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

By Robert W. Wood • Wood LLP • San Francisco

Part I of this article appeared in the March 2013 issue.

Management Rights

If a lender increases its management rights in connection with an advance, this indicates equity treatment. [*See American Offshore, Inc.*, 97 TC 579, 603, Dec. 47,750 (1991).] In some cases, this factor can be evident where the management rights are not exercised but are merely present. The fact that the putative lender has management rights at all can be viewed as equity-like by the very nature of such rights.

In effect, it is the legal rights as a creditor that may be viewed as suspect. Clearly, though, such management rights can be desirable for a creditor to have. This is particularly so where they are coupled with enforcement or triggered by events of default.

Status of Creditor as Subordinated or Senior

If the rights of a shareholder that makes an advance to a corporation are subordinated to the rights of other creditors, this subordination supports equity treatment. [*See W.L. Harlan*, CA-5, 69-1 USTC ¶9321, 409 F2d 904, 907 (1969).]

Thin Capitalization

There is no particular ratio of debt to equity or gross amount of capital devoted to a business that spells either adequate or thin capitalization. Indeed, the amount of capital necessary to a business varies widely among business types. To determine if a debtor/issuer was thinly capitalized, it is necessary to review the company's balance sheet at the time a Note or other instrument under examination was issued.

Identity of Interest Between Creditor and Shareholder

If the party making an advance to the obligor is also a shareholder, this tends to support equity treatment. Not surprisingly, the dual holdings are particularly suspect if the debt is held in proportion to equity interests. [*See Sayles Finishing Plants, Inc.*, CtCls, 68-2 USTC ¶9474, 399 F2d 214, 221 (1968).] Indeed, perhaps more than with many of the other factors noted here, this is fundamental.

An identity of interest between creditors and shareholders represents a classic case in which tax advisors customarily worry about debt-equity characterization. There is any number of answers for avoiding this situation, even where to do so involves injecting new debt or shareholdings.

Payment of Interest Only out of Dividends

This factor is closely related to the third factor (source of payments). [*See R.A. Hardman*, CA-9, 87-2 USTC ¶9523, 827 F2d 1409, 1414 (1987).] The presence of an obligation to pay interest and the actual payment of those interest payments tend to favor debt treatment. Conversely, the absence of these two features favors equity treatment.

Thus, the failure to provide for interest payments indicates that the holder is not expecting substantial interest income. In such a case, the holder may appear to be more interested in the corporation's future earnings or in the appreciation in value of the corporation. [*See American Offshore, Inc., supra* (*citing B.F. Curry*, CA-5, 68-2 USTC ¶9439, 396 F2d 630, 634 (1968)).] That sounds like equity.

Ability of Borrower to Obtain Credit from Outside Lending Institutions

The fact that no reasonable creditor would be willing to make a loan to a debtor on the same terms is telling. It generally will count as strong evidence in favor of viewing a purported loan as a capital contribution. [*See Roth Steel Tube Co.*, CA-6, 86-2 USTC ¶9676, 800 F2d 625, 631 (1986), *cert. denied*, 481 US 1014 (1987).] The nature and terms of payment of interest and principal, subordination and other terms would all be relevant in making this assessment.

Summary of Debt-Equity Factors

In determining whether a shareholder advance is properly treated as debt or equity, there is no litmus test or bright-line rule. Not all factors are of equal significance, but no single factor is controlling. [*See T. Mixon, Jr. Est.*, CA-5, 72-2 USTC ¶9537, 464 F2d 394, 402 (1972).] Reasonable tax advisors can and do differ in their opinions on whether a particular obligation should constitute debt or equity.

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.

CCH
a Wolters Kluwer business

4025 W. Peterson Ave.
Chicago, IL 60646

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