9 T.C. 887 (1947)

A corporate instrument labeled as a 'debenture' may be recharacterized as equity (preferred stock) for tax purposes if it lacks essential characteristics of debt, such as a reasonable maturity date, is subordinated to all other debt, and its 'interest' payments are contingent on earnings and director discretion.

Summary

Swoby Corporation issued a 99-year 'income debenture' and nominal stock to its sole shareholder in exchange for property. The corporation deducted 'interest' payments on the debenture, which the IRS disallowed. The Tax Court held that the debenture represented equity, not debt, because of its extremely long term, subordination to other debt, and the discretionary nature of 'interest' payments, which depended on earnings and the directors' decisions. The court emphasized that the 'debenture' was essentially preferred stock, meaning the interest payments were actually dividends, and not deductible. Additionally, the court addressed depreciation and abnormal income issues.

Facts

Madeleine Wolfe transferred real property to Swoby Corporation upon its incorporation in exchange for a 99-year 'income debenture' of $250,000 and stock with a par value of $200. The debenture stipulated that 'interest' was payable quarterly, up to 8%, if net earnings were available, as determined by the directors. Swoby Corporation leased the property to Court-Chambers Corporation. The corporation deducted payments to Wolfe, characterizing them as interest on the debt.

Procedural History

The Commissioner of Internal Revenue disallowed Swoby Corporation's deductions for 'interest' payments on the debenture and adjusted the corporation's invested capital. Swoby Corporation petitioned the Tax Court, contesting the Commissioner's determination. The Tax Court upheld the Commissioner's disallowance of the interest deduction but allowed some depreciation and directed adjustments to equity invested capital.

Issue(s)

1. Whether the amounts paid by Swoby Corporation, designated as 'interest' on the 99-year income debenture, are deductible as interest under Section 23 (b) of the Internal Revenue Code.
2. Whether the debenture represents borrowed capital in determining invested capital for excess profits tax purposes.
3. Whether Swoby Corporation is entitled to exclude a payment received from its lessee for consent to cancel a sublease as abnormal income under Internal

Revenue Code, section 721 (a) (2) (E).

Holding

1. No, because the debenture more closely resembled preferred stock than debt, given its extreme term, subordination, and discretionary ‘interest’ payments.
2. No, because the debenture represented equity and not a bona fide debt obligation.
3. No, because Swoby Corporation failed to demonstrate that receiving such payments was abnormal for lessors or that the amount received was abnormally high.

Court’s Reasoning

The Tax Court reasoned that the debenture lacked key characteristics of debt. It emphasized the nominal stock investment ($200) compared to the ‘excessive debt structure’ ($250,000 debenture). The court noted the 99-year maturity date was not ‘in the reasonable future.’ The court compared the situation to 1432 Broadway Corporation, stating, ‘No loan was made to the corporation by the owners…The entire contribution was a capital contribution rather than a loan.’ The court found the ‘interest’ payments depended on available profits and the directors’ discretion, similar to dividend payments on preferred stock. It concluded that the instrument was essentially redeemable preferred stock, irrespective of its label. As the court stated, “In a prosperous and solvent corporation like petitioner, the instrument in question was in every material respect the equivalent of an equity security, not the evidence of a debt.” The court also denied abnormal income treatment because the taxpayer didn’t prove the income was atypical or excessive.

Practical Implications

This case underscores the importance of analyzing the substance over the form of financial instruments for tax purposes. Labeling an instrument as ‘debt’ does not guarantee that the IRS will treat it as such. Courts will scrutinize the characteristics of the instrument, including its maturity date, subordination, and the discretion afforded to the issuer regarding payments, to determine its true nature. Attorneys structuring corporate capitalization must carefully consider these factors to ensure that the intended tax treatment is achieved. Later cases cite this principle to distinguish debt from equity, focusing on factors such as intent to repay, economic reality, and risk allocation. In practice, tax advisors must carefully balance debt and equity to achieve the desired tax benefits while ensuring economic reality supports the chosen structure.

