THIN INCORPORATION: THE MAJOR TESTS OF DEBT OR EQUITY FINANCING

Double taxation of corporate income under the Internal Revenue Code not only leaves a bad taste in the mouths of most shareholding taxpayers but constitutes probably the greatest single disadvantage to the corporate form of business organization today. To what extent the double tax bite influences decisions either in the formation or dissolution of corporations is not known. What is known is that shareholding taxpayers very frequently have endeavored to alleviate their predicament to some extent by means of advancing funds to their corporations in the form of loans rather than as capital contributions. In recent years a large number of cases have been litigated involving the basic question of when these advancements must be treated for tax purposes as creating equity ownership instead of normal debt obligation. The corporations involved in the cases holding that equity ownership results are said to be "thinly incorporated." Neither this term itself nor any section specifically covering the precise problem at hand is to be found in the code. Nevertheless, the determination of whether shareholders' advancements give rise to debt obligation or equity ownership is of utmost importance, the more significant potential tax consequences being as follows:

(1) If the advances are held to be loans, the corporation may deduct as a business expense any interest paid on such loans.[1] Conversely, if they are found to be contributions to equity, subsequent income distributions thereon are dividends non-deductible by the corporation.[2]

(2) When the principal amount of the advance is returned to the shareholder, no taxable event occurs if the advance is considered to have been a loan—the corporation is merely repaying its debt.[3] On the other hand, if held that the advance was to equity, then any repayment out of profits or earnings will be treated as fully taxable dividend income.[4]

(3) When the corporation has set aside funds to repay debts, such funds may be taxed as an excess accumulation of earnings if the advances are determined to have been to equity.[5]

---

1. See Int. Rev. Code of 1954, § 163.

2. See, e.g., Ryan Contracting Corp., 25 P-H Tax Ct. Mem. 795 (1956).

3. See, e.g., Vonnie M. Hicks, 26 P-H Tax Ct. Mem. 89 (1957); John H. Perkins, 26 P-H Tax Ct. Mem. 465 (1957).

4. Weyher & Weithorn, Capital Structure of New Corporations, N.Y.U. 16th Inst. on Fed. Tax. 277, 287 (1958).

5. See Int. Rev. Code of 1954, § 531. See Smoot Sand & Gravel Corp., 25 P-H Tax Ct. Mem. 330 (1956).

(4) If the corporation should fail, it may be very advantageous to a shareholder in the business of lending money to have his holdings in the corporation treated as debt, since he then may be enabled to take a business bad debt deduction in lieu of a capital loss.[6]

Because of the disparate treatment afforded debt and equity under the code, it is manifest that whenever a shareholder advances funds to his corporation in the form of a loan, a basis for potential contest is laid. The purpose of this note is to assemble and examine, from the standpoint of utility, the tests which the courts have used most frequently to resolve the debt or equity question. Major emphasis upon practical usefulness of the tests necessitates stating them in the form in which the courts have most commonly generalized them, without attempting an elaborate and exhaustive case-by-case analysis of the historical development of each.[7]

The "true intent" of the shareholder at the time the purported loan was made has frequently been looked to as a test.[8] Formerly, securities issued to shareholders under equivocal conditions quite often possessed characteristics of both debt obligation and equity ownership, and hence acquired the name "hybrid securities." In cases involving

6. Compare Int. Rev. Code of 1954, §§ 166(a)(1) and 165(f). It should be noted that under the 1958 Technical Amendments, security in a "small business" which becomes worthless is fully deductible in the same way as are business bad debts. This new section has led some to comment that the appeal of debt financing may be lessened somewhat, but it is suggested that only pessimists form corporations with the idea of failing, and it is only upon failure that the new section comes into play. See Int. Rev. Code of 1954, § 1244. For other tax consequences, see Caplin, The Caloric Count of a Thin Incorporation, N.Y.U. 17th Inst. on Fed. Tax. 771-74 (1959); Poindexter, Tax-Wise, 35 Taxes 880 (1957); Semmel, Tax Consequences of Inadequate Capitalization, 48 Colum. L. Rev. 202, 203 (1948); Spanbock, Carro & Katz, Nourishing the Thin Corporation, 34 Taxes 687n.1 (1956); Stefano, Stock or Debt—That Is the Question, 18 Fordham L. Rev. 251 (1949); Weyher & Weithorn, Capital Structure of New Corporations, N.Y.U. 16th Inst. on Fed. Tax. 277, 287 (1958).

7. No effort will be made to treat exhaustively *all* of the tests that the courts use in attempting to resolve the thin incorporation problem. Since the tests are not formalized, the language of the various courts differs considerably. It is believed that a close examination of these tests will show that most of those which may appear to have been omitted from this note are actually included in those specifically discussed, although the descriptive wording may not be the same.

Further, there will be no attempt to give a breakdown of the tests used at various times in each of the different courts. For an excellent treatment of this area see Caplin, Caloric Count of a Thin Incorporation, N.Y.U. 17th Inst. on Fed. Tax. 771 (1959).

8. E.g., Crawford Drug Stores, Inc. v. United States, 220 F.2d 292 (10th Cir. 1955); Canton Tool Mfg. Co., 26 P-H Tax Ct. Mem. 592 (1957); Alma de Bretteville Spreckels, 18 P-H Tax Ct. Mem. 971 (1949) (stating "for the intention is the controlling factor"); Lucia Chase Ewing, 15 P-H Tax Ct. Mem. 801 (1946).

such instruments it is necessary to look to all the surrounding circumstances to glean the true intent of the parties since the instruments are ambiguous on their face. Of late, however, the purported indebtedness more frequently has been evidenced by "entirely conventional" debt instruments.[9] In such cases the parties have manifested objectively their "true intent" to create a debt. It is obvious here that the problem is neither one of true nor of manifested intent, but whether *regardless* of the parties' unambiguous manifestations of intent there should be a particular classification for tax purposes.[10] To bridge the chasm between manifested intent and unknown "true intent" the courts often have brought in other independent tests and then stated, for instance, that the transaction was a "sham"[11] and the true intent was other than made to appear. It is submitted that, realistically, the courts here are relying on the independent tests in an endeavor to establish a set standard by which to make the debt or equity determination irrespective of the parties' evidenced intent.[12]

The "debt-equity ratio" test is often applied when a corporation has debt in excess of invested risk capital.[13] Prior to 1946 this test was not stressed in the opinions,[14] but after *John Kelley Co. v. Commissioner*[15] it became of prime concern.[16] As a result of this case it was generally felt that a safe or reasonable ratio was about four to one, i.e., a corporation's debt should not exceed four times its invested risk

9. E.g., Kraft Foods Co. v. Commissioner, 232 F.2d 118 (2d Cir. 1956); Texoma Supply Co., 27 P-H Tax Ct. Mem. 58 (1958).

10. Ibid.

11. See, e.g., Benjamin D. Gilbert, 25 P-H Tax Ct. Mem. 551 (1956), rem'd, 248 F.2d 399 (2d Cir. 1957), modified on rehearing, 27 P-H Tax Ct. Mem. 23 (1958), aff'd, 262 F.2d 512 (2 Cir. 1959).

12. There is a further way of viewing the intent test. The primary intent or expectation of the shareholder who advances funds to his corporation in the form of debt is always that such sums receive a *debt treatment* by the Commissioner. It is felt that this will be true equally of the "bona fide" creditor and the "sham" creditor for they are both seeking to avoid the double taxation of corporate income. Thus, when the courts look to intent it would appear that the same answer should be forthcoming from every situation. If this be true, it is clear that the intent test is of little value in determining what the advances are to be termed for tax purposes.

13. E.g., John W. Walter, Inc., 23 T.C. 550 (1954); Isidor Dobkin, 15 T.C. 31 (1950), aff'd per curiam, 192 F.2d 392 (2d Cir. 1951); Swoby Corp., 9 T.C. 887 (1947).

14. See, e.g., Commissioner v. Meridian & Thirteenth Realty Co., 132 F.2d 182 (7th Cir. 1942); Commissioner v. Schmoll Fils Associated, 110 F.2d 611 (2d Cir. 1940).

15. 326 U.S. 521 (1946), reversing 146 F.2d 466 (7th Cir. 1944), reversing 1 T.C. 457 (1943).

16. See generally Caplin, The Caloric Count of a Thin Incorporation, N.Y.U. 17th Inst. on Fed Tax. 771, 777-84 (1959).

capital.[17] Thus, if the corporate financial structure were within this range, shareholder advances would be treated as debt with little or no regard to other tests. However, this safe ratio theory has been weakened, if not negatived, by recent cases in which shareholder advances were held contributions to equity despite the fact that the ratio was well under four to one.[18] In view of these cases it appears that emphasis on the debt-equity ratio test has diminished to the extent that it is being considered now as just one of the various tests, and not conclusive in and of itself.

In using the debt-equity ratio test, courts face the difficult problem of having to assign a value to the debt and equity components. The standard of measurement to be employed can be of controlling effect, since two courts on the same set of facts could easily reach different results depending upon the standard utilized. In valuing corporate property, the present trend is towards use of market value as the measure rather than book value.[19] This is the more realistic approach, inasmuch as book value seldom represents true present worth of corporate property. It would seem equally realistic to consider good will and other intangibles in computing the value of equity components.[20] Problems of even greater complexity are encountered when the courts attempt to figure the total debt of the corporation.[21]

---

17. Weyher & Weithorn, Capital Structure of New Corporations, N.Y.U. 16th Inst. on Fed. Tax. 277, 293 (1958). See Rabin, Fat Advantages of the Thin Corporation, 32 Taxes 572, 574 (1954); Semmel, Tax Consequences of Inadequate Capitalization, 48 Colum. L. Rev. 202 (1948).

18. See Benjamin D. Gilbert, 25 P-H Tax Ct. Mem. 551 (1956), rem'd, 248 F.2d 399 (2d Cir. 1957), modified on rehearing, 27 P-H Tax Ct. Mem. 23 (1958), aff'd, 262 F.2d 512 (2d Cir. 1959); Gooding Amusement Co., 236 F.2d 159 (6th Cir. 1956), affirming 23 T.C. 408 (1954).

19. Bittker, Thin Capitalization: Some Current Questions, 34 Taxes 830-32 (1956); Weyher & Weithorn, Capital Structure of New Corporations, N.Y.U. 16th Inst. on Fed. Tax. 277, 295-96 (1958).

20. Caplin, The Caloric Count of a Thin Incorporation, N.Y.U. 17th Inst. on Fed. Tax. 771, 779 (1959); Spanbock, Carro & Katz, Nourishing the Thin Corporation, 34 Taxes 687, 689-91 (1956).

21. One of the most difficult of such problems is whether to include outside creditors' advances to the corporation in arriving at a figure for "debt." If this is done, the debt figure will be higher in relation to the equity figure. This increased ratio will tend to move the courts in the direction of treating the shareholders' purported loans as equity; but note, even though the advances of the outside lenders were included to arrive at a figure, it is only the shareholders' advances that the court will treat as contributions to equity. It is suggested that this lacks logical justification.

Another way of viewing the same situation is to note specially the presence of the outside lenders. This factor could then be used as a possible justifying basis for the validity of shareholder loans, thus giving the opposite effect of that in the preceding paragraph.

A related problem is that of shareholders guaranteeing loans of outside

The use of a *fixed* ratio as a test is subject to obvious criticisms. Corporations could pursue a purposeful tax avoidance scheme merely by establishing a financial position consistent with the fixed ratio and then justify what otherwise would be an excessive debt-equity ratio by pointing out that they were within the approved limits.[22] This, of course, should be tolerated no more than unfavorable tax treatment of loans made justifiably *over* a fixed ratio. It is suggested that the only fair way to consider debt-equity ratio in determining whether shareholder advances are bona fide loans is to consider in each case all surrounding circumstances and factors which bear on the desirability or non-desirability of debt over equity financing.[23] Special emphasis should be placed upon the nature of the particular business enterprise and the industry in which it operates, for, clearly, certain businesses lend themselves much more readily to extensive debt financing than do others. In any event, the debt-equity ratio test should be used with a high degree of care.

As noted previously, the debt-equity ratio test is generally being used at present not as conclusive in itself but merely as one test to be used in conjunction with others. This seems clearly to reflect the courts' recognition of the fallibility of the test and shows further the necessity that it be used with extreme care. However, there is one area in which it is believed that regular use of this test would bring about more equitable results—that of mitigating the penalty. Presently, once it is determined that the advances were to equity, the courts' tendency is to treat the entire sum as a capital contribution.[24] This produces an unnecessarily harsh result. It is submitted that the courts should determine first what constitutes a reasonable debt-equity ratio in the particular case and then give capital treatment only to that portion of the advance which exceeds such ratio.[25]

---

creditors. There has been a recent trend to look on such guaranteed loans as being actually those of the guaranteeing shareholder rather than those of the lender. Carried to its obvious conclusion, this approach would mean that if the courts determined that the guaranteed funds were contributions to equity, then the guaranteeing shareholder would be taxed for constructive receipt of dividends when the corporation repaid the lender. See Holzman, The Current Trend in Guaranty Cases: An Impetus to Thin-Incorporation?, 11 Tax L. Rev. 29 (1955).

22. Bryson, Stockholder Loans: "Thin" Capitalizations, N.Y.U. 8th Inst. on Fed. Tax. 732, 742 (1950).

23. See Rowan v. United States, 219 F.2d 51 (5th Cir. 1955).

24. There are, however, a few cases that have held part of the advances to be equity and part debt. E.g., George J. Schaefer, 24 T.C. 638 (1955).

25. A justifying analogy may be drawn to cases where courts, absent a statute, have declared void only that portion of a conveyance which violated the Rule Against Perpetuities. It might also be noted that there have been suggestions that different types of debt be utilized to permit the courts to adopt this

Courts sometimes have considered as a test whether funds were advanced to the corporation with due regard to normal creditor safeguards.[26] If outside money lenders would not have loaned funds under similar circumstances, the test is not met and the purported loans must be treated as contributions to capital. This test, bluntly applied, fails to make allowance for a factor that often is controlling in the situations in which the test is held not met. For in many situations involving shareholders' purported loans, the corporation is closely held and the shareholders are active in the business as directors, officers or both. Obviously the future of such a corporation is within the hands of the shareholders, the shareholders being largely masters of their own business fate. Since outside creditors are not close to the organization and have little control over its policies and decisions, they *must* take the extreme precautions of requiring security and carefully checking the rating and financial condition of the corporation before extending loans. It is submitted that equating the positions of shareholders with those of outside lenders is therefore a highly unrealistic and non-functional approach, and the test of whether there was due regard to normal creditor safeguards accordingly should be used, if at all, with great caution.

Another test which some courts have used has been to determine whether the shareholders' purported loans are "proportionate" or "disproportionate" to their respective shareholdings.[27] The application and significance of this test may be shown by considering the following illustration: Assume that *A* and *B* are the sole and equal owners (shareholders) of the *AB Corporation*. *A* advances money to the corporation. What will be the thoughts of *B* in regard to this advance of funds by *A*? He will first consider the effect on his present equal ownership. If the business is a going one, it is not reasonable that *B* would allow *A* to gain greater control of the corporation by virtue of an increased equity holding. Thus, it is inferable that *A*'s disproportionate advance was a loan.[28] *B* will also consider his relative risk position to that of *A* in event the business should fail.[29] The fact which prompts this thought is that in most cases of corporate in-

view more readily. See, e.g., Caplin, The Caloric Count of a Thin Incorporation, N.Y.U. 17th Inst. on Fed. Tax. 771, 823 (1959).

26. E.g., Benjamin D. Gilbert, 25 P-H Tax Ct. Mem. 551 (1956), rem'd, 248 F.2d 399 (2d Cir. 1957), modified on rehearing, 27 P-H Tax Ct. Mem. 2 (1958), aff'd, 262 F.2d 512 (2d Cir. 1959); Martin M. Dittmar, 23 T.C. 789 (1955).

27. E.g., Hilbert L. Bair, 16 T.C. 90 (1951), aff'd 199 F.2d (2d Cir. 1952); 1432 Broadway Corp., 4 T.C. 1158 (1945), aff'd 160 F.2d 885 (2d Cir. 1947); R. E. Nelson, 19 T.C. 575 (1952).

28. See, e.g., Sabine Royalty Corp., 17 T.C. 1071 (1951); H. E. Fletcher Co., 20 P-H Tax Ct. Mem. 940 (1951).

29. Cf., Sabine Royalty Corp., supra note 28; Dayton & Michigan R.R., 12 F.2d 627 (4th Cir. 1940), affirming 40 B.T.A. 857 (1939).

solvency or bankruptcy, the creditors of the corporation have priority over the shareholders. It is conceivable that, on failure of the business, *B* as a shareholder would salvage nothing of his investment while *A* as a shareholder-creditor would share to the extent of his advance in the corporate assets with the other creditors. Therefore, *B* would realize that if he allows *A* to build a debt account, the risk of failure is no longer being shared equally between them. Thus it may be seen that if *B* is willing, in spite of his inferior risk position, to treat *A*'s advance as a loan, the court could draw a valid inference that such advance was in fact a loan.

If, on the other hand, both *A* and *B* made purported loans "proportionate" to their equity holdings—in equal amounts in this example—no inference should arise on this fact alone, since their respective control and risk positions remain the same.[30] Thus, it would appear that the proportionate-disproportionate test would have valid probative significance *only* when the shareholders' advances were disproportionate to their equity positions.

A test which is related to that of intent, but apparently distinct from it, looks to "tax avoidance motives."[31] The Supreme Court, however, in *Gregory v. Helvering*[32] stated that a taxpayer has the right, within the scope of the law, to limit or avoid taxes.[33] Certainly this is a reasonable position, for once a shareholder decides for whatever purpose to make advances to his corporation it is inconceivable in this "tax age" that he would ignore a possible tax savings route. On the other hand, it seems equally reasonable to require of the taxpayer that some valid "business purpose" accompany his tax avoidance motive to enable advanced funds to be treated as debt.[34] Thus, it is considered

30. Maloney v. Spencer, 172 F.2d 638 (9th Cir. 1949), affirming 73 F. Supp. 657 (N.D. Ore. 1947). Contra, Hilbert L. Bair, 16 T.C. 90 (1951), aff'd, 190 F.2d 589 (2d Cir. 1952); Isidor Dobkin, 15 T.C. 31 (1950), aff'd per curiam, 192 F.2d 392 (2d Cir. 1951).

31. E.g., Talbot Mills v. Commissioner, 3 T.C. 95, aff'd, 146 F.2d 809 (1st Cir. 1944), aff'd, 326 U.S. 521 (1946). But see Kraft Foods Co. v. Commissioner, 232 F.2d 118 (2d Cir. 1956), reversing 21 T.C. 513 (1954).

32. 293 U.S. 465 (1935).

33. Id. at 469.

34. See Talbot Mills v. Commissioner, 3 T.C. 95, aff'd, 156 F.2d 809 (1st Cir. 1944), aff'd, 326 U.S. 521 (1946). See also Gilbert v. Commissioner, 248 F.2d 399, 412 (2d Cir. 1957), wherein Judge Hand in a dissenting opinion proffered the following test which may be construed as requiring a business purpose: "When the petitioners decided to make their advances in the form of debts, rather than of capital advances, did they suppose that the difference would appreciably affect their beneficial interests in the venture, other than taxwise?" But see John Kelley Co. v. Commissioner, 326 U.S. 521 (1946), reversing 146 F.2d 466 (7th Cir. 1944), reversing 1 T.C. 457 (1943). The Tax Court said, "It is apparent that the holders of the preferred stock . . . preferred the debtor-creditor status of debenture holders to that of stockholders, and stockholders have the

that this test can serve a useful function in assuring the taxpayer that the mere presence of a tax avoidance motive will not of itself be decisive against him, but if such was the *sole* motivating factor, the court may properly hold that the advances were to equity.

Another test utilized by the courts when possible is whether the shareholders' purported loans have been subordinated to subsequent loans by outside creditors.[35] On failure of a corporation, creditors usually take precedence over shareholders in recouping their investment. If there was subordination of the purported loans to outside indebtedness, the effect is to place the shareholders' rights with respect to those purported loans more on a par with their rights as equity investors. Hence it may reasonably be inferred that the purported loans were in truth risk capital, i.e., equity.[36]

Courts sometimes look to the formality of corporate minutes and financial records to make the debt or equity determination.[37] It is believed that this test is of slight value in the majority of cases, since it takes little time or effort to record formally the "authorization and purpose" of a purported loan in the minutes, or to make book accounts giving the formal appearance of indebtedness. The presence of such formalities may tell the investigator nothing except that the officers and directors of the corporation had good legal advice or were informed individuals themselves. The absence of formalities likewise may tell little in view of the informal manner in which many small corporations are operated. Any inference drawn by use of this test would be tenuous at best, and it is suggested therefore that presence or absence of formalities should be viewed only as one among other more relevant factors to be considered.

The test of whether there is a note or a bond evidencing the purported debt has also been used.[38] It appears that little need be said

right to change to the creditor-debtor basis, though the reason may be purely personal to the parties concerned." 1 T.C. at 462.

35. E.g., Wetterau Grocer Co. v. Commissioner, 179 F.2d 158 (8th Cir. 1950), affirming 18 P-H Tax Ct. Mem. 381 (1949); 1432 Broadway Corp., 4 T.C. 1158 (1945), aff'd per curiam, 160 F.2d 885 (2d Cir. 1947). But see Lansing Community Hotel Corp., 14 T.C. 183 (1950), aff'd per curiam, 187 F.2d 487 (6th Cir. 1951).

36. It should be noted that in certain cases this policy may work hardship on corporations with shareholder advances in the form of loans, for there are probably few financial institutions which will extend funds to a corporation if not placed on a level superior to that of shareholder-creditors. Weyher & Weithorn, Capital Structure of New Corporations, N.Y.U. 16th Inst. on Fed. Tax. 277, 290 (1958).

37. E.g., Erard A. Matthiessen, 16 T.C. 781 (1951), aff'd, 194 F.2d 659 (2d Cir. 1952); Martin M. Dittmar, 23 T.C. 789 (1955).

38. E.g., Mullin Bldg. Corp., 9 T.C. 350 (1947), aff'd per curiam, 167 F.2d 1001 (3d Cir. 1948); 1432 Broadway Corp., 4 T.C. 1158 (1945), aff'd per curiam, 160 F.2d 885 (2d Cir. 1957).

about this test since there can be, and frequently is, a binding debtor-creditor relationship with *no* writing present. An alternative to issuance of notes or bonds is simply to create an account payable in favor of the purported creditor. Similarly, it is clear that notes or bonds could be issued easily for no purpose other than appearance, with no necessity or intention of enforcement. However, when notes or bonds are present, some courts consider whether there is a due date, an interest provision, a provision for repayment of the note upon demand before its due date (upon default), and other "arm's length" provisions.[39] As with the test of the formality of records, it is too easy to meet all of these requirements and yet still be without a true debtor-creditor relationship. As noted above, such notes may be issued to a shareholder who lacks all intention to enforce the denominated provisions.

If the interest on or principal of the purported loan becomes due and the shareholder enforces the obligation, the inference is drawn by many courts that a true debtor-creditor relationship exists.[40] This test considers primarily whether the shareholder created a debt with the purpose that it be enforced regardless of the success or failure of the business. It is believed that the test is one of the most realistic and useful, for the inference is drawn from an affirmative act which is completely consonant with a bona fide debtor-creditor relationship, i.e., actual enforcement of the obligation.

Most of the statutes that have been proposed as solutions to the problem of thin incorporation have included one or more of the above tests in addition to standard requisites for the recognition of a debt.[41] They will, therefore, not be discussed, for the same criticisms levelled against the tests are equally applicable to the proposed statutes. Furthermore, it is believed that justice will be better served if a statute is not adopted in this area, for the predictability which might thus be gained would be at the expense of much preferred flexibility.

In conclusion, the courts often face the problem of determining whether a debt, as the term is used in the code, exists between a shareholder and his corporation. To make such determination many tests have been employed but, as shown, several lack a realistic basis. It is felt that one possible method whereby the courts could gain a degree of predictability without sacrificing needed flexibility would be to re-

39. E.g., Toledo Blade Co., 11 T.C. 1079 (1948), aff'd, 180 F.2d 357 (6th Cir. 1950); Mullin Bldg. Corp., 9 T.C. 350 (1947), aff'd per curiam, 167 F.2d 1001 (3d Cir. 1948).

40. E.g., Benjamin D. Gilbert, 25 P-H Tax Ct. Mem. 551 (1956), rem'd, 248 F.2d 399 (2d Cir. 1957), modified on rehearing, 27 P-H Tax Ct. Mem. 23 (1958), aff'd, 262 F.2d 512 (2d Cir. 1959).

41. For a discussion of several such statutes see Caplin, The Caloric Count of a Thin Incorporation, N.Y.U. 17th Inst. on Fed. Tax. 771, 813-17 (1959).

turn to the "age of ratios." The ratio test should be used, however, in the fashion described herein,[42] not in the manner that previously was employed. In addition to using the ratio test, it is suggested that the courts require a valid "business purpose" to be present in the transaction under scrutiny. Finally, if interest or principal has become due, heavy emphasis should be placed on whether the payment was enforced by the shareholder. After considering these three primary tests, the courts should look, if necessary, to the tests of whether the advances were disproportionate and whether there was subordination to debts of subsequent outside creditors. The use of the other tests, it is felt, should be sharply limited, and in many cases it appears preferable that such tests be abandoned entirely.

42. See the discussion of the use of the debt-equity ratio test in text supported by notes 13-25 supra.