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Bad Investments on the Wrong Side of the Debt–Equity Divide

By Donald P. Board • Wood LLP

Where—and how—do you draw the line? From the inception of the federal income tax, judges, practitioners, and the tax administrator have all struggled to distinguish between debt and equity. By the time Congress sat down to draft the Internal Revenue Code in 1954, the issue had already generated several decades' worth of inconclusive case law.

In an effort to restore order in the courts, the House version of the 1954 Code would have added definitions. The Senate, on the other hand, didn't want to put anything in writing. Definitions *sound* like a logical solution, but the Senate warned that motivated taxpayers—especially corporations—would inevitably find ways to manipulate any precisely defined set of rules [*see* S. Rep. No. 1622, 83d Cong., 2d Sess. 42 (1954)].

The Senate's view prevailed, so the 1954 Code remained definition-free. But the case law kept piling up, year after year, like the national debt. In 1969, Congress decided to let the Department of the Treasury give it a shot. New Code Sec. 385 gave the Treasury broad authority to prescribe regulations that would instruct taxpayers and the courts how to decide whether an "interest in a corporation" is stock or indebtedness.

The Treasury did not proceed with unseemly haste, but it promulgated several hundred pages of debt–equity regulations in 1980 [*see* T.D. 7747, 1981-1 CB 141]. The new rules were comprehensive and extremely detailed, which may explain why they attracted criticism from almost every conceivable direction. Several rounds of revisions failed to appease the haters, so the regulations were withdrawn in 1983 without ever having come into effect [*see* T.D. 7920, 1983-2 CB 69].

Congress continued to tweak Code Sec. 385, but the Treasury lay low for more than a generation. It didn't get back on the horse until 2016, when it issued regulations to prevent large corporations from misclassifying their investments in affiliates as debt [*see* T.D. 9790, IRB 2016-45, 540 (the "2016 Regulations")]. The 2016 Regulations were not so much an exercise in definition as a practical attempt to stop foreign companies from eroding the U.S. corporate tax base. [*See* Donald P. Board, *Death of Earnings Stripping? Proposed Regs Target Related-Party Debt*, THE M&A TAX REPORT 1 (Aug. 2016).]

The 2016 Regulations, which were controversial from the start, soon got enmeshed in the Trump Administration's campaign to eliminate unduly burdensome or complicated tax rules [*see* Executive Order 13789 (April 21, 2017)]. The Treasury, under new management, focused on Reg. §1.385-2, which requires big corporations to prepare and maintain documentation to establish that they really intended to enter into a debtor–creditor relationship with their affiliates (the "Documentation Requirements"). In Notice 2017–36, the Treasury postponed the effective date of Reg. §1.385-2 to 2019.

On April 24, 2018, the Treasury released *Regulatory Reform Accomplishments Under President Trump's Executive Orders*. According to this not-even-slightly-fawning report, the Treasury may withdraw the Documentation Requirements. If that happens, the combined efforts of Congress and the Treasury during the 49 years since the enactment of Code Sec. 385 will have done almost nothing to clarify the debt–equity distinction.

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Keep Calm and Decide Cases

The IRS and the courts could not put the tax system on hold while Congress and the Treasury looked for solutions. Taxpayers do transactions and take positions on their returns. Somebody has to decide whether they have correctly characterized their investments as debt or equity.

Fortunately, law-making through adjudication is second nature to U.S. lawyers and judges. As a result, the Code has managed to muddle through even in the absence of statutory or regulatory guidance on this basic issue. Results in debt–equity cases are sometimes hard to predict, but the system doesn't seize up.

The courts decide a steady stream of cases in which they must draw the line between stock and indebtedness. Relatively few of them involve the large corporate groups that are the focus of the 2016 Regulations. Instead, the cases present a cavalcade of ordinary business folk and their closely held corporations.

In this article, we will review two recent decisions of the Tax Court that illustrate how judges are approaching the debt–equity distinction. Both feature individuals trying to write off failed investments as "bad debts" under Code Sec. 166. Such cases don't grab headlines, but this is where the law gets made.

Diving for Deductions: *M.J. Burke*

In *M.J. Burke* [115 TCM 1066, Dec. 61,123(M), TC Memo. 2018-18], a taxpayer's fantasy investment in a tropical diving resort turned into a nightmare. His lawyers then got to work trying to salvage a favorable tax result from the debacle. They may have tried a little too hard, because the taxpayer would have been hit with a $175,000 penalty if the IRS hadn't fumbled some paperwork.

Reliving the Dream

Michael Burke was a senior executive at an extremely successful consulting firm. He was well into middle age when he reconnected with Hugh Parkey, an old friend who had taken a rather different path through life. In college, Messrs. Parkey and Burke had been diving enthusiasts. They had gone through a scuba-instructor training program together, and they had worked together as instructors.

After graduation, Mr. Burke traded his wetsuit for a business suit—a conventional but lucrative decision. But Mr. Parkey dove to the beat of a different drummer. He moved to Belize, where he gave scuba lessons and managed a fishing and diving resort.

Decades later, when Mr. Burke visited his old buddy in Belize City, he got a look at the road not taken. At the time, Mr. Parkey was running a guesthouse, but he wanted to get back in the water. He asked Mr. Burke to lend him $30,000 to start a new scuba-diving business.

For reasons perhaps only a Hemingway could understand, Mr. Burke jumped right in. In 1995, he and Mr. Parkey organized a Belizean corporation ("Hugh Parkey's Belize Dive Connection"), as 50/50 shareholders. The terms of Mr. Burke's $30,000 advance were left undocumented, except for a notation on his personal records describing it as a loan.

Lots of Good Money After Bad

Once Mr. Burke returned to the United States, his involvement in Belize Dive appears to have been limited to providing additional capital. But the company soon ran into difficulties, which gave Mr. Burke plenty of opportunities to pull out his checkbook. Over the next six years, he invested almost $800,000 in the business.

In 2002, Mr. Parkey died of a heart attack shortly after coming up from a dive. This would have been a good time for Mr. Burke to cut his losses, and he very nearly sold Belize Dive to a local resort. At the last minute, however, Mr. Parkey's widow convinced him to let her try to turn the business around.

With Mrs. Parkey at the helm, Belize Dive purchased a 186-acre island, built a lagoon, and stocked it with companionable dolphins. But these and other ambitious projects were wildly expensive, and Belize Dive never managed to turn a profit. By 2009, when Mr. Burke finally pulled the plug, he had sunk another *$10.3 million* into the business.

Tax Treasure Salvors

In 2011, Mr. Burke's consulting company was sold for $50 million. Faced with a large capital gain, he engaged a squadron of tax lawyers to help him prepare his 2010 and 2011 federal returns. On their advice, Mr. Burke claimed $2.8 million in losses relating to his investment in the diving business.

Mr. Burke's reporting position appears to have been based, in part, on the "bad debt" provisions of Code Sec. 166. Under Code Sec. 166(d), an individual taxpayer whose nonbusiness bad debt becomes worthless during the taxable year can claim a short-term capital loss. Mr. Burke, with his big capital gain, was in a position to put some capital losses to good use.

But did Mr. Burke's investment—more than $11 million in the aggregate—constitute indebtedness for U.S. tax purposes? A taxpayer's advances can qualify under Code Sec. 166 only if they represent "*bona fide* debt." Reg. §1.166-1(c) defines this as "a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money."

The IRS was understandably skeptical. There had been no loan documentation for any of Mr. Burke's advances until 2010. Belize Dive had never paid Mr. Burke a cent of interest, much less principal. And Belize Dive's *other* creditors had made their advances on conventional terms using normal loan documentation.

Multifactor Tests

Mr. Burke was a California resident, so the Tax Court marched his case through the Ninth Circuit's 11-factor analysis [*see A.R. Lantz Co., Inc.*, CA-9, 70-1 USTC ¶9308, 424 F2d 1330, 1333]. As usual with multifactor tests, the weight to be assigned to each factor depends on all the facts and circumstances. The point is not to tally up factors, but to discern the nature of the relationship the parties intended to enter into when the advances were made. [*See P.E. Bauer*, CA-9, 84-2 USTC ¶9996, 748 F2d 1365, 1367–68.]

Regarded as an algorithm, a multifactor "test" in which the weights of the various factors are unspecified is pretty much useless. However, this is exactly the kind of open-ended analysis that is characteristic of common-law adjudication. When common-law judges are asked to "apply the law" to particular cases, they must often weigh competing legal precedents, policies, and factual analogies. But the criteria they use are anything but algorithmic.

So, it is not surprising that each of the U.S. Circuit Courts of Appeals has developed a multifactor analysis to distinguish debt from equity. What one might not expect, however, is that Congress required the Treasury to adopt the same approach. Code Sec. 385(b) says that the regulations "*shall* set forth factors which are to be taken into account," and it provides five (nonbinding) examples.

Congress gave the Treasury discretion to decide *which* factors to enshrine in regulations, but the use of *some* set of factors was mandatory. It is possible that Congress expected the Treasury to devise strict rules to govern how the various factors would be "taken into account." But it seems more likely that Congress assumed that the courts would keep on weighing factors in the same loose-limbed fashion they always had.

Post-Hoc Papering

The Tax Court started from the proposition that the absence of formal loan documentation tends to show that an advance is not *bona fide* debt. Mr. Burke had advanced millions of dollars to Belize Dive without getting anything in writing until he was issued some promissory notes in 2010. That doesn't square with the behavior of normal creditors, who want to be ready to extract their pound of flesh ASAP in the event of default.

The Tax Court found that the 2010 promissory notes had been prepared on the advice of Mr. Burke's lawyers as part of their *post hoc* tax planning. As such, they did not constitute evidence of what Mr. Burke intended when he made his pre-2010 advances. That seems logical enough.

However, the Tax Court went further. It treated this "*post hoc* papering" as evidence that the advances had really been intended as *equity*. Belize Dive's treatment of Mr. Burke was inconsistent with how it had treated its regular, unrelated creditors. The outside creditors had gotten promissory notes up front. Delivery of the notes to Mr. Burke in arrears was therefore evidence that Mr. Burke had *not* been a creditor when he made his advances.

There seems to be some boot-strapping going on here. But the Tax Court's argument is worth noting even if it is invalid. It illustrates how an advisor's efforts to strengthen a client's tax position can sometimes make it weaker.

In normal commercial life, it is not unusual for a debtor to issue a promissory note to evidence an already-outstanding indebtedness. This often happens when a *bona fide* creditor is starting to feel insecure. Consequently, there was nothing inherently objectionable about Belize Dive's issuing notes to Mr. Burke in 2010.

Mr. Burke's advisors would have found that reassuring as they developed and implemented their plan. Yes, issuance of the notes might have helped Mr. Burke claim a loss under Code Sec. 166(d). But documenting an existing indebtedness is something that creditors do even when tax is *not* an issue.

The Tax Court brushed this aside. Issuing the notes to Mr. Burke was "just way too convenient" from a tax perspective [115 TCM 1066, Dec. 61,123(M), TC Memo. 2018-18 at *22]. So, the plan ended up undermining the credibility of the tax position it was intended to support.

Timing and Source of Payment

The classical creditor expects to get paid, come hell or high water, at the time or times specified in a note or loan agreement. Shareholders, on the other hand, are not paid until dividends are declared out of current or accumulated corporate profits. Preferred shareholders have a "right" to periodic dividends (if there are profits to divide). But all this really means is that they can *block* the payment of dividends to the common shareholders until their accrued preferences have been satisfied.

At trial, Mr. Burke admitted that he had not expected to receive payment until Belize Dive was in the black. Only then would he be paid what he termed "my share of the profits." This established that Mr. Burke's investment: (1) did not have a fixed maturity date and (2) was contingent on the success of the enterprise. Both factors strongly favored treating his advances as equity.

Right to Enforce Payment

Mr. Burke contended that Belize Dive had an enforceable and definite obligation to repay his advances even before the company issued the notes in 2010. He pointed out that Belize Dive had recorded his advances as loans on its financial statements. The Tax Court responded that Mr. Burke had failed to cite any authority indicating that the financial statements would have given him a right to enforce repayment.

The Tax Court was right that an entry on a financial statement is not the equivalent of a promissory note. But a loan doesn't need a note to be enforceable. Without a note, a lender may have to make a more elaborate evidentiary showing. The creditor may have to put the debtor's CFO on the stand, but that doesn't mean that the borrower's obligation was unenforceable or indefinite.

But even if Mr. Burke and Belize Dive had entered into a fully documented and enforceable contract, that would not have been the end of the story for tax purposes. It would still have been necessary to consider whether Mr. Burke had actually *intended* to enforce his contractual rights. If he had not, the advances would have been contributions of equity capital.

The Tax Court made this point with respect to the 2010 promissory notes. Even if the notes gave Mr. Burke the means to enforce repayment of his advances, he had nonetheless "failed to take customary steps" to force Belize Dive to pay up. He had never exercised any creditor's remedies. He hadn't even requested repayment.

The Tax Court found that Mr. Burke had never intended to enforce the promissory notes. It could have drawn the same conclusion, *a fortiori*, about the status of Belize Dive's obligations *before* they were formalized. The absence of documentation may not have rendered the purported loans unenforceable, but it did indicate that Mr. Burke was not serious about entering into a debtor-creditor relationship with Belize Dive.

Ability to Borrow, Period

The Tax Court thought there was one factor that *supported* finding that the advances had been *bona fide* debt. This was the fact that Belize Dive had been able to obtain credit from unrelated parties, even as Mr. Burke was pumping millions of dollars into the company. According to the Tax Court, a debtor corporation's ability to borrow from outside creditors counts in *favor* of an insider's claim that his advances were indebtedness.

But doesn't this get the dynamic backwards? Outside creditors are encouraged to lend to a troubled company when insiders provide additional *equity*, not additional debt. If it proved anything, the fact that unrelated creditors were willing to lend to Belize Dive demonstrated that they believed that their loans would *not* have to compete for repayment with Mr. Burke's massive advances. In other words, they thought that Mr. Burke held stock.

Perhaps the Tax Court was misled by the common situation in which a shareholder makes an advance to a corporation that is in such bad shape that *no* outside creditor will give it a loan. In that case, the corporation's *inability* to borrow from outsiders indicates that the shareholder's advance was not really indebtedness. The Tax Court may have inferred—erroneously—that the corporation's *ability* to borrow is evidence that the shareholder's advance *was* a loan.

Ability to Borrow on Comparable Terms

The IRS took a different approach to the "ability-to-borrow" analysis. According to the Tax Court, the government emphasized that the outside creditors had dealt with the company at arm's length, but that Mr. Burke had not. The Tax Court said that the IRS had "distorted" the factor by arguing that this should count against treating Mr. Burke's advances as *bona fide* debt.

It is not clear from the opinion in *Burke* exactly what the IRS's argument was. The most likely candidate, however, is that the IRS was urging the Tax Court to look beyond whether Belize Dive was able to borrow from unrelated parties on conventional terms. The real question was whether outside creditors would have been willing to lend the corporation $11 million on the same lenient and informal terms offered by Mr. Burke.

The Tax Court apparently thought that asking this question "distorted" the ability-to-borrow factor. But there is nothing novel in asking "whether an outside lender would have made the [purported loan] in the same form and on the same terms" [*Scriptomatic, Inc.*, CA-3, 77-1 USTC ¶9428, 555 F2d 364, 367]. If the answer is yes, the factor supports treating the insider's advance as indebtedness.

Under the facts of *Burke*, it seems obvious that the answer would have been no. Note, however, that this would not have rendered this factor simply irrelevant. Here, the test runs both ways. If outside creditors will lend on similar terms, that is evidence that the shareholder's advance is *bona fide* debt. If they won't, that indicates that the advance is equity.

Identity of Interest

When common shareholders make advances to their corporation in proportion to their stock ownership, this "identity of interest" can raise questions about whether the advances should be classified as indebtedness. If the corporation does not owe a significant amount of debt to outsiders, issuing debt to shareholders *pro rata* does not change their economic position compared with what it would be if their additional investment had taken the form of stock.

Messrs. Burke and Parkey were 50–50 shareholders, but only Mr. Burke claimed to be a creditor. Belize Dive also had third-party debt. Consequently, there was no "identity of interest" in the traditional sense.

This factor should have been treated as *neutral*. But the Tax Court regarded it as evidence that Mr. Burke's advances were equity. It noted that Mr. Burke had covered Belize Dive's operating expenses for many years, even though the company was probably insolvent.

Mr. Burke's behavior was plainly not that of an outside creditor. That is a good reason to conclude that his advances were equity. But it simply confuses the analysis to treat it under the "identity-of-interest" rubric.

Penalties

The Tax Court agreed with the IRS that Mr. Burke's advances were equity. It was also ready to uphold a $175,000 substantial-understatement penalty. Although Mr. Burke had engaged competent tax advisors and supplied them with the relevant records, the Tax Court thought there were too many "red flags" for Mr. Burke to reasonably rely on their advice.

In the end, however, the Tax Court had to let Mr. Burke off the hook. Under Code Sec. 6751(b)(1), no penalty can be assessed "unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination." The government had failed to present any evidence that the necessary paperwork had been signed, so the penalties could not be sustained. [*See L.G. Graev*, 149 TC No. 23, Dec. 61,095 (slip op. at 14) (Dec. 20, 2017), *supplementing* 147 TC No. 16, Dec. 60,748 (Nov. 30, 2016).]

Pennsylvania Dutch Venture Capital: *J.M. Sensenig*

Our second case, *J.M. Sensenig* [113 TCM 1001, Dec. 60,802(M), TC Memo. 2017-1, *aff'd*, CA-3, 2018-1 USTC ¶50,138, 121 AFTR2d 2018–505 (*per curiam*), *cert. denied* 2018 WL 2064990 (June 4, 2018)], transports us from tropical Belize to the loamy fields of Pennsylvania Dutch Country. John Sensenig, a Mennonite, was a self-taught accountant and the sole shareholder of Conestoga Log Cabins Leasing, Inc. (CLCL), an S corporation. During the 1990s and early 2000s, CLCL shifted its focus from leasing log cabins to investing in various high-risk ventures.

To fund its investments, CLCL needed capital. Mr. Sensenig raised an astonishing amount of it by advertising in a *Pennsilfaanisch Deitsch* newspaper and working his network of contacts in the close-knit Mennonite and Amish communities. Mr. Sensenig's plain and frugal neighbors entrusted CLCL with more than *$50 million* of their savings. In exchange, CLCL gave them unsecured demand notes promising a nine-percent return.

Under Mr. Sensenig's direction, CLCL invested in several dozen companies engaged in speculative businesses. As part of each investment, Mr. Sensenig received a personal equity stake in CLCL's new portfolio company. He also became a director and took charge of the portfolio company's finances.

In 2005, the Pennsylvania Securities Commission determined that Mr. Sensenig and CLCL had been raising tens of millions of dollars through the unregistered offer and sale of securities. The Commission issued a cease-and-desist order. Although Mr. Sensenig was slow to comply, it appears that CLCL's ability to raise additional capital was significantly impaired.

With most of its funding cut off, CLCL was unable to provide its portfolio companies with the capital they needed to complete their projects. CLCL determined that $10.7 million of its investments had become "wholly worthless" during 2005. The rest followed within a few years.

Tax Positions

On its 2005 Form 1120S, CLCL claimed a $10.7 million bad-debt deduction under Code Sec. 166(a). Corporations do not have to worry about Code Sec. 166(d), which limits *non*corporate taxpayers to a short-term capital loss when a nonbusiness debt goes bad. On his personal return, Mr. Sensenig claimed a deduction Code Sec. 166(a), reasoning that CLCL's Code Sec. 166(a) deduction passed through to him as an S corporation shareholder.

The IRS raised several objections to Mr. Sensenig's deduction. It is the IRS's position [*see* Rev. Rul. 93-36] that S corporations cannot deduct their worthless nonbusiness bad debts under Code Sec. 166(a). Those losses must be separately stated for the shareholders to report as nonbusiness bad debts on their personal returns, where they will be subject to Code Sec. 166(d).

However, the Tax Court did not reach this argument. It focused instead on the IRS's more fundamental objection that CLCL's investments in its portfolio companies were not *bona fide* debts. The Tax Court agreed, so Code Sec. 166(a) or 166(d) were both irrelevant.

The Wages of Informality

Courts in the Third Circuit, which includes Pennsylvania, apply the 16-factor debt-equity test announced in *Fin Hay Realty Co.* [CA-3, 68-2 USTC ¶9438, 398 F2d 694, 696]. The Tax Court in *Sensenig* dutifully but briefly cited a number of these factors. But its analysis concentrated on the paucity of loan documentation, which it called the "salient fact" of the case.

CLCL's records had included journal entries labeling some of its advances "loans." But the portfolio companies had not executed notes or entered into written loan agreements. As we noted in connection with *Burke*, an investor who fails to put documentation in place is not behaving like a serious creditor.

Not surprisingly, the Tax Court concluded that CLCL's undocumented advances were not loans. However, one of its arguments warrants comment. According to the Tax Court, an unfavorable inference could be drawn from the fact that CLCL *had* documented the $50 million in loans it had received from members of the Amish and Mennonite communities.

CLCL had issued demand notes that clearly provided for the payment of interest. The company had also provided its investors with quarterly statements and Forms 1099 showing how much interest had accrued in their favor. As the Tax Court observed, Mr. Sensenig had not hesitated to document the debtor–creditor relationship between CLCL and its investors.

The Tax Court therefore concluded that CLCL's *failure* to document the terms of its investments in the portfolio companies was evidence that the advances had been intended as equity. But this line of reasoning overlooks important differences between (1) CLCL's relationship to its investors, and (2) its relationship to its portfolio companies.

The individuals who provided capital to CLCL were in the normal position of third-party investors: (1) they stood on only *one* side of the transaction and (2) they had no control over the company or Mr. Sensenig. This gave them the usual reasons to want documentation to memorialize the terms of their investments.

However, when CLCL advanced funds to a portfolio company, it was not contracting at arm's length—at least once the relationship was established. Mr. Sensenig was not only a major shareholder and director of the portfolio company, but also the person who controlled its finances. Mr. Sensenig was effectively dealing with himself.

In a self-dealing situation, the parties' usual incentives to document the terms of their relationship disappear. The use of formal documentation is then a matter of prudence—the kind of thing that well-advised business people pay lawyers to nag them about. Busy, optimistic, or poorly advised business people may not to want to spend time or money addressing what they think are remote contingencies.

Hence, the fact that CLCL issued notes to its outside investors, while failing to document its investments in the portfolio companies, may not be as damning as the Tax Court supposed. This is not to say that informality should be treated as a neutral factor in a debt–equity analysis—there are strong argument against treating CLCL's related-party advances as *bona fide* debt. But they do not gain much force from the fact that CLCL observed normal formalities when borrowing from its own investors at arm's length.

Concluding Observations

For many decades, the courts have been applying multifactor tests to distinguish between debt and equity. The number of factors varies somewhat from circuit to circuit, but they all hit roughly the same notes. The Tax Court has probably worked through the canonical lists hundreds of times.

However, as the discussions of *Burke* and *Sensenig* suggest, the Tax Court can still go astray in its formulation and treatment of specific factors. Perhaps the judges have seen so many of these cases that they approach them mechanically. Anyone faced with a long list of factors will be tempted to check off items without giving too much thought to what they represent.

Be that as it may, *Burke* and *Sensenig* make it clear that the Tax Court cares about loan documentation. The Treasury, on the other hand, may be on the verge of withdrawing the Documentation Requirements established by Reg. §1.385-2. But the 2016 Regulations are directed at only the largest corporations, so the latest round of regulatory fiddling is unlikely to have much effect on where—and how—the Tax Court draws the line.

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