Debt or Equity? That Is the Question (Part I)

By Robert W. Wood • Wood LLP • San Francisco

There are few lines in the commercial world that are more important than what is debt and what is equity. The distinction is important for tax purposes, of course, but it is also significant for many arguably more pivotal concepts than taxes. It is also not a static point. There can be competing considerations and these considerations can change over time, which is one reason the IRS has always applied its own lens to the situation.

In general, whether an instrument qualifies as debt or equity for tax purposes is a question of fact. [Howard J. Rothman, Pamela M. Capps, Barry Herzog and Mary Jo Brady, *Transfers to Controlled Corporations: In General*, 758-2nd T.M., III.H.4.a., A-47.] The question must be asked about a fact pattern and particular document.

Thus, a common question is whether a shareholder advance to a corporation is actually debt, and that is a question of fact. [*See P.E. Bauer*, CA-9, 84-2 USTC ¶9996, 748 F2d 1365, 1367 (1984).] The Ninth Circuit Court of Appeals has identified the following 11 factors to determine if an instrument qualifies as debt:

1. Documentation and name of instrument
2. Fixed maturity date
3. Source of payments
4. Right to enforce payments of principal and interest
5. Participation in management
6. Status of creditor (subordinated or senior)
7. Intent
8. Thin capitalization
9. Identity of interest between creditor and stockholder
10. Payment of interest only out of dividends
11. Ability of borrower to obtain credit from outside lending institutions [*See NA General Partnership et al.*, 103 TCM 1916, Dec. 59,094(M), TC Memo. 2012-172 (2012), *citing R.A. Hardman*, CA-9, 87-2 USTC 9523, 827 F2d 1409, 1412 (1987) for 11-factor test.]

Documentation and Name of Instrument

The absence of any formal debt documentation such as a promissory note is a strong indicator in favor of equity treatment. [*See, e.g., Roth Steel Tube Co.*, CA-6, 86-2 USTC ¶9676, 800 F2d 625, 631 (1986), *cert. denied*, 481 US 1014 (1987).] Yet some lack of timely formalism is not uncommon to *bona fide* debts. Thus, even if an original advance was not formally documented, after-the-fact consolidation of advances into a single note may support debt treatment. [*Indmar Products Co.*, CA-6, 2006-1 USTC ¶50,270, 444 F3d 771, 780 (2006).]

Interestingly, some courts have cast doubt on the importance of this factor, noting that it is one of the most subjective factors in the debt-equity analysis. [*Texas Farm Bureau*, CA-5, 84-1 USTC ¶9502, 725 F2d 307, 312 (1984).] There also may be a tendency to discount debt forms and terminology, which are almost always present even where ostensible "debt" is re-characterized as equity.

Fixed Maturity Date

A fixed maturity date is one of the hallmarks of a debt. However, even a fixed maturity date does not mean debt treatment is certain. For example, if the putative debtor had already failed to repay an advance, a court might find that the parties did not believe a debt would be paid on the Note's stated maturity date.

If a court found that the parties did not believe or expect the Note to be repaid on the maturity date, this would tend to undercut debt treatment. [*See CMA Consolidated, Inc. v. Comm'r*, T.C. Memo 2005-16 (finding that conduct of parties showed that they did not believe an advance would be repaid, which undercut the finding of a fixed maturity date). In effect, an illusory promise of repayment may simply be ignored.

Source of Payments

Equity treatment is favored if payments are conditional on the profitability of a business or if payments only come out of certain sources of funds. For example, repayment of a Note could be conditional on earnings. However, a debt with contingent elements, such as an equity kicker component, can still be regarded as debt in appropriate cases.

Right to Enforce Payments of Principal and Interest

A Note that provides the holder with the right to enforce payment would tend to help support

debt treatment. However, the mere right of the holder of a Note to enforce payment can be outweighed by other circumstances that make uncertain the obligor's actual ability to pay. [*See CMA Consolidated, Inc.*, 89 TCM 701, Dec. 55,917(M), TC Memo. 2005-16.] Again, an illusory obligation will not be respected.

Intent of Parties

The objective expression of intent to treat an advance as debt may be treated as a factor in favor of debt treatment. [*See, e.g., American Underwriters*, 72 TCM 1511, Dec. 51,694(M), TC Memo. 1996-548.] However, courts have not determined intent solely upon the formal documentation used to document an advance. Timing is also relevant.

In determining the intent of the parties, courts have looked to the expectations of the parties at the time an advance is made. [*See L.M. Dunn Est.*, 60 TCM 317, Dec. 46,767(M), TC Memo. 1990-401 (1990) (holding that advances made by an individual to a closely held corporation were capital contributions rather than loans in part because of the lack of any expectation of repayment).]

For example, assume that a purported lender makes an advance to a financially distressed company and knows in doing so that the prospects of repayment are highly uncertain. Plainly, in such a case the purported lender lacks the intent for the advance to be treated as debt.

Thus, in *Tedford*, T.C. Summ. Op. 2004-132 (2004), the court held that when the advance was made by a taxpayer who had put a great deal of effort into making the company successful and when the taxpayer knew the company's financial problems, the taxpayer lacked the necessary intent for the advance to be debt). [*See also Flint Industries*, 82 TCM 778, Dec. 54,519(M), TC Memo. 2001-276 (2001) (advances were characterized as equity because the taxpayer knew the company was in financial distress and knew that it likely would not recover any amounts advanced).]

Article Submission Policy

THE M&A TAX REPORT welcomes the submission of unsolicited articles. Submissions should be 2,000 words or less and use textual citations, rather than footnotes. All submissions should be made via email attachment in either Microsoft Word or WordPerfect format to Robert W. Wood, Editor-in-Chief, at *wood@woodporter.com.* THE M&A TAX REPORT reserves the right to accept, reject, or edit any submitted materials.

TO SUBSCRIBE TO THE M&A TAX REPORT CALL 1-800-638-8437.

PRESORTED
FIRST-CLASS MAIL
U.S. POSTAGE
PAID
CCH

4025 W. Peterson Ave.
Chicago, IL 60646