

# Tax Metamorphosis

A MINUSCULE CONTRIBUTION TO LAW ☉ LITERATURE

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Theodore Tannenwald, Jr., an eminent judge who served on the United States Tax Court for a quarter-century, died this past January. This essay discusses his 1968 opinion in *Edwards v. Commissioner*.

- The Editors

**M**Y FAVORITE COURSE ever, fourth-year high school Latin, was also the most demanding. We translated all twelve books of Virgil's epic poem, *The Aeneid*, line by dactylic hexameter line, and large chunks of Ovid's *Metamorphoses* besides. The course was valuable in many ways, not least of which was that only my youthful reading of Ovid's *Metamorphoses* later enabled me to make sense of the U.S. Tax Court's otherwise inscrutable decision in *Edwards v. Commissioner*.<sup>1</sup>

*Edwards* involved a dramatic and puzzling departure from established rules for classifying corporate securities. The issue was whether promissory notes issued by a closely held corporation, Birmingham Steel (BS), were truly debt or equity. The facts were as follows.

BS's business was the fabrication of steel products. In the late 1950s, BS had significant losses. By 1960, its liabilities exceeded its assets, and BS consequently had a negative net worth.

BS desperately needed additional capital in order to continue operating. The company's principal shareholder, a Mr. Birmingham, who owned nearly 80 percent of BS's stock, made cash contributions of \$240,000 to BS in 1961 and 1962. In return, BS issued to Birmingham the notes that became the subject of the *Edwards* case.

Despite the large cash contributions from Birmingham, BS's losses continued, and the excess of liabilities over assets increased further. With the prospects for turnaround grim, Birmingham and the BS minority shareholders decided in 1962 to try to sell BS. At the same time, a Mr. Edwards and a Mr. Disler were planning to expand their business of manufacturing and selling heat exchangers. They needed the kind of steel fabrication equipment that BS owned. After inspecting BS's plant, Edwards and Disler purchased all the stock of BS plus the notes issued by BS

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<sup>1</sup> 80 T.C. 220 (1968).

and held by Birmingham.

It was a perfect match. In the following years, BS resumed profitable operations. BS's new owners, Edwards and Disler, then caused BS to pay off \$60,000 of the notes that they had acquired from Birmingham.

The tax treatment of this \$60,000 depended on whether the notes were regarded as debt or equity. If the notes were debt, as Edwards and Disler claimed, then the \$60,000 would produce preferentially treated capital gain. If the notes were equity, as the IRS claimed, then the \$60,000 would be taxed at full ordinary income rates. (The reasons for the different tax treatments of debt and equity do not affect our story and can be left to the tax mavens.)

In short, the question before the Tax Court in *Edwards* was whether the notes – issued by BS to Birmingham, sold to Edwards and Disler, and then paid off – should be regarded as debt or equity. Judge Theodore Tannenwald, Jr., who wrote the opinion for the Tax Court, made two very curious findings: first, that “the promissory notes in issue constituted valid outstanding indebtedness of Birmingham Steel in the hands of ... Birmingham”; and second, that the notes changed character and became equity when purchased from Birmingham by Edwards and Disler.<sup>2</sup>

How did Judge Tannenwald justify the first finding, that the notes were truly debt in Birmingham's hands? He didn't. Instead, Judge Tannenwald simply wrote,

We think that, on the basis of the record before us ... the notes in question constituted bona fide indebtedness in the hands of ... Birmingham. We see no reason to detail the various elements which led us to this factual conclusion.<sup>3</sup>

<sup>2</sup> *Id.* at 226.

<sup>3</sup> *Id.* at 227.

<sup>4</sup> 2 Boris I. Bittker & Lawrence Lokken, *FEDERAL TAXATION OF INCOME, ESTATES & GIFTS* ¶ 91.10.3 (2d ed. 1989).

<sup>5</sup> *Id.* at ¶ 91.10.4.

Could I do better? The legal principles determining whether to classify such obligations as debt or equity are famously imprecise. Professor Boris Bittker has called the judicial precedents

a viper's tangle of cases, which commonly employ such vague criteria as intent of the parties, the psychology of an outside lender, substance over form, business purpose, and tax avoidance. These judicial ruminations can be likened – without either disrespect or loss of clarity – to the Wall Street adage that you can make money by being a bull, you can make money by being a bear, but you can't make money being a pig.<sup>4</sup>

Congress and the Executive have also found it difficult to prescribe definite standards. In 1969, Congress declined to clarify the distinction between debt and equity through legislation but directed the Treasury to do so through regulations, a mandate that the Treasury has not yet fulfilled despite the passage of three decades.<sup>5</sup>

Notwithstanding the vague legal principles, the circumstances of *Edwards* were so extreme that the notes were obviously equity to Birmingham rather than, as Judge Tannenwald decided, debt. Two factors in particular stand out. First, the notes were issued to a shareholder who already owned nearly 80 percent of the BS stock. Second, at the time of Birmingham's cash contributions, BS had a negative net worth and was on the verge of collapse.

In these circumstances, the Tax Court's finding that the notes were valid debt to Birmingham seems untenable. Cash contributions by a nearly-80 percent shareholder to his negative-net-worth corporation bear so much of the enterprise's risk that they must surely be

regarded as equity rather than debt. No outside lender would have been likely to provide such a loan to a failing business with a negative net worth. Birmingham, the dominant BS shareholder, could not reasonably have expected the notes to create a genuine arm's-length debtor-creditor relationship between himself and BS. Indeed, if we accepted Judge Tannenbaum's judgment that notes should be treated as genuine debt even in these extreme circumstances, it would be difficult to imagine any case in which notes would ever be recast as equity.

The Tax Court's second finding, that the notes changed from debt to equity when sold, was equally astounding. When *Edwards* was decided, it was the practice of the courts and the IRS to determine the debt or equity character of such notes with reference to *only* one point in time, the time when the notes were originally issued. Once determined with reference to the time of the notes' issuance, this debt or equity character remained fixed and did not change during the life of the notes.

Of course, the debt or equity character of the notes need not have been decided for tax purposes once and for all when the notes were issued. The tax authorities might have decided to reassess this character at regular intervals, although the administrative burden might have proved daunting, given the hazy standards for classifying the notes as debt or equity. In any event, such an alternative approach was never embraced before Judge Tannenbaum's opinion in *Edwards*. Judge Featherston, in dissent, was prompted to muse, "One may wonder what it is that gave these pieces of paper the chameleon-like

ability to change character as they traveled from hand to hand."<sup>6</sup>

How did Judge Tannenwald justify holding that the character of the notes changed from debt in the hands of Birmingham to equity in the hands of Edwards and Disler? The judge first stated that the notes were equity for Edwards and Disler because when they purchased the notes, "[BS] was in a substantial deficit position";<sup>7</sup> thus, "[t]he face amount of the so-called notes ... was in the fullest sense at risk."<sup>8</sup> But this argument proves too much: When the notes were originally issued to Birmingham, BS also had a substantial deficit, and the face amount of the notes was similarly at risk in the fullest sense. Therefore, applied consistently, the argument should have required the court's classifying the notes as equity to Birmingham to begin with, contrary to its actual finding.

Judge Tannenwald also argued that the notes changed character because "[Edwards' and Disler's] prime objective at all times was to acquire the physical assets of [BS]. ... Only at the last minute did they learn of the outstanding corporate notes."<sup>9</sup> However, the fact remains that Edwards and Disler purchased the notes and stock of BS rather than simply BS's assets. Whether they would have preferred to acquire the assets alone or learned of the notes' existence sooner or later is irrelevant.

To summarize, both Tax Court findings in *Edwards* – first, that the notes were true debt to Birmingham; second, that the notes changed character on transfer to Edwards and Disler – seem absurd.<sup>10</sup> How could cash advanced by a majority shareholder to a

6 *Edwards*, 50 T.C. at 231.

7 *Id.* at 229.

8 *Id.* at 230.

9 *Id.* at 229.

10 Edwards and Disler appealed, and the 10th Circuit reversed. *Edwards v. Commissioner*, 415 F.2d 578 (10th Cir. 1969). Inexplicably, the IRS decided not to challenge the Tax Court's first finding, that the notes were genuine debt when issued to Birmingham. Therefore the Court of Appeals treated the

negative-net-worth corporation be anything but an equity contribution? How could the character of the notes change on their transfer?<sup>11</sup>

Moreover, the Tax Court's ultimate result in *Edwards* – the judgment that the notes were equity in the hands of Edwards and Disler – did not require or depend on the Tax Court's untenable findings. The Tax Court could have achieved the identical result with the following, more plausible findings: first, that the notes were equity when issued to Birmingham, the dominant BS shareholder, by a corporation with a negative net worth; second, that the character of the notes did *not* change on transfer to Edwards and Disler. In other words, the Tax Court could easily have found that the notes were originally equity to Birmingham and remained equity on transfer to Edwards and Disler.

Surely, Judge Tannenwald, a brilliant and distinguished jurist, realized all this. Why, then, did he make the questionable findings in *Edwards*? Why didn't he adopt the more

reasonable findings described above, which would have produced the same result?

These questions returned me ineluctably to Ovid's *Metamorphoses*, so named because many of the more than 200 classical legends recounted in the work involve a metamorphosis, or transformation. In the best known of the stories, "Pyramus and Thisbe," two thwarted lovers commit suicide; Pyramus is then transformed into the fruit of the mulberry tree. (I forget what happened to Thisbe.) William Shakespeare used the story for the play-within-a-play in *A Midsummer Night's Dream*.

There is one more critical fact. The first name of Birmingham, the dominant BS shareholder to whom the notes were originally issued, was Ovid. Thus had Judge Tannenwald made more reasonable findings in *Edwards*, he would have missed a golden opportunity: the chance to rule that the BS notes underwent one of Ovid's metamorphoses. Such a chance, Judge Tannenwald may have thought, was simply too good to resist. 

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original debt character of the notes as given. It disagreed, however, with the Tax Court's second finding, that the notes could change character on transfer from Birmingham to Edwards and Disler.

11 I am deeply indebted to Prof. Marvin Chirelstein, who posed these questions about *Edwards* in his corporate shareholder taxation course at Yale Law School in the fall of 1970.