Chap. 3 - Capital Structure of the Corporation

Options - Structuring the Corporation's Capital:

1) Common Stock, including:
   a) voting stock;
   b) non-voting stock; and,
   c) stock rights and stock warrants (for common stock).

2) Preferred Stock - (a) nonqualified preferred stock (§351(g)); (b) qualified preferred stock; & (c) convertible preferred stock. *continued*

Capital Structure Options, continued

3) Debt:

a) Convertible into stock (ordinarily common stock); or,

b) Nonconvertible (i.e., "straight debt"):

bonds, including "junk bonds;"
debentures; notes; trade payables.

c) Contingent convertible debt ("coco") – p.137, including debt payable in equity. Objective: debt for tax but equity for FASB.

Reasons for Corporation to Use Debt (Rather than Equity)

1) Interest on debt *is* deductible to obligor, but see Code §163(j) re interest deduction limit (*next slide*); dividends when paid *not* deductible to payor.

2) Repayment of the debt principal constitutes tax basis recovery to the lender, and not a dividend distribution; redemption of stock may be an ordinary dividend event, not a capital gains event (but both dividends and the stock gain are currently subject to 20% tax rate).

3) Bad debt deduction (nonbusiness bad debt treatment?) and not a capital loss.

Limit on Business Interest Expense Deduction (see Supp)

Code § 163(j) amended in TCJA to limit deduction for "business interest" for any taxable year to:

1) Business interest income for the taxable year; and,

2) 30 percent of taxpayer's "adjusted taxable income."

3) Business interest disallowed may be carried forward indefinitely. Code § 163(j)(2).

4) Relief is provided for "small businesses" (i.e., under $25 million annual gross receipts.

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).
- If shares are normally selling at some multiple of earnings per share, what should happen to share value when the earnings per share are increased by significant debt leveraging?
- What is a permissible debt-to-equity ratio?
- Is ROE impacted by current low interest rate?
- Caution: Leverage is a "two edged sword." Why?

Dividends Tax Rate

1) Dividends (and capital gains) are taxed at a maximum 20% (+3.8%) to individuals. Prior expiration of the 15% rate at end of <u>2012.</u>

2) Cf., interest income (to the lender) is taxed at up to 37% (+3.8%) (i.e., a 17% tax rate differential from the 20% rate for dividends).

3) But, interest expense is <u>deductible</u> at the corporation level; dividend <u>distributions</u> are <u>not deductible</u> to the corporation.

Alternative for Shareholder Income Tax Planning

- Individual can hold the shares for capital appreciation and eventual recognition of deferred capital gains taxed at 20% (or a §1014 tax basis step-up at death for shares then held).
- Corporation can use stock buy-backs (market repurchase programs) to (1) compress the shareholder equity base, and (2) increase the per share earnings (and, thereby - hopefully - contribute to increased stock appreciation; including by increasing demand for shares).

Debt vs. Equity Characterization p.122-125

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., a promissory note?

2) Debt/equity ratio – "thin capitalization"?

& 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 – for inside debt/hard to avoid?

Certain Debt vs. Equity Issues p.123

- Is an IRS private letter ruling available to assure the classification of a "loan" as being debt for federal income tax purposes? No. Rev. Proc. 2019-3, §4.02(1) - this is a "fact" issue (p. 123, fn. 17).
- What is the treatment of shareholder <u>guaranteed</u> debt: possibly recharacterized as an equity contribution? Plantation Patterns case (p. 124, fn.27) says yes.

Indmar Products Co., Inc. P.126

- Shareholder advances made to corporation & deduction for interest expense. Tax Ct. decision treating advances as equity reversed by Ct. App.
- No dividends were paid over an extended period.
- Demand notes were executed & credit agreements.
- Short term debt for state tax law purposes.
- Banks were also lending money to corporation (with subordination clauses). Interest rate was consistent with the then current prime rate. Co*nt.*

Indmar Products Co., Inc. P.126, continued

- See various factors (Roth Steel), p. 130.
- Standard of review: a question of "fact" or "law"? Concluding that here tax status of debt is a question of fact, and then determine whether "clear error" occurred in the U.S. Tax Court. FRCP 52(a).
- See criteria: p. 131-135, including source of repayments (profits?), use of the borrowed funds (capital assets?), sinking fund (reserve?), failure to pay dividends (and not an exorbitant interest rate).

Hybrid Instruments p.137
What Varieties of Debt (?)

- Monthly income preferred securities (MIPs).
- "Contingent convertible" debt securities: limited cash interest; OID; and, conversion into equity.
- Rev. Rul. 2002-31 – contingent convertible 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.
- *See 2016 JCT report (p.54) re treatment of debt*.

Code §163(l) – Interest Expense Deduction? – p.137

Situation: The debt is payable in the <u>equity</u> of the issuer (or a related party).

No income tax deduction is allowed for interest paid or accrued on this "disqualified debt instrument."

Corporate planning objective re this security:

(1) debt for tax, and (2) equity for financial reporting – why?

See Rev. Rul. 2003-97 (p.139) re §163(l).

Code §385 p.141
Debt/Equity Classification

- Authorizes the promulgation of debt/equity income tax regulations.
- Important classification issues identified re: proportionality; and, inside/outside debt ratios.
- Regulations withdrawn (1969 to issue 1980 & 1983 abandonment), but a continuing impact of Regs.?
- Possible bifurcation of putative debt instruments? See §385(a) (parenthetical).
- Example: “equity kickers.”

Code §385(b) Factors p.141-142

1) Form – written instrument?

2) Subordination to other corporate debt

3) Debt/equity ratio

4) Convertibility of debt into stock

5) Proportionality in the holdings of the several shareholders

Possible bifurcation of the instrument, e.g., where an "equity kicker" – p.143

2016 Proposed §385 Regs. April 4, 2016 Proposal

1) Documentation required for related party debt to be treated as debt.

2) Per se rules automatically classifying certain related party debt as equity – without regard to current multi-factors for classification.

3) IRS authorization to bifurcate related party instruments based on the substance of the instrument.

Regs finalized late 2016; then suspended.

Problem Facts p.145
& Balance Sheet

Assets	Adj. Basis	F.M.V.	Liabilities & Cap.
Cash	$1,920,000	$1,920,000	a) Liabilities:
Bldg.	20,000	80,000	x) Bank –
Goodwill	0	40,000	$900,000
			y) Sh. Loans $900,000
			b) Cap. Stock $240,000 or 140,000?
	$1,940,000	$2,040,000	$2,040,000

Problem 1 p.145
Debt-Equity Ratios

(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 (all debt) to 240,000? (7.5 to 1) or,

1.8 mil (all debt) to 140,000? (12.8 to 1)

Or, is the ratio computed as follows: 900,000 (*inside* debt only) to either: (i) 240,000 or (ii) 140,000 (i.e., ratios of 3.75 and 6.42)?

Problem 1 p.145
Interest Paid from Profits

(b) Transaction:

Three shareholders - each makes a loan for $300,000; note: proportionality of this debt.

- each receives a 10% 20 year subordinated income debenture;

- interest expense is payable only from the net profits of the business.

Probable treatment as stock (equity).

Problem 1 p.145
Guaranteed Loans

(c) Transaction:

$900,000 (additional) loan from the bank; unsecured but personally guaranteed by the shareholders;

Joint and several liability of the three shareholders for this (additional) loan.

Are also the bank loans equity because of the shareholder guarantees? Plantation Patterns case.

Problem 1 p.145
One Shareholder as Lender

(d) Transaction:

A (only) loans the $900,000 (additional) loan. Terms for this loan: five year term & variable interest rate one point <u>below</u> prime, determined annually.

Note: <u>*no* proportionality</u>, but high debt-equity ratio. Is this really "preferred stock"?

Problem 1 p.145
Default Two Years Later

(e) Transaction:

A (only) loans the $900,000 (additional) loan. Same terms (as (d)): five years & variable interest rate @ one point below prime, to be determined annually.

Borrower later fails to pay interest on the debt.

Issue: What impact on A's "original intent" to create a debtor/creditor relationship?

What was on the original "business plan"?

Apply a "second look" concept at a later date?

Problem 2 p.145
Avoiding equity status

Avoiding attributes of hybrid stock:

reasonable interest rate

fixed or floating (reference to external rate)

interest is regularly paid

fixed maturity date (and observed)

no convertibility (into stock) feature

Quite difficult to avoid equity status if:

(i) proportionality and (ii) subordination.

Character of Gain or Loss on Corporate Investment p.146

Equity and debt securities are held by investors as capital assets (i.e., not acting as traders).

Capital gain treatment for gains on sales.

Plus: 1) Special 100 percent exclusion (§1202(a)(4)) for gain on Qualified Small Business Stock;

See §1202(a)(4) (previously 50%). Hold for 5 yrs.

2) Code §1045 gain rollover - postponement when small business stock gain and reinvestment in qualified small business stock.

Tax Character of a Loss on Corporate Debt Investment

P. 146. §§165(g)(1) & (2) (worthless securities)

- capital loss treatment applies upon the sale of a security or it becomes worthless.

§166 (bad debts – when <u>not</u> a security) –

- business bad debt as an ordinary loss.
- nonbusiness bad debt as a short-term cap. loss.

Loan to corporation as an employee – see Generes (*next slide*)

Genereres case note, p.147

- 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 he also guaranteed corporate debts.
- <u>Dominant motivation was as an *investment*</u>, <u>not</u> to protect his employment status (i.e., his "business"). Therefore, <u>nonbusiness</u> bad debt treatment.

Section 1244 Stock – Ordinary Loss Deduction p.147

1. Individuals (and partnerships) only.

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

3. Small business ($1 mil. maximum capital).

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

5. Annual limit (50,000/100,000) on the ordinary loss tax deduction amount.

No formal Section 1244 plan is required.

Problem re Hi-Tech p.149 Alternative Investments

Capital structure for venture capital investment:

a) Five year note (not a security) - No participation in equity growth; §166 governs if the note defaults.

Nonbusiness bad debt status (STCL)

unless the lender's business is loaning money.

b) "Registered" bond - market interest rate.

"Security" categorization under §165(g)(2) & STCL status for 200x loss (or LTCL if holding one year).

Problem p.149 cont.

c) “Registered” bond; Bond loss would be $190,000 worthless <u>security</u>. Code §165(g)(1) & capital loss. Concept of "security" includes a subscription right. Therefore, loss on the warrants - $10,000 – is governed by Code §165(g)(2)(B) &, therefore, a $10,000 capital loss.

d) Common stock - qualifies as §1244 stock.

Is ordinary loss treatment available? Yes, for 50K (or 100K, if married). Remaining loss as LTCL.

Problem p.149, cont.

e) Convertible preferred stock.

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

f) Original contributions of $500,000 & $500,000. Hi-Tech not a "small business corporation" at time it issues the additional common stock because aggregate amount of money received for original stock exceeds $1 mil. Not an ordinary loss, but a capital loss to Jennifer.

Problem p.149, cont.

g) Wedding gift. Donees do not qualify for §1244 treatment. Son is limited to a $200,000 capital loss under Code §165(g)(1). Reg. §1.1244(a)-1(b). Only the original holder is eligible for ordinary loss treatment under §1244.

h) Purchase of the 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).