HOW MUCH EQUITY IS ENOUGH IN A U.S. ENTITY?

WHEN IS DEBT TREATED AS DEBT?

Stanley C. Ruchelman
Ruchelman P.L.L.C.
New York City
ruchelman@ruchelaw.com

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Why use intercompany loans?

- A foreign-owned subsidiary may encounter difficulty in obtaining external financing on its own
- Financing with debt can result in a U.S. interest expense deduction, reducing U.S. tax
- Repayment of debt principal will be free of U.S. withholding tax
- An applicable treaty may reduce or eliminate the imposition of withholding tax
- Possible tax arbitrage from hybrid instrument
- The net effect is to shift income from a high tax jurisdiction to a lower tax jurisdiction

Potential I.R.S. challenges

- The I.R.S. may recharacterize the loan as equity
  - Risk exists where principal and interest payments are deferred, company is undercapitalized with equity, or equity factors permeate the instrument
- If recharacterized:
  - Interest deduction taken will be disallowed
  - Interest payment may be treated as a dividend distribution
  - Payment of principal may be treated as a redemption that is essentially equivalent to a dividend
  - Withholding tax rate may be greater for dividend
  - Double taxation may arise if tax authorities in lender's jurisdiction honors the instrument as drafted

Code §385

- In 1969, the I.R.S. is authorized to issue regulations to determine whether an instrument is to be treated as debt or equity; final regulations were never issued
- Factors to be considered:
  - Does a written unconditional promise exist to pay on demand or on a specified date a certain sum of money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest
  - Is the instrument subordinated to another indebtedness of the corporation
  - The ratio of debt to equity of the corporation
  - Convertibility feature into the stock of the corporation
  - The relationship between holdings of stock in the corporation and holdings of the interest in question

Mixon Factors

- Court cases have taken an approach to test the genuineness of shareholder debt through the application of several factors
  - The names given to the certificates evidencing the indebtedness
    - If no documentation exists, the informality may suggest absence of an intent to repay
    - Example, intercompany advance, booked as a “due to,” to a money-losing subsidiary
  - The presence or absence of a fixed maturity date
    - The absence of a fixed maturity date may suggest the absence of an intent to repay
    - Creditors generally want a terminal date for a loan
  - The source of payments
    - If the only reasonably assured source of funds for repayment is the liquidation of the debtor's assets, the investment resembles equity

Mixon Factors

- Increased participation in management
  - Equity is suggested if, as a result of the loan, lender has an increased right to participate in
- The right to enforce payment of principal and interest
  - A general creditor typically has rights to enforce repayment on demand and the absence of this right may suggest equity
  - A holder of junior debt has an enforceable right, even if subject to preferences held by others
- The intent of the parties
  - How did the parties treated the instrument?
  - What was the accounting treatment of the loan on the company's books

Mixon Factors

- Thin or inadequate capitalization
  - The adequacy of a borrower’s capital suggests the creditor had reasonable expectation of repayment
  - Equity capitalization provides a cushion to protect the creditor from the borrower’s business losses and a decrease in the value of its assets
- Identity of interest between creditor and stockholder
  - Debt provided by stockholders in proportion to stock ownership suggests the debt is capital contribution
- Interest payments
  - The failure to insist on interest <u>payments</u> suggests the lender is not expecting interest income but is interested in the future earnings

Mixon Factors

- The ability of the corporation to obtain loans from outside lending institutions
  - In principle, this is a key factor
  - Actual third party debt is required, not a one page proposal letter by bank
- The extent to which the loan was used to acquire capital assets
  - Purported debt should be treated as equity if the loan proceeds are used to acquire the essential assets of a business
- The failure of the debtor to repay on the due date or to seek a postponement
  - Repayment of the loan under its terms and conditions is an indication of a true debt instrument
  - Debt/Equity analysis is performed at the time funds are advanced

Objective factors

- This approach is used on audit and more and more in cases
- It is believed that the I.R.S. has over 300 cases teed up for litigation in which status of intercompany loans are in issue
- Key financial ratios are reviewed to determine if the borrower objectively fits within an independent lender’s paradigm to extend a loan
- If a lender does not document the credit worthiness of borrower, the debtor-creditor relationship is placed at risk

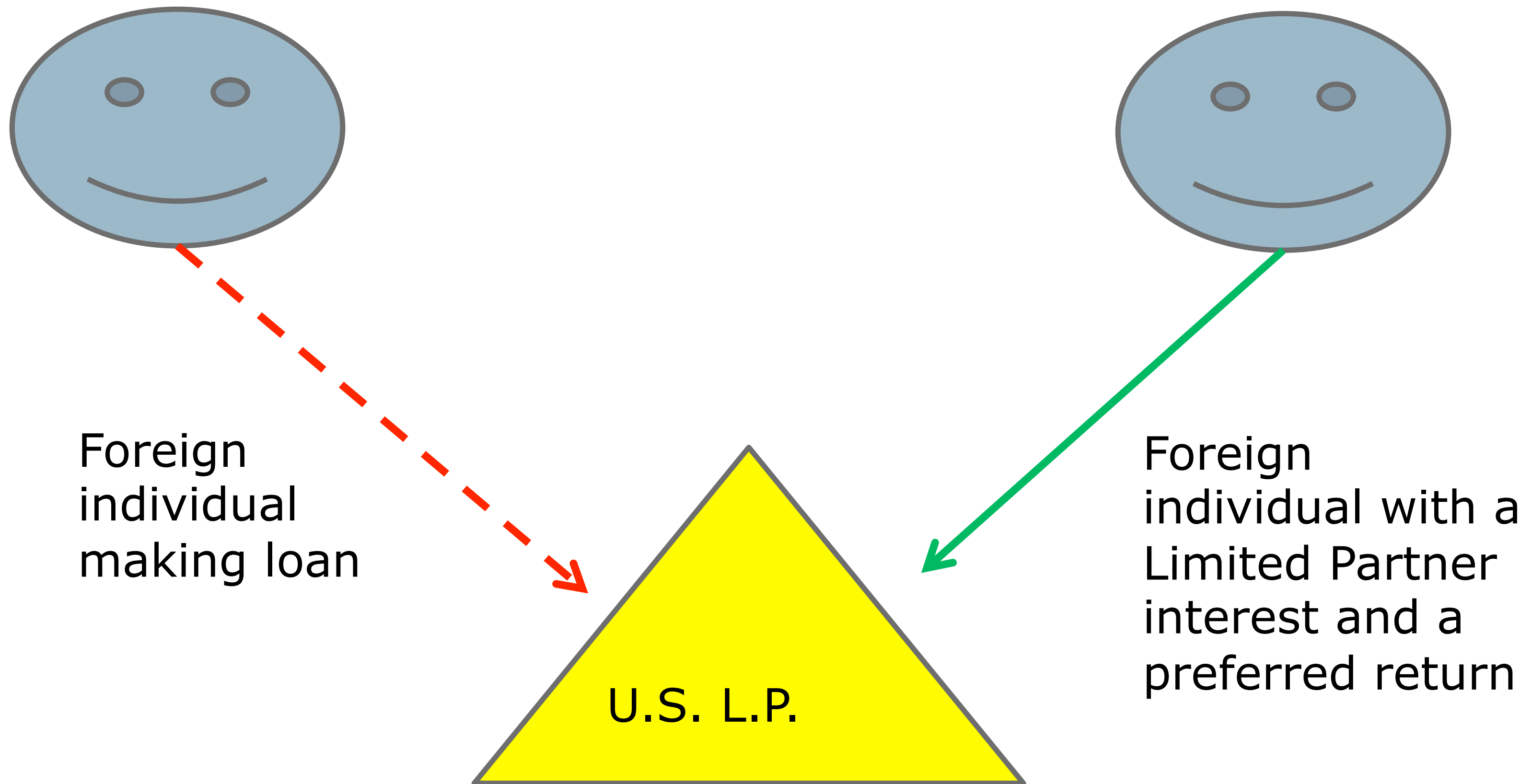
Objective factors

- Factors looked at:
  - The ratio of E.B.I.T.D.A. to interest payments
    - The E.B.I.T.D.A. must be an adequate multiple of interest payments,
  - Debt to equity ratio
    - The ratio must meet industry standards gleaned from objective data bases
  - The ratio of current assets to current liabilities
  - The ratio of current assets minus inventory to current liabilities
- Industry standards control whether objective factors support debt character

Is the interest rate appropriate?

- If the factors suggest debt, the next issue is the whether the interest rate under the instrument is arm's length
- Typically, this is an exercise in creating a synthetic D&B or Bloomberg rating
- Then determine the premium required in comparison to interest rate on risk-free debt
- In principle, AFR rate can be used rather than a determined rate
  - The AFR is based on government borrowing costs for the month in which debt is issued
  - Since 2008, the AFR is held artificially low through TARP and Quantitative Easing

Unique situations

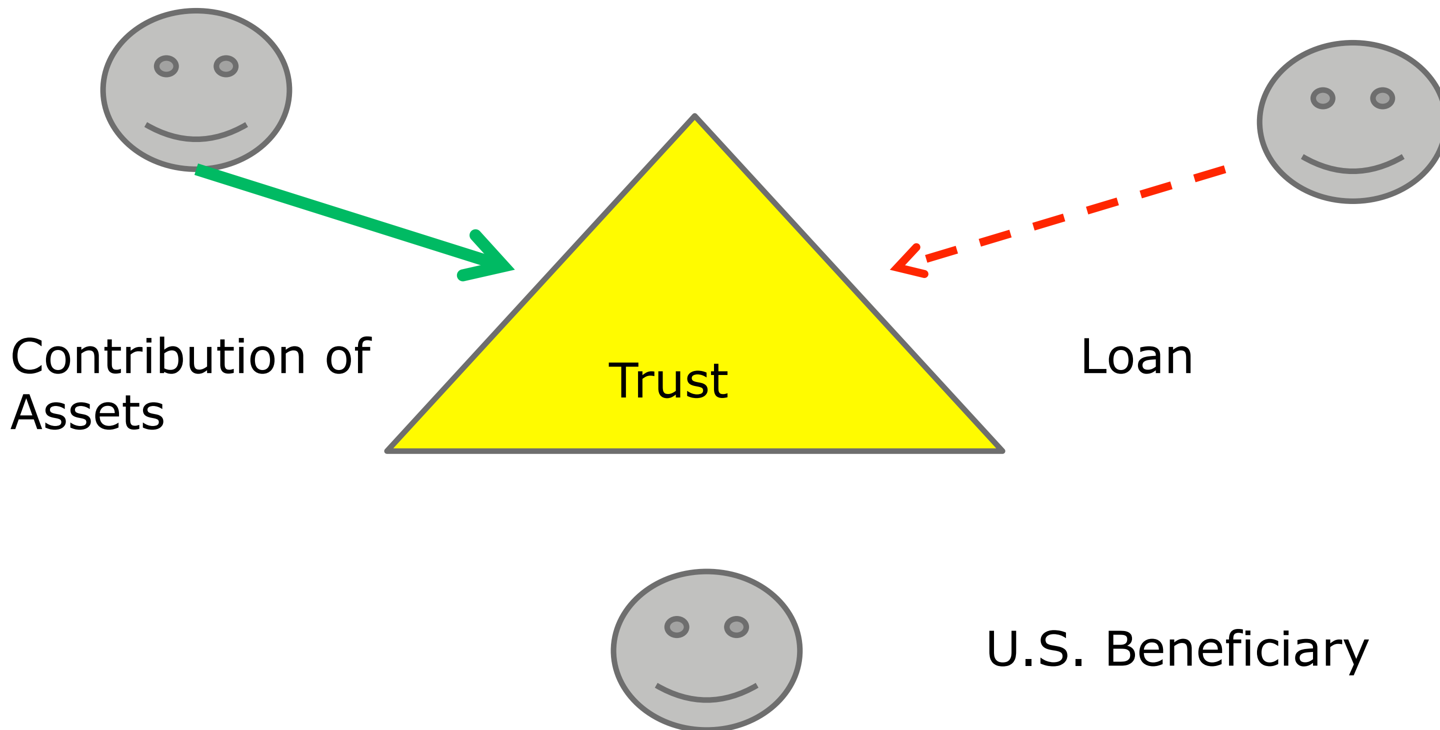


Comparison of interests

- Terms of debt
  - Fixed interest of 6%
  - Participation feature of 20% of gain
- Fixed interest is exempt as portfolio debt
- Participation feature taxed at 30%
- No estate tax exposure

- Limited partner interest
  - Preferred return of 6%
  - Entitled to 20% of the gain
- Subject to the following tax exposure:
  - Effectively connected income taxed at ordinary rates
  - LTCGs taxed at 20%
  - Estate tax exposure

Unique Situation



Comparison of interests

- Terms of Capital
  - $50,000 capital
  - Distributions only to settlor and spouse
  - Accepts estate tax exposure, but treaty benefits eliminate the tax
- Terms of debt
  - $6.0MM loan
  - Fixed interest at 6%
  - Goal is to avoid tax on interest and to avoid estate tax exposure
  - Lender is related to U.S. beneficiary

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NEW YORK

Ruchelman P.L.L.C.
Architects and Designers Building
150 East 58th Street, 22nd Floor
New York, New York 10155
Tel. 212-755-3333

TORONTO

Ruchelman P.L.L.C.
The Exchange Tower, P.O. Box 233
130 King Street West, Suite 2300
Toronto, Ontario M5X 1C8
Tel. 416-350-2026

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