Options – Structuring Corporation’s Capital:

1) Common stock (voting, non-voting, and stock rights & warrants)

2) Preferred Stock (qualified preferred stock, nonqualified preferred stock, and convertible preferred stock)

3) Debt (convertible or nonconvertible). Debt can take many forms including bonds, debentures, notes, and 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 20% tax).

3) Bad debt deduction may not be a capital loss.
Beneficial Effects of Corporate Debt Leveraging

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

<table>
<thead>
<tr>
<th>Capital</th>
<th>Debt (10%)</th>
<th>Equity</th>
<th>Profits</th>
<th>Return on Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Example 1: 100% Equity Financing</td>
<td>0</td>
<td>200</td>
<td>40</td>
<td>20%</td>
</tr>
<tr>
<td>Example 2: 50:50 Debt/Equity</td>
<td>100</td>
<td>100</td>
<td>30</td>
<td>30%</td>
</tr>
</tbody>
</table>

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

What is permissible debt to equity ratio?

Caution: Leverage is a “two edged sword”.

Impact of the ATRA 2013 Legislation
Re Dividends Tax Rate

1) Dividends (and capital gains) are taxed at a maximum 20% to individuals.

2) Cf., interest income (to the lender) taxed at up to 39.6 percent (i.e., a 19.6 percent tax rate differential from the 20% rate for individuals).

3) But, interest expense is **deductible** at the corporation level; dividend **distributions** are **not deductible** to the corporation.
Hold the shares for capital appreciation and eventual recognition of deferred capital gains (or §1014 tax basis step-up at death for shares held).

Corporation can use stock buy-backs (market repurchase programs) to compress the shareholder equity base and increase the per share earnings (and, thereby-hopefully- contribute to increased stock appreciation).
Significant factors in differentiating between debt and equity (a fact question) include:

1) The form of the obligation – what existence of the indicia of a debt, e.g., promissory note?

2) Debt/equity ratio – “thin capitalization”? And what is “debt” for determining this ratio?

3) Intent to create a debt (is interest actually paid?).

4) Proportionality – really a “super factor”?

5) Subordination – inside debt/hard to avoid?

See articles cited in Note 18 on p.123
Is an IRS private letter ruling available to assure the classification of debt as such for federal income tax purpose? No. Rev. Proc. 2011-3, §4.02(1) – this is a fact issue.

What treatment of shareholder guaranteed debt: recharacterized as an equity contribution? Plantation Patterns case (p.124 n.27) says yes if the company is inadequately capitalized and the shareholder guarantor is in substance the primary borrower.
FACTS: Advances outstanding for long time. Advances were undocumented (no notes) initially. No maturity date. 10% interest rate. Indmar classified the advances as debt on its books and deducted interest.

Tax Court: Held that the advances were equity.

6th Circuit: Held that the advances were debt for tax purposes. Debt is “an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor’s income or lack thereof. Some variation from this formula is not fatal” Note the factor analysis in the court’s opinion.
Notice 94-47: If holder must receive stock and cannot elect otherwise, then the instrument is equity

Contingent convertible debt securities can be debt. See Rev. Rul. 2002-31 – contingent convertible debt.
General Rule: The debt is payable in the equity of the issuer (or a related party). No deduction is allowed for interest paid or accrued on this “disqualified debt instrument”.

Exception: 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. Although the economic return is linked to the equity return, the issuing corporation does not have the option to redeem with company stock.

Corporate planning objective: debt for tax and equity for financial reporting – why?
Section 385(a): “The Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness).

Section 385(b): includes a list of non-exhaustive factors that may be taken into account.

Section 385(c): issuer’s characterization of an instrument is binding on the holder.

   a. Amended by Omnibus Budget Reconciliation Act of 1989, P.L. 101-239, 103 Stat. 2106 to expressly authorize Secretary to treat an instrument as part stock / part debt.
   b. Amended by Energy Policy Act of 1992, Pub. L. 102-486, §1936(a), 106 Stat. 3032, which added Section 385(c) to provide that the issuer’s characterization of an interest is binding on the issuer and all holders (but not the Secretary).

2. **Prior Effort:**

3. **New Effort:**
Common Law Applies First. If an instrument is otherwise considered a debt instrument under the common law, then the section 385 regulations may still recast it as equity if those regulations apply. The controversial final regulations under section 385 have the following main parts:

I. **Operating rules (Reg. §1.385-1 and -2(d) and -3(g)(3))**: The final regulations apply a recast rule for related party debt to equity for instruments issued by a “covered member” (a domestic issuer - so foreign issuer debt instruments are not addressed) to an expanded group member (a new affiliated group definition).

II. **Documentation and Maintenance Requirements (Reg. §1.385-2)**: Formal documentation and creditor oversight is required as a prerequisite to debt characterization.

III. **Per se and Funding rules (Reg. §1.385-3)**: Even if an instrument meets the formal documentation and maintenance requirements, it can still be recharacterized as stock if the debt instrument is issued in specified transactions or within 3 years of a specified transaction.

IV. **Consolidated group rule (Reg. §1.385-4)**: Exception to these rules remains unchanged.

V. **General Anti-Abuse Rule (Reg. §1.385-3(b)(4))**: Debt issued with a principal purpose of avoiding the application of -2 or -3 are subject to being treated as stock.
FACTS: Total equity contributions of $240,000. Debt of $900,000 from Friendly. Additional debt from shareholders of $900,000.

### Balance Sheet

<table>
<thead>
<tr>
<th>Assets</th>
<th>Adj. Basis</th>
<th>F.M.V.</th>
<th>Liabilities and Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$1,920,000</td>
<td>$1,920,000</td>
<td>Liabilities:</td>
</tr>
<tr>
<td>Building</td>
<td>20,000</td>
<td>80,000</td>
<td>Friendly</td>
</tr>
<tr>
<td>Goodwill</td>
<td>0</td>
<td>40,000</td>
<td>Bank</td>
</tr>
</tbody>
</table>

- **Liabilities:**
  - Friendly: $900,000
  - Bank: $900,000

- **Shareholder Loans:** $900,000

**Capital:**
- Common Stock: $240,000

Total Assets: $1,940,000

Total Liabilities and Capital: $2,040,000
Three shareholder loans for $300,000 each; for five years; variable interest rate one point below prime, determined annually.

Factors

Form ✔

Proportionality ✔

Debt/Equity Ratio ✔

Intent ✔

Other ✔

Equity

(Assets @ FMV 7.5:1 @ AB 12.85:1)

(If shareholder debt were subordinated)

Conclusion: strong risk of equity given poor debt/equity ratio and proportionality
Problem 1(b)  
Interest Paid from Profits  

FACTS: Same but each shareholder receives a 10%, 20 year subordinated income debenture. Interest expense is payable only from net profits of the business.

Factors | Debt | Equity
--- | --- | ---
Form | ✔ | 
Proportionality | ✔ | 
Debt/Equity Ratio | ✔ | (Assets @ FMV 7.5:1 @ AB 12.85:1) 
Intent | ? | (If shareholder debt were subordinated)
Other | ✔ | 

Conclusion: Equity features dominate.
$900,000 (additional) loan from the bank; unsecured but personally guaranteed by the shareholders so that shareholders have joint and several for the additional loan.

Factors

Form ✔
Proportionality ✔
Debt/Equity Ratio ✔
Intent ✔
Other ✔

Equity

(Assets @ FMV 7.5:1 @ AB 12.85:1)

(If shareholder debt were subordinated)

Conclusion: A strong risk that all the loans, including the Bank loan, are equity under a Plantation Patterns analysis.
FACTS: A (only) loans the $900,000 loan. Five year fixed term. Variable interest rate one point below prime, determined annually.

**Factors**
- **Debt**
  - Form ✔
  - Proportionality ✔
  - Debt/Equity Ratio ✔
- **Equity**
  - Intent ✔
  - Other ✔

(Assets @ FMV 7.5:1 @ AB 12.85:1)

(If shareholder debt were subordinated)

**Conclusion:** No proportionality, but still a high debt-equity ratio. Is this instrument really “preferred stock”?
Problem 1(e)
Default Two Years Later

FACTS: Same as Problem (d) except that Newco fails to pay interest on the debt.

Issue: What impact on A’s “original intent” to create a debtor/creditor relationship?

Answer: We look to the facts at the time of the loan and test at that date only, but courts will use the benefit of hindsight to help determine what they think was the original “intent” of the advance.
Avoiding attributes of hybrid stock:

- Reasonable interest rate
- Fixed or floating (reference to external rate)
- Interest paid with regularity
- Fixed maturity date
- No convertibility feature

Quite difficult to avoid risk of equity status if:
(i) Proportionality and (ii) subordination.
Equity and debt securities held by investors as capital assets (i.e., not traders) receive capital gains treatment.

Special 50 percent exclusion (§1202) for gain on Qualified Small Business Stock (100% exclusion for investments through 2013 where held for 5 years).

Code §1045 gain rollover provision – postponement when investment in qualified small business stock.
§§165(g)(1) & (2) (worthless securities). Capital loss treatment upon sale or becoming worthless.

§166 (bad debt – not a security)
- Business bad debt as an ordinary loss
- Nonbusiness bad debt as a short-term cap. loss

Loan to corporation as an employee. Issue re business or non-business bad debt status (i.e., what value of the deduction).

See Generes (p.145 n.67) who 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. Court held that Generes’ dominant motivation was as to make an investment, not to protect his employment status (i.e., his “business”).
1) Individuals (and partnerships) only.

2) Common or preferred stock issued for money or property, but not for services.

3) Small business.

4) Gross receipts test: requires active business income and not passive income.

5) Annual limit on the ordinary loss amount.

No formal Section 1244 plan is required.
Hi-Tech capital structure for 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) & STCL status if held ≤ a year & LTCL if held more than a year.
c) Registered bond. Bond loss for a worthless security would be a capital loss per §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 if held > 1 year.

d) Common stock – qualifies as §1244 stock. Ordinary loss treatment available? Yes, for 50K (or 100K, if married).
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. Now, Newco is no longer a “small business corporation” at the time it issues the additional stock because aggregate amount of money received for original stock exceeds $1 million. Consequently, any loss would not be an ordinary loss, but rather would be a capital loss.
g) Wedding gift. Donees do not qualify for §1244 treatment. Son is limited to $200,000 capital loss under Code §165(g)(1). Reg. §1.1244(a)-1(b). Only original issuee is eligible for ordinary loss treatment.

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 (not corporations).