DEBT V. EQUITY: JUDICIAL FACTORS STILL APPLICABLE POST-§385 REGULATIONS

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In a recent Tax Court case, *Sensenig v. Commr.*, the court held that a shareholder's advance to several corporations should be considered equity investment and not debt. The reasoning behind the ruling was not based on the new regulations under Code §385 but on longstanding judicial factors determining the classification of an instrument as debt versus equity.[1]

NEW §385 REGULATIONS

New regulations under Code §385 were released in final form in October of last year.[2] Under these rules, specific regulations relating to documentation apply to instruments issued after January 1, 2018, while recasting regulations apply to taxable years ending on or after January 19, 2017 with respect to debt instruments issued after April 4, 2016.[3]

Nevertheless, not all instruments issued after such dates are affected by the new regulations. The Code §385 regulations exempt the first $50 million of debt instruments (measured by reference to an adjusted issue price) from recharacterization under the factors provided therein.[4] Other exceptions apply with respect to, *inter alia*, (i) debt issued by regulated companies, (ii) certain acquisitions of subsidiary stock where the transferor holds more than 50% of the vote and value of the stock for a 36-month period following the issuance of the shares, and (iii) "qualified short term debt obligations," which include, *inter alia*, debt instruments used to meet short term funding needs in the ordinary course of the issuer's business as well as ordinary course loans that are expected to be repaid within 120 days.[5]

Consequently, the new regulations largely impact large corporations and sizeable investments. Transactions of owner-managed companies will remain subject to the scrutiny of the judicial factors developed by years of case law. Although the recasting regulations have already taken effect, only time will tell if the new Code §385 regulations will ultimately be effective with regard to multinational corporations' transactions. Congress may seek to overturn the Code §385 regulations prior to the

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1 *John M. Sensenig, et ux. v. Commr.*, TC Memo 2017-1.

2 For a detailed discussion of the regulations, see Philip R. Hirschfeld, "Related-Party Debt: Proposed Code §385 Regulations Raise Major New Hurdles," *Insights* 5 (2016).

3 Treas. Reg. §1.385-3(j)(1).

4 Treas. Reg. §1.385-3(c)(4).

5 Treas. Reg. §§1.385-3(g)(3)(iv), 1.385-3(c)(3), 1.385-3(c)(2)(ii), 1.385-3T(b)(3)(vii), 1.385-3(g)(10)-(11). For a further discussion of these exceptions, see Hirschfeld, "Related-Party Debt: Proposed Code §385 Regulations Raise Major New Hurdles."

final January 2018 effective date, having voiced its disapproval for the new rules.[6]

JUDICIAL FACTORS

Several courts have developed checklists of factors to be considered when determining whether an advance should be treated as equity or debt.

Mixon

The leading case is *Estate of Mixon v. U.S.*, in which the Fifth Circuit listed the following factors as important in determining whether an advance is considered debt or equity:

- Names Given to the Certificates Evidencing the Indebtedness – If no documentation exists, the informality may suggest that intent to repay was not present at the time the loan came into existence.
- Presence or Absence of a Fixed Maturity Date – The absence of a fixed maturity date may suggest that intent to repay was not present at the time the loan came into existence.
- Source of Payments – In general, a purported debt can be repaid from three possible sources: (i) the liquidation of the corporation's assets, (ii) profits and cash flow from the corporation's business, and (iii) refinancing the debt. If the only reasonably assured source of funds for repayment of the debt is the liquidation of the debtor's assets, then the investment resembles an equity investment. Conversely, a purported debt will be recognized as debt if the projected cash flow is adequate to repay the obligation.
- Increased Participation in Management – If as a result of granting the loan the lender has an increased right to participate in management, this may suggest that the instrument is an equity investment.
- Right to Enforce Payment of Principal and Interest – Although junior to a secured creditor, a general creditor typically has the right to enforce repayment on demand. The absence of this right may be an indicium of equity.
- Intent of the Parties – In seeking the intent, focus is placed on how the parties treated the instrument. While not conclusive, relevant considerations, in addition to the preceding factors, include the accounting treatment of the loan on the company's books.
- "Thin" or Inadequate Capitalization – The adequacy of a borrower's capital structure at the onset of the purported debtor-creditor relationship may indicate the creditor's intent to be repaid in accordance with the terms of the instrument. Equity capitalization provides a cushion to protect the creditor from

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[6] H.J. Res. 54. 115th Congress, First Session, "Disapproving the rule submitted by the Department of the Treasury and the Internal Revenue Service relating to documentation requirements for certain related-party interests in a corporation to be treated as indebtedness," introduced in House of Representatives, January 31, 2017. See also Committee on Ways and Means, U.S. House of Representatives, "Letter to the Honorable Jacob Lew, United States Treasury Secretary," August 22, 2016.

the borrower's business losses and any decrease in the value of its assets. Thus, inadequate capitalization at the time the relationship was established may be an indication of whether a reasonable expectation of repayment existed.

- Identity of Interest Between Creditor and Stockholder – If debt is provided by stockholders in proportion to their respective stock ownership, it may indicate that the investment is an equity contribution.

- Interest Payments – The lack of provisions for the payment of interest indicates that the funds loaned were intended as a contribution to equity rather than an arm's length debt obligation. The failure to insist on interest payments ordinarily indicates that the lender is not expecting interest income but is interested in the future earnings of the corporation or the increased market value of its interest.

- Ability of the Corporation to Obtain Loans from Outside Lending Institutions – If a corporation is able to borrow funds from outside sources, the shareholder loan would appear to be a *bona fide* indebtedness.

- Extent to Which the Loan Was Used to Acquire Capital Assets – Courts have held that purported debt should be treated as equity if the funds advanced are used to acquire the essential assets of a business.

- Failure of the Debtor to Repay on the Due Date or Seek a Postponement – Repayment of the loan under its terms and conditions is an indication of a true debt instrument.[7]

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Fin Hay

Another notable case is *Fin Hay Realty Co. v. U.S.*,[9] which was decided in the same circuit as the *Sensenig* case. Most of the factors included in *Fin Hay* were also mentioned in *Mixon*. However, several factors were added, including the following:

- Voting Power of the Holder of the Instrument – Unlike shareholders, creditors generally do not have voting power.

- Contingency on the Obligation to Repay – If the contingency is considered too remote to occur, the instrument might be considered equity.

- Provision for Redemption by the Corporation – If the corporation can redeem the share at its option, this may suggest debt.

- Provision for Redemption at the Option of the Holder – If the holder retains the right to redeem his share, this may be an indication of equity.

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[7] Galia Antebi and Nina Krauthamer, "Tax 101 – Introductory Lessons: Financing a U.S. Subsidiary – Debt vs. Equity," *Insights* 3 (2014), referencing *Estate of Mixon v. U.S.*, 464 F.2d 394, 402 (5th Cir. Ala. 1972).

[8] *John M. Sensenig, et ux. v. Commr.*, TC Memo 2017-1.

[9] *Fin Hay Realty Co. v. U.S.*, 398 F.2d 694, 696 (3d Cir. 1968).

- Timing of the Advance with Reference to the Organization of the Corporation – If a corporation is immediately financed by debt with a remote possibility of repayment, this may be considered an equity investment rather than a debt.

THE SENSENIG CASE

In the recent case before the Tax Court, the petitioner, John M. Sensenig, was the sole shareholder of an S-corporation, CLCL. CLCL's purpose was to invest in high risk companies. The petitioner was also a part owner of several other companies, some of which received advances from CLCL. No loan documents were prepared for these advances, nor was a due diligence analysis prepared for the lender analyzing the ability of the companies to pay interest and repay the loans. The borrowers were very thinly capitalized and the lender never attempted to collect a repayment on the advances.

CLCL raised the capital used for the above-mentioned advances from unrelated investors who received demand notes payable by Sensenig individually or by CLCL. The Pennsylvania Securities and Exchange Commission determined these notes were securities that required registration and thus barred CLCL from offering or selling securities in Pennsylvania unless a valid registration statement was granted, which CLCL never obtained. As a result, CLCL had liquidity and cash flow problems.

CLCL's C.P.A. determined that a return on the advances was considered remote and thereby recommended that CLCL take a Code §166 worthless debt deduction. Upon an audit, the I.R.S. disallowed the worthless debt deduction and charged the petitioner with an accuracy-related penalty. The shareholder then appealed the I.R.S.'s finding. The I.R.S.'s reasoning for the disallowance was that these advances were not debt but equity.

Debt-Equity Recharacterization

Sensenig was determined in the Third Circuit, and thus, it quoted judicial factors from the *Fin Hay* case, which was decided in that circuit. In *Sensenig*, the court focused on three factors in determining whether the advance was considered debt or equity:

- The intent of the parties
- The form of the instrument
- The objective economic reality of the transaction as it relates to the risks taken by investors

The court held that the advance was equity and not debt for several reasons. The court focused on the documentation requirement, and held that although shareholder and director resolutions authorized the loan, there was no evidence that a loan was actually made or that the borrower agreed to repay the funds as per the resolution. Further, the borrower did not treat the investment as a line of credit on its books. Therefore, the court held that the parties did not demonstrate the requisite intent to treat the advance as a loan.

Additionally, the investment lacked formal documentation indicating that the investment was to be repaid. The court further noted that "the absence of an unconditional

right to demand payment is practically conclusive that an advance is an equity investment rather than a loan for which an advancing taxpayer might be entitled to claim a deduction for a bad debt loss." Furthermore, the court remarked that the shareholder was not unsophisticated in the matter and had issued formal demand letters to other investors, demonstrating that he previously recognized the importance of formal demand documents.

Finally, the court analyzed whether an arm's length third party would have made the same "loans" under similar circumstances. The court discovered that there were no repayment projections or business plans regarding the advances. The court also found that the lender was deducting the advances as worthless debt that could never be repaid but then continued to make future investments to the borrowers. The court thus held that an arm's length third party would not invest in a similar manner, as demonstrated by both the lack of third-party bank financing and the improbability that a lender would continue to lend funds to a person with little chance of being repaid.

For the foregoing reasons, the court concluded that the advance was to be characterized as equity and not debt.

Worthless Debt Deduction

Per Code §166(a)(1), a taxpayer can obtain a deduction for any worthless *bona fide* debt in a tax year. A *bona fide* debt arises from a "debtor-creditor relationship based on a valid and enforceable obligation to pay a fixed or determinable sum of money."[10] Because the court found that the investment was an equity investment and not debt, no worthless debt deduction can be allowed.

CONCLUSION

Among other exceptions, the new Code §385 regulations regarding the recharacterization of instruments as debt or equity only apply to instruments of over $50 million. As such, smaller investments will continue to be scrutinized using prior court decisions and I.R.S. rulings. Using these factors as a guide, an investment without proper loan documentation may be considered an equity investment rather than debt. While the documentation requirement is not controlling, lack of documentation commonly indicates a lack of interest payments, a lack of commitment to repay the loan, and a lack of penalties applicable to late or non-payment. One can satisfy the documentation requirement by having "a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest."[11]

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[10] Treas. Reg. §1.166-1(c).

[11] Code §385(b)(1).

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