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# Corporations -- Taxation -- Status of Payments to Hybrid Security Holders

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The free dissolution, both voluntary and involuntary, of modern corporations should not defeat their suability in other sovereign states.<sup>53</sup> The analogy of dissolution to natural death in its old aspect is fallacious, in that it carries forward the common law conception of evaporation of the corporation, whereas today there are shareholders, assets, and successors to wind up its affairs and they should answer to suits brought in the corporate name. The corporate entity does not extend beyond the borders of its creating state until another state admits it, and when so admitted, *some* new sort of entity is *reincorporated* which should not be said to "die" when the other state dissolves that which it created.<sup>54</sup> The local forum can subscribe to pro rata distribution of assets and still protect local creditors by giving them their share out of local assets, and thus not force them to go to the creating jurisdiction with their claim.<sup>55</sup> Corporations should no longer be able to defeat civil and criminal actions brought against them by working a dissolution in the creating state, only to reappear the next day in identical form with a new charter.<sup>56</sup> With the present ability of corporations to shop for the most advantageous state corporation law, the only other real solution would be the drastic legislation already introduced in Congress requiring a federal charter for all corporations engaging in interstate commerce.<sup>57</sup>

EDWARD B. HIPPIE.

### Corporations—Taxation—Status of Payments to Hybrid Security Holders

It often becomes necessary for a court to determine whether certain hybrid securities are in fact stocks or bonds.<sup>1</sup> This determination is frequently essential in order to ascertain whether periodic payments by a corporation to the holders of its securities should be classified as interest on indebtedness, which is deductible from gross income for income tax purposes,<sup>2</sup> or as dividends to stockholders, which are not

<sup>53</sup> See note 3 *supra*.

<sup>54</sup> HOHFELD, FUNDAMENTAL LEGAL CONCEPTIONS 278 and 313 (1923).

<sup>55</sup> Notes, 35 CALIF. L. REV. 306 (1947), 13 N. Y. U. L. Q. REV. 283 (1936).

<sup>56</sup> See note 3 *supra*.

<sup>57</sup> U. S. News & World Report, Oct. 14, 1949, p. 30. Cf. English Companies Act (1929) §338(2) (providing that foreign corporations be wound up as unregistered companies despite dissolution by the creating state).

<sup>1</sup> The distinction between these securities must in many cases be ascertained in order for the court to establish the priority between a certificate holder and general unsecured or subsequent secured creditors of the corporation. *Warren v. King*, 108 U. S. 389 (1883) (foreclosure proceeding); *Mathews v. Bradford*, 70 F. 2d 77 (6th Cir. 1934) (receivership proceeding); *Spencer v. Smith*, 201 Fed. 647 (8th Cir. 1912) (bankruptcy proceeding); *Phoenix Hotel Co.*, 13 F. Supp. 229 (E. D. Ky. 1935) (reorganization proceeding).

<sup>2</sup> INT. REV. CODE §23. "In computing net income there shall be allowed as deductions: (b) Interest.—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obli-

deductable.<sup>3</sup>

In the recent case of *Bowersock Mills and Power Company v. Commissioner of Internal Revenue*,<sup>4</sup> the court was faced with this issue. In that case, a closely held corporation,<sup>5</sup> so that it might be in a position to obtain bank credit, issued preferred stock to its bondholders (the Bowersock Trust, hereinafter referred to as the Trust) in payment of the bonds with accrued interest. The Trust further agreed to release the first deed of Trust on the corporation's assets. The above-mentioned stock was to be preferred both as to dividends and as to assets; bear cumulative dividends of three per cent payable annually if the net earnings at the time should be sufficient to pay such dividends; carry voting rights equal to those carried by common stock in the case of sale, mortgage or pledge of the fixed assets of the corporation and in case of other fundamental changes in the corporation; be retirable at par plus accrued dividends on call of the corporation; provided that if any dividends in excess of three per cent were declared on the common in any year, one half of such excess was to be paid on the preferred stock as an additional dividend.

Simultaneously with the issuance of the stock, the common stockholders entered into a contract with the Trust whereby the common stockholders agreed to buy and the Trust to sell the preferred stock, a certain number of shares per year, provided the corporation had not redeemed that amount within the prescribed period. To insure payment of the dividends and repurchase of the preferred stock, the common stockholders agreed to put their stock in trust, on condition that in the event of default of the corporation on the dividends for a period of six months, or the failure of the common stockholders to cause the corporation to purchase the stock as provided in the contract, the common stock would be transferred to the Bowersock Trust as liquidated damages.

The majority opinion of the court held that inasmuch as the corporation was closely held, considering the two contracts together was obligatory. By so doing, it became evident that the real intention of the parties was merely to change the form of the indebtedness, thereby subordinating it to bank credit, and that the parties intended to and did retain a debtor-creditor relationship. Following this reasoning, the court held that the payments fell into the category of interest and were therefore deductible.

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gations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter."

<sup>3</sup> 4 MERTENS, LAW OF FEDERAL INCOME TAXATION §26.10 (1942).

<sup>4</sup> 172 F. 2d 904 (10th Cir. 1949).

<sup>5</sup> All of the outstanding stock was held by one family.

The dissenting judge felt that the contract between the corporation and the Trust clearly created a shareholder relationship and that the second contract did not alter this relation, as that contract was solely between the common stockholders and the Trust.

A persuasive argument is advanced by the majority in that it is more realistic to disregard the corporate entity in the case of a closely held corporation. It is recognized that in a proper case it is equitable to look behind the corporate entity,<sup>6</sup> but it is submitted that this is not such a case. The corporation neither assumed any liabilities nor obtained any benefits under the contract between the common stockholders and the Trust. Furthermore, the corporation and its stockholders are taxed separately and it would, therefore, seem more logical to consider only the contract between the corporation and the Trust in determining the tax liability of the corporation.

Furthermore, there is authority in support of the proposition that where the payment of dividends on, or the redemption of, preferred stock is guaranteed by one other than the issuing corporation, the undertakings are separate and the stockholder relationship does not become a creditor relationship.<sup>7</sup> Some cases so hold even where the issuing corporation guarantees the payment of the periodic dividends.<sup>8</sup>

In deciding whether the payments are interest or dividends, the "traditional approach" is to consider the factors indicating a shareholder relationship and those indicating a debtor-creditor relationship and to conclude that the security more nearly resembles, and therefore should for all purposes be treated as bonds or as stocks.<sup>9</sup>

Evaluation of the weight assigned by the courts to each individual factor is difficult. Occasionally a particular element is pronounced decisive, but more often a combination of the elements present in the case sways the judgment. The determining factors are usually listed as: the name given to the certificates;<sup>10</sup> the presence or absence

<sup>6</sup> As was stated by Judge Sanborn in *United States v. Milwaukee Refrigerator Co.*, 142 Fed. 247, 255 (7th Cir. 1905) "A corporation will be looked upon as a legal entity as a general rule, and until sufficient reason to the contrary appears; but, when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons."

<sup>7</sup> *Hazel Atlas Glass Co. v. Van Dyke and Reeves*, 8 F. 2d 716 (2d Cir. 1925), *cert. denied sub nom Van Dyke v. Young*, 269 U. S. 570 (1925) (guaranteed by Ellis and Reeves, principal stockholders); *Northern Refrigerator Lines, Inc. v. Commission of Internal Revenue*, 1 T. C. 824 (1943) (guaranteed by another corporation holding the common stock); *McCoy-Garten Realty Co.*, 14 B. T. A. 853 (1928). See note 88 A. L. R. 1131, 1143 (1934) and cases cited.

<sup>8</sup> *Leaschold Realty Co.*, 3 B. T. A. 1129 (1926); see 1 MACHEN, *MODERN LAW OF CORPORATIONS* §542 (1908) where it is pointed out that "courts construe such a guaranty to apply only to payment out of funds legally available for dividends."

<sup>9</sup> 4 MERTENS, *LAW OF FEDERAL INCOME TAXATION* §26.10 (1942). A recent case following this approach is *Jordan Co. v. Commissioner of Internal Revenue*, 5 C. C. H. 1949 Fed. Tax Rep. ¶9372 (D. C. 1949).

<sup>10</sup> The courts vary as to the amount of weight they will give to the name of

of a definite maturity date with a right to enforce the payment of principal and interest;<sup>11</sup> status equal to or inferior to that of regular corporate creditors;<sup>12</sup> the presence or absence of voting rights;<sup>13</sup> the right to participate in dividends after common stock has received a percentage equal to preferred;<sup>14</sup> the circumstances surrounding the issuance of the certificates;<sup>15</sup> and the intention of the parties.<sup>16</sup>

The majority of the court in the principal case did not specifically follow the "traditional approach," but they did appear to make the factors of intention and circumstances surrounding the issuance of the certificates controlling.<sup>17</sup>

It is submitted that it would be better not to follow the "traditional approach" of balancing the provisions of the security as a whole and discovering whether the security more nearly resembles bonds or shares

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the security. Some cases appear to give it little; see *Jewel Tea Co. v. United States*, 90 F. 2d 451 (2d Cir. 1937), while others appear to give it considerable weight. *Mathews v. Bradford*, 70 F. 2d 77 (6th Cir. 1934) ("intention to create debt must be clear and convincing, where called stock"); *Spencer v. Smith*, 201 Fed. 647 (8th Cir. 1912); *Leasehold Realty Co.*, *supra* note 8.

There are certain cases in which the corporation should be estopped to deny that the certificate is something other than the name given it. *E.g.*, creditors may have extended credit relying on the fact that outstanding securities labeled preferred stock were stock and not bonds and that the holders therefore had a claim on the corporate assets inferior to his claim. *Cf. Gallatin Farmers Co. v. Commissioner of Internal Revenue*, 132 F. 2d 706 (9th Cir. 1942); 1 MACHEN, MODERN LAW OF CORPORATIONS §547 (1908).

It is submitted that the courts could follow, in tax cases, the rule that the corporation was aware of the taxable consequences of the label placed on the certificates and that it should be bound by its election except in cases where the form used was obviously fictitious on its face. This rule would have the advantage of facilitating the disposition of the cases without allowing a corporation to evade taxes by giving the security an artificial name.

<sup>11</sup> *Finance and Investment Corp. v. Burnet*, 57 F. 2d 444 (App. D. C. 1932). Some cases treat this factor as the most important. As was stated in *United States v. South Ga. Ry.*, 107 F. 2d 3, 5 (5th Cir. 1939) "There is, thus, an entire absence here of the most significant, if not the essential feature of a debtor and creditor and opposed to a stockholder relationship, the existence of a fixed maturity for the principal with the right to force payment of the sum as a debt in the event of default."

<sup>12</sup> *Helvering v. Richmond, F. and P. Ry.*, 90 F. 2d 971 (4th Cir. 1937).

<sup>13</sup> This factor seems to be frequently discussed but seldom given much weight. Although the voting privilege is usually extended only to shareholders, preferred stock is often issued with an express provision that it is to have no voting rights. 11 FLETCHER, CYCLOPEDIA CORPORATIONS, §5301 (perm. ed. 1931).

<sup>14</sup> See *Cass v. Realty Securities Co.*, 148 App. Div. 96, 132 N. Y. Supp. 1074 (1941).

<sup>15</sup> See *Miller v. Ratterman*, 47 Ohio St. 141, 24 N. E. 496 (1890) (certificates were issued under a statute which authorized issuance of preferred stock but not certificates of indebtedness. Therefore, held to be certificates of preferred stock even though contained many elements of indebtedness).

<sup>16</sup> *Schmoll Fils Associated v. Commissioner of Internal Revenue*. 39 B. T. A. 411 (1939).

<sup>17</sup> Had the court, in the principal case, held that the two contracts were separate, the securities would clearly have been stocks under the traditional approach. They were called preferred stock; dividends were payable only out of earnings; they had no fixed maturity date; they carried voting rights for certain purposes; and they were to an extent participating—all of which are characteristics of stocks rather than bonds.

of stock with a view to imposing all the legal consequences generally associated with the particular label given the security. This approach may cause a decision to rest on considerations not necessarily relevant to the question before the court. *E.g.*, in the principal case the factors of intention and circumstances surrounding the issuance of the certificates do not seem to be necessarily relevant in determining whether or not the periodic payments are a definite and fixed obligation on the part of the corporation regardless of earnings.

It would appear to be a sounder approach to limit the inquiry to the characteristics of the security material to the particular question before the court and cause the judgment to depend not on the entire complex of attributes but on those aspects determined to be pertinent to the particular issue under consideration.

Under this analysis the court, in cases involving the taxability of periodic payments made by a corporation to its security holders and guaranteed by a third party, could narrow the issue to: Are these payments a definite obligation of the corporation regardless of earnings? The guaranty by the third party should be disregarded in that the corporation and the third party are taxed individually and only the tax liability of the corporation is involved.

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### Courts—Venue—Inconvenient Forum Considerations and Special Venue Provisions Under the New Judicial Code\*

The new Judicial Code,<sup>1</sup> effective September 1, 1948, gave the federal courts in §1404(a)<sup>2</sup> the power to transfer a civil action to any other district or division where it might have been brought if necessary for the convenience of witnesses and in the interest of justice. Prior to this revised code, there was no provision in the federal statutes for the transfer of venue from one district to another district; but where more than one venue was available to a plaintiff, the federal courts could exercise the equitable right to dismiss a case without prejudice and thus force the plaintiff to sue over again somewhere else.<sup>3</sup> Both before and after final approval of §1404(a), there was speculation by writers as to the effect of this new power on actions arising under special venue

\* For some interesting discussions of other problems presented by §1404(a), see Mangan, *Federal Legislation*, 37 GEO. L. J. 394, 400 (1949); Marcus, *The Supreme Court and the Antitrust Laws*, 37 GEO. L. J. 341, 356 (1949); Notes, 60 HARV. L. REV. 424 (1947), 23 IND. L. J. 82 (1947); and materials listed in footnote 4 *infra*.

<sup>1</sup> Title 28 U. S. C. C. S.

<sup>2</sup> "For the convenience of parties and witnesses, in the interest of justice, a district court may transfer any civil action to any other district or division where it might have been brought."

<sup>3</sup> *Gulf Oil Corp. v. Gilbert*, 330 U. S. 501 (1947); *Koster v. Lumbermen's Mutual Casualty Co.*, 330 U. S. 518 (1947); *Rogers v. Guaranty Trust Co.*, 288 U. S. 123, 130-131 (1932).