Corporate Tax    Segment 4
Capital Structure

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Capital Structure of the
Corporation

Options for Capital Structuring:
1) Common Stock, including:
   a) voting stock;
   b) non-voting stock; and,
   c) rights and warrants.
2) Preferred Stock - (a) nonqualified preferred stock; (b) qualified preferred stock; (c) convertible preferred stock.

continued
Capital Structure Options, continued

3) Debt:
   a) Convertible into stock; or,
   b) Nonconvertible:
      bonds, including “junk bonds;”
      debentures;
      notes;
      trade payables.

Reasons for Corporation to Use Debt (Rather than Equity)

1) Interest on debt is deductible; dividends paid are not deductible to the corporation.
2) Repayment of the debt constitutes tax basis recovery to the lender and not a dividend distribution; redemption of the stock may be an ordinary dividend event, not a capital gains event (but both 15% tax).
3) Bad debt deduction (nonbusiness bad debt treatment?) and not a capital loss.
**Beneficial Effects of Debt Leveraging**

Enhance the corporation’s return on its equity (ROE) component and, thereby, increase earnings per share.

If shares are normally selling at some multiple of earnings per share, what should happen when the earnings per share are increased by significant debt leveraging?

What is a permissible debt to equity ratio?

Caution: Leverage is a “two edged sword”.

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**Impact of the 2003 Legislation re Dividends Tax Rate**

1) Dividends (and capital gains) are taxed at a maximum 15% to individuals.

Expiration of 15% rate at end of 2010.

2) Cf., interest income (to the lender) taxed at up to 35 percent (i.e., a 20 percent tax rate differential from 15% rate).

3) But, interest expense is deductible at the corporation level; dividend distributions are not deductible to the corporation.
Alternative Shareholder Tax Planning

Hold the shares for capital appreciation and eventual recognition of deferred capital gains (or §1014 tax basis step-up at death). Corporation can use stock buy-backs (market repurchase programs) to compress the shareholder equity base and increase the earnings per share (and thereby -hopefully- contribute to increased stock appreciation).

Debt vs. Equity Characterization

Significant factors in differentiating between debt and equity (a fact question) include:

1) The form of the obligation – existence of indicia of debt, e.g., promissory note.
2) Debt/equity ratio, "thin capitalization".
3) Intent to create a debt (is interest paid?).
4) Proportionality - really a “super factor”?
5) Subordination - inside debt/hard to avoid?
Certain Debt vs. Equity Issues

Is an IRS private letter ruling available to assure classification of debt as such for tax purposes? No. Rev. Proc. 2007-3, § 4.02(1) - this is a fact issue.

Treatment of shareholder guaranteed debt: recharacterized as equity? Plantation Patterns case says yes.

Example: Fin Hay Realty

Demand debt outstanding for a long period. Issue re deduction of interest expense - §163. Tax refund action - held equity & not debt. Important factors: (listing 16 factors) Proportionality as critical.

Debt was committed for equity investment by the corporation in real estate and prompt liquidation of corporate assets was difficult.
What Varieties of Debt ()?

Monthly income preferred securities (MIPs).
Contingent convertible debt securities:
- limited cash interest;
- OID; and, possible conversion into equity.
- Rev. Rul. 2002-31 – concerning this debt
- Rev. Rul. 2003-97, Merrill Lynch’s “feline prides” – 5 year note and 3 year forward contract to purchase issuer’s stock; the interest expense is deductible.
- Similar ACES Units, PEPS Units, and Upper DECS.

Code Section 163(l)

Debt is payable in equity of the issuer (or a related party).
No deduction is allowed for interest paid or accrued on this “disqualified debt instrument.”
Code §385

Authorizes promulgation of regulations.
Issues re: proportionality; and,
inside/outside debt ratios
Regulations withdrawn (1969 to 1980 to abandonment) but a continuing impact?
Possible bifurcation of putative debt instruments? Code §385(a) (parenthetical).
Example: equity kickers.

Code §385(b) Factors

1) Form
2) Subordination
3) Debt/equity ratio
4) Convertibility into stock
5) Proportionality
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Example – Option 1

(a) Transaction: Three shareholder loans for $300,000 each; for five years; variable interest rate one point below prime, determined annually.

What is the “debt-equity ratio”?

1.8 mil to 240,000? or,

1.8 mil to 140,000?

Or, is ratio computed as follows: 900,000 (inside debt only) to either: (i) 240,000 or (ii) 140,000?
Example – Option 2

(b) Transaction:
Three shareholders - each makes a loan for $300,000;
each for a 10% 20 year subordinated income debenture;
interest expense is payable only from the net profits of the business.

Example – Option 3

(c) Transaction:
$900,000 (additional) loan from the bank;
unsecured but personally guaranteed by the shareholders;
joint and several liability to the three shareholders for this additional loan.
Example – Option 4

(d) Transaction:
A (only) loans the $900,000 (additional) loan.
Terms:
  five year term;
  variable interest rate one point below prime, determined annually.

Example – Option 5

(e) Transaction:
A (only) loans the $900,000 (additional) loan.
Same terms (as (d)): five years & variable interest rate one point below prime, determined annually.
Borrower fails to pay interest on the debt.
Issue: What impact on A’s “intent” to create a debtor/creditor relationship?
Avoiding equity status

Avoiding attributes of hybrid stock:
- reasonable interest rate
- fixed or floating
- interest paid with regularity
- fixed maturity date
- no convertibility feature

Ordinarily quite difficult to avoid if:
(i) proportionality and (ii) subordination.

Tax Character of a Loss on Corporate Debt Investment

Code §§165(g)(1) & (2) (worthless securities)
capital loss treatment upon sale or becoming worthless.

Code §166 (bad debts) –
- business bad debt as an ordinary loss.
- nonbusiness bad debt as a short-term capital loss.
Generes case

Issue re business or non-business bad debt status (i.e., what value of the deduction). Generes owned 44 percent of the stock and was part-time president - salary $12,000. He advanced funds to the corporation and also guaranteed corporate debts. Dominant motivation was as an investment, not to protect his employment status (i.e., his “business”).

Section 1244 Stock – Ordinary Loss Deduction

1. Individuals (and partnerships) only.
2. Common or preferred stock issued for money or property, but not for services.
5. Annual limit on the ordinary loss amount.
No formal Section 1244 plan is required.
Example of Alternative Investments

Capital structure for a venture capital investment.

a) Five year note - No participation in equity growth; §166 governs if the note defaults. Nonbusiness bad debt status unless the lender’s business is loaning money.

b) Registered bond - market interest rate. Security categorization under §165(g)(2).

Example, cont.

c) Registered bond; Bond loss would be worthless security. Code §165(g)(1). Concept of "security" includes subscription right. Loss on warrants - $10,000 – is governed by Code §165(g)(2)(B) & therefore, a $10,000 LTCL.

d) Common stock - qualifies as §1244 stock. Ordinary loss treatment available?
Example, cont.

e) Convertible preferred stock.
Does qualify under §1244. Eligibility of up to $50,000 loss (or $100,000 on a joint return) if other requirements are satisfied.

f) Original contributions of $500,000 & $500,000. Not a "small business corporation" at the time it issues the additional common stock because aggregate amount of money received for original stock exceeds $1 mil.

Example, cont.

g) Wedding gift of stock. Donees do not qualify for §1244 treatment. Donee is limited to capital loss under Code §165(g)(1). Reg. §1.1244(a)-1(b).

h) Purchase of stock through a partnership. Partnership is eligible for an ordinary loss deduction under Code §1244. Loss will flow through to the eligible partners.