

# DEBT VS. EQUITY

## PRIMER

### Introduction

Corporate cash advances can be divided into two categories: **debt** and **equity**. Debt is acquired through the borrowing of funds to be repaid at a later date; equity is a contribution to capital,<sup>1</sup> typically an investment in exchange for a stake in the company.

The debt vs. equity classification, in the tax context, has important implications for both the corporation raising money and the holder of the obligation providing the advance. A corporation may deduct interest payments on debt (under § 163 of the Internal Revenue Code (IRC)), but it cannot deduct dividend payments on equity. Additionally, a corporation may be able to deduct “bad debt” if an instrument can be successfully characterized as debt (under § 166 of the IRC). While debt is taxed once, equity funding is taxed twice: once at the business level, and once at the

shareholder level through dividend and capital gains taxes.<sup>2</sup> Successfully classifying funding as debt as opposed to equity produces tax advantages for the corporation.

The opposite preference exists for the entity that provides the cash advance. If a cash advance is characterized as equity, the holder of the obligation may receive dividend income taxed at a preferential rate.<sup>3</sup> If a cash advance is characterized as a debt, then the interest income from the debt is taxed as ordinary income at the taxpayer’s marginal rate.<sup>4</sup>

This primer summarizes the key principles, concepts, and considerations relating to the treatment of certain interests in corporations as stock or

indebtedness in the tax context. The legal question central to this primer asks whether an interest in a corporation is debt or equity for tax purposes.

## Key Principle

The focus of debt vs. equity is whether the taxpayer, by giving or receiving an advance of funds, *intended* to create a debt with a reasonable expectation of repayment, and if so, whether that intent comports with creating a debtor-creditor relationship.<sup>5</sup> If a court finds that the advance of funds did not give rise to a bona fide debt, then it may be treated as an equity investment.

## Legislative Context

Although § 385 of the IRC and § 385 regulations (26 C.F.R. § 1.385) provide some guidance, determining whether an advance is a debt or equity for tax purposes is mostly a question of common law. Except otherwise provided in the regulations, the question of debt vs. equity is determined based on common law.

§ 385(a) of the IRC authorizes the Secretary to prescribe whatever regulations may be necessary or appropriate to determine whether an interest in a corporation is to be treated as stock or indebtedness (or as part stock and part indebtedness). § 385(b) mandates that the regulations set forth factors to be taken into account for making a debt vs. equity determination, which could include the following five factors, among others:

1. whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest;
2. whether there is subordination or preference over any indebtedness of the corporation;
3. the ratio of debt to equity of the corporation;
4. whether there is convertibility into stock of the corporation; and
5. the relationship between the holdings of stock in the corporation and holdings of the financial interest at issue.

IRC § 385 has existed since 1969 but until 2016, the IRS has never issued final regulations on the debt vs. equity distinction. In 2016, the IRS exercised its authority to regulate the determination of debt and equity in the context of multinational enterprises. This was prompted by the use of the “earnings stripping” technique used by multinational corporations to advance funds to their related entities, in order to minimize U.S. taxes.<sup>6</sup>

## Regulatory Context

§ 385 regulations (26 C.F.R. § 1.385) provide rules for determining the appropriate characterization of debt or equity, depending on the circumstances. These regulations are very complex and apply to only large multinational enterprises that engage in transactions between related entities. The IRS estimates that the § 385 regulations will impact only 0.4% of the 1.6 million C-corporations in the U.S.

The regulations make it much harder for multinational corporations to shift income to their subsidiaries in lower tax jurisdictions. They do this by imposing burdensome restrictions and documentation requirements that make it harder to set up debt instruments for which interest payment deductions will be upheld by the IRS. The regulations are divided into the following sections:

- § 1.385-1 sets out a series of complex

definitions for the associated regulations, and notably, § 1.385-1(b) states that debt vs. equity should be determined based on common law unless it is covered by the regulations.

- §§ 1.385-2 and 1.385-3 provide additional guidance regarding the tax treatment of an interest in a corporation that is held by a member of the corporation's "expanded group."
- § 1.385-3T(f) provides rules regarding the treatment of debt instruments issued by certain partnerships.
- § 1.385-4T provides rules regarding the application of the factors set forth in §§ 1.385-3 and 1.385-3T as they relate to consolidated groups.

In addition to the recent regulations, the IRS issued Notice 94-47<sup>7</sup> in 1994 as part of the enforcement effort against hybrid financing arrangements and mischaracterizations. This notice sets out eight factors to distinguish debt from equity. All eight of the factors are subsumed under the thirteen common law factors listed in the section below.<sup>8</sup> The IRS does not typically cite Notice 94-47.<sup>9</sup>

## Case Law Context

As early as 1894, Congress expressed concern that corporations could disguise equity investments as debt in order to deduct interest payments from gross taxable income.<sup>10</sup> In 1909, to address this problem, Congress changed the law to disallow interest payment deductions associated with excess indebtedness, defined as indebtedness that exceeds the aggregate value of paid-up capital stock. In 1919, Congress removed the statutory cap on interest deductions.

Following the removal of this statutory cap, courts began to refine the boundary between debt and

equity. Early rulings focused on the manifest intent of the parties, for example, in *Commissioner v. Meridian & Thirteenth Realty Co.*, 132 F.2d 182, 184 (7th Cir. 1942), the court respected the parties' characterization of the advance as indebtedness because the documents characterized it as such. Eventually, some corporations emerged with capital structures comprising almost entirely of borrowed funds. To address this problem, courts began to look at the economic reality<sup>11</sup> in order to characterize an advance. The modern case law for debt vs. equity is built on top of these developments.

The classic case is *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972). In this case, the taxpayer and shareholder to the bank advanced funds under threat that without the money, the bank would close. The court held that the taxpayer created debt for income tax purposes despite the lack of certificate, or fixed maturity date. In this case a frequently cited passage appears: "real issue [of debt vs. equity] for tax purposes has long been held to be the extent to which the transaction complies with arm's length standards and normal business practice."<sup>12</sup> In other words, the court was concerned about the substance of the cash advance over the form of the advance. The court in *Mixon* listed thirteen factors for the debt vs. equity classification. Courts have applied these and other factors with some variation in weight and content.

Shortly after the *Estate of Mixon* ruling, the Tax Court in *Litton Business Systems, Inc. v. Commissioner*, 61 TC 367, 377 (1973) phrased the question as, "Was there a genuine intention to create a debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship?" The court emphasizes the role of genuine intention to create debt, while reiterating the substance-over-form nature of the debt vs. equity inquiry. *Litton* is a frequently cited case where the court sided with the taxpayer. The court based its holding on facts

that showed the parties' reasonable expectation of repayment.

In the recent case of *PepsiCo Puerto Rico, Inc. v. C.I.R.*, 104 T.C.M. (CCH) 322, the Tax Court chose to adopt the thirteen factors compiled in *Dixie Dairies Corp. v. Commissioner of Internal Revenue*, 74 TC 476 (1980). In *Dixie Dairies*, the petitioner advanced money to a corporation owned one-third by the petitioner. The court ruled to disallow bad debt deduction by the petitioner, turning on the thinness of the receiving corporation's capital structure, and the "substantial" risk that the petitioner would not be repaid. As a result of the recent and widespread use by the Tax Court as precedent, *Dixie Dairies* is often considered one of the leading cases in this area of law.

## Key Considerations in Case Law

This primer examines the nonexclusive relevant factors identified in *Mixon* and *Dixie Dairies*<sup>13</sup> and applied across the leading cases as the common law test for debt vs. equity, and how they relate to each other to lean towards debt or equity. These 13 factors are not equally significant, and no single factor is determinative.<sup>14</sup>

1. **Name or label:** the names given to the certificates evidencing the indebtedness, "a bond, debenture, or note is indicative of a bona fide indebtedness".<sup>15</sup> However, the form of the advance is often discounted by the courts and the IRS<sup>16</sup>: "form does not necessarily correspond to the intrinsic economic nature of the transaction".<sup>17</sup>
2. **Fixed maturity date:** presence of a fixed maturity date indicates a fixed obligation to repay, a characteristic of debt, while the absence is indicative of an equity advance.<sup>18</sup>
3. **Source of principal payments:** if repayment of the principal amount is not dependent upon earnings, the transaction reflects a loan to the corporation.<sup>20</sup> If repayment is expected from the liquidation of assets, cash flow, or refinancing, it supports a debt characterization. In *Mixon*, the court demonstrated that repayment is not expected from business profits, thus supporting a debt characterization.
4. **Right to enforce payments:** If there is a definite obligation to repay the advance, the transaction would take on some indicia of a loan.<sup>21</sup> The distinction here is that shareholders cannot force the payment of a dividend<sup>22</sup> but creditors can enforce payment on a loan.
5. **Participation in management as a result of the advances:** if a stockholder's percentage interest in the corporation or voting rights increase as a result of the transfer, it will contribute to a finding that the transfer was a contribution to capital.<sup>23</sup>
6. **Status of the advances in relation to regular corporate creditors:** whether the advance has a status equal to or inferior to that of regular corporate creditors is indicative of shareholder or creditor status.<sup>24</sup> The position of an advance relative to regular corporate debt determine whether the holder's rights are more like that of a shareholder, or that of a creditor. Courts generally agree that the subordination of an instrument to general corporate debt supports a finding of

equity.<sup>25</sup>

7. **Intent of the parties:** the key to the debt vs equity determination is generally the taxpayer's actual intent.<sup>26</sup> It is relevant whether the parties intended, at the time of issuance of the debentures, to create a debtor-creditor relationship. The intent of the parties, in turn, may be reflected by their subsequent acts: in the manner in which the parties treat the instruments.<sup>27</sup>
8. **Identity of interest between creditor and stockholder:** If advances are made by stockholders in proportion to their respective stock ownership, an equity capital contribution is indicated. A sharply disproportionate ratio between a stockholder's percentage interest in stock and debt is, however, strongly indicative that the debt is bona fide.<sup>28</sup> Bona fide indebtedness is not tainted by the mere fact that the transaction occurred between related parties.<sup>29</sup>
9. **"Thinness" of capital structure in relation to debt:** thin capitalization is very strong evidence of a capital contribution where (1) the debt to equity ratio was initially high, (2) the parties realized the likelihood that it would go higher, and (3) substantial portions of these funds were used for the purchase of capital assets and for meeting expenses needed to commence operations.<sup>30</sup> It is important to note that the sufficiency of this factor is disputed in different courts. The Second Circuit declared that the debt-to-equity ratio is of "great importance".<sup>31</sup> The Fourth Circuit, on the other hand, stressed that the undercapitalization was insufficient to recharacterize debt as equity.<sup>32</sup>
10. **Ability of the corporation to obtain credit from outside sources:** if a corporation is able to borrow funds from outside sources at the time an advance is made, the transaction has the appearance of a bona fide indebtedness. Otherwise, if no reasonable creditor would have loaned funds to the corporation at the time of the advance, it leans towards equity.<sup>33</sup> A commentator proposed that the debt vs. equity question focuses solely on the creditworthiness of the borrower, or, in other terms, whether a third-party would have entered into the transaction.<sup>34</sup>
11. **The use to which advances were put:** using funds to acquire capital assets, or expand its operations suggests the advance is equity.<sup>35</sup> Using funds to meet daily operating needs suggests a bona fide indebtedness.<sup>36</sup>
12. **Failure of the debtor corporation to repay:** the failure of a corporation to repay principal amounts on the due date indicates that advances were equity.<sup>37</sup> The usefulness of this factor can be minimal, however, when the debtor encounters unforeseen obstacles against repayment.<sup>38</sup>
13. **Risk involved in making advances:** a reasonable expectation of repayment by the provider of an advance when the advance is made suggests that the advance is debt.<sup>39</sup> The risk question was not addressed in *Estate of Mixon*, and is unique to *Dixie Dairies* and the line of cases that follow. In *PepsiCo Puerto Rico*, the court called it a "significant consideration,"<sup>40</sup> and that many factors evince the uncertainty of repayment.

While not all factors will be relevant in every fact scenario, courts will analyze all applicable factors to determine which factors favor bona fide indebtedness and which factors favor equity. A court may properly characterize a transfer of funds as equity even if “all the formal indicia of an obligation were meticulously made to appear.”<sup>41</sup> In other words, the question of debt vs. equity depends entirely on the economic substance of the transaction, and not the form of the advances.<sup>42</sup>

## Key Concepts

**Advance (or Cash Advance):** Courts use the term “advance” to indicate a provision of funds to an entity. Where the debt vs. equity question arises, the entity receiving the advance will be a corporation.

**Transaction:** A transaction is the event that created the cash advance and the associated obligation.

**Obligation:** An obligation is the neutral term used to describe a contribution of funds from the holder to the issuer, with a corresponding commitment to repay by the issuer.

**Issuer:** An issuer is the party to a transaction that issued the obligation and is obligated to repay the funds. This is the same entity that is receiving the funds.

**Holder:** A holder is the party who holds the right to repayment of the funds. This is usually the same entity that is providing the advance.

**Thin Capitalization:** The “thinness” of capitalization describes a corporation’s debt-to-equity ratio. A high debt-to-equity ratio is indicative of thin capitalization and a risky investment more similar to equity. Acceptable debt-to-equity ratios are highly dependent on the industry, year and other business indicators, but a few examples follow. A debt-to-

equity ratio of 2:1 has been considered relatively low and indicative of normal capitalization. A debt-to-equity ratio of 5:1 has been considered neutral, and thus not indicative of thin capitalization. A debt-to-equity ratio of 10:1 has been considered relatively high and indicative of thin capitalization. A debt-to-equity ratio greater than 10:1 has been found to be acceptable in the early stages of a start-up venture requiring few core assets and significant operating expenses.

**Capital spending vs. operating spending:** A capital expense (CAPEX) is an expense a business incurs to create a benefit in the future. An operating expense (OPEX) is an expense required for the day-to-day functioning of a business.<sup>43</sup> The use of cash advances to cover capital expenses indicates that it is an equity investment. The use of cash advances to cover operating expenses indicates debt.

## How to Answer the Debt vs. Equity Question

When considering the debt vs. equity question in the tax context, one possible way to organize the analysis is in this order:<sup>44</sup>

1. **Consider the form of the transaction.** The form of the transaction can be indicative of the genuine intent of the parties to create a bona fide debt. Did the parties characterize the transaction as a debt? Did the transaction have traditional indicia for debt, such as a fixed (or determinable) sum certain, an interest rate, and a maturity date (or otherwise payable on demand)? How is it treated in the issuer’s financial records -- as debt, or as equity?
2. **Consider the relationship between the parties to the transaction.** Was there

an arms-length relationship between the parties, or are they related pursuant to § 267(b) of the IRC? Did the transaction result in a change in ownership percentage, or participation in management? If the transaction is made by stockholders of the corporation, was the amount proportional to the stockholder's pro rata stock ownership?

3. **Consider the financial circumstances of the issuer surrounding the transaction.**

The financial circumstances can indicate the equity nature of an advance, for example, if there is risk uncharacteristic of debt or the inability for the issuer to obtain other funding. Was the issuer thinly capitalized at the time of the transaction? Could the issuer have obtained similar funding from other sources at the time of the transaction? Were the funds used for capital acquisitions, or to fund business operations?

4. **Consider the terms of repayment.**

The existence of enforceable rights to repayment, independent of the profitability of the issuer, can push the analysis towards a finding of debt. Does the holder rank equal to other creditors? Was there actual payment of principal or interest? Did the holder make efforts to enforce the obligation, or did the holder acquiesce in the non-payment of principal or interest? Were there rights to repayment such as collateral, acceleration clauses, reserve accounts, or other creditors' rights and guarantees?

## Blue J Tax

The question of debt vs. equity in the tax context looks at the substance of a cash advance. When an advance is in substance a bona fide debt, the parties to the advance may be entitled to certain tax benefits such as interest deductions or bad-debt write offs. The courts look at 13 relevant factors identified in *Dixie Dairies* as indicia for the substance of a transaction. These factors look at the form of the transaction, the relationship between the parties, the financial circumstances of the corporation receiving the funds, and the conditions surrounding the repayment. The determination of a transaction as debt can have significant financial consequences for your client. A thorough review and analysis of the case law is imperative in preparing to advise your client.

Blue J Tax's Debt vs. Equity Classifier can assist you in determining whether your specific set of facts result in a finding of debt or equity. With the Classifier you can modify fact scenarios to produce the most optimal outcome and advise your client accordingly.

Blue J Tax's Debt vs. Equity Case Finder can save you valuable time in your reading and research by finding cases by outcome, transaction characteristics, relationship between parties, financial circumstances of the issuer, terms of repayment, etc. The Case Finder can find the most relevant cases for a specific combination of factors.

## Endnotes

- 1 *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 694 (3d Cir. 1968)
- 2 Curtis Dubay, *Taxation of Debt and Equity: Setting the Record Straight*, The Heritage Foundation (September 30, 2015), <https://www.heritage.org/taxes/report/taxation-debt-and-equity-setting-the-record-straight>.
- 3 For “qualified dividends”, defined as dividend income from a company is domiciled in the U.S. or in a country that has a double-taxation treaty with the U.S. See I.R.S. Pub. No. 500, Cat. No. 15093R, 19 (Mar 28, 2019), <https://www.irs.gov/pub/irs-pdf/p550.pdf>.
- 4 Neil O’Hara, *Investment Tax Basics For All Investors*, Investopedia (last updated Jun 25, 2019), <https://www.investopedia.com/articles/investing/072313/investment-tax-basics-all-investors.asp>.
- 5 *Litton Business Systems, Inc. v. Commissioner*, 61 T.C. 367, 376-377 (1973) (“In view of the many decided cases in this area, we think the determinative question, to which an evaluation of the various independent factors should ultimately point, is as follows: Was there a genuine intention to create a debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship?”).
- 6 IRS Clarification | Corporate Debt Versus Equity, Wallace, Plese + Dreher, L.L.P. (December 27, 2016) <https://www.wpdcpa.com/irs-clarification-corporate-debt-versus-equity/>
- 7 I.R.S. Notice 94-47, 1994-1 C.B. 357.
- 8 *PepsiCo Puerto Rico, Inc. v. Commissioner*, 104 T.C.M. (CCH) 322, n.50 (2012).
- 9 Thomas D. Greenaway & Michelle L. Marion, *A Simpler Debt-Equity Test*, 66 Tax Law. 73, 78 (2012).
- 10 *Id.* at 75.
- 11 *Fin Hay Realty*, 398 F.2d at 697.
- 12 *Estate of Mixon v. United States*, 464 F.2d 394, 403 (5th Cir. 1972).
- 13 *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476, 493 (1980).
- 14 *Id.* See also *John Kelley Co. v. Commissioner*, 326 US 521 (1946).
- 15 *Estate of Mixon*, 464 F.2d at 403.
- 16 *A Simpler Debt-Equity Test*, 66 Tax Law. at 82.
- 17 *Fin Hay Realty*, 398 F.2d at 697.
- 18 *Estate of Mixon*, 464 F.2d at 404.
- 19 *A Simpler Debt-Equity Test*, 66 Tax Law. at 84.
- 20 *Estate of Mixon*, 464 F.2d at 405.
- 21 *Id.*
- 22 *A.R. Lantz Co. v. United States*, 424 F.2d 1330, 1334 (9th Cir. 1970)
- 23 *Hardman v. United States*, 827 F.2d 1409, 1413 (9th Cir. 1987).
- 24 *Estate of Mixon*, 464 F.2d at 406.
- 25 *A Simpler Debt-Equity Test*, 66 Tax Law. at 86.
- 26 *Bauer v. Commissioner*, 748 F.2d 1365, 1367-1368 (9th Cir. 1984), rev’g T.C. Memo. 1983-120; *A.R. Lantz Co.*, 424 F.2d, 1333.
- 27 *Monon Railroad v. Commissioner*, 55 T.C. 345, 357 (1970).
- 28 *Id.* at 409.
- 29 *Litton Business Systems*, 61 T.C. at 380 (“[I]t is just as clear that where such scrutiny has been exercised, the fact of proportional identity of interest between stockholders and creditors, particularly where a sole stockholder is involved, does not preclude the existence of a valid debt.”).
- 30 *Monon Railroad*, 55 T.C. at 408.
- 31 *Kraft Foods Co. v. Commissioner*, 232 F.2d 118, 127 (2d Cir. 1956).
- 32 *In re: Dornier Aviation (North America), Incorporated*, 453 F.3d 225, 234 (4th Cir. 2006).
- 33 *Monon Railroad*, 55 T.C. at 410.
- 34 Wayne M. Gazur, *An Arm’s Length Solution to the Shareholder Loan Tax Puzzle*, 40 Seton Hall L. Rev. 407, 418 (2010).
- 35 *Laidlaw Transportation, Inc. v. Commissioner*, T.C. Memo 1998-232, 79 (1998).
- 36 *Stinnett’s Pontiac Service, Inc. v. Commissioner*, 730 F.2d 634, 640 (11th Cir. 1984).
- 37 *Laidlaw*, T.C. Memo 1998-232 at 80.
- 38 *Bordo Products Co. v. United States*, 201 Ct. Cl. 482, 503 (1973) (“[I]ntent at the time the advances were made is an important consideration, and subsequent unexpected developments may well explain the fact of forbearance.”).
- 39 *Laidlaw*, T.C. Memo 1998-232 at 82.
- 40 *PepsiCo Puerto Rico*, 104 T.C.M. (CCH) 322 at 33.
- 41 *Davis v. Commissioner*, 69 T.C. 814, 835-836 (1978).
- 42 *Estate of Reynolds v. Commissioner*, 55 T.C. 172, 201-202 (1970).
- 43 Christina Majaski, *The Difference Between an Operating Expense vs. a Capital Expense*, Investopedia (last updated Apr 14, 2019), <https://www.investopedia.com/ask/answers/042415/what-difference-between-operating-expense-and-capital-expense.asp>.
- 44 This is based on the structure of analysis found in Blue J Tax’s Debt vs. Equity classifier.