5th Cir.1976). Taxpayers assert that if we look beyond the form of the transaction at what they contend is its substance—a loan from Hibernia to them, which in turn they contributed to Harmar as capital—we must find that a $700,000 outlay occurred and that their stock bases therefore correspondingly increased. They contend that use of debt/equity principles will lead us to such a conclusion.

"(2) the presence or absence of a fixed maturity date;

"(3) the source of payments;

"(4) the right to enforce payment of principal and interest;

"(5) participation in management flowing as a result;

"(6) the status of the contribution in relation to regular corporate creditors;

"(7) the intent of the parties;

"(8) 'thin' or adequate capitalization;

"(9) identity of interest between creditor and stockholder;

"(10) source of interest payments;

"(11) the ability of the corporation to obtain loans from outside lending institutions;

"(12) the extent to which the advance was used to acquire capital assets; and

"(13) the failure of the debtor to repay on the due date or to seek a postponement."

In re Lane, 742 F.2d 1311, 1314–15 (11th Cir.1984) (quoting *Estate of Mixon v. United States,* 464 F.2d 394, 402 (5th Cir.1972)).

[10] The Fourth Circuit embraced the Tax Court's interpretation of its earlier opinion in *Blum v. Commissioner,* 59 T.C. 436 (1972). In *Blum,* the court rejected the taxpayer's substance over form argument. The *Leavitt* Tax Court asserted that the *Blum* court never reached the debt/equity issue "because the taxpayer had failed his burden of proving that the bank in substance had loaned the funds to the taxpayer and not to the corporation." *Leavitt,* 90 T.C. at 215. Thus construed, *Blum* in no way undermines the Fourth Circuit's § 1374 analysis.

[11] *See* S. Rep. No. 1983, 85th Cong., 2d Sess. at 220, U.S. Code Cong. & Admin. News 1958, p. 4791, (1958–3 Cum. Bull. at 1141); *see also* Comment, *Subchapter S Loss Limitation: The Effect of Shareholder Loan Guarantees on Basis,* 40 Sw. L.J. 1241, 1263 (1987).

Ordinarily, taxpayers are bound by the form of the transaction they have chosen; taxpayers may not in hindsight recast the transaction as one that they might have made in order to obtain tax advantages. *Don E. Williams Co. v. Commissioner,* 429 U.S. 569, 97 S.Ct. 850, 856–57, 51 L.Ed.2d 48 (1977); *C.I.R. v. National Alfalfa Dehydrating & Milling Co.,* 417 U.S. 134, 94 S.Ct. 2129, 2137, 40 L.Ed.2d 717 (1974). The IRS, however, often may disregard form and recharacterize a transaction by looking to its substance. *Higgins v. Smith,* 308 U.S. 473, 60 S.Ct. 355, 357, 84 L.Ed. 406 (1940). The Tax Court has recognized an exception to the rule that a taxpayer may not question a transaction's form in cases such as this one in which the shareholder argues that guaranteed corporate debt should be recast as an equity investment on the shareholder's part. *Blum v. Commissioner,* 59 T.C. 436, 440 (1972).

In this case we find that the transaction as structured did not lack adequate substance or reality and that an economic outlay justifying the basis claimed by Taxpayers never occurred.

The summary judgment evidence reflects that the parties to this transaction intended that the Hibernia loan be one to the corporation. Each of the two $350,000 promissory notes was executed by and only in the name of Harmar. The notes have been renewed and remain in the same form, namely notes payable to Hibernia in which the sole maker is Harmar.[12] Hibernia, an independent party, in substance earmarked the loan proceeds for use in purchasing the subject property to which Harmar took title, Harmar contemporaneously giving Hibernia a mortgage to secure Harmar's debt to Hibernia. The bank sent interest due notices to Harmar, and all note payments were made by checks to Hibernia drawn on Harmar's corporate account.[13] Harmar's books and records for all years through the year ended December 31, 1985, prepared by its certified public accountant, reflect the $700,000 loan simply as an indebtedness of Harmar to Hibernia. They do not in any way account for or reflect any of the $700,000 as a capital contribution or loan by Taxpayers to Harmar, although they do reflect the $1,000 capital contribution each Taxpayer made and Harmar's indebtedness to Taxpayers for the various cash advances Taxpayers made to it. The Harmar financial statements for the year ended December 31, 1986, are the first to show any contributed capital attributable to the Hibernia loan. Further, Hibernia's records showed Harmar as the "borrower" in respect to the $700,000 loan and the renewals of it. Harmar's 1982 tax return, which covered August 15 through December 31, 1982, indicates that Harmar deducted $12,506 in interest expenses. Because only the Hibernia loan generated such expenses for that period, it is reasonably inferable that the deduction corresponded to that loan. The 1982 Harmar return showed no distribution to Taxpayers, as it should have if the $700,000 Hibernia loan on which Harmar paid interest was a loan to the Taxpayers. Further, the return shows the only capital contributed as $2,000 and the only loan from stockholders as $68,000, but shows other indebtedness of $675,000. In short, Harmar's 1982 income tax return is flatly inconsistent with Taxpayers'

[12] In his deposition, when discussing the documentation required to make the loan, Smith stated that items such as the corporate certificate of good standing, corporate charter, and articles of incorporation were prerequisites to closing the loan because Hibernia needed to know that it was "dealing with a valid entity." Harris' deposition demonstrates that he intended the loan to be one to Harmar. He acknowledged there that his legal and tax consultants had advised him that it was to his advantage to have a corporation borrow the funds from Hibernia. Martin stated that he was aware that in signing the promissory notes on November 1, 1982, he was executing them on behalf of Harmar.

[13] To the extent Harmar did not have funds available, Taxpayers would deposit personal funds into Harmar's account, but the checks were always drawn on Harmar's checking account. These and other amounts advanced by Taxpayers to Harmar were carried on its books as part of its interest-bearing indebtedness *to Taxpayers.*

present position. Moreover, there is no indication that Taxpayers treated the loan as a personal one on their individual returns by reporting Harmar's interest payments to Hibernia as constructive dividend income. In sum, the parties' treatment of the transaction, from the time it was entered into and for years thereafter, has been wholly consistent with its unambiguous documentation and inconsistent with the way in which Taxpayers now seek to recast it. Hibernia was clearly an independent third party, and the real and bona fide, separate existence of Harmar is not challenged. The parties did what they intended to do, and the transaction as structured did not lack adequate reality or substance.[14]

Moreover, if the transaction is to be "recast," it is by no means clear that it should be recast in the form sought by Taxpayers, namely as a cash loan to them from Hibernia followed by their payment of the cash to Harmar as a contribution to its capital, and Harmar's then using the cash to purchase the building. Such recasting does not account for Hibernia's mortgage on the building. In any event, if the transaction is to be recast, why should it not be recast as a loan by Hibernia to Taxpayers, with the Taxpayers using the funds to themselves purchase the building, giving Hibernia a mortgage on the building to secure their debt to it, and then transferring the building, subject to the mortgage, to Harmar as a contribution to capital? Presumably in that situation Taxpayers' bases in their Harmar stock would be reduced by the amount of the debt secured by the mortgage under I.R.C. § 358(d). *See Wiebusch v. Commissioner,* 59 T.C. 777, *aff'd* per curiam "on the basis of the opinion of the Tax Court," *Wiebusch v. Commissioner,* 487 F.2d 515 (8th Cir.1973).[15] While section 358(d) likely does not affect stockholder basis in the debt of the Subchapter S corporation to the stockholder, Taxpayers have not sought to recast the transaction as a loan by Hibernia to them followed by their loan of the proceeds to Harmar; indeed even after Harmar's books were rearranged starting with the year ending December 31, 1986, the books do not show any indebtedness in this respect of Harmar to Taxpayers and do continue to show Harmar as owing the money in question to Hibernia. There is simply no evidence of Harmar indebtedness to Taxpayers in respect to these funds.

---

[14] This is unlike the situation in *Underwood,* 535 F.2d at 312 & n. 2, where we allowed the IRS to disregard a note of the shareholders of the Subchapter S corporation to another of their wholly-owned corporations that was substituted for the Subchapter S corporation's note, because it was not shown that the shareholders there intended to or would ever "make a demand upon themselves ... for payment of their note." Here, Hibernia was clearly an independent third party (and it is those who structured the transaction, not the IRS, who seek to recast it).

We also observe that this case stands in contrast to those involving nominees or dummy corporations. In such instances, courts may look beyond the form of a transaction if it is clear that the corporation served no significant business activity and that the shareholders intended that the corporation serve only as a dummy for them. *See, e.g., Paymer v. Commissioner,* 150 F.2d 334, 337 (2d Cir.1945); B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 2.10 (1979). In this case, Taxpayers intended that Harmar conduct significant business activity, and they do not contend that Harmar's separate, corporate identity should be disregarded or that it was a mere sham.

We do not suggest that had the transaction been structured in a different manner it would have lacked adequate substance or reality, or that there was no way the transaction could have been structured to afford Taxpayers a further $700,000 basis in Harmar under section 1374(c)(2) (now section 1366(d)(1)).

[15] *See also* Megaard, *No Stock Basis for Shareholder Guarantee of S Corporation Debt,* 15 J. Corp. Tax'n 340 (1989). Megaard explains that "[u]nder Section 358(d), the assumption by a corporation of its shareholder's debt is treated as money received which reduces the shareholder's basis in the stock." *Id.* at 349. *Cf. id.* at 350 ("Having the corporation's assets encumbered by the shareholder's personal debt runs the risk of a basis reduction under Section 358 should the Service argue that the transaction was a purchase by the shareholder of the ... assets followed by a contribution of the assets to the corporation subject to the debt.").

Taxpayers' guarantees and Harris' pledge of certificates of deposit do not undermine the intent of the parties that Harmar be the borrower in this transaction. It certainly is not difficult to fathom that a careful lender to a new, small, closely held corporation such as Harmar would seek personal guarantees from all of its shareholders. *See* Bogdanski, *supra,* at 269. Moreover, the wholly unperformed guarantees do not satisfy the requirement that an economic outlay be made before a corresponding increase in basis can occur. *See generally Underwood,* 535 F.2d at 312. In the same light, Harris' pledge to Hibernia of some $355,000 in certificates of deposit of his (and Harris Mortgage Corporation) does not provide such an outlay.[16]

We conclude that the transaction must be treated as it purports to be and as the parties treated it—namely as a loan by Hibernia to Harmar, all payments on which through the relevant time have been made by Harmar to Hibernia. For any funds or other assets Taxpayers have actually provided to Harmar as loans or contributions, Taxpayers are, of course, entitled to basis additions as of the time such contributions or loans were furnished by them to Harmar, but they are not entitled to a 1982 basis addition for Hibernia's 1982 $700,000 loan to Harmar, notwithstanding that it was also secured by Taxpayers' execution of guarantees and Harris' pledge to Hibernia of his and Harris Mortgage Corporation's certificates of deposit in the total face amount of some $355,000.

Conclusion

There was no genuine dispute as to any material fact necessary to sustain the Government's summary judgment motion. The district court's judgment is correct and it is therefore

AFFIRMED.

[16] Taxpayers would have us, in effect, convert this pledge to Hibernia into a $700,000 cash contribution made to Harmar by Taxpayers equally. But that did not happen. Taxpayers do not contend that the certificates of deposit were contributed to Harmar's capital.

Problem Set 4

case, assume that X is a business entity being formed by three equal owners, R, S, and T. In the formation transaction, each owner receives his or her one-third ownership share—stock, partnership interests or LLC interests, as the case may be. Like stock, the partnership and LLC interests entitle each owner to a share of the capital of X as well as a share of its profits.

What are the tax consequences to X, R, S, and T of each of the following fact patterns? For R, S, and T, consider the basis of their ownership interests as well as the amount, character and timing of any income they have. In addition, consider the basis to X of any property it receives. In each case, address *each* of the following scenarios:

Scenario A. X is a C corporation.

Scenario B. X is an S corporation.

Scenario C. X is a partnership, or an LLC taxed as a partnership. Under the partnership agreement or LLC operating agreement, all items of income, deduction, loss and credit are allocated equally among R, S, and T.

Problem 4.1. R contributes $10,000 cash; S contributes Blackacre, with a basis to S of $3,500 and a fair market value of $10,000; T contributes $10,000 cash. S is not a real estate dealer.

Problem 4.2. Same as Problem 4.1, except that, about a year after the formation of X, X sells Blackacre to Y for $12,500. The sale was not planned or contemplated prior to the organization of X.

Problem 4.3. Same as Problem 4.1, except that T contributes $10,000 of future services.

Problem 4.4. Same as Problem 4.1, except that T contributes Whiteacre, with a basis to T of $8,000 and a fair market value of $25,000; Whiteacre is encumbered by a mortgage securing a recourse loan with an outstanding principal balance of $15,000. X assumes the mortgage. In Scenario C, assume that X is a general partnership.

Study Materials for Problem Set 4

Scenario A (C corporations): I.R.C. §§ 351, 357, 358, 362, 1032, 83.

Scenario B (S corporations): Same Code sections as Scenario A, plus I.R.C. §§ 1366, 1367.

Scenario C (partnerships): I.R.C. §§ 721, 722, 723, 752, 731, 704(c), 1061; Treas. Regs. §§ 1.752-2(a), (b); Rev. Proc. 93-27 (below).

Readings in Burke & Friel Casebook

Chapters 2–5.

Readings in Schwarz & Lathrope Black Letter Outlines

Corporate Tax

Chapter IV.

Partnership Tax

Chapter III.

Rev. Proc. 93-27
1993-2 C.B. 343

SECTION 1. PURPOSE

This revenue procedure provides guidance on the treatment of the receipt of a partnership profits interest for services provided to or for the benefit of the partnership.

SEC. 2. DEFINITIONS

The following definitions apply for purposes of this revenue procedure.

.1 A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest.

.2 A profits interest is a partnership interest other than a capital interest.

SEC. 3. BACKGROUND

Under section 1.721-1(b)(1) of the Income Tax Regulations, the receipt of a partnership capital interest for services provided to or for the benefit of the partnership is taxable as compensation. On the other hand, the issue of whether the receipt of a partnership profits interest for services is taxable has been the subject of litigation. Most recently, in Campbell v. Commissioner, 943 F.2d 815 (8th Cir. 1991), the Eighth Circuit in dictum suggested that the taxpayer's receipt of a partnership profits interest received for services was not taxable, but decided the case on valuation. Other courts have determined that in certain circumstances the receipt of a partnership profits interest for services is a taxable event under section 83 of the Internal Revenue Code. See, e.g., Campbell v. Commissioner, T.C.M. 1990-236,rev'd, 943 F.2d 815 (8th Cir. 1991); St. John v. United States, No. 82-1134 (C.D. Ill. Nov. 16, 1983). The courts have also found that typically the profits interest received has speculative or no determinable value at the time of receipt. See Campbell, 943 F.2d at 823; St. John. In Diamond v. Commissioner, 56 T.C. 530 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974), however, the court assumed that the interest received by the taxpayer was a partnership profits interest and found the value of the interest was readily determinable. In that case, the interest was sold soon after receipt.

SEC. 4. APPLICATION

.01 Other than as provided below, if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, the Internal Revenue Service will not treat the receipt of such an interest as a taxable event for the partner or the partnership.

.02 This revenue procedure does not apply:

(1) If the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;

(2) If within two years of receipt, the partner disposes of the profits interest; or

(3) If the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of section 7704(b) of the Internal Revenue Code.

* * * * *

Problem Set 5

X is a corporation. X's shareholders are three individuals, R, S, and T. Before the transactions described here, each shareholder owns 100 shares of X's common stock, which is the only class of stock outstanding. Each share has a basis of $1.000. X redeems some of its sharers, i.e., it buys shares back from one or more shareholders and continues to operate as a corporation thereafter. In the redemption, X pays $2,000 per share, in cash, to the shareholder(s) whose stock is being redeemed.

In the C corporation scenario, assume that X has enormous accumulated earnings and profits. In the S corporation scenario, assume that X has been an S corporation continuously from the first day of its existence.

Problem 5.1. R, S, and T are unrelated individuals. X redeems 10 shares from each shareholder.

Problem 5.2. R, S, and T are unrelated individuals. X redeems all of R's stock.

Problem 5.3. Same as Problem 5.2, except that R is S's spouse. T is unrelated to R and S.

Problem 5.4. Same as Problem 5.2, except that R is S's sister. T is unrelated to R and S.

Problem 5.5. R is S's grandfather. T is unrelated to R and S. X redeems 80 of R's shares and 40 of S's shares.

Problem 5.6. Same as Problem 5.1, but instead of receiving cash for the stock, each redeeming shareholder receives from X 50 shares of the stock of X's newly formed subsidiary, Y.

Problem 5.7. Same as Problem 5.1, except that X is a partnership in which the partners are R, S, and T.

Study Materials for Problem Set 5

I.R.C. §§ 302, 318.

Readings in Burke & Friel Casebook

Chapter 13.

Readings in Schwarz & Lathrope Black Letter Outline

Corporate Tax

Chapter VII.

Problem Set 6

In each case, assume that X is a business entity owned by three individuals: R, S, and T. Each owner has a one-third ownership share – stock, partnership interests, or LLC interests, as the case may be. Each owner has been active in the management of X. Like stock, the partnership and LLC interests entitle each owner to a share of the capital of X as well as a share of its profits.

X's books reveal the following assets:

	Adjusted Basis	***Fair Market Value***
Cash	$ 6,000	$ 6,000
Land (investment)	9,000	15,000
Inventory	21,000	30,000
Total	*$ 36,000*	*$ 51,000*

In addition, X has a strong customer following, which it has cultivated over the years through advertising and other activities that have generated immediate business expense deductions.

X has outstanding a bank debt of $21,000. It is the only liability of X.

P is a corporation that wishes to purchase X.

What are the tax consequences to X, R, S, T, *and P* of each of the following fact patterns? Consider the basis of each taxpayer's assets as well as the amount, character and timing of any income each taxpayer has. In each case, address *each* of the following scenarios:

Scenario A. X is a C corporation with substantial earnings and profits ("E&P"). Each shareholder's stock basis is $5,000.

Scenario B. X is an S corporation that has been an S corporation all its life; therefore, it has no E&P. Each shareholder's stock basis is $5,000.

Scenario C. X is a partnership, or an LLC taxed as a partnership. Under the partnership agreement or LLC operating agreement, all items of income, deduction, loss and credit are allocated equally among R, S, and T. The agreement's allocations have substantial economic effect. The $21,000 bank debt is properly allocated one-third to each partner under the regulations under I.R.C. § 752. Each partner's basis in his or her partnership interest or LLC interest is $12,000.

In this problem set, we will first discuss all of the problems together as applied to C corporations. We will then discuss all of the problems together in the context of S corporations; finally, we will discuss all of the problems together in the context of partnerships.

Problem 6.1. P buys R's, S's, and T's ownership interests for $15,000 each.

Problem 6.2. P buys all of X's assets from X for $45,000, plus the assumption of X's $21,000 liability to the bank. X liquidates and dissolves, distributing $15,000 in cash to each of R, S, and T.

Problem 6.3. X liquidates and dissolves, distributing its assets to R, S, and T as one-third tenants in common. R, S, and T assume the liability of X. R, S, and T immediately sell the former X assets to P for $45,000 cash, plus P's assumption of the X liability.

Problem 6.4. Same facts and questions as in Problems 5.1 and 5.2, except that T is a corporation, all of the stock of which is owned by another corporation, Z. T and Z do not file a consolidated tax return, and Z is not a qualified subchapter S subsidiary.

Problem 6.5. Same facts and questions as in Problems 5.1 and 5.2, except that the consideration received by R, S and T consists solely of P stock. Each shareholder receives P stock with a fair market value of $15,000.

Study Materials for Problem Set 6

Scenario A (C corporations): I.R.C. §§ 331, 334(a), 336, 1001, 1060, 197.

Scenario B (S corporations): Same Code sections as Scenario A, plus I.R.C. §§ 1366, 1367.

Scenario C (partnerships): I.R.C. §§ 708, 731, 732, 741, 751(a), 1001, 1060, 197.

Readings in Burke & Friel Casebook

Chapters 15, 18.

Readings in Schwarz & Lathrope Black Letter Outlines

Corporate Tax

Chapter IX.

Partnership Tax

Chapters X, XII.

Problem Set 7

At the end of year 1, X is a C corporation owned by three shareholders, R, S, and T. Each shareholder owns one third of the only class of stock of X. Each shareholder has a basis in his or her X stock of $95,000. X has accumulated earnings and profits of $150,000. It owns three assets: Blackacre, Whiteacre, and Lossacre. At the end of year 1, Blackacre has a fair market value of $120,000 and an adjusted basis of $30,000; Whiteacre has a fair market value of $90,000 and an adjusted basis of $75,000; and Lossacre has a fair market value of $5,000 and an adjusted basis of $35,000.

X makes an S election effective January 1 of year 2. January 1 is the first day of X's taxable year.

Problem 7.1. In year 2, X has taxable income of $30,000 from operations. Immediately before the end of year 2, X distributes $13,000 cash to each shareholder.

Problem 7.2. In year 3, X sells Blackacre for $90,000 cash. X's other activities for the year are profitable.

Problem 7.3. In year 3, X sells Blackacre for $150,000 cash. X's other activities for the year are profitable.

Problem 7.4. X retains Blackacre, but in year 7, X sells Whiteacre for $120,000 cash. X's other activities for the year are also profitable.

Problem 7.5. In year 2, half of X's gross receipts are from rents and royalties.

Study Materials for Problem Set 7

I.R.C. §§ 1362(d)(3), 1368(c), 1374−1375.

Readings in Burke & Friel Casebook

Pages 591–601.

Readings in Schwarz & Lathrope Black Letter Outlines

Corporate Tax

Chapter XV, Parts C(2) and F.

Partnership Tax (redundant with Corporate Tax for this problem set)

Chapter XV, Parts C(2) and F.

Problem Set 8

R and S form a general partnership, X, to conduct an active business. Each of the partners contributes $10,000 cash to start X. X also borrows a considerable amount of money from a bank on a recourse basis. The economic deal between R and S is that for the first three years of X's operation, income and gain items will be split equally, but expenses will not be: All the depreciation attributable to buildings will be allocated to R. All other expenses will be allocated 40 percent to R and 60 percent to S. After the first three years, all items of income, gain, loss, and expense will be shared equally.

In the first year of its operations, X has gross income of $80,000, depreciation deductions attributable to buildings of $50,000, and other deductible business expenses of $40,000. Under R and S's agreement, the partners expect that for tax purposes, the gross income will pass through $40,000 each to R and S; the $50,000 depreciation deduction will be allocated all to R; and the $40,000 of other deductions will be allocated $16,000 to R and $24,000 to S.

Problem 8.1. Can X elect to be an S corporation? To be a C corporation?

Problem 8.2. Assuming that X is classified as a partnership for tax purposes, will the gross income and deductions be allocated between R and S for tax purposes the way they expect? What effect will the partnership agreement of X have on this question? What should that agreement say to help ensure these tax results? Does it matter what X's nontax financial statements say?

Study Materials for Problem Set 8

I.R.C. §§ 704(a)–704(b), 1361(b).

Treas. Reg. § 1.704-1(b).

Readings in Burke & Friel Casebook

Chapter 8.

Readings in Schwarz & Lathrope Black Letter Outlines

Partnership Tax

Chapter V.

Problem Set 9

R, S, and T are equal shareholders of X, a C corporation with substantial earnings and profits. Each shareholder has a basis in their X stock of $50,000. R, S, and T each lend $100,000 in cash to X for 20 years. In the first year in which the loans are outstanding, in accordance with the terms of the loan agreements, X pays $2,000 of principal and $5,000 of interest to each of R, S, and T. What are the tax consequences of these payments under the following scenarios?

Problem 9.1. The terms of each loan provide that the interest due in any given year varies based on the lowest rate of interest set by Banco, a regional commercial bank.

Problem 9.2. The terms of each loan require payments of principal and interest in any given year that fluctuate depending on whether X has positive cash flow for that year.

Problem 9.3. The required payments of principal and interest are fixed. The debts to R, S, and T are subordinated to X's unsecured bank loan, with an outstanding balance of $30,000.

Problem 9.4. The required payments of principal and interest are fixed. At the time R, S, and T make the loans to X, X owes $6,000,000 to a bank and has a tort judgment against it for $1,000,000, the amount of which X is appealing.

Problem 9.5. Do the terms of the loans from R, S, and T affect X's eligibility to be an S corporation?

Study Materials for Problem Set 9

I.R.C. §§ 385, 1361(c)(5); *Fin Hay Realty Co. v. United States* (on next page).

Readings in Burke & Friel Casebook

None.

Readings in Schwarz & Lathrope Black Letter Outlines

Corporate Tax

Chapter V, Parts A and B.

(398 F.2d 694)

FIN HAY REALTY CO., Appellant, v. UNITED STATES of America.

United States Court of Appeals Third Circuit.
June 20, 1968.

FREEDMAN, Circuit Judge.

We are presented in this case with the recurrent problem whether funds paid to a close corporation by its shareholders were additional contributions to capital or loans on which the corporation's payment of interest was deductible under § 163 of the Internal Revenue Code of 1954.[1]

The problem necessarily calls for an evaluation of the facts, which we therefore detail.

Fin Hay Realty Co., the taxpayer, was organized on February 14, 1934,[2] by Frank L. Finlaw and J. Louis Hay. Each of them contributed $10,000 for which he received one-half of the corporation's stock and at the same time each advanced an additional $15,000 for which the corporation issued to him its unsecured promissory note payable on demand and bearing interest at the rate of six per cent per annum. The corporation immediately purchased an apartment house in Newark, New Jersey, for $39,000 in cash. About a month later the two shareholders each advanced an additional $35,000 to the corporation in return for six per cent demand promissory notes and next day the corporation purchased two apartment buildings in East Orange, New Jersey, for which it paid $75,000 in cash and gave the seller a six per cent, five year purchase money mortgage for the balance of $100,000.

Three years later, in October, 1937, the corporation created a new mortgage on all three properties and from the proceeds paid off the old mortgage on the East Orange property, which had been partially amortized. The new mortgage was for a five year term in the amount of $82,000 with interest at four and one-half per cent. In the following three years each of the shareholders advanced an additional $3,000 to the corporation, bringing the total advanced by each shareholder to $53,000, in addition to their acknowledged stock subscriptions of $10,000 each.

Finlaw died in 1941 and his stock and notes passed to his two daughters in equal shares. A year later the mortgage, which was about to fall due, was extended for a further period of five years with interest at four per cent. From the record it appears that it was subsequently extended until 1951.[3] In 1949 Hay died and in 1951 his executor requested the retirement of his stock and the payment of his notes. The corporation thereupon refinanced its real estate for $125,000 and sold one of the buildings. With the net proceeds it paid Hay's estate $24,000 in redemption of his stock and $53,000 in retirement of his notes.[4] Finlaw's daughters then became and still remain the sole

[1] Section 163(a) provides: "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

[2] The formal date of incorporation was March 1, 1934.

[3] The corporation's tax returns show a continuing decline in the principal of the debt until that year.

[4] The record is fragmentary and provides no clear basis from which to reconstruct the events of 1951. It may perhaps be inferred from it that Hay's estate received the total of $77,000 solely for the redemption of his stock and that the notes of $53,000 were retired either from the proceeds of the sale of real estate or in some other manner during the same year. In such event the total paid in redemption of Hay's stock and the retirement of his notes would be $130,000 rather than $77,000.

shareholders of the corporation.[5]

Thereafter the corporation continued to pay and deduct interest on Finlaw's notes, now held by his two daughters. In 1962 the Internal Revenue Service for the first time declared the payments on the notes not allowable as interest deductions and disallowed them for the tax years 1959 and 1960. The corporation thereupon repaid a total of $6,000 on account of the outstanding notes and in the following year after refinancing the mortgage on its real estate repaid the balance of $47,000. A short time later the Internal Revenue Service disallowed the interest deductions for the years 1961 and 1962. When the corporation failed to obtain refunds it brought this refund action in the district court. After a nonjury trial the court denied the claims and entered judgment for the United States. 261 F.Supp. 823 (D.N.J.1967). From this judgment the corporation appeals.

This case arose in a factual setting where it is the corporation which is the party concerned that its obligations be deemed to represent a debt and not a stock interest. In the long run in cases of this kind it is also important to the shareholder that his advance be deemed a loan rather than a capital contribution, for in such a case his receipt of repayment may be treated as the retirement of a loan rather than a taxable dividend.[6] There are other instances in which it is in the shareholder's interest that his advance to the corporation be considered a debt rather than an increase in his equity. A loss resulting from the worthlessness of stock is a capital loss under § 165(g), whereas a bad debt may be treated as an ordinary loss if it qualifies as a business bad debt under § 166. Similarly, it is only if a taxpayer receives debt obligations of a controlled corporation[7] that he can avoid the provision for nonrecognition of gains or losses on transfers of property to such a corporation under § 351.[8] These advantages in having the funds entrusted to a corporation treated as corporate obligations instead of contributions to capital have required the courts to look beyond the literal terms in which the parties have cast the transaction in order to determine its substantive nature.

In attempting to deal with this problem courts and commentators have isolated a number of criteria by which to judge the true nature of an investment which is in form a debt: (1) the intent of the parties; (2) the identity between creditors and shareholders; (3) the extent of participation in management by the holder of the instrument; (4) the ability of the corporation to obtain funds from outside sources; (5) the 'thinness' of the capital structure in relation to debt; (6) the risk involved; (7) the formal indicia of the arrangement; (8) the relative position of the obligees as to other creditors regarding the payment of interest and principal; (9) the voting power of the holder of the instrument; (10) the provision of a fixed rate of interest; (11) a contingency on the obligation to repay; (12) the source of the interest payments; (13) the presence or absence of a fixed maturity date; (14) a provision for redemption by the corporation; (15) a provision for redemption at the option of the holder; and (16) the timing of the advance with reference to the organization of the corporation.[9]

---

[5] The husband of one of the daughters, who is a director of the corporation, holds a single qualifying share and his wife holds one share less than her sister.

[6] The partial retirement of an equity interest may be considered as essentially equivalent to a dividend under § 302, while the repayment of even a debt whose principal has appreciated is taxed only as a capital gain under § 1232.

[7] While not all debt obligations qualify for the desired tax treatment, equity interests can never qualify.

[8] A taxpayer might wish to avoid § 351 when he transfers depreciated property to the corporation and seeks to recognize the loss immediately and also when the transferred property is to be resold by the corporation but will not qualify for capital gains treatment in the hands of the corporation.

[9] See J. S. Biritz Construction Co. v. Commissioner of Internal Revenue, 387 F.2d 451 (8 Cir. 1967); Tomlinson v. 1661 Corporation, 377 F.2d 291 (5 Cir. 1967); Smith v. Commissioner of Internal Revenue, 370

While the Internal Revenue Code of 1954 was under consideration, and after its adoption, Congress sought to identify the criteria which would determine whether an investment represents a debt or equity, but these and similar efforts have not found acceptance.[10] It still remains true that neither any single criterion nor any series of criteria can provide a conclusive answer in the kaleidoscopic circumstances which individual cases present. See John Kelley Co. v. Commissioner of Internal Revenue, 326 U.S. 521, 530, 66 S.Ct. 299, 90 L.Ed. 278 (1946).

The various factors which have been identified in the cases are only aids in answering the ultimate question 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.[11] Since there is often an element of risk in a loan, just as there is an element of risk in an equity interest, the conflicting elements do not end at a clear line in all cases.

In a corporation which has numerous shareholders with varying interests, the arm's-length relationship between the corporation and a shareholder who supplies funds to it inevitably results in a transaction whose form mirrors its substance. Where the corporation is closely held, however, and the same persons occupy both sides of the bargaining table, form does not necessarily correspond to the intrinsic economic nature of the transaction, for the parties may mold it at their will with no countervailing pull. This is particularly so where a shareholder can have the funds he advances to a corporation treated as corporate obligations instead of contributions to capital without affecting his proportionate equity interest. Labels, which are perhaps the best expression of the subjective intention of parties to a transaction, thus lose their meaningfulness.

To seek economic reality in objective terms of course disregards the personal interest which a shareholder may have in the welfare of the corporation in which he is a dominant force. But an objective standard is one imposed by the very fact of his dominant position and is much fairer than one which would presumptively construe all such transactions against the shareholder's interest. Under an objective test of economic reality it is useful to compare the form which a similar transaction would have taken had it been between the corporation and an outside lender, and if the shareholder's advance is far more speculative than what an outsider would make, it is obviously a loan in name only.

In the present case all the formal indicia of an obligation were meticulously made to appear. The corporation, however, was the complete creature of the two shareholders who had the power to

---

F.2d 178 (6 Cir. 1966); Gilbert v. Commissioner of Internal Revenue, 262 F.2d 512 (2 Cir. 1959); 4A Mertens, Law of Federal Income Taxation, §§ 26.10a, 26.10c (1966).

[10] The original House version of the 1954 Code, H.R. 8300, 83d Cong., 2d Sess., contained a provision, § 312, which distinguished between "securities", "participating stock", and "nonparticipating stock". Only payments with regard to "securities" were deductible by the corporation as interest. See proposed § 275. "Securities" were defined as unconditional obligations to pay a sum certain with an unconditional interest requirement not dependent on corporate earnings. The Senate rejected the proposed classification on the ground that it was inflexible. See S. Rep. No. 1622, 83d Cong., 2d Sess., 1954 U.S.C.Cong. & Admin.News, pp. 4621, 4673.

A similar list of determinants was proposed in 1957 by an advisory group to a subcommittee of the House Committee on Ways and Means, but was not acted upon.

In 1954 the American Law Institute embodied such a test in § x500 of its draft income tax statute. See ALI Federal Tax Project, Income Tax Problems of Corporations and Shareholders 396 (1958).

[11] See Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, § 4.04, at 127 (2d ed. 1966); Stone, Debt-Equity Distinctions in the Tax Treatment of the Corporation and Its Shareholders, 42 Tulane L.Rev. 251, 253-62 (1968).

create whatever appearance would be of tax benefit to them despite the economic reality of the transaction. Each shareholder owned an equal proportion of stock and was making an equal additional contribution, so that whether Finlaw and Hay designated any part of their additional contributions as debt or as stock would not dilute their proportionate equity interests. There was no restriction because of the possible excessive debt structure, for the corporation had been created to acquire real estate and had no outside creditors except mortgagees who, of course, would have no concern for general creditors because they had priority in the security of the real estate. The position of the mortgagees also rendered of no significance the possible subordination of the notes to other debts of the corporation, a matter which in some cases this Court has deemed significant.[12]

The shareholders here, moreover, lacked one of the principal advantages of creditors. Although the corporation issued demand notes for the advances, nevertheless, as the court below found, it could not have repaid them for a number of years. The economic reality was that the corporation used the proceeds of the notes to purchase its original assets,[13] and the advances represented a long term commitment dependent on the future value of the real estate and the ability of the corporation to sell or refinance it. Only because such an entwining of interest existed between the two shareholders and the corporation, so different from the arm's-length relationship between a corporation and an outside creditor, were they willing to invest in the notes and allow them to go unpaid for so many years while the corporation continued to enjoy the advantages of uninterrupted ownership of its real estate.

It is true that real estate values rose steadily with a consequent improvement in the mortgage market, so that looking back the investment now appears to have been a good one. As events unfolded, the corporation reached a point at which it could have repaid the notes through refinancing, but this does not obliterate the uncontradicted testimony that in 1934 it was impossible to obtain any outside mortgage financing for real estate of this kind except through the device of a purchase money mortgage taken back by the seller.

It is argued that the rate of interest at six per cent per annum was far more than the shareholders could have obtained from other investments. This argument, however, is self-defeating, for it implies that the shareholders would damage their own corporation by an overcharge for interest. There was, moreover, enough objective evidence to neutralize this contention. The outside mortgage obtained at the time the corporation purchased the East Orange property bore interest at the rate of six per cent even though the mortgagee was protected by an equity in excess of forty per cent of the value of the property.[14] In any event, to compare the six per cent interest rate of the notes with other 1934 rates ignores the most salient feature of the notes—their risk. It is difficult to escape the inference that a prudent outside businessman would not have risked his capital in six per cent unsecured demand notes in Fin Hay Realty Co. in 1934. The evidence therefore amply justifies the conclusion of the district court that the form which the parties gave to their transaction did not match its economic reality.

It is argued that even if the advances may be deemed to have been contributions to capital when they were originally made in 1934, a decisive change occurred when the original shareholder, Finlaw, died and his heirs continued to hold the notes without demanding payment. This, it is said could be construed as a decision to reinvest, and if by 1941 the notes were sufficiently secure to be

---

[12] See P. M. Finance Corp. v. Commissioner of Internal Revenue, 302 F.2d 786 (3 Cir. 1962); General Alloy Casting Co. v. Commissioner of Internal Revenue, 345 F.2d 794 (3 Cir. 1965), aff'g per curiam 23 CCH T.C.Mem. 887 (1964).

[13] See United States v. Henderson, 375 F.2d 36, 40 (5 Cir. 1967).

[14] The corporation purchased the property for $175,000 and the sellers took back a purchase money mortgage of $100,000.

considered bona fide debt, they should now be so treated for tax purposes. Such a conclusion, however, does not inevitably follow. Indeed, the weight of the circumstances leads to the opposite conclusion.

First, there is nothing in the record to indicate that the corporation could have readily raised the cash with which to pay off Finlaw's notes on his death in 1941. When Hay, the other shareholder, died in 1949 and his executor two years later requested the retirement of his interest, the corporation in order to carry this out sold one of its properties and refinanced the others. Again, when in 1963 the corporation paid off the notes held by Finlaw's daughters after the Internal Revenue Service had disallowed the interest deductions for 1961 and 1962 it again refinanced its real estate. There is nothing in the record which would sustain a finding that the corporation could have readily undertaken a similar financing in 1941, when Finlaw died even if we assume that the corporation was able to undertake the appropriate refinancing ten years later to liquidate Hay's interest. Moreover, there was no objective evidence to indicate that in 1941 Finlaw's daughters viewed the notes as changed in character or in security, or indeed that they viewed the stock and notes as separate and distinct investments. To indulge in a theoretical conversion of equity contributions into a debt obligation in 1941 when Finlaw died would be to ignore what such a conversion might have entailed. For Finlaw's estate might then have been chargeable with the receipt of dividends at the time the equity was redeemed and converted into a debt. To recognize retrospectively such a change in the character of the obligation would be to assume a conclusion with consequences unfavorable to the parties, which they themselves never acknowledged.

The burden was on the taxpayer to prove that the determination by the Internal Revenue Service that the advances represented capital contributions was incorrect.[15] The district court was justified in holding that the taxpayer had not met this burden.

The judgment of the district court will be affirmed.

[continued on next page]

[15] See P. M. Finance Corp. v. Commissioner of Internal Revenue, 302 F.2d 786, 789 (3 Cir. 1962).

VAN DUSEN, Circuit Judge (dissenting).

I respectfully dissent on the ground that the "entire evidence," in light of appellate court decisions discussing the often-presented problem of corporate debt versus equity, does not permit the conclusion reached by the District Court.[1]

When the parties holding debt of the taxpayer corporation have a formal debt obligation and it is clear that all parties intended the investment to take the form of debt, a series of considerations such as those mentioned by the District Court should be used to determine whether the form and intent should be disregarded for federal tax purposes. Tomlinson v. 1661 Corporation, 377 F.2d 291 (5th Cir. 1967);[2] J. S. Biritz Construction Co. v. C.I.R., 387 F.2d 451, 455-456 (8th Cir. 1967). As I read the District Court's opinion, the focus was entirely on inferring "the intent of the taxpayer's only two stockholders" at the time the debt was created. To that end, the District Court drew certain inferences which are largely immaterial to the proper decision, and which are clearly erroneous in light of the stipulated facts and uncontroverted evidence.[3]

---

[1] As to the determination of the trial court that payments were not "interest paid * * * on indebtedness" (26 U.S.C. § 163), this court has stated:

> "* * * it is well-settled that such findings are 'in the nature of an ultimate finding of fact and since such finding is but a legal inference from other facts it is subject to review free of the restraining impact of the so-called "clearly erroneous" rule applicable to ordinary findings of fact by the trial court. * * *'"

Kaltreider v. Commissioner of Internal Revenue, 255 F.2d 833, 837 (3rd Cir. 1958). Although listed under legal conclusions by the District Court, this determination is similar to the 'findings' referred to in *Kaltreider*. See, also, Soles v. Franzblau, 352 F.2d 47, 50 (3rd Cir. 1965). Moreover, regardless of the characterization of the District Court's findings, I am 'left with the definite and firm conviction that a mistake has been committed' by the trial court on the record in this case. Diamond Bros. Company v. C.I.R., 322 F.2d 725, 731, n. 9 (3rd Cir. 1963), quoting from United States v. United States Gypsum Co., 333 U.S. 364, 395, 68 S.Ct. 525, 92 L.Ed. 746 (1948).

[2] The panel which decided *Tomlinson* included Senior Circuit Judge Maris of this court. The corporate taxpayer seeking to deduct interest payments was engaged in the construction, owning and operation of a certain office building, an economic activity quite similar to that of the corporate taxpayer in this case except that construction of real estate arguably increases the "risk" involved in the enterprise. *Tomlinson* relied heavily on United States v. Snyder Brothers Company, 367 F.2d 980 (5th Cir. 1966), in which the Fifth Circuit adopted with approval the conceptual analysis of Kraft Foods Company v. Commissioner of Internal Revenue, 232 F.2d 118, 123 (2nd Cir. 1956). This carefully reasoned Second Circuit decision suggested that the relevant inquiry for courts seeking to define "indebtedness" under 26 U.S.C. § 163 should turn initially on whether the alleged debt is a "hybrid," partaking of certain characteristics of traditional corporate equity as well as characteristics of debt, or whether the alleged debt is in form entirely debt and intended to be such. See, also, Gloucester Ice & Cold Storage Co. v. C.I.R., 298 F.2d 183, 185 (1st Cir. 1962). It is noteworthy that the Third Circuit case relied on heavily by the District Court, Mullin Building Corporation v. C.I.R., 9 T.C. 350 (1947), aff'd 167 F.2d 1001 (3rd Cir. 1948), is a case of a "hybrid" investment which, although the corporate taxpayer was formed solely to hold real estate, was named "debenture preferred stock" and demanded corporate liquidation before the 'debenture preferred stock' principal could be returned. Similarly, Messenger Publishing Co. v. C.I.R., P.H.Memo, T.C., P41.241, aff'd 168 F.2d 903 (3rd Cir. 1948), involved a hybrid named "preferred stock."

[3] To the extent that the District Court proceeded under a misconception as to the relevant legal test, this court is not bound by the "clearly erroneous" rule of F.R.Civ.P. 52. See C.I.R. v. Danielson, 378 F.2d 771, 774 (3rd Cir. 1967). See, also, United States v. United Steelworkers of America, 271 F.2d 676, 685 (3rd Cir.), aff'd 361 U.S. 39, 80 S.Ct. 1, 4 L.Ed.2d 12 (1959); and Kraft Foods Company v. Commissioner of Internal Revenue, supra, 232 F.2d at 122: "* * * where, as here, the evidence consisted of stipulated facts, this Court is

Whether or not the corporate taxpayer is entitled to an interest deduction turns in this case on the "real nature of the transaction in question" or on whether "the degree of risk may be said to be reasonably equivalent to that which equity capital would bear had an investor, under similar circumstances, made the advances * * *." Diamond Bros. Company v. C.I.R., 322 F.2d 725, 732 (3rd Cir. 1963); Tomlinson v. 1661 Corporation, supra, at 295.[4] When this test is used, the entire history of the corporate taxpayer becomes relevant[5] and a focus solely on the year of incorporation or investment of the debt is not sufficient.

Turning within this framework to the facts, the record does not justify the conclusion that the form of the debt should be disregarded for purposes of federal taxation. The debt was evidenced by written notes,[6] carried 6% Interest which was paid every year,[7] and was not subordinated in any way to similar debt of general creditors.[8] It was carried on the corporate books and tax returns as debt,[9] being payable on demand, it was always listed as a debt maturing in less than one year,[10] and on Mr. Finlaw's estate tax return was listed as promissory notes payable on demand.[11] The parties clearly

---

entitled to draw its own inferences of ultimate fact from the record."

[4] Charter Wire, Inc. v. United States, 309 F.2d 878, 880 (7th Cir. 1962), cited by the District Court as a source of the relevant criteria, also suggests that the test is whether "the totality of facts indicates a risk-capital investment." The corporate taxpayer in the *Charter Wire* case, however, was involved in manufacturing, not real estate; the debt, 100 times the size of equity, was subordinated to other unsecured debt of general creditors; and a new shareholder was forced to buy debt in proportion to his new stock at a time when no additional financing was needed.

[5] See, e.g., Wilbur Security Company v. C.I.R., 279 F.2d 657, 662 (9th Cir. 1960).

[6] See, e.g., Diamond Bros. Company v. C.I.R., supra, where the only evidence of debts was book entries; Wilbur Security Company v. C.I.R., supra, where the first written evidence of debt was 28 years after investment; Montclair v. C.I.R., 318 F.2d 38 (5th Cir. 1963).

[7] See, e.g., Tomlinson v. 1661 Corporation, supra, where the debt was upheld even with a provision for accruing and accumulating interest when not paid; Montclair v. C.I.R., supra, where no fixed interest was given and the debt was disallowed; United States v. Henderson, 375 F.2d 36 (5th Cir. 1967), no interest paid; Diamond Bros. Company v. C.I.R., supra, no interest paid.

[8] See, e.g., P. M. Finance Corporation v. C.I.R., 302 F.2d 786 (3rd Cir. 1962), agreement prevented any payment on loans until bank loans paid off in full—loans could not be paid off while corporation continued in bar and cocktail lounge financing business; Gooding Amusement Co. v. C.I.R., 236 F.2d 159 (6th Cir. 1966), subordination to general creditors; United States v. Snyder Brothers Company, supra; McSorley's Inc. v. United States, 323 F.2d 900 (9th Cir. 1963); subordinated by agreement to all debt, existing or not, secured or not; Charter Wire, Inc. v. United States, supra, subordinate to later bank loan.

[9] See, e.g., "hybrid" cases such as John Wanamaker Philadelphia v. Com'r of Int. Revenue, 139 F.2d 644 (3rd Cir. 1943; Mullin Building Corporation v. C.I.R., supra; Pierce Estates v. Commissioner of Internal Revenue, 195 F.2d 475 (3rd Cir. 1952), where the instruments had names that indicated equity attributes and were carried as capital entries.

[10] Apparently the District Court regarded demand notes as having no fixed maturity, see Conclusion of Law 4. This seems incorrect since demand paper means that the debt is "mature" at the holder's option. The better characterization would seem to be that demand notes held by someone with a voice in management are a type of long-term investment. See, e.g., Taft v. C.I.R., 314 F.2d 620 (9th Cir. 1963).

[11] This consistent treatment does not, of course, estop either the Commissioner or the taxpayer any more than the decision in this case controls the tax status of repaid principal on these loans in the hands of the remaining Fin Hay shareholders. The Government may well have sought to challenge these corporate interest deductions before challenging the individuals' returns as a matter of tactics, but this, and the question of the tax consequences of the liquidation of the remaining loans in 1962–1963, should not influence the decision in

intended the advances as debt and unfailingly treated them as such. The only testimony on the usual capitalization of real estate companies in the Newark area was that:

> "The usual capitalization is a thousand dollar investment in capital and then the rest of the monies are loaned either * * * by individuals or stockholders of the corporation to the corporation, which in turn the individuals lending the money expect a return for their loans.
>
> * * * * * *
>
> '[Of the real estate corporations that] I have dealt with, at least ninety-five per cent and more have had a thousand capitalization and, of course, loans from the various lenders would depend upon the size of the transaction, monies that were required."

On this record, Conclusions of Law 3-8 as worded are not justified. The District Court placed heavy reliance on the fact that the stockholder's debt was in the same proportion as their equity holdings. This fact, without more, is not controlling since there is no doubt that investors can have a dual status.[12] The inferences that "more" was involved in this case are not justified by this record. The fact that the loans were used to begin the corporate life and buy the income-producing assets must be placed in proper perspective. Without any basis in the record, the District Court assumed that the loans were advanced to prevent a sudden corporate deficit that was created by the Wainwright Street property investment's unexpectedly requiring more funds than the corporation had. Real estate cases, however, and uncontroverted testimony in this case show that corporations owning and operating buildings frequently and traditionally borrow the substantial part of money needed to secure their principal assets and that this was contemplated by a corporate resolution passed in the month of organization at the original directors' meeting.[13] Cases denying the validity of debt because it is contemporaneously advanced with the start of corporate life generally involve other industries[14] or a partnership becoming a corporation.[15]

The loans were denied debt status because there was no intent to seek repayment within a "reasonable time," because the corporation had no retirement provision (or fund) for the principal and because the debt had no maturity date (Conclusions 3 and 4). To the contrary, demand notes have a maturity date at the discretion of the holder (or of his transferee when the notes are freely negotiable, as were the Fin Hay notes). And failure to transfer the notes or demand payment is irrelevant when, as here, the evidence shows that the 6% rate made the debt a good investment.[16] In addition, when a

---

the present case, see Budd Company v. United States, 252 F.2d 456, 458 (3rd Cir. 1957).

[12] See, e.g., Farley Realty Corporation v. C.I.R., 279 F.2d 701, 704 (2nd Cir. 1960); Wilshire & West Sandwiches v. Commissioner of Int. R., 175 F.2d 718, 720 (9th Cir. 1949). As noted in P. M. Finance Corporation v. C.I.R., supra, at 789, control of the corporation requires the courts to examine the shareholder-creditor relationship with great care but "the decisions in most instances have required some further indication that sole or pro-rata shareholder 'debt' is in reality equity rather than indebtedness."

[13] See, e.g., Tomlinson v. 1661 Corporation, supra; Mullin Building Corporation v. C.I.R., supra; Farley Realty Corporation v. C.I.R., supra; McSorley's Inc. v. United States, supra.

[14] See, e.g., United States v. Henderson, supra, relied upon by the majority, involving an iron castings foundry.

[15] See, e.g., United States v. Snyder Brothers Company, supra; Gooding Amusement Co. v. C.I.R., supra.

[16] See, e.g., Tomlinson v. 1661 Corporation, supra, at 297. Uncontroverted testimony of one creditor-stockholder showed that he regarded the 6% return as a good investment (it is noted that interest was always paid on time) and nothing on the record or in any other cases showing interest rates in 1934 or later indicates

corporation holds appreciating real estate and contemplates recourse to refinancing, the lack of a sinking fund assumes little, if any, significance.[17] There was no evidence and no discussion of what constitutes a "reasonable time" for refraining from making a demand on such a promissory note.

The loans were also found to be equity because redemption was expected only out of future earnings or surplus and because they were unsecured and subordinate to prior secured loans (Conclusions 6 and 8). To the contrary, the evidence shows that the parties contemplated redemption out of 'refinancing' as well if a demand were made when surplus was deficient; and this in fact was what happened in 1951 and 1962–1963.[18] Corporate debt does not become equity because it is contemplated that principal will be retired by refinancing. In addition, a review of the 'subordination' cases shows that there was no 'subordination' in this case as that term is used in other cases where the other debt of similar type or otherwise subordinated by agreement.[19]

The District Court also placed emphasis on the fact that at the end of 1936 the shareholders' salaries were accrued but unpaid in the amount of $2400 and that in 1938 through 1940 the shareholders advanced an additional $6000 as loans. The corporate tax returns and books, however, show that the salaries could have been paid at the end of 1935 from $4,340.21 in cash on deposit,[20] and that

---

that a 6% Return on an unsecured demand note was unreasonably low when issued in 1934 or subsequently anything other than the good investment alleged. Many corporations are forced to continue with initial financing at higher rates (such as the 6% here) and an interest rate that fluctuated with the "going rate" would be an additional indication against the *bona fides* of this debt. See, e.g., Montclair Inc. v. C.I.R., supra, at 40. The Fin Hay notes were freely transferable, unlike the situation, for instance, in Mullin Building Corporation v. C.I.R., supra, and such transferability is additional argument for allowing debt status under § 163.

[17] See J. S. Biritz Construction Co. v. C.I.R., supra, at 457.

[18] The Hay interests were bought out entirely in 1951, apparently after arm's-length dealing with his executor. After study of the tax returns and corporate books introduced as exhibits, the cash events of 1951 seem to be as follows (figures rounded off):

A. Refinance, new mortgage of	$124,000.	
B. Pay Hay notes	53,000.	
Balance		$ 71,000.
C. Sell Wainwright Street		79,000.
Balance		$150,000.
D. Expenses–cost of sale	$ 3,000.	
Capital Gains tax	10,000.	
Pay off old mortgage	40,000.	53,000.
Balance		$ 97,000.
E. Redeem Hay stock		77,000.
Balance		$ 20,000.

The 1952 return lists the $20,000 as invested in "S. & L. Assn." As can be seen, even though the sale proceeds were used to pay off the old mortgage, more than enough money was available from the refinancing to pay off the notes and the mortgage. Similarly, the 1963 re-mortgaging gave net mortgage proceeds of approximately $210,000 for paying $47,000 of the remaining $53,000 in notes ($6,000 was apparently paid for out of earnings).

[19] See cases in footnote 8, supra. The majority also seems to agree with this reading of the cases, see their footnote 12.

[20] Even with the subsequent payment of these salaries, the 1936 salaries of $4000 and a $1600 dividend for 1936, the 1936 year-end cash balance improved to $5,657.13. It does not appear that the corporation had to maintain such large cash balances; subsequent tax returns show several lower year-end totals: 1937—

during the period of the additional loans of $6000 the shareholders received $6800 in dividends from the corporation.[21] These additional facts, unexplained by the District Court, negate the implication that Fin Hay Realty Company was in serious financial trouble at the outset of its existence, at least to any such degree that all the challenged loans were made "at a risk" similar to that of venture capital.[22] It is noted, in addition, that by 1938, when the original purchase money mortgage was re-financed, $18,000 of principal had been paid.

Although appellate decisions on the debt-equity problem constantly reiterate the maxim that each instance of definition turns on the particular facts of each case, a reading of many of these cases, including all those cited above, indicates two rather distinct conclusions concerning the assessment of the severity of the "risk" attached to alleged debt transactions. First, when the problem of definition arises under 26 U.S.C. §§ 165, 166 (worthless stock, bad debt), the risk of failure has already been realized and the party seeking to minimize the degree of such risk must show more "factors" than otherwise clearly argue for a debt classification. Secondly, regardless of the end purpose for defining indebtedness, fewer factors need be present (such as subordination, no interest, etc.) to allow a conclusion of "equity" when, as a matter of common knowledge, the economic enterprise has a higher chance of commercial failure. Consequently, few cases (and particularly few where taxpayers holding formal debt lose) deny debt status or even raise the question where the enterprise risk, as in this case, involves the mere holding and operation of real estate. As the risks increase, involving in addition construction of the real estate, or non-real estate operations subject to more immediate risk-creating problems of marketing, labor, advertisement, supplies, etc., the frequency of cases challenging debt and of decisions finding equity increase. The uncontradicted testimony (without finding of lack of credibility) of the universal practice in the Newark area in conformity to the course followed by taxpayer is entitled to consideration. Also, the subsequent successful history of this corporate taxpayer cannot be disregarded and militates strongly against denying an interest deduction on this record. The Fin Hay Realty Co. did not go bankrupt, was not unable to refinance or extend its purchase money mortgage due in 1939, and has never failed to meet a demanded purchase of the notes.

On this record, these loans were bona fide loans, "at risk" in this enterprise in no different way than any debt investment is "at risk" for a general creditor[23] of a real estate holding and operating corporation. The District Court pointedly took judicial notice, both of the bargain real estate purchases possible in 1934 and of the steadily rising real estate values in Essex County, New Jersey.[24] Subsequent refinancings by the taxpayer, as well as the entire course of its history, demonstrate that this investment in this particular venture was not a "risk capital" investment of the type that should compel

---

$158.29; 1939—$536.98; 1940—$2,532.93.

[21] Thus the stockholders received $800 more than they loaned during the period 1938-1940. These dividends were paid continuously from 1936 through 1952, a total of $26,000.00.

[22] See, for instance, the factors of 'risk' noted in Gilbert v. C.I.R., 262 F.2d 512, 514 (2nd Cir. 1959).

[23] The interest paid reflects to a certain extent the risk involved, Tomlinson v. 1661 Corporation, supra, at 300, and the 6% rate does not appear to be sufficiently low to suggest that in this case a substantial amount of risk was unreflected in the interest rate and, hence, the notes must be equity investment.

[24] And see the court's observations on real estate transactions, entrepreneurs wishing to limit equity investment, and payment out of earnings in J. S. Biritz Construction Co. v. C.I.R., supra, at 459.

The 1952 return lists the $20,000 as invested in 'S. & L. Assn.' As can be seen, even though the sale proceeds were used to pay off the old mortgage, more than enough money was available from the refinancing to pay off the notes and the mortgage. Similarly, the 1963 re-mortgaging gave net mortgage proceeds of approximately $210,000 for paying $47,000 of the remaining $53,000 in notes ($6,000 was apparently paid for out of earnings).

disregarding the clear intent of the parties and form of the transaction. Two recent "real estate" decisions (involving, moreover, construction as well as holding of real estate) suggest the proper result for the present case. As stated in Tomlinson v. 1661 Corporation, supra, at 300:

> 'We cannot, by manipulation of tax law, preclude the parties from exercising sound business judgment in obtaining needed investment funds at the most favorable rate possible, whether it be a commercial loan, or, more likely and as is the case here, a loan from private interested sources with sufficient faith in the success of the venture and their ultimate repayment to delete or minimize the 'risk factor' in their rate of return."

Similarly, in J. S. Biritz Construction Co. v. C.I.R., supra, at 459, the court said:

> "There is actually no evidence that this was not a loan, was not intended to be a loan, or that Biritz actually intended to make a capital investment rather than a loan.
>
> "We think the Tax Court has painted with too broad a brush in limiting the permissible activities of an entrepreneur in personally financing his business. Financing embraces both equity and debt transactions and we do not think the courts should enunciate a rule of law that a sole stockholder may not loan money or transfer assets to a corporation in a loan transaction. If this is to be the law, Congress should so declare it. We feel the controlling principle should be that any transaction which is intrinsically clear upon its face should be accorded its legal due unless the transaction is a mere sham or subterfuge set up solely or principally for tax-avoidance purposes."

I would reverse and enter judgment for the corporate taxpayer.

Course Learning Objectives

Students in this course will gain knowledge of substantive law relating to the federal income, Social Security, and Medicare taxes as they are imposed on corporations, partnerships, limited liability companies, and their owners. Students will also develop the ability to apply that law to a variety of fact patterns.

The source materials with which students will obtain substantial familiarity are the U.S. Internal Revenue Code (the "Code"); the Treasury regulations implementing the Code; published rulings and other pronouncements by the Internal Revenue Service; and opinions by various federal courts, including the U.S. Tax Court.

The crucial provisions of substantive law in which proficiency will be built are Subchapters C, K, and S of Chapter 1 of the Internal Revenue Code, and related statutory provisions imposing payroll and self-employment taxes to fund social welfare programs. Specifically, students will develop skills in these areas:

- choosing tax-optimal entity formats for businesses;
- identifying taxable events arising out of formation, operation, sale, and reorganization of business entities; and
- quantifying taxable income as these transactions give rise to such income.