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## An Arm's Length Solution to the Shareholder Loan Tax Puzzle

Wayne M. Gazur

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## An Arm's Length Solution to the Shareholder Loan Tax Puzzle

*Wayne M. Gazur\**

I.	INTRODUCTION .....	408
II.	THE JUDICIAL MULTIPLE-FACTOR CLASSIFICATION TEST .....	411
III.	THE STATUTORY AND ADMINISTRATIVE RESPONSES TO THE CLASSIFICATION ISSUE.....	414
IV.	INVIGORATING THE THIRD-PARTY LENDER TEST .....	417
	A. A Simpler and More Coherent Solution .....	417
	B. Establishing the Arm's Length Standard.....	428
	C. The Promise of the Proposed Test .....	436
	1. Simplicity, Predictability and Administrability .....	437
	2. Improved Reliability of Classification Outcomes and Horizontal Equity .....	441
	3. Efficiency .....	442
	4. Vertical Equity.....	444
V.	POTENTIAL OBJECTIONS TO THE PROPOSED TEST.....	445
	A. Identifying an Appropriate Hypothetical Lender.....	445
	B. Discrimination Against Small Businesses .....	446
	C. Shareholder Guaranteed Third-Party Debt.....	453
	D. The Application of the Third-Party Test Beyond Shareholder Loans .....	455
	1. Straight Debt Instruments .....	456
	2. Hybrid Securities.....	459
V.	CONCLUSION.....	465

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The litigated cases are legion and the court decisions have been aptly vilified as a ‘jungle’ and a ‘viper’s tangle. . . .’ Exhaustive research leaves one with the firm conviction that the courts are applying an amorphous and highly unsatisfactory ‘smell test.’<sup>1</sup>

## I. INTRODUCTION

In all but the most obvious cases, classifying shareholder loans as either debt or equity for federal income tax purposes is not an easy task.<sup>2</sup> Courts and the Internal Revenue Service (“Service”) have approached the classification issue by applying lists of multiple factors with little predictive value for taxpayers or other courts.<sup>3</sup> Congress responded to this disappointing state of affairs in 1969 with the enactment of barebones statutory direction, most of which reflects the judicial factors<sup>4</sup> and is of little value without interpretive regulations.<sup>5</sup> In the 1980s, the Department of the Treasury attempted to provide such regulatory direction, but it withdrew its proposals after several unsuccessful attempts.<sup>6</sup>

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<sup>1</sup> STEPHEN A. LIND ET AL., FUNDAMENTALS OF CORPORATE TAXATION 140 (7th ed. 2008) (citations omitted).

<sup>2</sup> The debt/equity classification issue is often described as searching for a result along a continuum, for which one endpoint is debt, and the other is equity. *See, e.g.*, I BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 4.02[1] (7th ed. 2000) (“[D]ebt’ and ‘equity’ are labels for the two edges of a spectrum.”); William J. Rands, *The Closely Held Corporation: Its Capital Structure and the Federal Tax Laws*, 90 W. VA. L. REV. 1009, 1018–19 (1988) (“The problem is that the line of demarcation between what is debt and what is equity is simply unclear. Between the classic versions of debt and equity is a continuum of interests that have aspects of both debt and equity.”) (citations omitted). One can reasonably predict the outcome of factual situations that cluster around either endpoint, but the other points along the continuum produce unpredictable outcomes. Despite the continuum nature of the inquiry, the ultimate result under a binary analysis is generally debt or equity, with no shading in between. *See, e.g.*, Paul Carman & Kelly Bender, *Debt, Equity or Other: Applying a Binary Analysis in a Multidimensional World*, J. TAX’N, July 2007, at 17, 17. There have been notable exceptions to this binary approach. For example, in 1989, Congress amended I.R.C. § 385 to authorize the Treasury to issue regulations that would bifurcate instruments into equity and debt portions, but those regulations have not been issued. *See infra* note 33 and accompanying text.

<sup>3</sup> *See infra* notes 18–29 and accompanying text.

<sup>4</sup> *See* I.R.C. § 385 (2006); *infra* Part III. As discussed in Part III, the statutory list of classification factors differs from the judicial approach because the Treasury is authorized to issue regulations that bifurcate an instrument into “part stock and . . . part indebtedness.” § 385(a).

<sup>5</sup> In a relatively recent case, *Delta Plastics, Inc. v. Commissioner*, the Tax Court did not bother to cite the applicable code provision, § 385, in the opinion. *See* 85 T.C.M. (CCH) 940 (2003).

<sup>6</sup> *See infra* note 36 and accompanying text.

Commentators have spent considerable effort analyzing the mass of judicial pronouncements. Indeed, William T. Plumb, Jr., then a partner at Hogan & Hartson, published an exhaustive evaluation of the courts' treatment of the classification factors in a 1971 article published in the *Tax Law Review*.<sup>7</sup> The article was notable for, among other things, its length (271 pages) and detail (1591 footnotes).<sup>8</sup> Somewhat ironically, the introduction to the laborious Plumb article observed that "[t]his vexing subject has no doubt been written to death."<sup>9</sup> In that spirit, this Article will refer to the influential Plumb article from time to time to avoid repetition when references to the traditional multifactor classification doctrine are relevant.<sup>10</sup>

Barring fundamental changes to the corporate taxation system that would render the debt/equity distinction irrelevant,<sup>11</sup> this issue remains a continuing concern in corporate capitalization decisions.<sup>12</sup>

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<sup>7</sup> William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1971).

<sup>8</sup> *See id.* at 369, 640.

<sup>9</sup> *Id.* at 371.

<sup>10</sup> More than four decades after its publication, commentators and judges still cite the Plumb article. *See, e.g.*, *Bradshaw v. United States*, 683 F.2d 365, 377 n.28 (Ct. Cl. 1982); *Gold Kist Inc. v. Comm'r*, 104 T.C. 696, 718 n.27 (1995); Steven A. Dean, *The Incomplete Global Market for Tax Information*, 49 B.C. L. REV. 605, 632 n.179 (2008); Charlene D. Luke, *Risk, Return, and Objective Economic Substance*, 27 VA. TAX REV. 783, 790 n.21 (2008). *See also infra* note 24 (describing the continued relevance of the Plumb article and the little change in applicable doctrine in almost four decades).

<sup>11</sup> *See infra* notes 216–18 and accompanying text.

<sup>12</sup> The issue remains a concern because the deductibility of interest expense is the primary income tax benefit of debt classification. The Jobs and Growth Tax Relief Reconciliation Act of 2003, however, reduced the individual shareholder tax on dividend income to zero percent, five percent, and fifteen percent depending upon the taxpayer's tax bracket and the year of receipt, as compared with interest income, which can be taxed at rates up to thirty-five percent. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, §§ 105(a), 301(a)(1)–(2), 117 Stat. 752, 755, 758 (codified as amended in scattered sections of 26 U.S.C.) (extended by the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, 120 Stat. 345 (2006) (codified as amended in scattered sections of 26 U.S.C.)). The reduced rate on dividends will expire for tax years beginning after December 31, 2010. Tax Increase Prevention and Reconciliation Act § 101, 120 Stat. at 346. Nevertheless, considering the corporation's ability to deduct the interest (dividends are not deductible), a lower combined federal income tax is still produced, in most cases, if the return on capital is paid in the form of interest rather than dividends. *See LIND ET AL.*, *supra* note 1, at 133 ("Even though most dividends now qualify for a preferential tax rate . . . they are still includible in a shareholder's income and are not deductible by the corporation. . . . Assuming the owners of the business desire some ongoing return on their investment, there is an incentive to distribute earnings with tax-deductible dollars."). There are a number of other income tax consequences that

It remains of special importance to closely held businesses (including subsidiaries) that choose C corporation status despite the attractiveness of the limited liability company or S corporation.<sup>13</sup> For public corporations, the broader search for “tax deductible equity” has pushed the limits of traditional debt classification doctrine.<sup>14</sup>

This Article proposes the substitution of a hypothetical, arm’s length, third-party lender test for the multiple-factor classification test. If a third-party lender acting at arm’s length would not make the

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turn on the debt/equity classification. One is simplicity. If the lender receives the face amount of the debt obligation (and if the adjusted basis of the obligation is equal to the face amount), the repayment is generally not a taxable event. *See* I.R.C. § 1271(a)(1) (2006). If the redeemed corporate interest is instead equity, the complex requirements of I.R.C. §§ 302–304 and 306 must be navigated. Further, a loss on the worthlessness of stock or debt securities is generally treated differently from a loss on a debt obligation that is not a security. *See generally id.* § 165(g)(1) (stating that the loss from the worthlessness of a security is “treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset”); *id.* § 166(d)(1)(B) (stating that worthlessness of a nonbusiness debt is treated as a short term capital loss); *id.* § 1244(a) (stating that a loss on the worthlessness of certain small business stock is treated as an ordinary loss to a limited degree). Courts have denied a bad debt deduction for shareholder advances. *See, e.g., In re Lane*, 742 F.2d 1311, 1320 (11th Cir. 1984); *Lease v. Comm’r*, 66 T.C.M. (CCH) 1121, 1129–30 (1993). Section 351 permits only the receipt of “stock” if the incorporation of appreciated assets is to be accomplished on an entirely tax-deferred basis. § 351(a). In the reorganization area, the receipt of debt in the form of “securities” as compared with stock produces different consequences in most cases. *See id.* §§ 354, 356(d). In both the incorporation and reorganization contexts, Congress has attempted to limit the use of certain types of preferred stock that functionally resemble debt. *See* §§ 351(g), 354(a)(2)(C), 356(e). Only one economic class of stock is permitted in an S corporation. *Id.* § 1361(b)(1)(D). Consequently, there is a “straight debt safe harbor” available to avoid the risk that classifying debt as equity might produce a prohibited second class of stock. *See* § 1361(c)(5). This brief description of the consequences of debt/equity classification is not intended to be exhaustive. For a more complete discussion, see 1 BITTKER & EUSTICE, *supra* note 2, ¶¶ 4.01, 4.20–4.25. The debt/equity classification issue is not confined to corporations and arises in other taxation contexts. *See generally* Carman & Bender, *supra* note 2, at 24 (in part discussing a partnership taxation case).

<sup>13</sup> The taxable income and losses of limited liability companies and S corporations are passed to their owners, such that the entity generally is not subject to federal income taxes. *See* I.R.C. §§ 701 (partners, but not the partnership, are subject to the income tax), 1363(a) (S corporation generally not subject to the income tax), 1366 (passthrough of items of income, loss, deduction, or credit to S corporation shareholders). An S corporation, however, may be required to pay income taxes in certain limited circumstances. *See id.* §§ 1374–1375. A subsidiary of a C corporation cannot generally elect S corporation status. *See id.* § 1361(b)(1)(B).

<sup>14</sup> *See* Thomas A. Humphreys, *Tax Deductible Equity: The Quest for the Holy Grail—Part II*, in TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS, 1125, 1217–18 (2008).

capital infusion as a loan, then the presumptive classification is equity. This proposal would simplify and focus the classification doctrine. Although third-party willingness to lend funds is already one of the factors considered by courts,<sup>15</sup> this Article suggests that it should be the predominant factor. No court or commentator has expressly adopted this proposed approach. The third-party lender test is a more coherent doctrinal solution to the debt/equity classification issue as applied to shareholder loans of closely held corporations.<sup>16</sup> It is an incomplete answer, however, to the broader issues presented by the “debt” of public corporations with ready access to public capital markets and more options in satisfying their capital requirements.<sup>17</sup>

Part II of this Article briefly describes the courts’ application of the multifactor classification test. Part III succinctly discusses the statutory and administrative responses to the classification issue. Part IV provides an overview of the proposed third-party lender test and assesses its claimed benefits. Part V evaluates potential objections to its adoption. Part VI concludes.

## II. THE JUDICIAL MULTIPLE-FACTOR CLASSIFICATION TEST

To assess whether capital infusions are debt or equity, courts generally apply a list of factors to a taxpayer’s circumstances to determine whether the capital contributor is assuming the risks and seeking the rewards of a creditor or those of an owner of a corporation.<sup>18</sup> The factors are not of equal weight and no single factor is de-

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<sup>15</sup> See, e.g., *Delta Plastics, Inc. v. Comm’r*, 85 T.C.M. (CCH) 940, 943–44 (2003).

<sup>16</sup> See *infra* Part II. Practitioners continue to publish articles discussing the debt/equity classification factors. See generally, e.g., Sharon Burnett & Darlene Pulliam Smith, *Debt or Equity? The Current Status of Section 385*, 71 PRAC. TAX STRATEGIES 77 (2003); Carman & Bender, *supra* note 2; Humphreys, *supra* note 14. *Contra* David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1627 (1999) (“[T]ax academics generally do not write serious articles on doctrinal issues. For example, since William Plumb summarized the case law on the difference between debt and equity in 1971, no one has touched the subject.”)

<sup>17</sup> See *infra* Part V.D.

<sup>18</sup> Income tax law is replete with multifactor tests, many of which are judicial creations. See, e.g., *United States v. Winthrop*, 417 F.2d 905, 909–12 (5th Cir. 1969) (applying seven judicially created factors to determine that land was held primarily for sale to customers in the ordinary course of business and therefore not a capital asset); Treas. Reg. § 1.183-2(b) (1972) (listing nine factors used in determining whether an activity is engaged in for profit). Assessing the reasonableness of compensation of corporate employees (as compared with constructive dividend treatment) also involves a multiple-factor approach. See generally Melanie G. McCoskey, *Reasonable Compensation: Do You Know Where Your Circuit Stands?*, J. TAX’N, Oct. 2008, at 228. The reasonableness of compensation and the classification of debt share a common tax

terminative.<sup>19</sup> Consequently, courts exercise broad discretion in applying the test.<sup>20</sup>

In *Fin Hay Realty Co. v. United States*,<sup>21</sup> a well-known and fairly representative case,<sup>22</sup> the court applied sixteen factors to determine the nature of a capital contribution:

- (1) the intent of the parties;
- (2) the identity between creditors and shareholders;
- (3) the extent of participation in management by the holder of the instrument;
- (4) the ability of the corporation to obtain funds from outside sources;
- (5) the “thinness” of the capital structure in relation to debt;
- (6) the risk involved;
- (7) the formal indicia of the arrangement;
- (8) the relative position of the obligees as to other creditors regarding the payment of interest and principal;
- (9) the voting power of the holder of the instrument;
- (10) the provision of a fixed rate of interest;
- (11) a contingency on the obligation to repay;
- (12) the source of the interest payments;
- (13) the presence or absence of a fixed maturity date;
- (14) a provision for redemption by the corporation;
- (15) a provision for redemption at the option of the holder; and
- (16) the tim-

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structural thread as both are means to distribute corporate wealth in a tax deductible fashion. Perhaps one of the most pervasive—yet ultimately impotent—multifactor tests was announced by the Supreme Court of the United States in *Morrissey v. Commissioner*, in which the Court sought to classify entities as associations taxable as a corporation, partnership, or trust by weighing at least eight corporate characteristics. 296 U.S. 344, 360–62 (1935). The corporate characteristics test was largely abolished by the so-called “check-the-box” regulations adopted in 1997. See Treas. Reg. §§ 301.7701-1 to 301.7701-4 (as amended in 2009). Problems distinguishing “debt” from “equity” are not confined to the tax area and also appear in the bankruptcy treatment of shareholder or insider “loans” to undercapitalized corporations. See generally 1 NANCY C. DREHER & JOAN N. FEENEY, BANKRUPTCY LAW MANUAL §6:61 (5th ed. 2009).

<sup>19</sup> See, e.g., *John Kelley Co. v. Comm’r*, 326 U.S. 521, 530 (1946) (“There is no one characteristic, not even exclusion from management, which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts.”); *J.S. Biritz Constr. Co. v. Comm’r*, 387 F.2d 451, 456–57 (8th Cir. 1967) (“These indicia have varying degrees of relevancy, depending on the particular factual situation and are generally not all applicable to any given case.”).

<sup>20</sup> There is a split of authority as to whether the debt/equity characterization is a question of law or fact. See *infra* notes 101–02 and accompanying text.

<sup>21</sup> 398 F.2d 694 (3d Cir. 1968).

<sup>22</sup> Although each Court of Appeals generally follows its own list of factors when deciding this issue, the courts’ approaches are generally similar. See, e.g., *Roth Steel Tube Co. v. Comm’r*, 800 F. 2d 625, 630 (6th Cir. 1986) (applying an eleven-factor test); *Bauer v. Comm’r*, 748 F. 2d 1365, 1368 (9th Cir. 1985) (following an eleven-factor test); *Lane v. United States*, 742 F.2d 1311, 1314–15 (11th Cir. 1984) (adopting the U.S. Court of Appeals for the Fifth Circuit’s thirteen-factor test); *J.S. Biritz Constr. Co. v. Comm’r*, 387 F.2d 451, 457 (8th Cir. 1967) (applying a ten-factor test).

ing of the advance with reference to the organization of the corporation.<sup>23</sup>

The factors have not evolved much in the four decades since *Fin Hay Realty Co.*<sup>24</sup> In *Delta Plastics, Inc. v. Commissioner*,<sup>25</sup> a recent U.S. Tax Court memorandum decision, the court applied eight general factors, some of which had multiple parts: (1) thin or adequate capitalization, with an emphasis on debt-to-equity ratios (the fifth factor of *Fin Hay Realty Co.*); (2) “[e]xtent to [w]hich [f]unds [w]ere [u]sed [t]o [a]cquire [c]apital [a]ssets” (the sixteenth factor of *Fin Hay Realty Co.*); (3) proportionality of stock ownership to creditor interests (the second factor of *Fin Hay Realty Co.*); (4) risk, which examines the unconditional nature of the obligation to repay and payments that were not dependent on profits or excused in the event of losses (the eleventh factor of *Fin Hay Realty Co.*); (5) third-party loans, meaning whether loans were available from outside creditors (the fourth factor of *Fin Hay Realty Co.*); (6) management participation (the ninth factor of *Fin Hay Realty Co.*); (7) payments made when due; and (8) intent of the parties, with reference to the presence of fixed dates for payments and the lenders’ understanding and knowledge of the cor-

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<sup>23</sup> *Fin Hay Realty*, 398 F.2d at 696.

<sup>24</sup> See DANIEL N. SHAVIRO, *DECODING THE U.S. CORPORATE TAX* 49 (2009) (“Because so little has changed doctrinally since the [Plumb] article was published and the prospects for any sort of intellectual breakthrough appear too poor to encourage would-be successors, this article . . . remains the gold standard of debt-equity analysis despite its extreme antiquity as secondary legal sources go.”); Burnett & Smith, *supra* note 16, at 85 (“Despite the fact that this statement [from *Fin Hay Realty Co.*] was written 35 years ago, the current state of the debt vs. equity question remains the same.”). A 2002 Field Service Advisory identified twelve familiar factors drawn from case law:

- (1) the name and presence of a written agreement demonstrating indebtedness;
- (2) the presence of a fixed maturity date;
- (3) the source of payments, e.g., whether there is anticipated cash flow to cover payments;
- (4) the right to enforce payment;
- (5) increased participation in management as the result of the advance;
- (6) subordination;
- (7) thinness of the capital structure in relation to debt;
- (8) the identity of interest between the creditor and stockholder;
- (9) the source of interest payments, e.g., from earnings;
- (10) the ability of the corporation to obtain credit from outside sources;
- (11) the use of funds for capital assets or risk involved in making the advances; and
- (12) the failure of the debtor to repay.

I.R.S. Field Serv. Adv. Mem. 200205031, at 3 (Nov. 1, 2001) (line breaks and citations omitted).

<sup>25</sup> 85 T.C.M. (CCH) 940 (2003).



poration's business and a reasonable expectation of its likely success (the first, seventh, and thirteenth factors of *Fin Hay Realty Co.*).<sup>26</sup>

In the context of a closely held corporation, in which the overwhelming majority of reported cases arise,<sup>27</sup> thin capitalization is a particularly important factor.<sup>28</sup> Some of the factors, such as incomplete documentation of the loan, are pitfalls primarily for careless or uninformed taxpayers and can be easily satisfied with little inconvenience.<sup>29</sup>

### III. THE STATUTORY AND ADMINISTRATIVE RESPONSES TO THE CLASSIFICATION ISSUE

In the years leading up to the Tax Reform Act of 1969, the problems of classifying corporate capital infusions produced demands for

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<sup>26</sup> *Id.* at 943–44; *Fin Hay Realty Co.*, 398 F.2d at 696. In *Delta Plastics, Inc.*, the court applied the factors that it deemed relevant from a list of ten factors used by the U.S. Court of Appeals for the Eighth Circuit, to which an appeal of the case would lie. *Delta Plastics, Inc.*, 85 T.C.M. (CCH) at 943 (citing *In re Uneco*, 532 F.2d 1204, 1208 (8th Cir. 1976)).

<sup>27</sup> *Cf.* Paul J. Robertson et al., *Debt or Equity? An Empirical Analysis of Tax Court Classification During the Period 1955-1987*, 47 TAX NOTES 707, 715 (1990) (“The case law, concerned largely with investment in closely held corporations, classifies an interest in a corporation on the basis of a long list of characteristics whose weight, number, and importance may vary somewhat from court to court.”).

<sup>28</sup> See Plumb, *supra* note 7, at 512–13.

In recent years, the courts . . . have placed the debt-equity ratio in perspective, as not requiring nonrecognition as a matter of law . . . but as one of the significant factors bearing on the reasonableness of the expectation of repayment, reflecting the extent of the cushion by which the purported creditors are shielded against the effects of business losses and declines in property values.

*Id.* at 512–13 (citations omitted). The Robertson empirical study found that seven variables “correctly classified, as debt or equity, 96.7 percent of the Tax Court cases.” See Robertson et al., *supra* note 27, at 714. The factors, in rank order of importance, were (1) repayment from uncertain profits; (2) whether rights were enforced; (3) debt/equity ratio; (4) independent sources of credit; (5) formal documentation; (6) subordination; and (7) presence of a sinking fund. See *id.* at 715. Although proportionality in holdings of debt and equity was not identified by Robertson as one of the highly discriminative factors, descriptive commentators consider it to be a significant factor. “Although it is not fatal per se to debt classification, the fact that debt is owned in proportion to stockholdings tends to poison the atmosphere and to invite special scrutiny by the courts.” 1 BITTKER & EUSTICE, *supra* note 2, ¶ 4.04[2]. However, proportionate holdings of stock and debt played a central role in the Treasury’s approach to regulations interpreting I.R.C. § 385, discussed *infra* Part III. See generally Jack S. Levin & Stephen S. Bowen, *The Section 385 Regulations Regarding Debt Versus Equity: Is the Cure Worse than the Malady?*, 35 TAX LAW. 1, 2–39 (1981) (discussing the promulgation of the regulations and the importance of proportionality).

<sup>29</sup> See Plumb, *supra* note 7, at 461–62.

more certainty in the law. In 1954, the American Law Institute proposed safe harbor rules of classification, and the American Bar Association weighed in as well.<sup>30</sup> Ultimately, the Tax Reform Act of 1969 added I.R.C. § 385 to the Code, which, although not a safe harbor, presented a non-exclusive list of factors drawn from those applied by the courts.<sup>31</sup>

Section 385 provides that regulations shall set forth factors to be taken into account in classifying corporate capital infusions as debt or equity, and that

[those factors] may include among other factors: (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 to or preference over any indebtedness of the corporation, (3) the ratio of debt to equity of the corporation, (4) whether there is convertibility into the stock of the corporation, and (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.<sup>32</sup>

In 1989, Congress amended § 385 to provide that the regulations can prescribe rules which treat instruments "as in part stock or in part indebtedness," a break with the all or nothing judicial approach to classification.<sup>33</sup> Three years later, Congress revisited § 385 and provided that the issuer's characterization of an instrument as

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<sup>30</sup> See *id.* at 579–88 (discussing proposals leading up to the adoption of I.R.C. § 385).

<sup>31</sup> Tax Reform Act of 1969, Pub. L. No. 91-172, § 415(b), 83 Stat. 487, 613 (codified as amended at I.R.C. § 385 (2006)).

<sup>32</sup> I.R.C. § 385(b) (2006) (line breaks omitted).

<sup>33</sup> Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7208(a)(1), 103 Stat. 2106, 2337 (codified as amended at I.R.C. § 385(a) (2006)). Two courts had bifurcated a hybrid instrument into debt and equity components, but those decisions are aberrations. See *Richmond, Fredericksburg & Potomac R.R. Co. v. Comm'r*, 528 F.2d 917, 920 (4th Cir. 1975) (stating that "hybrid securities may be treated either as debt or equity, depending upon the circumstances" and that for the hybrids, interest deductions are permitted for guaranteed dividend payments, but that other amounts are treated as equity); *Farley Realty Corp. v. Comm'r*, 279 F.2d 701, 704 (2d Cir. 1960) (stating that "an individual investor may occupy dual statuses of stockholder and creditor in relation to a corporation . . . even though the two types of investments occur simultaneously"). Some commentators have criticized a wholesale bifurcation approach as potentially leading to tax abuse "because corporations simply would treat all instruments as debt until the Commissioner challenged the characterization." Margaret A. Gibson, Comment, *The Intractable Debt/Equity Problem: A New Structure for Analyzing Shareholder Advances*, 81 NW. U. L. REV. 452, 461 (1987).

stock or debt at the time of issuance is binding on the issuer and the holders of such instrument, but not on the Service.<sup>34</sup>

With the exception of the bifurcation concept introduced in the 1989 amendments, the statute adds little to the longstanding judicial classification doctrine. Consequently, the application of § 385 is highly dependent on the issuance of regulations, and the statute invites the Treasury to promulgate them.<sup>35</sup> To its credit, the Treasury made several efforts from 1980 to 1983 to issue final regulations but failed to adopt them in the end.<sup>36</sup>

Unlike the narrow focus of the test proposed by this Article, the regulations attempted to answer the debt/equity riddle for both closely held and public corporations.<sup>37</sup> One hallmark of the regulations was their attempt to inject a degree of certainty by establishing several bright line rules.<sup>38</sup> Commentators carefully analyzed and cri-

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<sup>34</sup> See § 385(c)(1). Subsection (c) of § 385 was added by the Energy Policy Act of 1992, Pub. L. No. 102-486, § 1936(a), 106 Stat. 2776, 3032. Subject to exceptions in regulations, if the holder of an instrument discloses a characterization inconsistent with that of the issuer on his return, the holder is not bound by the issuer's characterization. See I.R.C. § 385(c)(2).

<sup>35</sup> See I.R.C. § 385(a).

<sup>36</sup> The Treasury issued the first proposed regulations in March 1980. See Prop. Treas. Reg. §§ 1.385-1 to 1.385-12, 45 Fed. Reg. 18957, 18957-73 (Mar. 24, 1980). The March 1980 proposed regulations, as revised, were filed with the Federal Register on December 29, 1980, and published in the Federal Register as final regulations on December 31, 1980, effective for interests created after April 30, 1980. See T.D. 7747, 1981-1 C.B. 141. This Article follows the convention of most writers in referring to the regulations as the December 31, 1980, regulations. On May 1, 1981, the effective date of the regulations was postponed to January 1, 1982. See T.D. 7774, 1981-1 C.B. 168. The effective date was again postponed to July 1, 1982. See T.D. 7801, 1982-1 C.B. 60. On January 5, 1982, the Treasury issued proposed regulations that amended and restated the December 31, 1980, regulations. See Prop. Treas. Reg. §§ 1.385-0 to 1.385-8, 47 Fed. Reg. 170, 170-87 (Jan. 5, 1982). The effective date was then postponed again to the later of "90 days after the publication of the final revisions to the regulations or January 1, 1983." T.D. 7822, 1982-2 C.B. 84. On July 6, 1983, the Treasury published a notice of proposed withdrawal of the December 31, 1980, regulations. See 48 Fed. Reg. 31053, 31053 (July 6, 1983). The regulations project was ultimately withdrawn, effective August 5, 1983, with the publication of Treasury Decision 7920 on November 3, 1983. See T.D. 7920, 1983-2 C.B. 69.

<sup>37</sup> Richard L. Kaplan & Lowell D. Yoder, *New Variations on an Old Enigma: The Treasury Department's Debt-Equity Regulations*, 1981 U. ILL. L. REV. 567, 585.

<sup>38</sup> See, e.g., Prop. Treas. Reg. § 1.385-8, 45 Fed. Reg. 18957, 18971 (Mar. 24, 1980). For example, the March 1980 proposed regulations treated any instrument issued by a corporation as stock if the debt-to-equity ratio of the issuing corporation was greater than ten to one immediately after the instrument was issued and at the end of the taxable year that it was issued. *Id.* That approach was obviously flawed because it did not account for the borrower's overall business prospects or the customary capital structures across industries. The December 31, 1980, proposed regulations con-

tiqued the multiple waves of proposals.<sup>39</sup> None of the interested parties was fully satisfied with the regulations,<sup>40</sup> and the Treasury withdrew the proposals in 1983.<sup>41</sup> The Treasury has apparently done this project.<sup>42</sup>

#### IV. INVIGORATING THE THIRD-PARTY LENDER TEST

##### A. A Simpler and More Coherent Solution

As discussed in Part II, the conventional judicial approach to the debt/equity classification issue is to consider a list of unequally weighted resemblance factors. In resolving the issue of whether shareholder salaries are “a reasonable allowance,”<sup>43</sup> the courts follow a similar route.<sup>44</sup> In *Exacto Spring Corp. v. Commissioner*, however,

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verted this rule to a two-part safe harbor, where straight debt instruments would not be reclassified if the corporation’s “outside” debt-to-equity ratio did not exceed ten to one, and the ratio of insider debt to equity did not exceed three to one. See Prop. Treas. Reg. § 1.385-6(f), 45 Fed. Reg. 86438, 86441 (Dec. 31, 1980); T.D. 7747, 1981-1 C.B. 141, 160.

<sup>39</sup> See, e.g., Kaplan & Yoder, *supra* note 37; Bayless Manning, *Hyperlexis and the Law of Conservation of Ambiguity: Thoughts on Section 385*, 36 TAX LAW. 9 (1982); William Nathony, *Cleaning the Augean Stables: The Debt-Equity Regulations*, 8 J. CORP. TAX’N 185 (1981) (comparing the March 24, 1980, regulations and the December 31, 1980, final regulations); Lawrence M. Stone & C. Kevin McGeehan, *Distinguishing Corporate Debt from Stock Under Section 385*, 36 TAX. L. REV. 341 (1981).

<sup>40</sup> The small business community was reportedly unhappy with the proposed regulations. See *infra* note 174. In addition, it appeared that the certainty provided to public corporations would permit them to create instruments that abused the regulations, which alarmed the Treasury. See Mark P. Gergen & Paula Schmitz, *The Influence of Tax Law on Securities Innovation in the United States: 1981–1997*, 52 TAX L. REV. 119, 161 (1997).

<sup>41</sup> See T.D. 7920, 1983-2 C.B. 69.

<sup>42</sup> See, e.g., LIND ET AL., *supra* note 1, at 152 (“[T]he Treasury is unlikely to initiate the mobilization that would be required to resurrect this project.”); Humphreys, *supra* note 14, at 1244 (“Even mentioning revisiting Code section 385 regulations, however, is likely to be ‘dead on arrival’ in Washington D.C. [sic] parlance.”). These examples are representative of a common observation. As has been the case for many years, § 385 regulations are not listed in the priority guidance plan projects for corporations and their shareholders. See OFFICE OF TAX POLICY AND I.R.S., I.R.S., UPDATE TO 2007–2008 PRIORITY GUIDANCE PLAN (2008), available at 2008 WL 4287826.

<sup>43</sup> I.R.C. § 162(a)(1) (2006) (“There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including, . . . a reasonable allowance for salaries or other compensation for personal services actually rendered. . . .”).

<sup>44</sup> See, e.g., *Mayson Mfg. Co. v. Comm’r*, 178 F.2d 115, 119 (6th Cir. 1949). The court considered the following factors to determine that the compensation paid to the employees at issue was reasonable:

Judge Posner parted with the prevailing multifactor analysis and applied an independent investor test in determining whether the shareholders could still earn a market return on the corporation's equity.<sup>45</sup> In effect, Posner's economic analysis split the profits of the corporation between the service provider and the capital providers.<sup>46</sup>

This Article similarly proposes a more direct approach to the debt classification question that would supplant the judicial multifactor test as applied to shareholder loans. As discussed in Part II, the availability of third-party loans has been one of the many factors already applied by the courts. This Article proposes that it should be the principal test applied to shareholder loans in closely held corporations, including parent-subsidiary and otherwise affiliated<sup>47</sup> structures. The test could be applied to some of the financing features of publicly traded corporations, but as discussed in Part V, it would be

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the employee's qualifications; the nature, extent and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with the gross income and the net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; the salary policy of the taxpayer as to all employees; and in the case of small corporations with a limited number of officers the amount of compensation paid to the particular employee in previous years.

*Id.* This 1949 opinion of the U.S. Court of Appeals for the Sixth Circuit is generally cited as the doctrinal foundation of the multiple-factor test in this area. See McCoskey, *supra* note 18, at 230.

<sup>45</sup> *Exacto Spring Corp. v. Comm'r*, 196 F.3d 833, 838–39 (7th Cir. 1999).

<sup>46</sup> In prior cases, courts evaluating the reasonableness of compensation paid to shareholder employees had considered the issue “from the perspective of a hypothetical independent investor” and appropriate returns on equity. See, e.g., *Elliot's, Inc. v. Comm'r*, 716 F.2d 1241, 1245 (9th Cir. 1983); *Diverse Indus., Inc. v. Comm'r*, 51 T.C.M. (CCH) 525, 532–34 (1986). Consequently, *Exacto Spring Corp.* is notable not for pioneering those concepts, but in applying them as the sole classification criterion in creating a presumption of a reasonable salary. As explained at length in *Me-nard, Inc. v. Commissioner*, 560 F.3d 620, 623 (7th Cir. 2009), the presumption can be rebutted by evidence, including “that the company's success was the result of extraneous factors, . . . that the employee does no work for the corporation, . . . [or] evidence of a conflict of interest.” The *Exacto Spring Corp.* approach is a market-based approach, as it employs an estimated rate of return demanded by independent investors. *Exacto Spring Corp.*, 196 F.3d at 838–39. Establishing that market rate of return for a particular company makes application of the test dependent on expert witness analyses of those factors.

<sup>47</sup> See, e.g., *Tex. Farm Bureau v. United States*, 725 F.2d 307, 314 (5th Cir. 1984) (holding that advances between affiliated nonprofit corporations were contributions to capital, not loans); *Cerand & Co., Inc. v. Comm'r*, 82 T.C.M. (CCH) 755, 759 (2001) (holding that advances to brother-sister corporations were contributions to capital and not loans).

an incomplete solution due to public corporations' numerous and more nuanced alternatives for raising capital. The proposed test would be adopted as a regulation through an exercise of the Treasury's authority under § 385.<sup>48</sup>

This Article proposes the following test: if a third-party lender, acting at arm's length and with reasonable knowledge of all relevant facts existing at the time the transaction is consummated,<sup>49</sup> would not make the loan<sup>50</sup> in substantially<sup>51</sup> the same manner in which it was

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<sup>48</sup> See *infra* notes 107–09 and accompanying text.

<sup>49</sup> This portion of the test draws from the established definition of fair market value for estate tax purposes, which “is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.” Treas. Reg. § 20.2031-1(b) (as amended in 1965). This is a challenge, inasmuch as shareholders and third-party lenders may not otherwise have access to the same information about the corporate borrower. See *infra* notes 87–89 and accompanying text. As discussed later, the phrase “existing at the time the transaction is consummated” can be applied later in certain situations, such as a demand loan or upon extension or renegotiation of the loan. See *infra* notes 71–75 and accompanying text.

<sup>50</sup> One might claim that there is a tautological flaw in this test, as the test for a “debt” analyzes whether a hypothetical third party would “lend” money to the borrower on the same terms and conditions. There are several responses to this that have the most force in the closely held business context. First, the taxpayer will have identified the transaction as a “loan” in its tax treatment of the capital infusion. As so denominated, the test is whether a third party would accept such instrument in exchange for its cash. If the “loan” so labeled by the taxpayer is *in substance* equity, particularly because it requires the lender to assume uncustomary risks of the business, then a lender would not make the investment in that manner. To ensure that the third-party lender may not be acting as an equity investor, the test incorporates some aspects of a “straight debt” instrument. Second, as discussed in the text accompanying *infra* notes 91–98, the courts, in considering an aspect of this test as part of the multiple-factor tests, have not been reluctant to entertain testimony couched in this fashion. Third, the proposed arm's length test, while focusing on the risk a third-party lender would assess, also includes some of the more formalistic factors that have traditionally separated debt from equity (such as 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) and those factors inject a traditional debt flavor. Fourth, and this is admittedly the least satisfactory response, the definition of “debt” in an income tax sense resembles the income tax's definition of “gift.” *Commissioner v. Duberstein* offered no definitions and relegated the inquiry to a question of fact. 363 U.S. 278, 289 (1960). Likewise, the Court's leading pronouncement about the debt classification issue, *John Kelley Co. v. Commissioner*, 326 U.S. 521, 530 (1946), offered little definition beyond a multifactor “smell test” of equity resemblance that the courts continue to apply today, albeit after dutifully reciting the applicable multiple-factor test. Perhaps the debt classification issue invokes a meaning of debt in a financial sense akin to the “more colloquial sense” of a gift definition. See *Duberstein*, 363 U.S. at 285. Accordingly, although the rigor of the proposed test is diminished to a degree, overall courts should still be able to employ it to aid better decision making. The December

structured,<sup>52</sup> then the presumptive classification<sup>53</sup> is equity. The hypothetical third-party lender could include any lenders appropriate to

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31, 1980, regulations applied a commercial lender standard to determine whether debt was excessive (a related but more limited inquiry) that sidestepped the tautology by referring to whether the instrument and the borrower's structure "would not be satisfactory to a bank, insurance company or similar lending institution which makes ordinary commercial loans." Prop. Treas. Reg. § 1.385-6(f)(2), 45 Fed. Reg. 86438, 86453 (Dec. 31, 1980). The proposed test could be cleverly restated in this manner but this Article has declined to do that for the sake of simplicity.

<sup>51</sup> The proposed test employs "substantial" comparability to contribute to flexibility in application. In comparison, § 482's arm's length standard also can consist of values within a range of comparables. See Treas. Reg. § 1.482-1(e)(2)(ii)-(iii) (as amended in 2009); cf. I.R.C. § 465(b)(6)(D)(ii) (2006) (exempting certain related-party financing if it "is commercially reasonable and on substantially the same terms as loans involving unrelated persons").

<sup>52</sup> Much like the courts' current treatment of the debt classification issue, which examines all of the facts and circumstances of the purported debt, the proposed arm's length standard would still examine all of the borrower's factors in determining whether outside financing on the same terms would be available.

[A]nalysis of the corporation's ability to secure outside financing does not necessarily provide insight into the nature of the shareholder advance. Although in some cases the inability of a company to secure outside financing will reflect that such an advance involves excessive financial risk, this factor is not sufficiently predictive of the nature of the underlying loan. In assessing its willingness to provide financing to a company, a lending institution considers too many extraneous factors to warrant using traditional lending institutions as a benchmark for distinguishing debt and equity for tax purposes. For example, the "perceived integrity of the borrower plays a primary role in a company's ability to obtain financing from commercial lending institutions." Such subjective criteria should not play a role in the federal tax debt/equity distinction.

Gibson, *supra* note 33, at 488-89 (citation omitted).

<sup>53</sup> The presumptive classification is equity, but that can be overcome by proof to the contrary. There is, however, always an information asymmetry between taxpayers and the Service when the facts concern what the taxpayer did or did not do, such that taxpayers have the edge. The proposed test's presumption would encourage taxpayers, in their self-interest, to document the third-party lender factors, to consider them in deal making, and to produce that evidence in litigation. The presumption would be rebuttable, permitting a court to examine other factors. There is the obvious risk that this exception could swallow the rule, particularly in light of the courts' longstanding adherence to the multiple factor approach. This approach, however, is necessary to inject some flexibility into a difficult area of the law. This presumption in favor of the government could contravene the burden shifting rule of § 7491(a), as that section deals with "evidence with respect to any factual issue," and the proposed test should be construed as an issue of fact. I.R.C. § 7491(a)(1); see *infra* notes 99-102 and accompanying text. Although this Article envisions that the proposed test would be applied through regulations, if necessary § 7491(a)(3) yields when "any other provision of this title provides for a specific burden of proof with respect to such issue." In that event, a statutory revision to § 385 adopting the proposed test would be helpful. Empirical studies of Tax Court decisions have generally

the particular borrower, such as private “angel” investors,<sup>54</sup> venture capital investors,<sup>55</sup> commercial banks,<sup>56</sup> credit unions,<sup>57</sup> or public fi-

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found no impact from the adoption of § 7491 in overall Tax Court litigation not confined to the debt/equity issue. See, e.g., Janene R. Finley & Allan Karnes, *An Empirical Study of the Change in the Burden of Proof in the United States Tax Court*, 6 PITT. TAX REV. 61, 81 (2008) (“Overall, the change in the burden of proof in the Act did not have a statistically significant effect on those cases decided within the Tax Court when the taxpayer was an individual.”).

<sup>54</sup> See Adrian Wooldridge, *Global Heroes*, ECONOMIST, Mar. 14, 2009, at 3, 5.

Venture capitalists fund only a small fraction of start-ups. The money for the vast majority comes from personal debt or from the “three fs”—friends, fools and families. . . .

Monitor, a management consultancy that has recently conducted an extensive survey of entrepreneurs, emphasises the importance of “angel” investors, who operate somewhere in the middle ground between venture capitalists and family and friends. They usually have some personal connection with their chosen entrepreneur and are more likely than venture capitalists to invest in a business when it is little more than a budding idea.

*Id.* at 4. One overview of the leading studies of angel investing found that between 250,000 and 300,000 angel investors are active each year with an annual investment that ranges between twenty and thirty billion dollars. See GERALD A. BENJAMIN & JOEL MARGULIS, *ANGEL FINANCING: HOW TO FIND AND INVEST IN PRIVATE EQUITY* 77 (2000). A simple profile of angel investors would be people who have likely owned and sold their own businesses and are private, affluent citizens particularly interested in early stage deals. *Id.* at 83–84. In fact, “as venture capital is the real contributor to later-stage deals, angel capital has become the indubitable contributor to early-stage deals, the resource for the majority of companies.” *Id.* at 69.

<sup>55</sup> See STEPHEN BLOOMFIELD, *VENTURE CAPITAL FUNDING: A PRACTICAL GUIDE TO RAISING FINANCE* 44 (2d ed. 2008). The purpose of venture capitalism (VC) “is to make a substantial rate of return to both the investor and the entrepreneur(s) within a reasonably closely defined time, typically three to five years, by enhancing the capital value of the business in which the investment is made.” *Id.* VC does not ensure a return, however, as “[s]even out of 10 companies in the average VC’s portfolio will either fold or be sold at a loss to investors.” JOEL CARDIS ET AL., *VENTURE CAPITALISM: THE DEFINITIVE GUIDE FOR ENTREPRENEURS, INVESTORS, AND PRACTITIONERS* 14 (2001). One company, on average, of those ten will have a 1000 percent return either through a successful IPO or acquisition. *Id.* VC makes only a small percentage of start-up financing, as venture capitalists tend to “reject about ninety-nine percent of the business plans that come to them.” *Id.* at 11. The law firm Fenwick & West studied the trends of VC in Silicon Valley and found that in the first quarter of 2009, the amount invested by venture capitalists was \$3.8 billion on 470 deals throughout the United States, a decline from the \$5.9 billion invested on 590 deals in the fourth quarter of 2008 and the \$7.3 billion invested on 680 deals in the first quarter of 2008. FENWICK & WEST LLP, *TRENDS IN TERMS OF VENTURE FINANCINGS IN SILICON VALLEY I* (2009), available at [http://www.fenwick.com/docstore/VCSurvey/Q109\\_VC\\_Terms\\_Survey\\_Report.pdf](http://www.fenwick.com/docstore/VCSurvey/Q109_VC_Terms_Survey_Report.pdf). Producing a yearly figure from these numbers shows how little financing comes from VC as compared to the numbers for angel financing. This is especially true considering that 400,000 to 500,000 companies are aggressively seeking financing at any given time. See BENJAMIN & MARGULIS, *supra* note 54, at 77. In *Adelson v. United States*, the court found that a business consultant’s short-term ad-



nancial markets.<sup>58</sup> The hypothetical lender would own no other interest in the borrowing corporation,<sup>59</sup> nor would she have any non-

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vances to start-up companies seeking to go public were debt for income tax purposes when the consultant sought to claim a bad debt deduction. 737 F.2d 1569, 1573, 1575 (Fed. Cir. 1984). “A factor that is particularly significant in this case is that taxpayer had at best a minor equity interest in the client-companies. It is clear from the facts that, with the possible exception of [one company], taxpayer was dealing with the client-companies as an ‘outsider. . . .’” *Id.* at 1572. The government had tried to characterize the relationship as that of a “venture capitalist,” which it apparently equated with an equity investor. *See id.*

<sup>56</sup> This would include loans guaranteed by the Small Business Administration (SBA). The SBA 7(a) Loan Program is the typical loan guaranteed by the SBA, and these loans are provided and administered by commercial lenders. *See* Small Bus. Admin., 7(a) Loan Program, <http://www.sba.gov/financialassistance/borrowers/guaranteed/7alp/index.html> (last visited Feb. 8, 2010). Thus, in order to obtain one of these loans, the small business owner goes to the commercial lender, and the lender decides if it will make the loan internally or if the application has weaknesses that will require an SBA guaranty on a portion of the loan. *Id.* The lenders must choose to structure their loans by the SBA’s requirements and then apply to receive a guaranty from the SBA. *Id.* Then, if the lender is able to receive an SBA guaranty, the applicant must meet SBA-mandated size standards, be for profit, not already have the internal resources to provide the financing, and be able to demonstrate repayment. *Id.*

<sup>57</sup> Reportedly, approximately twenty-seven percent of credit unions offer business loans, with an average loan size of approximately \$215,000. *See* Jilian Mincer, *Small Businesses Find a New Source for Funding*, WALL. ST. J., Mar. 3, 2009, at B7. In fact, some believe that credit unions need to offer this sort of member business lending in order to survive. *See* David Winsheimer, *New Territory*, CREDIT UNION MGMT., June 2008, at 46, 46 (2008), available at 2008 WLNR 11872339. One example is Synergy One FCU, which had thirty small business loans valued at \$11 million in 2008. *Id.* at 47.

<sup>58</sup> The December 31, 1980, regulations considered whether a corporation’s debt was excessive, in which case the instrument would be treated as stock.

The corporation’s debt is “excessive” if (i) all of the instrument’s terms and conditions and (ii) the corporation’s financial structure, taken together, would not be satisfactory to a bank, insurance company or similar lending institution which makes ordinary commercial loans. For this purpose, the corporation’s size, industry, geographic location, and financial condition must be taken into account.

Prop. Treas. Reg. § 1.385-6(f)(2), 45 Fed. Reg. 86438, 86453 (Dec. 31, 1980). The test proposed by this Article is broader in terms of the types of hypothetical lenders that are allowed, but the regulations’ broad weighing of the borrower’s factors is helpful.

<sup>59</sup> The December 31, 1980, regulations included an independent creditor safe harbor test. A creditor was deemed to be independent if stock owned by the corporate borrower would not be attributed to the creditor under modified § 318 attribution rules and the creditor’s holdings of stock and instruments were “not substantially proportionate.” Prop. Treas. Reg. § 1.385-6(b)(2)(ii), 45 Fed. Reg. at 86452 (Dec. 31, 1980). Essentially, the creditor could not own five percent or more of the corporate borrower.

creditor relationship,<sup>60</sup> with limited exceptions.<sup>61</sup> In the interest of simplicity, this would focus the inquiry on the lending relationship, distinct from any current or potential investing relationships, including warrants or convertibility options.<sup>62</sup> Although the determination of the debt portion would be made without reference to those equity attributes, the test could be softened a bit by permitting the bifurca-

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<sup>60</sup> The January 5, 1982, proposed regulations included consideration of “[w]hether the creditor has a relationship with the corporation other than that of a creditor, e.g., as an employee, supplier, or customer.” Prop. Treas. Reg. § 1.385-6(b)(1)(ii), 47 Fed. Reg. 164, 180 (Jan. 5, 1982).

<sup>61</sup> One exception to the proposed third-party lender test would exempt promissory notes of a corporation payable to a redeemed shareholder in a transaction that qualifies for sale or exchange treatment under §§ 302 and 303. The exception would be based on pragmatic considerations (as this is often the most practical means of exit from a closely held corporation) and in recognition of the reduced potential for abuse due to the nonrecurring and relatively short-term nature of the transaction.

<sup>62</sup> A warrant or convertible option to purchase shares in the borrower would be ignored, recognizing that this would potentially impact a hypothetical third-party lender’s incentives and decision whether to extend the loan. Indeed, many of these relationships demonstrate a sliding scale of attributes from lender to investor, based on interest rates, security for the loan, priority, convertibility, and so forth.

As lenders have contemplated inflation and the growth in the value of real estate and some other equities, they have increasingly sought to share in the earnings and appreciation that historically inured exclusively to the benefit of the borrower’s shareholders. Conversely, even in a high-risk financial environment, some entrepreneurial investors have attempted to cut their exposure by bargaining for some of the protections that have traditionally been the hallmarks of the lender. To satisfy these conflicting appetites for risk and security, financial planners have devised a bewildering variety of fence-straddling securities . . . that, although by no means innocent of tax motivations, seek to meet genuine business objectives achievable only by abandoning the historic distinction between the terms “pure debt” and “pure equity.”

1 BITTKER & EUSTICE, *supra* note 2, ¶ 4.03[1] (citations omitted).

Some courts otherwise would resist this strict application of the arm’s length test. In *Scriptomatic, Inc. v. United States*, the court granted judgment notwithstanding the verdict in favor of the taxpayer. 397 F. Supp. 753, 766 (E.D. Pa. 1975), *aff’d*, 555 F.2d 364 (3d Cir. 1977). The government agreed that outsiders would have purchased the debentures on the same terms as they were sold to the stockholders. *Id.* at 763. But the court accepted that the taxpayer “was unable to establish that an unrelated person would have purchased a debt instrument, similar to the seven percent subordinated debenture, solely for the interest to be earned, that is, without some equity acquisition in the corporation.” *Id.* The court further stated that

[t]he fact that outsiders might have refused to advance money on the debentures alone, however, is not significant. The economic realities of an entire transaction should be determined not by an analysis of a part but of the whole. . . . Eliminating the equity that went with the debentures would change the whole picture.

*Id.* at 763–64.

tion of the instrument into debt and equity, rather than imposing an all or nothing result.<sup>63</sup>

The application of a single arm's length lender test might appear to be folly, as it conceivably does not capture and weigh all of the factors currently considered by the courts. Many of the current judicial multifactor tests of debt classification, however, could be considered as attempts, in substance, at satisfying a third-party lender test, *but by looking at what facts a third-party lender would assess rather than relying on evidence as to what would be the final conclusion of a third-party lender.*<sup>64</sup> A third-party lender, in determining whether to extend a loan to a corporate borrower, would presumably weigh many of the factors that judges also now consider. In *Delta Plastics, Inc. v. Commissioner*, for example, lenders would consider the following factors: thin or adequate capitalization; risk (which examines the unconditional nature of the obligation to repay and payments that were not dependent on profits or excused in the event of losses); whether loans were available from outside creditors (the inquiry itself); whether payments were made when due; and "intent" of the parties (determined with reference to the presence of fixed dates for payments and the lenders' understanding and knowledge of the corporation's business and a reasonable expectation of its likely success).<sup>65</sup>

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<sup>63</sup> The § 385 regulations that were issued between 1980 and 1983, *see supra* notes 36–41, did not include a bifurcation option. In dealing with hybrid instruments, the proposed regulations prescribed debt or equity status for the entire instrument based on the predominant class of characteristics. *See infra* note 208 and accompanying text. In 1989, Congress granted the Treasury authority to promulgate regulations that bifurcate instruments. *See supra* note 33 and accompanying text. It is beyond the scope of this Article to fully develop the details of how a bifurcation rule would operate in conjunction with the proposed test.

<sup>64</sup> As discussed in the pages that follow, the courts look to many of the factors that would influence a third-party lender's decision to extend a loan. However, the courts then substitute their judgment as to the result, rather than principally relying on factual evidence of what third-party lenders would demand with respect to the taxpayer's circumstances. Indeed, although the Robertson empirical study of thirty-two years of Tax Court decisions rejected the use of one factor as conclusive in the debt/equity determination, all of the seven factors that were highly predictive of Tax Court outcomes in substance were factors that would influence a third-party lender's decision whether to lend funds. *See Robertson et al., supra* note 27, 715–16.

<sup>65</sup> 85 T.C.M. (CCH) 940, 943–44 (2003). *See generally* COM. LENDING COMMERCIAL., AM. BANKERS ASS'N, A BANKER'S GUIDE TO COMMERCIAL LOAN ANALYSIS (2nd ed. 1977) (relevant factors include experience and business reputation of the principals, background of the business, form of organization, financial statement analysis, ratio and comparative analysis, and ability to generate cash); Credit Loan, Credit Factors: A Potential Small Business Loans Borrower Should Know, <http://www.creditloan.com/credit-factors-a-potential-small-business-loans-borrower->

The factor of proportionality of stock ownership to creditor interests is also a part of the third-party lender inquiry. In a strictly proportionate holding of stock or debt, the shareholder lenders are ambivalent as to whether their investment is stock or debt—their risk and motivations are the same irrespective of the instrument's form.<sup>66</sup> In a highly disproportionate holding of debt, however, a shareholder lender can be viewed as more of a lender than a shareholder, as he or she has more at stake financially with respect to the investment denominated as debt.<sup>67</sup> This disproportionate situation is considered to favor debt classification,<sup>68</sup> but it is in substance seeks to place the shareholder lender in a third-party lender position—again, the inquiry of the proposed test.

Several of the judicial factors do not fit with a third-party lender test, but they are generally of little consequence. The factor that considers the extent to which funds were used to acquire capital assets (or “core” assets) is generally not applied rigorously by the courts.<sup>69</sup> Courts likely understand that some businesses would rent (a form of borrowing) or finance the acquisition of core assets; there is no business principle dictating that such assets must be backed by equity contributions. Indeed, if the corporate borrower cannot obtain a loan to fund such acquisitions, that lack of creditworthiness leads, again, to the fundamental facts considered in applying a third-party

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should-know.html (last visited Feb. 8, 2010) (factors include debt to worth ratio, future cash flows, working capital evaluation, collateral, and “effective management of business resources”).

<sup>66</sup> Of course, if all shareholders are not strictly proportionate with respect to their holdings of stock and loans, the priority of payments that debt enjoys would assume importance.

<sup>67</sup> See LIND ET AL., *supra* note 1, at 142 (“In a closely held setting, debt held by the shareholders in the same proportion as their stock holdings normally raises the eyebrows of the Service.”) (citations omitted).

<sup>68</sup> See 1 BITTKER & EUSTICE, *supra* note 2, ¶ 4.04[2] (“Although it is not fatal per se to debt classification, the fact that debt is owed in proportion to stockholdings tends to poison the atmosphere and to invite special scrutiny by the courts.”).

<sup>69</sup> See Plumb, *supra* note 7, at 522.

Plainly, despite occasional verbal flourishes suggesting the contrary, the core asset concept is not and cannot be a rule of law, since essential assets of a business are often acquired with the aid of outside credit and there is no reason, per se, to discriminate merely because shareholders supply the funds.

*Id.* (citations omitted). In *Delta Plastics, Inc. v. Commissioner*, the court observed that “[a] substantial portion of the debenture funds appears to have been used to acquire capital assets.” 85 T.C.M (CCH) 940, 943 (2003). Eschewing additional comment on this factor, the court ultimately concluded that the capital infusions should be accorded debt treatment. *Id.* at 944.

arm's length lender test. Another factor, management participation by the lender, is not particularly useful. In the context of a closely held corporation, management participation is provided through the accompanying stock ownership, so it is unnecessary for the corporation to offer this in the putative debt.<sup>70</sup>

The proposed test would be generally applied as of the time of the capital infusion, ignoring changes in the financial markets and the borrower's financial standing during the term of the loan.<sup>71</sup> A forward-looking quality would be introduced as loans mature, are renewed, or are modified,<sup>72</sup> because the test would be applied at such subsequent event.<sup>73</sup> A demand loan would remain subject to the

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<sup>70</sup> See Plumb, *supra* note 7, at 447 ("Controlling shareholders would rarely, if ever, have occasion to provide voting rights in purported debt instruments held by them, since such rights would add nothing to the control they otherwise have."). Plumb suggests that the test is rarely applied in an outcome determinative fashion. See *id.* ("Although that court, by dictum, said that the *presence* of voting rights would 'strongly indicate' an equity interest, it is all but impossible to find a decision in which that view has been applied.") (citation omitted).

<sup>71</sup> See *Lease v. Comm'r*, 66 T.C.M. (CCH) 1121, 1126 (1993).

Generally, the time for applying the tests required to classify a transaction as debt or equity is at its inception. For the most part, this creates a one-way street. Although an advance may initially qualify as debt and then become equity at a later date, an advance initially treated as equity will not thereafter become debt, unless there is a later recapitalization or the equivalent.

*Id.* (citations omitted). Nevertheless, the debt or equity classification analysis under current law has a wait-and-see bias. In *Delta Plastics, Inc.*, the Tax Court stated,

In spite of petitioner's initial debt-to-equity ratio of 26:1, prior to startup of petitioner, petitioner's officers and directors understood petitioner's business and the plastics manufacturing industry and reasonably projected that petitioner would be successful. As a result of revenues quickly generated by its operations, petitioner's debt-to-equity ratio was reduced in just over 3 years to 4:1. This reduction indicates to us, in this case, that petitioner was adequately capitalized from its inception.

85 T.C.M. (CCH) at 943.

<sup>72</sup> The March 24, 1980, proposed regulations treated a "substantive" change in the terms of an instrument as a new issuance. See Prop. Treas. Reg. § 1.385-7(b)(2), 45 Fed. Reg. 18957, 18969-70 (Mar. 24, 1980). Substitutions of collateral and prepayments were not considered substantive changes. *Id.*

<sup>73</sup> Cf. I.R.C. §306(g) (2006) (providing that § 306 tests are applied at a later date "if a substantial change is made in the terms and conditions of any stock"); Treas. Reg. § 1.1001-3(a) (1996) (modification of debt instrument treated as a taxable exchange).

arm's length test throughout its duration.<sup>74</sup> But even with an arm's length test, there must be measures to address de facto modifications of the instrument through events such as nonpayment of interest or principal or other failures to abide by the stated loan terms.<sup>75</sup>

So that the test would not be employed to reconsider capital contributions already conceded to be equity by their form, certain factors would remain requirements for debt status before application of the third-party lender test, such as investments denominated as common or preferred stock, the § 385 factors of 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 payment of a fixed rate of interest. This acknowledges the taxpayer's continuing prerogative to dictate at least the opening issues in controversy through the selection of the form and labels of the obligation.<sup>76</sup> The unconditional, specified date and fixed rate requirements would also sift out securities that permit the postponement of interest payments or for which the "interest" is tied to the profits of the issuer.<sup>77</sup>

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<sup>74</sup> The March 24, 1980, proposed regulation singled out demand loans payable to principal owners of the corporation for special scrutiny. Prop. Treas. Reg. § 1.385-7(d)(1), 45 Fed. Reg. at 18970.

<sup>75</sup> The March 24, 1980, proposed regulations treated instruments as stock if the holder was a principal shareholder of the corporation and the holder failed to pursue "available remedies with the ordinary diligence of an independent creditor" upon the failure to pay interest or to pay principal within ninety days of a principal due date. Prop. Treas. Reg. § 1.385-7(d)(3)(ii), 45 Fed. Reg. at 18970; *cf.* Treas. Reg. § 1.1001-3(c)(1)(i) (providing that a loan modification arises from any alteration stemming from oral or written agreement, by the parties' conduct, or "otherwise").

<sup>76</sup> *See supra* note 34 and accompanying text. The 1992 amendments to § 385 added subsection c, which provides that the form adopted by the taxpayer is binding on the taxpayer. I.R.C. § 385(c)(1).

<sup>77</sup> The "fixed rate of interest" would permit floating rates tied to an external index or standard but would preclude linkage to the issuer's profits. This resembles the S corporation straight debt safe harbor which requires

any written unconditional promise to pay on demand or on a specified date a sum certain in money if (i) the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors, (ii) there is no convertibility (directly or indirectly) into stock, and (iii) the creditor is an individual (other than a nonresident alien), an estate, [certain trusts], or a person which is actively and regularly engaged in the business of lending money.

I.R.C. § 1361(c)(5)(B). As discussed in the text that follows, the proposed test treats convertibility in a different manner. *See infra* notes 201-07 and accompanying text. The Service has declined to apply the unconditional payment requirement to debts of public companies. *See id.*

Even if a borrower is otherwise creditworthy, the failure to respect formality in the terms of the loan documentation could still produce equity classification because a third-party lender would not accept such sloppy evidence of its loan. This was the situation in *Segel v. Commissioner*, where the Tax Court wrote,

Most important to our ruling in this case, . . . however, is the independent creditor test. . . . The focus . . . is not simply on the ability of the corporation to obtain funds from outside sources; rather, the focus is whether an outside lender would have lent the funds on *the same or similar terms*. We do not doubt that an outside lender could have been found to finance Presidential's incorporation and operations; Joseph Segel's experience and track record were impressive and likely would have been sufficient to convince a lender to finance Presidential. What we cannot believe, however, is that a disinterested outside lender would have lent the money to Presidential in a debtor-creditor relationship on the same, or anywhere near the same, terms as did the shareholders.

. . . .

. . . We believe that an outside lender, at the outset, would require some formal indicia of the understanding by which the funds are advanced; even if the payments were on open account, a prudent businessperson would require a written agreement to that effect to protect such an investment. Additionally, we believe that an outside lender would *require* interest for use of the funds and some time or schedule for repayment, if not some security for the debt as well.<sup>78</sup>

#### B. *Establishing the Arm's Length Standard*

Although the hypothetical arm's length standard<sup>79</sup> can be pronounced in the abstract, applying the standard will challenge litigants and the courts. As demonstrated by experience with the arm's length valuation standard applied under § 482,<sup>80</sup> simply stating the test is not

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<sup>78</sup> 89 T.C. 816, 832, 833–34 (1987).

<sup>79</sup> There is a rich body of academic discourse concerning the definition and function of “rules” as compared with “standards” or “principles.” See, e.g., Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992). Kaplow, for example, notes that such definitions “commonly emphasize the distinction between whether the law is given content *ex ante* or *ex post*.” *Id.* at 559. The proposed test is a rule but includes as a component the arm's length standard.

<sup>80</sup> The arm's length standard language is not located in I.R.C. § 482 itself but has been adopted by the regulations. See Treas. Reg. §1.482-1(b)(1) (as amended in 2009) (“In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer.”). The § 482 regulations and § 7872 impose requirements

enough. Interested actors must be able to quantify the term. The § 482 arm's length standard has been applied primarily through the use of extensive economic analysis by experts, which the courts have found to be helpful, but not binding.<sup>81</sup> The § 482 arm's length standard is a market valuation test, in part based on "the belief in the efficiency of markets and the complementary emphasis on commercial competition as a guarantor of perfect markets . . . ."<sup>82</sup>

Two mighty, highly fact-dependent steps are required in applying the proposed arm's length lender test. As with § 482,<sup>83</sup> the first step is selection of the appropriate lender market for financing the corporation.<sup>84</sup> Reliable data about the appropriate market<sup>85</sup> and the

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for the rate of interest on related-party and corporation/shareholder loans but do not address the debt versus equity question. See I.R.C. § 7872(c)(1)(C); Treas. Reg. § 1.482-2(a) (as amended in 2009). Additionally, the impact of potentially value-diminishing rights or restrictions in the federal wealth transfer taxation context is subject to an exception that applies an arm's length test. See I.R.C. § 2703(b)(3) ("[T]erms are comparable to similar arrangements entered into by persons in an arm's length transaction.").

<sup>81</sup> See, e.g., *Sundstrand Corp. v. Comm'r*, 96 T.C. 226, 331, 335 (1991) (two economic experts, Baumol and Lynk, in addition to other experts); *Eli Lilly & Co. v. Comm'r*, 84 T.C. 996, 1137, 1146 (1985) (four economic experts, Brozen, Baumol, Berry, and Comanor, in addition to other experts). The Tax Court in *Sundstrand* described the level of deference given to experts:

We weigh expert testimony in light of the expert's qualifications as well as all the other credible evidence in the record. We are not bound by the opinion of any expert witness, and we will accept or reject that expert testimony when, in our best judgment, based on the record, it is appropriate to do so. While we may choose to accept the opinion of one expert in its entirety, we may also be selective in the use of any portion of that opinion.

96 T.C. at 359 (citations omitted); see also Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX REV. 89, 151 (1995) ("The IRS spent about \$15 million on expert witnesses in section 482 cases in 1992, and a recent Treasury report recommends increased use of such experts.").

<sup>82</sup> Yariv Brauner, *Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes*, 28 VA. TAX REV. 79, 102 (2008).

<sup>83</sup> See *id.* at 105–07 (discussing difficulties in applying a market valuation approach in § 482 transfer pricing).

<sup>84</sup> See *supra* notes 54–58 and accompanying text (identifying the possible hypothetical lenders).

<sup>85</sup> The 2008 U.S. financial crisis produced observations that the credit markets for all corporations had "frozen up" to various degrees. See David Bogoslaw, *Where the Credit Freeze Has Thawed*, BUS. WK. ONLINE, Oct. 9, 2008, [http://www.businessweek.com/investor/content/oct2008/pi2008108\\_563455.htm](http://www.businessweek.com/investor/content/oct2008/pi2008108_563455.htm) (last visited Feb. 8, 2010). This was evident in the bond market as investment grade companies had 834 bond offerings for \$551 billion through September 30, 2008, down from 1782 offerings for \$752 billion over the same time period in 2007. *Id.*



standards of that market must be gathered. As a second step, those external factors must then be applied to the corporate borrower's relevant facts in constructing the hypothetical lender's loan, which will be compared to the existing loan for which debt classification is claimed.

In addition to the problems of proof, market-based tests of this nature may be imperfect even if a third-party market standard can be established. Some shareholders will presumably loan money to the corporation, even if a third-party loan is available, to reduce the intrusion and transaction costs attendant to such loans and to benefit from potentially attractive interest rates.<sup>86</sup> Simply put, all shareholder loans should not be considered suspect. More fundamentally, it

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Small business was hit particularly hard because if banks have to pull back, they will tend to pull back from small business loans first. Emily Maltby & Stacy Cowley, *Credit Crunch Freezes Hiring, Expansion*, CNN MONEY, Sept. 25, 2008, [http://money.cnn.com/2008/09/24/smallbusiness/small\\_biz\\_credit\\_freeze.smb/index.htm](http://money.cnn.com/2008/09/24/smallbusiness/small_biz_credit_freeze.smb/index.htm) (last visited Feb. 8, 2010). In the last three months of 2008, the SBA backed less than half the number of loans that it approved a year earlier, and in the first quarter of fiscal year 2009, there was a fifty-seven percent drop in SBA backed loans as compared to the first quarter 2008. Emily Maltby, *Sharp Plunge in Small Business Loans*, CNN MONEY, Jan. 6, 2009, [http://money.cnn.com/2009/01/05/smallbusiness/sba\\_loans\\_plunge.smb](http://money.cnn.com/2009/01/05/smallbusiness/sba_loans_plunge.smb) (last visited Feb. 8, 2010). This is partly the result of tightened lending standards (the Federal Reserve reported in October 2008 that seventy-five percent of banks polled had tightened lending standards for small business loans in the previous three months), small businesses experiencing poor sales and not wishing to expand in a poor economic climate, banks wanting to protect their bottom line, and a decrease in the value of assets that business owners can use as collateral. *Id.* Although the proposed arm's length test offers some flexibility considering the "substantially in the same manner" phrasing, *see supra* note 51 and accompanying text, there is no principled way (outside of a new safe harbor divorced from the market) to smooth out shifts in the market. That said, in applying the § 1274(d) applicable federal rate (which is a market rate tied to Treasury obligations) to selected transactions, some leeway is allowed by permitting the taxpayer to choose the interest rate for the month of the transaction or for either of the two months preceding the transaction. I.R.C. § 1274(d) (2006); *see* Treas. Reg. § 1.7520-2(a)(2) (1994). Otherwise, a strict application of the proposed test may unfairly punish those that are unable to find financing during tough and irrational economic times. On the other hand, "irrationality" in lending markets can also work to the taxpayer's advantage in boom times by producing a more liberal third-party lending standard.

<sup>86</sup> *See* Kaplan & Yoder, *supra* note 37, at 596.

[O]btaining loans from shareholders rather than from a bank might be faster, less cumbersome, and less intrusive. Lengthy loan applications and detailed—perhaps even audited—financial statements can usually be avoided by going to the company's stockholders. Moreover, if a company's prospects look promising . . . there may be a feeling that the interest money should be kept in the "family," rather than paid to outsiders.

*Id.*

could be that the third-party lender market suffers from a lack of complete information about the borrower's prospects, as compared with the level of knowledge possessed by the shareholders, creating asymmetrical information.<sup>87</sup> This asymmetry could be reflected in reluctance by third-party lenders to extend loans in a particular situation, as contrasted with the shareholders. In addition, information asymmetries may be more pronounced with the complexity of the borrower's enterprise. A retail store or franchise, for example, may be easier to evaluate than a technology firm. If one pursues this point to its conclusion, the technology firm may be disadvantaged under the proposed test as compared with the more conventional undertaking. Although this is an intriguing argument, at worst it could muddy the third-party test with the potentially unfounded optimistic claims of entrepreneurs or the less than rational motivations<sup>88</sup> that are a part of any start-up venture; the reality is that start-up businesses often fail.<sup>89</sup> A better response to information asymmetries lies in ensuring that all relevant information is considered in applying the hypothetical third-party lender test to a particular corporation. Un-

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<sup>87</sup> I thank Victor Fleischer for his insights on this point.

<sup>88</sup> See *supra* note 54. Family and friends are typically the source of capital for start-up businesses. *Id.* An arm's length test needs to ignore motivations founded on, or investment decisions clouded by, kinship or friendship, as the test could otherwise lose the benefit of arm's length, third-party, rational, and profit-seeking market comparables. That said, the Treasury's § 385 regulations project was criticized for its partial reliance on an "independent creditor" test, due to the difficulty of establishing what such a creditor would demand in difficult situations. See Levin & Bowen, *supra* note 28, 40–41 ("Often, even after the rules have been correctly followed, the answer to these questions will turn on extremely difficult factual determinations, such as the rate an independent creditor would charge a closely held corporation in a very risky, high-technology business or in financial difficulty for a heavily subordinated loan. . . .").

<sup>89</sup> The statistics on business failures vary from source to source and depend on the relevant time frame, but there seems to be a consensus that the failure rate for start-up businesses is at least fifty percent. See SCOTT SHANE, *THE ILLUSIONS OF ENTREPRENEURSHIP* 98–99 (2008) (Figure 6.2 shows that only twenty-nine percent of businesses started in 1992 were still in business in 2002); Zeke Camusio, *Business Failure Rate: What is the Real Business Failure Rate and Why Businesses Fail*, *EZINE ARTICLES*, <http://ezinearticles.com/?Business-Failure-Rate-What-is-the-Real-Business-Failure-Rate-and-Why-Businesses-Fail&id=1736448> (last visited Feb. 4, 2010) ("Between 75% and 90% of all new businesses fail within the first 10 years."); *Chains that Train New Store Owners Help Keep Franchises Afloat*, U.S. FED. NEWS, Mar. 6, 2008, available at 2008 WLNR 15984253 ("failure rate for traditional start-up businesses . . . can approach 70%"); John Luciew, *Bad Economy: Is It Time to Start a Business?*, *PATRIOT NEWS* (Harrisburg, Pa.), May 31, 2009, at A1, available at 2009 WLNR 10554092 ("failure rate for business start-ups remains a ruthless 50 percent-plus").

like insiders in other settings, the taxpayer will have an incentive to make all positive information available for court consideration.

If an arm's length standard is to be part of the dominant test applied in classifying capital infusions for income tax purposes, the proof of the standard may be established in several ways. The courts' role in assessing the financial capacity of the corporate borrower will remain of importance, but rigorous, informed application of the test will likely require a degree of financial sophistication and knowledge of current financial markets beyond the expertise of most judges.<sup>90</sup> The testimony of expert witnesses would play a more important role, although debt classification cases already feature significant reliance on expert witnesses. In *National Farmers Union Service Corp. v. United*

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<sup>90</sup> For closely held corporations, credit scores from small business credit rating agencies, such as FD Insight, D&B, and Experian Business, for example, would provide an external marker. For public corporations, ratings from third parties such as Fitch Ratings, Moody's Investor Services, and Standard & Poor's would play a role. "In essence, a credit rating reflects a rating agency's opinion, as of a specific date, of the creditworthiness of a particular company, security, or obligation." SEC. & EXCH. COMM'N, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKET 5 (2003). The rating agencies provide ratings on both long-term debt obligations, such as bonds, and short-term obligations like commercial paper. TIMOTHY J. SINCLAIR, *THE NEW MASTERS OF CAPITAL: AMERICAN BOND RATING AGENCIES AND THE POLITICS OF CREDITWORTHINESS* 8 (2005). Some of the factors that the rating agencies consider are

- (a) quantitative data from the issuer about its financial position;
- (b) quantitative data the agency gathers on the industry, competitors, and the economy;
- (c) legal advice relating to the specific bond issue;
- (d) qualitative data from the issuer about management, policy, business outlook, and accounting practices; and
- (e) qualitative data the agency gathers on such matters as competitive position, quality of management, long-term industry prospects and economic environment.

*Id.* at 31 (footnote omitted). After the agency grades an issue, it continues to do surveillance over the issue and will notify investors of any developments that may affect the issue's grade. *Id.* at 8. Executives at the rating agencies are adamant that ratings are simply independent opinions on credit risk and not recommendations to buy or sell securities. See *The Role of Credit Rating Agencies in the Structured Finance Market: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Servs.*, 110th Cong. 78, 81 (2007) (statement of Michael Kanef, Group Managing Director, Asset Backed Finance Rating Group, Moody's Investor Services). The quality of the ratings agencies' evaluations of debt instruments has been criticized in the financial downturn that began in 2008, but such criticisms were also common before the downturn. See, e.g., Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 44 (2004); Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 621 (1999); Arthur R. Pinto, *Control and Responsibility of Credit Rating Agencies in the United States*, 54 AM. J. COMP. L. 341, 343-46 (2006); Francis A. Bottini, Jr., Comment, *An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such Agencies*, 30 SAN DIEGO L. REV. 579, 585-88 (1993).

*States*, for example, the trial court relied on the testimony of an officer from a large Denver bank who stated that “without question a commercial bank or other unrelated informed lender would not have made the advances.”<sup>91</sup> The witness applied commercial lending standards that, to a degree, resemble the multifactor tests applied by the courts. The bank officer took into consideration “the absence of security, upon the apparent inability of the taxpayer to service the debt without invading its working capital, and the absence of any loan agreement, acceleration provisions, and without any analysis of cash flow from taxpayer’s subsidies.”<sup>92</sup> Indeed, who is better equipped than a finance professional to make these analyses?

On the other hand, in the clearest cases one would expect judges to continue the practice of applying their judgment of what a hypothetical independent lender would require if the precise question is not fully developed in the record by either party, but the proposed test’s promotion of better evidence should discourage this. For example, in *Hardman v. United States*, the U.S. Court of Appeals for the Ninth Circuit reversed the trial court’s classification as a contribution to capital, observing that “[t]he district court found that Hardman, Inc. was an ongoing, viable corporation with assets. . . . Presumably Hardman, Inc. could easily obtain financing from other sources and the government makes no assertion to the contrary.”<sup>93</sup>

In applying the current multifactor test for debt classification, the courts have, not unexpectedly, demonstrated varying degrees of rigor in assessing witness testimony on the third-party lender issue. In *Bauer v. Commissioner*, a victory for the taxpayer, the Ninth Circuit relied on its own analysis of the corporation’s creditworthiness as well as the testimony of witnesses from the banking sector:

[The corporation’s] financial structure and these other factors indicate that [it] could readily have obtained a loan from a bank or other financial institution for the purpose for which the stockholders’ loans were made, which was to finance inventory and accounts receivable. There is specific evidence in this case that one bank would have been willing to make these loans. In a letter from a vice president of Bank of America that was attached to the Stipulated Facts, the officer noted that it had dealt with [the corporation] and was familiar with [its] financing during the years in question and the bank was “ready to make bank loans for those

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<sup>91</sup> 400 F.2d 483, 486 (10th Cir 1968).

<sup>92</sup> *Id.*

<sup>93</sup> 827 F.2d 1409, 1414 (9th Cir. 1987).

amounts of officers' loans and/or more if [the corporation] desired to use bank financing."<sup>94</sup>

In *Fin Hay Realty Co. v. United States*, the government prevailed, and the court referred to "the uncontradicted testimony that in 1934 it was impossible to obtain any outside mortgage financing for real estate of this kind except through the device of a purchase money mortgage taken back by the seller."<sup>95</sup> This is to be contrasted with *Delta Plastics, Inc. v. Commissioner*, a taxpayer victory in which the Tax Court judge simply found that "[t]he evidence indicates that petitioner was successful in obtaining secured loans from outside creditors, and at no time was petitioner refused a loan from a third party."<sup>96</sup>

Other courts have been less receptive to bank officer hypotheticals of the type offered in *Bauer*. In *John Lizak, Inc. v. Commissioner*, the Court stated:

To be sure, petitioners did offer testimony of Robert C. Brainard, who had been an assistant cashier at [the taxpayer's] bank at the time of [the corporation's] incorporation and who had since become a vice president, to the effect that the bank would have made a loan to the corporation in an amount approaching that purportedly lent by [the taxpayer]. However, the short answer is that we found his testimony wholly unconvincing and did not believe it. Certainly, we do not believe that any lender in an arm's-length transaction would have advanced an amount equivalent to that involved herein in the circumstances of this case, particularly on the terms granted by [taxpayer] i.e., without any security, or interest, or maturity.<sup>97</sup>

Similarly, in a decision that was reversed on appeal by the Ninth Circuit, the district court judge criticized comparable testimony as just another instance in which a bank officer stretched the truth for a good customer on facts that did not and probably would never occur. Luckily, the bank officer did not have to defend the

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<sup>94</sup> 748 F.2d 1365, 1370 (9th Cir. 1984).

<sup>95</sup> 398 F.2d 694, 698 (3d Cir. 1968). Although the "substantially similar" standard of the proposed test imparts a measure of flexibility, the use of third-party lenders to establish the market will tend to likewise produce equity characterizations when the third-party lending market is uninviting.

<sup>96</sup> 85 T.C.M. (CCH) 940, 944 (2003). The loans in question were unsecured debentures, and the passage refers to past lending practice, so this statement only tangentially addressed the issue of whether the debentures would satisfy an arm's length standard. *See id.*

<sup>97</sup> 28 T.C.M. (CCH) 804, 808 (1969).

loan before a bank examiner, and obviously he did not expect anyone to believe his testimony.<sup>98</sup>

The overwhelming majority of tax cases<sup>99</sup> originate in the Tax Court where a jury is not available.<sup>100</sup> Generally, Tax Court findings of fact are binding on an appellate court unless they are clearly erroneous.<sup>101</sup> The appellate courts, however, are currently split on whether debt classification is a question of law or fact, which determines the standard of review and the concomitant degree of deference to the trial court.<sup>102</sup> Given the highly factual nature of properly applying the proposed legal standard, the results of the arm's length classification test should be treated as a question of fact.

One would expect that if an arm's length standard were adopted as the principal test of debt/equity classification, taxpayers and the government in litigation would respond by providing higher quality evidence of that standard, prompting more rigorous factual analysis by courts.<sup>103</sup> Development of the facts of a case often determines the outcome, but development of the facts rests with the litigants and their legal counsel. Admittedly, an expert witness is often an advocate for the party who retains the witness. Warts notwithstanding, the role of expert witnesses in tax litigation is already important, particularly in matters of valuation.<sup>104</sup> Although the arm's length standard

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<sup>98</sup> *Murphy Logging Co. v. United States*, 239 F. Supp. 794, 797 (D. Or. 1965), *rev'd*, 378 F.2d 222 (9th Cir. 1967).

<sup>99</sup> Judge Laro of the United States Tax Court has placed the percentage of tax litigation originating in the Tax Court at over ninety-five percent. See David Laro, *The Evolution of the Tax Court as an Independent Tribunal*, 1995 U. ILL. L. REV. 17, 18.

<sup>100</sup> A jury trial is available in Federal District Court but not in the Tax Court or the Court of Federal Claims. See U.S. COURT OF FED. CLAIMS, UNITED STATES COURT OF FEDERAL CLAIMS: THE PEOPLE'S COURT 9 (2006), available at <http://www.ucfc.uscourts.gov/> (follow "Jurisdiction" banner to the "Brochure" hyperlink); U.S. Tax Court, About the Court, <http://www.ustaxcourt.gov/about.htm> (last visited Jan. 25, 2010).

<sup>101</sup> See GERALD A. KAFKA & RITA A. CAVANAGH, LITIGATION OF FEDERAL CIVIL TAX CONTROVERSIES ¶ 11.13[3] (2d ed. 1997).

<sup>102</sup> See generally Nathan R. Christensen, Comment, *The Case for Reviewing Debt/Equity Determinations for Abuse of Discretion*, 74 U. CHI. L. REV. 1309 (2007) (acknowledging the split and recommending an abuse of discretion standard of review).

<sup>103</sup> To further encourage the production of quality evidence of the arm's length standard by taxpayers, amendments to § 385 could expressly override the rule of I.R.C. § 7491 (2006), which otherwise shifts the burden of persuasion to the government if the taxpayer meets the burden of production with respect to factual issues. See also *supra* note 53 (failure to meet the arm's length third-party lender test would produce a presumption of equity classification).

<sup>104</sup> See JOHN A. BOGDANSKI, FEDERAL TAX VALUATION ¶ 5.01[2][c][ii] (2006 & 2008 Cum. Supp. No. 2) ("In virtually all of the cases in which the [fractional interest] dis-

would have primacy, judges would retain their prerogative to determine the weight to be given to the testimony.<sup>105</sup> But that could bring us back to the status quo of judges acting as lending or financial experts—a role for which most are not suited.<sup>106</sup>

A solution that would blend judicial discretion with a substantive change in the law evoked by the adoption of an arm's length third-party lender test would rest on the promulgation of regulations. This Article proposes that the Treasury adopt the proposed rule as a regulation, using its authority under § 385.<sup>107</sup> Although the Treasury's prior efforts in 1980–1983 were unsuccessful,<sup>108</sup> the proposed test would apply to a narrower context (shareholder loans). Further, the test would be more conceptual than the judicial multifactor test, and less rule-based than the withdrawn § 385 regulations, promoting flexibility in application while avoiding prolixity in the expression of the regulatory intent.<sup>109</sup>

### C. *The Promise of the Proposed Test*

As discussed in Part II, the multifactor judicial classification test is now firmly entrenched, and consequently, the courts have great

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count has been established, an expert's opinion on the subject backed it up."). Tax Court Rule 143(g) requires a written expert witness report, and a copy of the report must be furnished to the court and opposing counsel at least 30 days before the call of the trial calendar. TAX CT. R. 143(g).

<sup>105</sup> See, e.g., *Lukens v. Comm'r*, 945 F.2d 92 (5th Cir. 1991) (upholding Tax Court's disregard of parts of expert's report and adoption of its own valuation formula). See generally Joni Larson, *Tax Evidence III: A Primer on the Federal Rules of Evidence as Applied by the Tax Court*, 62 TAX LAW. 555, 654–72 (2009) (discussing the rules of evidence as applied to expert testimony in the Tax Court).

<sup>106</sup> The cases are split as to whether the debt classification question is a question of law or fact. See generally Christensen, *supra* note 102, at 1309 & n.1.

<sup>107</sup> The Treasury also enjoys general authority to promulgate regulations under I.R.C. § 7805(a) (2006). The regulations would not have retroactive effect, except with respect to demand loans already in place and modifications or renewals of existing loans. *Id.*

<sup>108</sup> See *supra* notes 36–42 and accompanying text.

<sup>109</sup> The proposed § 385 regulations presented a number of classification rules that required lengthy explanations and examples. See Prop. Treas. Reg. § 1.385-2, 45 Fed. Reg. 18957, 18963–72 (Mar. 24, 1980). For example, the January 5, 1982, proposed regulations, the last substantive proposal by the Treasury, filled eighteen pages and offered approximately ninety-eight illustrations and examples. See Prop. Treas. Reg. §§ 1.385-0 to 1.385-8, 47 Fed. Reg. 170, 170–87 (Jan. 5, 1982). In comparison, the proposed test provides a rule which relies on a factually based standard. Cf. Kaplow, *supra* note 79 (discussing the difference between rules and standards). As compared with a formulaic rule, standards are considered to be more flexible, but can be more costly to apply. *Id.* at 557.

experience in applying it. Moreover, with the unsuccessful attempts to refine the principles through the adoption of § 385 and its still-born interpretive regulations, the multifactor judicial approach, even if imperfect, remains the primary source of guidance. Adopting the proposed test will involve some degree of change with concomitant dislocation, experimentation, and costs in adapting to the new rules. It is not sufficient to justify the proposed test simply on its appeal from the purely intellectual basis that it solves or clarifies a longstanding logical or analytical problem.<sup>110</sup> Accordingly, this Part contends that the benefits of the proposed test outweigh its drawbacks. The discussion is in part couched in customary tax policy principles that include administrability, equity, and efficiency.<sup>111</sup>

### 1. Simplicity, Predictability and Administrability

The traditional debt/equity characterization doctrine is largely so discretionary as to be unadministrable in any principled way, which can result in unfairness and abuse, as well as unacceptable transaction costs. Adoption of the proposed test, which primarily focuses on an easily enunciated single factor, should simplify the income tax classification of shareholder loans. Taxpayers structuring

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<sup>110</sup> Llewellyn, for example, in an essay that spoke of “aesthetics,” “structured beauty,” and “elegance,” ultimately concluded that beauty must serve a functional role. See Karl N. Llewellyn, *On the Good, the True, the Beautiful, in Law*, 9 U. CHI. L. REV. 224, 229 (1942). “But the prime test of its legal beauty remains the functional test. Structural harmony, structural grandeur, are good to have, they add, they enrich; but they are subsidiary. So is ornament. Legal aesthetics are in first essence functional esthetics.” *Id.* As discussed in the text that follows, the proposed test’s greatest strengths lie in its simplicity. The philosophical doctrine of “Occam’s Razor” has many interpretations, but some would employ it to suggest that “simplicity is a theoretical virtue” or that “simplicity has intrinsic value.” See Alan Baker, *Simplicity*, in *THE STANFORD ENCYCLOPEDIA OF PHILOSOPHY* (Edward N. Zalta ed., 2008), <http://plato.stanford.edu/archives/fall2008/entries/simplicity/> (last visited Feb. 4, 2010). Occam’s Razor has been employed in legal scholarship and judicial decisions. See, e.g., *Young v. Young*, 191 P.3d 1258, 1261 (Wash. 2008); Christopher R. Leslie, *Cutting Through Tying Theory with Occam’s Razor: A Simple Explanation of Tying Arrangements*, 78 TUL. L. REV. 727 (2004).

<sup>111</sup> See, e.g., Reuven S. Avi-Yonah, *The Three Goals of Taxation*, 60 TAX L. REV. 1, 1 (2006) (“The current debate in the United States about whether the income tax should be replaced with a consumption tax has been waged on the traditional grounds for evaluating tax policy: efficiency, equity, and administrability.”); Lily L. Batchelder et al., *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23, 42 (2006) (identifying minimization of administrative and compliance costs, distributional fairness, and efficiency as principles upon which any tax system should be built); Richard Winchester, *Parity Lost: The Price of a Corporate Tax in a Progressive Tax World*, 9 NEV. L.J. 130, 130 (2008) (“Scholars typically apply three criteria to evaluate a tax: fairness, efficiency, and simplicity.”).



their affairs—as well as the Service monitoring and courts reviewing those structures—would consider a simple question: would a disinterested lender agree to loan the money to the corporation in this fashion? This is to be contrasted with the bundle of factors that courts now weigh. Greater simplicity should reduce taxpayer transaction costs in structuring transactions and in predicting the income tax result of such structure *ex ante*.<sup>112</sup> A simpler test should also reduce the Service's enforcement costs and hopefully deter aggressive taxpayer positions. The administrative and compliance costs of a tax provision also detract from its efficiency so that gains in administrability should improve efficiency.<sup>113</sup> Further, the magnitude of the offsetting transaction costs that the change in rules produces should be moderate because, as discussed earlier, the proposed test is not a dramatic departure from many of the core concepts of the multifactor test. Courts already have been, in substance, looking at many of the same facts that underlie the proposed test.<sup>114</sup>

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<sup>112</sup> See JOEL SLEMROD & JON BAKIJA, *TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES* 160 (3d ed. 2004) ("Small and medium-size businesses also incur significant compliance costs. In fact, studies consistently find that the smaller the firm, the larger the cost of complying with the tax system per dollar of tax payment, sales, assets, or any other measure of the size of the firm."). In speaking to his proposal for a taxable income adjustment (aimed at addressing the book income/taxable income gap), Shaviro argues that, although enhanced penalties and enforcement could play a partial role, his proposal

would reduce the managerial incentive to waste resources engaging in transactions that are legally permissible, and thus that would survive heightened scrutiny, and yet that serve no good social purpose beyond advancing the manager's income manipulation goals. Examples include creating hybrid financial instruments that are debt for tax, but not accounting, purposes and engaging in tax shelter transactions that have just enough economic substance to withstand IRS review.

Daniel Shaviro, *The Optimal Relationship Between Taxable Income and Financial Accounting Income: Analysis and a Proposal*, 97 *GEO. L.J.* 423, 482 (2009). As discussed in the text that follows, there is some question whether a clearer standard alone would induce shareholders in closely held businesses to eschew excessive loans. *Id.*

<sup>113</sup> See Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 *TAX L. REV.* 1, 24 (1992).

The standard tax efficiency norm of minimizing excess burden implies two principal objectives. The first is minimizing substitution effects, or changes in taxpayer decisions or behavior due to the tax system. The second is minimizing what I call "tax overhead costs," or the amount of resources (including the value of time or labor) consumed in applying the tax system, through taxpayer and government activities such as tax planning, compliance, litigation, administration, and law-making.

*Id.*

<sup>114</sup> See *supra* notes 64–70, 90–98 and accompanying text.

Although one might be hopeful that the adoption of a simpler characterization test would lead to greater corporate compliance,<sup>115</sup> that may not be the case, particularly with regard to closely held corporations, the context in which most shareholder loans arise.

The use of excessive debt in a closely held corporation, sometimes referred to as “thinning” the capital structure,<sup>116</sup> is almost without any external constraints<sup>117</sup> if the corporation does not need to maintain relevant financial ratios or satisfy guidelines of third-party lenders,<sup>118</sup> or is not courting new investors or potential buyers.<sup>119</sup>

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<sup>115</sup> See SLEMROD & BAKIJA, *supra* note 112, at 187.

<sup>116</sup> See, e.g., ZOLMAN CAVITCH & MATTHEW P. CAVITCH, *TAX PLANNING FOR CORPORATIONS AND SHAREHOLDERS* § 4.04[1] (2d ed. 2003) (“By incorporating thin, we mean the procedure whereby the smallest possible amount of assets are transferred into the corporation as equity capital.”).

<sup>117</sup> Schizer refers to external constraints on tax planning as “frictions.” See David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1315 (2001). Although shareholder loans might be subordinated to the claims of other creditors in bankruptcy, that is a better starting place than a formal equity contribution, which will surely have a lower priority in the competition for any liquidating proceeds. See generally 1 DREHER & FEENEY, *supra* note 18, § 6:61.

<sup>118</sup> Interest is an expense for financial accounting purposes so corporate earnings are reduced. See generally RICHARD G. SCHROEDER, ET AL., *FINANCIAL ACCOUNTING THEORY AND ANALYSIS* 373–74 (9th ed. 2009) (discussing the straight-line method and effective interest method of reporting a bond’s interest expense). Debt is a liability for financial accounting purposes, so financial ratios used in financial or credit analysis (such as the debt-to-equity ratio) are also reduced. *Id.* at 505. See generally DAVID R. HERWITZ & MATTHEW J. BARRETT, *ACCOUNTING FOR LAWYERS* 331–429 (4th ed. 2006) (discussing financial statement analysis and financial ratios). There may be other internal consequences if debt is used if, for example, employee bonuses or shareholder stock repurchase agreements are in part linked to levels of net income after interest expense. *Id.* “Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions.” FIN. ACCT. STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 1: OBJECTIVES OF FINANCIAL REPORTING BY BUSINESS ENTERPRISES 1 (1978), available at [http://www.fasb.org/pdf/aop\\_CON1.pdf](http://www.fasb.org/pdf/aop_CON1.pdf). Thus, for public corporations, it is of great importance to maintain financial ratios for the purposes of satisfying lending covenants or maintaining financial ratings. For example, the recent downgrade of General Electric’s credit rating was a significant event, producing consequences including as increased costs of financing its operations. See Ben Steverman, *The Triple-A Rating: Going Extinct?*, BUS. WK. ONLINE, Mar. 13, 2009, [http://www.businessweek.com/investor/content/mar2009/pi20090312\\_235326.htm](http://www.businessweek.com/investor/content/mar2009/pi20090312_235326.htm) (last visited Feb. 4, 2010). The corporation’s level of shareholder equity, which is a product of the amount of capital contributions characterized as debt or equity, can impact state corporate law limitations on distributions. See DOUGLAS M. BRANSON ET AL., *BUSINESS ENTERPRISES: LEGAL STRUCTURES, GOVERNANCE, AND POLICY: CASES, MATERIALS, AND PROBLEMS* 207–14 (2009) (discussing limitations on corporate distributions under corporate statutes). Closely held corporations often do not pay regular dividends, instead relying on the payment of income tax deductible salaries or interest. See *id.* at 199. Due to the shortcomings of

The aggressive use of debt in a closely held corporate structure is also almost without meaningful income tax risk. If the taxpayer concedes the issue at the outset of the transaction and uses a conservative amount of equity, the corporation is assured that it cannot claim an interest expense deduction with respect to that capital. Further, the shareholders can withdraw equity capital with not altogether benign income tax consequences only if the corporate redemption exceptions apply.<sup>120</sup> In comparison, an aggressive allocation to debt from the outset at least gives the corporation an opportunity to claim an interest expense deduction and permit tax-free repayments of the principal.<sup>121</sup> The corporation must be selected for audit,<sup>122</sup> and the Service must prevail, and both of those probabilities are less than certain. In addition, the statute of limitations patiently and methodically reduces the taxpayer's level of risk for prior years.<sup>123</sup> For example, the

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corporate law's protection of general creditors, loan covenants may be utilized to fill the resulting gaps. "Given the illusory protections afforded creditors under state corporate law, it is understandable that those creditors with the power to do so have turned to contract law to protect themselves against potentially harmful distributions to the corporate debtors' shareholders." *Id.* at 214; *cf. id.* ("Banks and other lending institutions often impose outright prohibitions or substantial limitations on the payment of dividends, share repurchases, and other forms of corporation distributions.")

<sup>119</sup> *Cf. Shaviro, supra* note 112, at 426 n.5 ("Privately held companies may also seek to over-measure their earnings—for example, to impress prospective buyers or investors. . . .").

<sup>120</sup> *See* I.R.C. §§ 302–304 (2006) (treating qualifying corporate redemptions as a sale of the shareholder's stock). While redemption treatment permits sale or exchange treatment that in turn allows the shareholder to offset the basis of the redeemed shares and to report the gain at favored long-term capital gain rates, the transaction nevertheless produces potential gain or loss. *Id.* In a family-controlled corporation, the potential application of I.R.C. § 267(a)(1) must be considered if a loss is recognized on the redemption.

<sup>121</sup> *See supra* note 12.

<sup>122</sup> For fiscal year 2007, the rate of audits for corporations with total assets under \$10,000,000 was 0.9 percent. INTERNAL REVENUE SERV., STATISTICS OF INCOME, TABLE 9: EXAMINATION COVERAGE: RECOMMENDED AND AVERAGE RECOMMENDED ADDITIONAL TAX AFTER EXAMINATION, BY TYPE AND SIZE OF RETURN, FISCAL YEAR 2007, at 1 (2009), <http://www.irs.gov/taxstats/article/0,,id=207079,00.html> (last visited Feb. 14, 2010).

<sup>123</sup> If a tax return is filed, then barring fraud or a substantial understatement of gross income, the normal statute of limitations period is three years after the due date of the return. *See* I.R.C. § 6501(a), (b)(1). The impact on the shareholder must also be considered because the failure to report constructive dividends could trigger application of the six-year period for substantial understatements of gross income prescribed by I.R.C. § 6501(e). *See, e.g.,* *Benson v. Comm'r*, 560 F.3d 1133 (9th Cir. 2009). But if the shareholders are already reporting interest income from the putative debt obligations, then only principal repayments will result in an increase in gross income if the payments are recharacterized as dividends. *Id.*

taxpayer in *Fin Hay Realty Co.* enjoyed almost thirty years of interest expense deductions before the issue surfaced.<sup>124</sup> On the other hand, reflecting the randomness of tax enforcement, the taxpayer in *Delta Plastics, Inc.* was audited with respect to its fourth year of operations.<sup>125</sup>

The possible imposition of penalties, the reluctance to incur professional fees, the distractions attendant to an income tax audit, and the instinct that it is better to include some equity to improve the corporation's chances of prevailing in an audit are all countervailing considerations. Still, the incentives to use debt in the capital structure could remain compelling, even in the face of the proposed test.<sup>126</sup> Changes to the statutes of limitation, increased penalties, and more audits by the Service are some possible solutions beyond the focus of this Article.<sup>127</sup>

## 2. Improved Reliability of Classification Outcomes and Horizontal Equity

The core claim of this Article is that a hypothetical third-party's assessment that a loan would be made in the manner structured by the corporation is the best measure of whether a shareholder loan should be treated as such for federal income tax purposes. Although

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<sup>124</sup> See *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 695 (3d Cir. 1968).

<sup>125</sup> See *Delta Plastics, Inc. v. Comm'r*, 85 T.C.M. (CCH) 940, 942–43 (2003).

<sup>126</sup> Although their work continues to be debated, in 1958 Franco Modigliani and Merton Miller argued that the total value of the firm's securities (its equity and debt together) is not increased by the use of debt. See WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE* 352–85 (10th ed. 2007) (discussing this issue). The theory turns on the ability of shareholders to borrow as a substitute for borrowing by the corporation. As Klein and Coffee sum up the issue, “where personal debt is a perfect substitute for corporate debt, the value of a firm is not affected by its capital structure.” *Id.* at 360. The income tax benefits of debt turn in part on a comparison of the shareholders' and the corporation's tax rates. *Id.* at 373.

The moral of the story is that debt should be held by individuals, rather than by corporations, where the individual rate is sufficiently higher than the corporate rate and earnings can be retained and reinvested at a reasonable rate of return for a sufficiently long period of time. . . . It is simply not true, therefore, that the tax system unqualifiedly favors corporate debt financing.

*Id.* Klein and Coffee's examples assume a corporate rate of thirty-five percent, an individual rate of thirty-eight percent, and an effective rate on capital gain income of ten percent, producing a “slight edge to corporate debt.” *Id.* at 373 n.21.

<sup>127</sup> See, e.g., I.R.C. § 6662 (penalties for understatement of tax liability). While there is probably no realistic prospect for a different penalty structure applicable only to corporate debt characterization, one sees calls for increased penalties in general. See, e.g., Michael Doran, *Tax Penalties and Tax Compliance*, 46 HARV. J. ON LEGIS. 111 (2009).

the courts apply this test as one of the multiple factors and also may be applying it as part of some of the other factors, the quality of classification decisions should be improved in instances where the court would otherwise be reluctant, or hostile, to fully embracing a third-party lender analysis. The proposed test provides a single harmonizing doctrinal thread. Quality of decision making should also be improved because the quality of the evidence provided by litigants would be more fully developed if the parties know that the third-party test is the primary test of classification. A more thorough development of the facts would preclude courts from relying on simple intuition about the loans in question.<sup>128</sup>

A fundamental tax policy principle is horizontal equity, that similarly situated taxpayers be treated in equal fashion.<sup>129</sup> The goal of horizontal equity is “consistency, meaning that the same tax treatment should apply to economically comparable bets.”<sup>130</sup> Classification doctrine that is more focused and predictable would promote more equitable classification treatment among corporate taxpayers, thus treating economically comparable bets with more consistency than the current multifactor test.

### 3. Efficiency

Although the context shapes the definition,<sup>131</sup> it is a fair statement that a tax provision is “efficient” if it is economically neutral and does not influence taxpayers’ market choices to a degree that

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<sup>128</sup> The analyses in *Hardman v. United States*, 827 F.2d 1409 (9th Cir. 1987), *Murphy Logging Co. v. United States*, 239 F. Supp. 794, 797 (D. Or. 1965), *rev’d*, 378 F.2d 222 (9th Cir. 1967), and *John Lizak, Inc. v. Comm’r*, 28 T.C.M. (CCH) 804, 808 (1969), could have benefited from better evidence of third-party lending practices. See *supra* Part IV.B.

<sup>129</sup> See, e.g., WILLIAM D. ANDREWS & PETER J. WIEDENBECK, BASIC FEDERAL INCOME TAXATION 9 (6th ed. 2009) (“Horizontal Equity is imposing similar burdens on people in like circumstances. . . .”); WILLIAM A. KLEIN, POLICY ANALYSIS OF THE FEDERAL INCOME TAX 7 (1976) (“Thus, we derive the *principle of horizontal equity*: the justness of the system is measured in part by the extent to which people with equal incomes pay equal taxes.”).

<sup>130</sup> Samuel D. Brunson, *Elective Taxation of Risk-Based Financial Instruments: A Proposal*, 8 HOUS. BUS. & TAX L.J. 1, 16 (2007) (quoting David M. Schizer, *Balance in the Taxation of Derivative Securities: An Agenda for Reform*, 104 COLUM. L. REV. 1886, 1889 (2004)).

<sup>131</sup> See, e.g., Edward A. Zelinsky, *Efficiency and Income Taxes: The Rehabilitation of Tax Incentives*, 64 TEX. L. REV. 973, 980–95 (1986) (discussing universal market efficiency, sectoral efficiency, and technical efficiency as applied to income tax incentives).

would result in suboptimal allocation of society's total resources.<sup>132</sup> Inasmuch as the differing corporate income tax consequences of the debt/equity characterization are themselves inefficient as a general proposition,<sup>133</sup> it is not particularly worthwhile to consider at length the efficiency consequences of a proposed change that would refine, and indeed sharpen, the core doctrinal distinction. Concerning closely held corporations, for which the shareholder loan is most prevalent, the loan is a self-help response to mitigate those consequences that are at the root of the inefficiency. Even if that self-help may result in the overuse of debt, this may not be to the overall non-tax detriment of many closely held corporations.<sup>134</sup> If the proposal would diminish to any degree the mitigation role of such debt, that exposes a concern with the overall corporate taxation system, not a flaw of the proposal.<sup>135</sup> If the corporate taxation system endures in its current

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<sup>132</sup> This definition draws from Zelinsky's definition of universal market efficiency. See *id.* at 980–87. Shaviro uses a similar definition:

The efficiency norm that I use is that of minimizing excess burden, or the deadweight loss generated by the tax system. Excess burden arises not only from administrative and compliance costs, but also from substitution effects, or changes in taxpayer decisions or behavior to reduce tax liability. A tax system minimizes substitution effects by being neutral at key decisional boundaries, thereby giving taxpayers no reason to change their decisions or behavior.

Shaviro, *supra* note 113, at 4; see also Brunson, *supra* note 130, at 16 (“An economical-ly efficient tax creates minimal economic distortions. This means, essentially, that the imposition of a tax will not cause taxpayers to alter their behavior.”).

<sup>133</sup> See Shaviro, *supra* note 113, at 2. Shaviro notes that one of the principal problems associated with the C corporation taxation regime is “that it distorts the choice between retaining and distributing corporate earnings,” but he claims this “is a function of the realization doctrine rather than double taxation and would persist under some prominent [corporate] integration proposals.” *Id.* Nevertheless, for purposes of the article he “accept[s] the conventional academic view that tax-penalizing equity-financed corporate investment is inefficient.” *Id.* at 51. Shaviro identifies four corporate tax biases that affect efficiency: consequences of corporate versus noncorporate entity choice, debt versus equity financing, distributions versus retention of earnings, and the form of distributions. See SHAVIRO, *supra* note 24, at 25–41; see also Karen C. Burke, *Is the Corporate Tax System “Broken?”* 28 VA. TAX REV. 341, 345 (2008) (“The existence of a separate corporate tax has long been criticized as causing economic distortions. . . . Significantly, the corporate tax tends to penalize investment in corporate rather than noncorporate form and to favor debt over equity.”).

<sup>134</sup> See *supra* notes 116–19 and accompanying text.

<sup>135</sup> See Weisbach, *supra* note 16, at 1651–52. Weisbach proposes that the debt/equity distinction should be made in terms of efficiency, which he defines in terms of minimizing deadweight loss or “the loss in value to consumers in excess of the revenue raised by the government.” *Id.* at 1651. As an example, he questions whether the current doctrine that treats Monthly Income Preferred Stock (MIPS) as debt for income tax purposes has the effect of shifting issuance from debt to MIPS

form, the proposal nevertheless does offer some efficiency gains, but primarily from its simplification of the classification puzzle.<sup>136</sup>

#### 4. Vertical Equity

The vertical equity principle proposes that tax burdens should be borne in accordance with ability to pay and that the rates of tax should be progressive.<sup>137</sup> It is redistributive in nature.<sup>138</sup> It is often stated that corporate income taxes are ultimately paid by individuals,<sup>139</sup> but it is unclear which individuals (shareholders, labor, or customers) bear those taxes.<sup>140</sup> If corporate income taxes are borne solely by shareholders, then the impact of a “tighter” shareholder loan classification rule could increase the tax burdens of shareholders. If the shareholders of closely held corporations in particular (as they are the corporations principally impacted by shareholder loans) are higher income taxpayers, then the proposed test could increase the

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(where the “creditors” have fewer rights) or from equity to MIPS. *Id.* at 1674. If it is the latter, then he argues that the result is likely to be inefficient. *Id.* If shareholder loans bear few other non-tax consequences, then it would seem that simply increasing the corporate tax burden through an improved classification test would not necessarily be inefficient.

<sup>136</sup> See *supra* Part IV.C.1 (discussing simplicity and administrability gains).

<sup>137</sup> See ANDREWS & WIEDENBECK, *supra* note 129, at 9 (“[V]ertical equity is creating an appropriate differential in burdens for people in unlike circumstances.”); J. Clifton Fleming, Jr. & Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and Its International Dimension*, 27 VA. TAX REV. 437, 453 (2008) (“taxpayers with unequal incomes should pay amounts of tax which are sufficiently unequal to fairly reflect the differences in their incomes”).

<sup>138</sup> See, e.g., Avi-Yonah, *supra* note 111, at 10–22 (discussing progressive taxation and historical redistribution in the context of a consumption tax); Winchester, *supra* note 111, at 131 (“When scholars ask whether a tax is fair or equitable, they generally focus on the distribution of the tax burden.”).

<sup>139</sup> See, e.g., SLEMROD & BAKIJA, *supra* note 112, at 77 (“[A] tax on the income from corporations will be spread to the recipients of all types of capital income as funds that otherwise would have been invested in corporations flow into the noncorporate sector.”); Shaviro, *supra* note 112, at 431 (“Corporations figure only indirectly in the distributional story, via the effect of the corporate tax on whichever individuals bear it.”).

<sup>140</sup> See, e.g., SHAVIRO, *supra* note 24, at 55–71 (discussing the debate over incidence issue); *id.* at 70 (“Thus, while the debate about the incidence of the corporate tax is ongoing and unlikely to be resolved definitively any time soon, it does appear to be trending strongly toward the view that labor rather than capital bears the largest share of the burden.”); Yariv Brauner, *The Non-Sense Tax: A Reply to New Corporate Income Tax Advocacy*, 2008 MICH. ST. L. REV. 591, 629–34 (discussing the incidence of the corporate income tax); Burke, *supra* note 133, at 344 (“While the ultimate incidence of the corporate tax remains hotly contested, traditional analysis generally assumes that the burden is borne by all owners of capital, rather than solely by corporate shareholders.”).

progressiveness of the federal income tax,<sup>141</sup> but this is not a central aim of the proposed test.

## V. POTENTIAL OBJECTIONS TO THE PROPOSED TEST

Plumb briefly addresses the shortcomings of considering the availability of third-party financing as a classification factor, but only after first describing it as “[t]he acid test of the economic reality of a purported debt.”<sup>142</sup> Plumb’s account of the judiciary’s application of the arm’s length test suggests that the judiciary has not been doctrinally consistent or rigorous, instead bending the test in favor of taxpayers.<sup>143</sup> This Article consequently proposes that the Service, by exercising its regulatory authority under § 385, add to the rigor of the debt/equity classification analysis by adopting a third-party lender standard as the primary test. The objections of Plumb and others, however, must be considered.

### A. Identifying an Appropriate Hypothetical Lender

Plumb argues that applying such a test is difficult because different creditors have different risk appetites.<sup>144</sup> Consequently, the test must be “whether ‘no responsible banker or businessman’ would have made such a loan, at least without the inducement of a substantial stake in the enterprise.”<sup>145</sup> This observation is not relevant to the proposed third-party test, which would use any relevant lender to establish the standard.

Plumb, however, suggests that if independent parties would have made the loan with a profit-participation interest, then shareholder financing on the same terms should be valid, with shareholdings representing the profit-participation interest.<sup>146</sup> Plumb admits that the “participatory financing would itself have to be subjected to the

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<sup>141</sup> See, e.g., Burke, *supra* note 133, at 344 (stating that “[b]ecause aggregate capital ownership is more concentrated among higher-income taxpayers than labor income or consumption, the corporate tax may be viewed as contributing to overall progressivity” and suggesting that “[t]he corporate tax would appear even more progressive if the burden were allocated entirely to shareholders, since this group is more affluent than owners of capital as a whole”).

<sup>142</sup> Plumb, *supra* note 7, at 530.

<sup>143</sup> *Id.* at 533–34.

<sup>144</sup> *Id.* at 531 (quoting C.M. Gooch Lumber Sales Co. v. Comm’r, 49 T.C. 649, 651 (1968)).

<sup>145</sup> *Id.* (quoting Wood Pres. Corp. v. United States, 347 F.2d 117, 119 (4th Cir. 1965)).

<sup>146</sup> *Id.* n.957.



test of economic reality if the corporation is inadequately capitalized.”<sup>147</sup> Plumb slices this issue too fine. The presence of a participation interest in profits, one of the hallmarks of an equity investment, would muddle the third-party test. For purposes of a third-party test with any promise, certain direct or indirect profit-participations must be ignored; the third-party lender must only consider a loan without convertibility into equity or any participation in profits of the enterprise. The convertibility feature would be ignored in determining whether a third-party lender would otherwise extend the loan without the convertibility feature.<sup>148</sup> If the convertibility feature were of significant value to the hypothetical lender in its decision to extend the loan on its terms (which includes the interest rate charged), then ignoring convertibility would produce a negative response to the question of whether a hypothetical lender would otherwise extend the loan. The proposed test asks whether the hypothetical lender would extend the loan “in substantially the same manner.”<sup>149</sup> The substantiality component would add some flexibility to the inquiry, but in some cases not enough to overcome the impact of the loss of the convertibility feature.

*B. Discrimination Against Small Businesses*

Plumb also argues that “to give conclusive effect to the corporation’s inability to obtain outside credit would unfairly discriminate against small business which, although meeting abstract credit standards, may lack ready access to financial markets.”<sup>150</sup> Plumb notes that because of this argument, the courts have tended to apply “a sort of reasonable man test, based not upon the actual availability of outside credit to the corporation but upon comparability to the general standards of the financial community, of which the actual failure of the corporation’s efforts to borrow may be evidentiary.”<sup>151</sup> This statement presents two fundamental issues. One, the process of quantifying the arm’s length standard, is discussed in the prior sec-

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<sup>147</sup> *Id.* at 531.

<sup>148</sup> To deny debt status due to convertibility status alone would unduly limit corporations’ flexibility in designing their financial structure and could otherwise be undesirable. *See infra* note 210 and accompanying text. But ignoring the convertibility factor as the proposed test suggests will, in most cases, change the incentives of the hypothetical lender’s bargain such that no hypothetical lender would extend the loan on those conditions.

<sup>149</sup> *See supra* text accompanying note 51.

<sup>150</sup> Plumb, *supra* note 7, at 531.

<sup>151</sup> *Id.* at 532.

tion.<sup>152</sup> This Article now addresses the other issue, the impact of an arm's length standard on closely held businesses in particular.

Plumb is not alone in making the claim that adopting an arm's length test would have an adverse impact on small businesses by limiting their use of shareholder debt. In discussions of debt/equity classification, one sees this argument couched in terms of "discrimination" against small businesses, which do not have the same degree of access to capital markets as larger companies.<sup>153</sup> But an arm's length test requires only a nonshareholder lender, not necessarily public capital markets. Still, many private lenders may not advance money to small businesses in exchange for a fixed return because the businesses are simply too risky. And many traditional institutional lenders, such as banks, will not make such loans—again, because the businesses are simply too risky. The Small Business Administration loan guarantee program was created to address some of these borrowing needs, and the loan default statistics bear out the risks involved.<sup>154</sup> While to some the "discrimination" tag suggests unfairness, it is simply a reflection of a sobering reality that the owners of risky businesses often need to inject more equity into the business, rather than substitute debt from *anyone*.<sup>155</sup> While that might be the case for

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<sup>152</sup> See *supra* Part IV.B.

<sup>153</sup> See William M. Goldstein, *Corporate Indebtedness to Shareholders: "Thin Capitalization" and Related Problems*, 16 TAX L. REV. 1, 33 (1960) (arguing that an all-or-nothing approach to debt classification may have a discriminatory effect); Gibson, *supra* note 33, at 488 ("[T]he ability of the corporation to secure outside financing [should] be given little weight, if any, in the debt/equity analysis. First, use of this factor may unduly limit the availability of capital to small, closely held corporations.").

<sup>154</sup> See, e.g., Veronique de Rugy, *Axe the SBA—Pro: Gratuitous Crutch*, THE DEBATE ROOM (BUS. WK.), June 22, 2007, [http://www.businessweek.com/debateroom/archives/2007/06/axe\\_the\\_sba.html](http://www.businessweek.com/debateroom/archives/2007/06/axe_the_sba.html) ("Default rates on SBA loans are roughly 17% as opposed to 1.5% for FDIC-insured bank loans and 4.3% for credit card loans."). The Small Business Administration program guarantee traditionally did not cover the entire loan, such that the originating bank was exposed to some risk of loss; however, the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 502, 123 Stat. 115, 152 (2009), temporarily increased the guaranteed portion up to ninety percent for certain small business loans.

<sup>155</sup> See Richard B. Stone, *Debt-Equity Distinctions in the Tax Treatment of the Corporation and Its Shareholders*, 42 TUL. L. REV. 251, 261 (1968).

The most theoretically effective means of assuming equal treatment among corporations would be to require that the shareholders of closely held corporations put in sufficient equity capital to enable them to obtain outside financing for their remaining needs. Any argument that this would force close corporations, particularly those beginning new businesses, to exist at the mercy of unfriendly creditors only supports the assertion that there is no point at which pro rata shareholder

many closely held businesses, there will be those who could qualify for third-party financing but nevertheless choose to pursue shareholder financing.<sup>156</sup> The proposed third-party test would permit that.

Nevertheless, courts apparently understand the potentially adverse consequences of rigorously applying an arm's length test to closely held businesses and dutifully recite that it is considered as only one of several factors.<sup>157</sup> This could reflect an unspoken deference toward closely held businesses.<sup>158</sup> On the other hand, both the multi-factor doctrinal test that courts currently apply and the proposed arm's length test would often produce the same result.<sup>159</sup> Consider

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loans are really debt investments. In a sense, allowance of the interest deduction on loans extended by shareholders on a pro rata basis discriminates *against* widely held corporations, who must obtain funds at arm's length from potentially hostile sources.

*Id.*

<sup>156</sup> See *supra* notes 86–89 and accompanying text.

<sup>157</sup> See *supra* Part II.

<sup>158</sup> As compared with public companies, closely held corporations enjoy certain tax benefits, which are not generally limited by the “size,” i.e., wealth or income, of their shareholders. First, as discussed *infra* text accompanying note 164, many can avoid the corporate income tax altogether by adopting the limited liability company or S corporation structure. Second, due to the overlap of the shareholder and manager classes, closely held corporations can mitigate the corporate tax burden to a larger degree by paying salaries rather than dividends. Third, the corporate income tax rates are mildly progressive, such that low amounts of taxable income incur a marginal tax rate as low as fifteen percent, as compared with thirty-five percent for corporations with taxable income in excess of \$10,000,000. See I.R.C. § 11(b) (2006). Fourth, the loss on worthlessness of public stock is generally treated as a capital loss, while losses on certain small business stock can be treated as ordinary losses. Compare *id.* § 165(g), with *id.* § 1244. Fifth, \$5000 of organizational expenditures can be deducted in the year the corporation begins business, but amounts in excess of that must be amortized over 180 months. See *id.* § 248. The \$5000 de minimis amount which is most favorable to small corporations is reduced by the amount that total organizational expenditures exceed \$50,000. See *id.* Sixth, “small” corporations with less than \$7,500,000 in gross receipts are exempt from the alternative minimum tax. See *id.* § 55(e)(1)(A). This list is not exhaustive. The courts’ reluctance to apply the “acid test” of a third-party lender may also demonstrate their reluctance to do so for other reasons, such as a lack of confidence in the test, reluctance to cede the discretion they enjoy under the current doctrine, or simple blind adherence to precedent.

<sup>159</sup> See *Segel v. Comm’r*, 89 T.C. 816, 834 (1987) (finding advances to be equity).

Thus, the ultimate issue under *Fin Hay* is measurement of the transactions by objective tests of economic reality, and the touchstone of economic reality is whether an outside lender would have made the payments in the same form and on the same terms. If the shareholders’ payments were far more speculative than what an outsider would make, the payments would be loans in name only.

*Id.* at 828 (citations omitted); see also *Austin Vill., Inc. v. United States*, 432 F.2d 741, 745–46 (6th Cir. 1970) (“The shareholders were unable to obtain outside financing

the Tax Court's language in *Lease v. Commissioner*,<sup>160</sup> a case in which the purported loan was treated as an equity contribution.

The ultimate question, however, is not so much whether a third party would have made the loan, which would almost invariably be an insurmountable obstacle to debt characterization as applied to a startup corporation . . . . The question is whether, on the basis of the facts known when the stockholder made the advance, he could reasonably expect the corporation to repay the loan in accordance with terms in line with those generally prevailing in the business community. . . .

. . . .  
. . . No reasonable creditor would have been comfortable making a loan to a corporation without any assets, capital, or contractually committed investors. Petitioner's situation is another sad case of a promoter trying to start a business that could not justify an indebtedness on any arm's-length standard because its prospects were so speculative and its tangible and intangible assets so insubstantial.

. . . .  
Although a negative answer to whether a commercial lender would have lent Montex the funds when petitioner did is insufficient, standing alone, to treat purported debt as equity, it does bear on whether petitioner's expectations of repayment were reasonable. Inasmuch as Montex had no other capital or assets at the time petitioner made the advances, it would in all likelihood have been impossible for Montex to qualify for a loan from a commercial lender. In addition, Montex was going to engage in the risky business of gold mining, which it had not yet started. It is doubtful that a reasonable creditor would have lent Montex the funds it needed, solely on the basis of an oral commitment from a foreign investor.<sup>161</sup>

Likewise, in *Cerand & Co. v. Commissioner*, finding that the taxpayer's advances were equity contributions, the Tax Court observed:

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for development of the land and decided therefore to invest their own funds according to a plan which made repayment contingent upon the success of the venture. This is a classic example of an investment of risk capital.”); *cf. supra* note 128 (listing cases that could have benefited from greater evidence of third-party lending practices). *Compare* Piggy Bank Stations, Inc. v. Comm’r, 44 T.C.M. (CCH) 299, 305–06 (1982), *aff’d*, 755 F.2d 450 (5th Cir. 1985) (corporation was unable to obtain third-party financing; result was equity characterization), *with* Estate of Mixon v. United States, 464 F.2d 394, 410–11 (5th Cir. 1972) (stating that there was “no evidence that the Bank made any unsuccessful attempts at further outside financing,” that “all such efforts proved successful,” and that debt characterization was therefore appropriate).

<sup>160</sup> 66 T.C.M. (CCH) 1121 (1993).

<sup>161</sup> *Id.* at 1125–27 (citations omitted).

Though no outside financing was sought, it is reasonable to assume that an outside financier would not have accepted similar credit terms: an open, unsecured line of credit with no set interest rate, no set payment schedule, and no fixed maturity date to three companies with no financial history and no capital assets.<sup>162</sup>

On remand from the Court of Appeals for the District of Columbia Circuit, the Tax Court reaffirmed its result and further stated:

A third-party creditor would not have advanced funds to the sister corporations at a preferred rate (less than 10 percent), considering the fact that they were startup companies without a business performance record, assets, security, guaranties, etc.<sup>163</sup>

The potential impact on small business may be overstated due to the increasing use of passthrough entities like the S corporation and the limited liability company (LLC).<sup>164</sup> With both entities, the use of shareholder or member debt is not as critical from an income tax standpoint because there is no need to mitigate double taxation as there is in C corporations.<sup>165</sup> Consequently, the impact would primarily fall on existing small business corporations that cannot,<sup>166</sup> or

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<sup>162</sup> 76 T.C.M. (CCH) 933, 935 (1998).

<sup>163</sup> *Cerand & Co. v. Comm'r*, 82 T.C.M. (CCH) 755, 758 (2001).

<sup>164</sup> See Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055, 1070 (2000) ("Allowing small private firms to have both limited liability and pass-through treatment has taken pressure off the debt-equity distinction in the context of closely held businesses since many small businesses are not subject to the double corporate tax."). In 2006, 2,947,100 partnership income tax returns were filed, which would include returns filed by limited liability companies treated as partnerships for federal income tax purposes. See STATISTICS OF INCOME DIV., INTERNAL REVENUE SERV., TABLE 12: NUMBER OF BUSINESS INCOME TAX RETURNS, BY SIZE OF BUSINESS FOR INCOME YEARS, 1990-2007 (2008), available at <http://www.irs.gov/taxstats/article/0,,id=175843,00.html>. In 2005, 1,974,961 C corporation returns were filed, with 936,015 of those returns not reporting net income; however, more than ninety-six percent of the total income tax after credits was paid by corporations with at least \$500,000 in income tax after credits, and those corporations comprised less than one percent of total returns filed. See STATISTICS OF INCOME DIV., INTERNAL REVENUE SERV., RETURNS OF ACTIVE CORPORATIONS, OTHER THAN FORMS 1120S, 1120-REIT, AND 1120-RIC: TABLE 22: NUMBER OF RETURNS AND SELECTED TAX ITEMS, BY SIZE OF TOTAL INCOME TAX AFTER CREDITS (2005), available at <http://www.irs.gov/taxstats/bustaxstats/article/0,,id=112834,00.html>.

<sup>165</sup> S corporation shareholder debt serves several other purposes. A shareholder's share of losses cannot exceed the shareholder's basis in stock and any indebtedness of the S corporation to the shareholder. See I.R.C. § 1366(d) (2006). Further, the income tax rules governing payment of interest and the repayment of principal are less complicated than the income tax rules governing the treatment of S corporation distributions. See *id.* § 1368.

<sup>166</sup> S corporation status is unavailable if the corporation has more than 100 shareholders, has shareholders that are not individuals (with some exceptions for estates

choose not to, elect S corporation status and on new ventures that choose to incorporate rather than establish as an LLC.<sup>167</sup> Of course, the movement to pass-through taxation entities could abate or reverse in the future if individual income tax rates increase significantly in comparison with C corporation rates, which could arise from changes to the individual income tax rates, the C corporation income tax rates, or both.

New ventures that still choose to incorporate as C corporations in spite of the double taxation that accompanies such status can be of some significance. Companies that expect to launch an initial public offering (IPO) of stock may choose this status.<sup>168</sup> Start-up companies that expect to attract venture capital investment may also choose this status.<sup>169</sup> Both pre-IPO and start-up companies will likely not be as financially mature as public companies, such that the imposition of a third-party lender test may produce more characterizations as equity

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and certain trusts and tax-exempt organizations), have nonresident alien shareholders, or have more than one class of stock (other than differences in voting rights). *Id.* § 1361(b)(1), (c)(4). In addition, certain corporations, such as insurance companies, are ineligible. *Id.* § 1361(b)(2)(B).

<sup>167</sup> C corporation status might be attractive to shareholders who are determined to defer individual federal or state income taxes. Although the details are beyond the scope of this Article, the formation of a C corporation in a state that imposes no corporate or individual income taxes may present some current advantages to shareholders who reside in a state that imposes high individual income taxes. Of course, federal limits on this practice must be considered. *See, e.g., id.* § 531 (imposition of accumulated earnings tax); *id.* § 541 (imposition of personal holding company tax).

<sup>168</sup> Public companies cannot escape C corporation status because they will exceed the 100 shareholder limit of S corporations, *id.* § 1361(b)(1)(A), and because public trading of partnership or LLC interests will invoke I.R.C. § 7704 in most cases, with the result of imposing C corporation taxation. Public companies do have the option of forming in a foreign jurisdiction to avoid a U.S. corporate income tax on foreign sourced earnings.

<sup>169</sup> *See* Steven D. Bortnick & John I. Forry, *Structuring International Private Equity Investments in the People's Republic of China*, 126 *BANKING L.J.* 195, 196 (2009). Venture capital transactions, like other private equity transactions, are made up of funds that pool their money from a number of investors. *Id.* These funds are managed by management companies that receive compensation in the form of an asset-backed fee plus an interest in the fund. *Id.* Both institutional and individual investors may make private equity investments. *Id.* Venture capitalists also typically gain an equity interest in the companies in which they invest in addition to the debt investment. *Id.* The partners in the fund may be tax exempt: dividends and interest received from a portfolio C corporation remain tax-exempt, but income from a pass-through portfolio entity can result in the imposition of the unrelated business income tax. *See generally* I.R.C. § 501(a) (general tax exemption for qualified organizations); *id.* § 501(b) (tax on unrelated business income); *id.* § 512 (unrelated business taxable income defined).

than as debt.<sup>170</sup> But many of the investors in these companies are seeking robust equity-like returns, even if the investments are dressed as debt.<sup>171</sup> The arm's length test simply reveals the economic reality of the structure, which is equity-return driven. Certainly, there will be start-up companies that may be so successful that the third-party lender test will be satisfied. That was apparently the case with the taxpayer in *Delta Plastics, Inc.*<sup>172</sup> Nevertheless, considering the assumed role of start-up companies as agents of innovation,<sup>173</sup> one could expect criticism of the proposed test from that perspective.<sup>174</sup>

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<sup>170</sup> James H. Ball, Jr. & Andrew F. Fowler, *Bumps on the Road to an IPO: Structuring Provisions to Anticipate Issues in Pre-IPO Convertible Bonds*, WALL ST. LAW., Dec. 2007, at 1, 1 ("In some cases, even aggressive hedge funds specializing in venture capital investments can be unwilling to provide traditional debt financing to private companies in the development stage. . .").

<sup>171</sup> The financing structure of a pre-IPO company may include multiple classes of stock, convertible debt, debt with detachable warrants, and so forth. *Id.* at 1–3. Convertible debt is particularly popular for pre-IPO companies, especially in the later development stage, because investors are willing to trade interest now for potentially unlimited equity upside associated with conversion of pre-IPO convertible bonds into shares of a public company down the road. *Id.* at 3. Likewise, a portfolio company dealing with venture capital investors may also offer those types of investments as well as convertible preferred stock. *See, e.g.*, Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 875 (2003) ("[O]verwhelmingly, venture capitalists make their investments through convertible preferred stock.").

<sup>172</sup> 85 T.C.M. (CCH) 940 (2003). The facts of the Tax Court opinion suggest that the founders of Delta Plastics, Inc. had prior experience and success in plastics manufacturing. *See id.* at 941. The new venture was not launched until the expiration of a covenant not to compete granted in connection with the sale of a prior plastics venture. *Id.* Experienced management, technological expertise, knowledge of markets, and prior experience in the same business of the start-up present good odds of success.

<sup>173</sup> *See, e.g.*, Reid Hoffman, *Let Start-ups Bail Us Out*, WASH. POST, Mar. 3, 2009, at A13 ("Small companies represent 99.7 percent of all employer firms, Commerce Department data show. They pay nearly 45 percent of U.S. private payroll and have generated 60 to 80 percent of net new jobs annually over the past decade."). Past start-up companies that are now successful include Microsoft, MTV, CNN, FedEx, Intel, Hewlett Packard, and Burger King. *Id.* Several of these companies developed products and ideas that were innovative at the time and revolutionized their respective industries. President Obama has also commented on how small businesses provide the innovation that helps the U.S. lead the global economy. *Obama Lauds Small Firms, Innovation*, TECH DAILY DOSE (NAT'L J.), March 16, 2009, <http://techdailydose.nationaljournal.com/2009/03/obama-lauds-small-firms-innova.php>.

<sup>174</sup> Although the overall impact of C corporation taxation was much more pronounced for small businesses at the time the § 385 regulations were proposed (for example, the limited liability company had not yet emerged as a choice of entity), it has been noted that the regulations' perceived negative impact on closely held businesses contributed to their demise. *See, e.g.*, 2 STEFAN F. TUCKER, TAX PLANNING FOR

Corporate subsidiaries are generally “closely held,”<sup>175</sup> and the proposed test would be valuable in classifying the parent company’s capital infusions.<sup>176</sup>

### C. Shareholder Guaranteed Third-Party Debt

Finally, Plumb touches upon the issue of shareholder guarantees of third-party debt,<sup>177</sup> which is a troublesome issue that clouds application of a third-party lender test because a third-party lender is part of the transaction; however, the third-party lender may have been induced, perhaps almost entirely, to make the loan as a result of the shareholder guarantees. Existing doctrine tends to benignly treat shareholder-guaranteed debt as debt unless the corporation is so thin that the lender is principally relying on the guarantee.<sup>178</sup> Consequently, this type of structure is a common income tax planning recommendation, as it obfuscates what might otherwise have been a clear shareholder loan to the corporation.

A promising solution is to phrase the arm’s length test in terms of whether a third party would make the loan in question without

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REAL ESTATE TRANSACTIONS § 26:04 (2009) (stating that the regulations “were generally not acceptable to small business or the real estate industry”); John Lee et al., *Restating Capitalization Standards and Rules: The Case for “Rough Justice” Regulations (Part Two)*, 23 OHIO N.U. L. REV. 1483, 1512 (1997); Charles R. Taylor, *Classifying Shareholder Advances to a Closely Held Corporation as Debt or Stock: Guidelines for the Befuddled Practitioner*, 33 DRAKE L. REV. 641, 643 (1984) (“The proposed regulations under section 385 were deemed to be too lengthy and complex by numerous small business experts and members of the bar, and thus were withdrawn by the Treasury in August of 1983, with no hint as to when, if ever, another draft would be forthcoming.”).

<sup>175</sup> For example, in 2002, the largest 100 American multinational corporations owned an average of 187 subsidiaries. In this group, an average of 179 subsidiaries were owned by their parent companies in amounts of at least ninety-five percent. See PHILLIP I. BLUMBERG ET AL., *BLUMBERG ON CORPORATE GROUPS*, § 1.03, at 1-9 (2d. ed. 2005 & Supp. 2009).

<sup>176</sup> See generally *Laidlaw Transp., Inc. v. Comm’r*, 75 T.C.M. (CCH) 2598 (1998) (debt status denied for loans between related, but not directly affiliated corporations); *Litton Business Sys. v. Comm’r*, 61 T.C. 367, 379 (1973) (parent company advances to subsidiary held to be valid debt, in part because third-party funding was available); David B. Friedel, *Asymmetries in Taxation of Debt in and Outside Consolidated Groups*, CORP. TAX’N, Mar./Apr. 2009, at 3 (discussing traditional lending arrangements of parent companies and subsidiaries).

<sup>177</sup> Plumb, *supra* note 7, at 534-35.

<sup>178</sup> The leading case is *Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (5th Cir. 1972). For a list of citations to the cases addressing this issue see 1 BITTKER & EUSTICE, *supra* note 2, ¶ 4.23[3] n.261. See also David S. Miller, *Federal Income Tax Consequences of Guarantees: A Comprehensive Framework for Analysis*, 48 TAX LAW. 103, 134-39 (1994) (discussing the doctrine of guarantees as equity).



shareholder guarantees. In *Stinnett's Pontiac Service, Inc. v. Commissioner*, the Eleventh Circuit found the taxpayer's advances to be equity contributions.<sup>179</sup> With respect to the corporate borrower's ability to secure outside financing, the court observed that

[i]n this case, evidence exists to show that [the borrower] could not secure credit from outside sources unless the [borrower's] shareholders guaranteed the extension of credit. Yet [the lender] made advances to [the borrower] without securing personal guarantees from [the borrower's] shareholders. [The lender] failed to act as would a reasonable creditor, and this factor also indicates that the advances were contributions to capital.<sup>180</sup>

An arm's length test, which ignores shareholder guarantees as an inducement to lend, shifts the focus to the creditworthiness<sup>181</sup> of the corporation. In a similar vein, the March 24, 1980, proposed regulations offered a test that considered the likelihood of payment of the obligation by the corporation.

[If] it is not reasonable (at the time of the guarantee) to expect that the loan can be enforced against the corporation according to its terms, then (at the time of the guarantee) the loan is treated as made to the shareholder, and the shareholder is treated as making a contribution to the capital of the corporation.<sup>182</sup>

Although the likelihood of payment by the corporation is the basis of the third-party lender's decision to lend funds, the arm's length test would need to account for the possibility that guarantees are required for other purposes.<sup>183</sup> For example, the preamble to the

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<sup>179</sup> 730 F.2d 634, 640 (11th Cir. 1984).

<sup>180</sup> *Id. Contra Nestle Holdings, Inc. v. Comm'r*, 70 T.C.M. (CCH) 682, 702 (1995) (advances to subsidiary treated as debt because the court was "satisfied that petitioner, as a separate entity, could have obtained the full amount from some combination of private lenders and commercial banking sources").

<sup>181</sup> Banks look at several factors when considering the creditworthiness of a small business. The use of credit scores for small business lending, however, is a more recent phenomenon. CHARLES D. COWAN & ADRIAN M. COWAN, SMALL BUS. ADMIN., A SURVEY BASED ASSESSMENT OF FINANCIAL INSTITUTION USE OF CREDIT SCORING FOR SMALL BUSINESS LENDING I (2006). The majority of banks that do consider the credit score look at the score of the owner as the key metric. *Id.* at 7-8. The majority of banks listed cash flow as the most important factor, with collateral as the next most important factor. *Id.* at 9.

<sup>182</sup> Prop. Treas. Reg. § 1.385-11(a)(2), 45 Fed. Reg. 18957, 18972 (Mar. 24, 1980).

<sup>183</sup> It was the author's experience in law practice that banks would invariably demand a personal guarantee from the shareholder and the shareholder's spouse for closely held business loans, seemingly without first engaging in meaningful credit analysis of the corporate borrower. It is just "prudent lending practice" to demand as much as possible. The guarantee requirement could be waived, however, if the bor-

proposed regulations notes that a guarantee may provide the creditor with assurance that the corporation will not dissipate assets by transfers to shareholders.<sup>184</sup>

*D. The Application of the Third-Party Test Beyond Shareholder Loans*

The greatest promise for the third-party lender test lies in its application to shareholder loans in closely held corporations. In other contexts, such as where there are a number of willing and competing third-party lenders who will satisfy the test, the test is somewhat hollow in terms of distinguishing loans from equity. The third-party lender test also ignores the presence of equity interests in the borrower or convertibility into equity of the borrower, which makes it an inflexible test with respect to more complex hybrid instruments. The shortcomings of the third-party lender test in these respects are briefly discussed below.

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rower was stubborn and well-advised, and the corporation met certain capitalization requirements. In fact, lenders require personal guarantees from their small business borrowers in all but the most unusual circumstances. Ronald J. Mann, *The Role of Secured Debt in Small-Business Lending*, 86 GEO. L.J. 1, 23 (1997). One reason for this is that borrowers tend to have an undue preference for risk when they are able to shift the risk of losses to the lenders, but a personal guaranty mitigates this problem by increasing the risk that the borrower will feel any losses personally. *Id.* at 22. Lenders also want the individual to be as financially committed to the company as they are. *Id.* at 24. In fact, these factors are so important that lenders insist on a guaranty even if it will add nothing to the credit strength of the borrower. *Id.* at 23–24. *But see* Miller, *supra* note 178, at 138.

If no creditors are willing to loan funds at any interest rate to the debtor without a guarantee, it would appear as if the market does not have sufficient confidence that any loan to the debtor will be repaid, and thus, the guarantee represents in substance a debt obligation of the guarantor. Nevertheless, if the market is flawed and in a particular situation lenders always require personal guarantees, the unavailability of “non-guarantee” creditors should not be dispositive.

*Id.*

<sup>184</sup> PmbL., Prop. Treas. Reg. § 1.385-11, 45 Fed. Reg. at 18962 (“[T]he creditor may want to provide against the possibility that the corporation will transfer assets to its shareholders (by paying them dividends, salaries, etc.). When shareholders guarantee a loan for this . . . reason, the guarantee is a substitute for detailed protective covenants.”). The easiest case would be a situation where the shareholders have much of their personal wealth committed to the corporate borrower and consequently, the guarantee is not worth much, aside from the “play honestly” aspects alluded to by the Preamble. In that event the proposed test would assess the likelihood of a loan based on the corporation’s creditworthiness and prospects alone.

### 1. Straight Debt Instruments

An arm's length test would have less outcome determinative force in its application to "straight" debt instruments issued by creditworthy corporations, particularly public corporations, the financial standing of which could permit the structuring of capital contributions as debt or equity in response to a number of factors, including investor demand,<sup>185</sup> corporate income tax planning, corporate finance considerations,<sup>186</sup> financial reporting consequences,<sup>187</sup> and regulatory requirements.<sup>188</sup> It would seem likely that putative debt ob-

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<sup>185</sup> Some investors prefer equity treatment due to income tax preferences for dividends. Corporate shareholders enjoy a dividend received deduction. *See* I.R.C. § 243 (2006). Dividends received by individuals can be taxed at the same rates as capital gain income. *Id.* § 1(h)(11); *see also* SHAVIRO, *supra* note 24, at 89–99 (discussing the implications of capital finance theory and investor choices, indeed elections, between debt (which is essentially taxed at the investor's rate because the return is deductible by the corporation) and equity (which is essentially taxed at the corporation's rate because the return is not deductible by the corporation)).

<sup>186</sup> Generally, the amount, timing, and riskiness of the expected cash flows combined with the investor's assessment of the riskiness of the cash flows and the investor's willingness to bear risk will generate the investor's required rate of return (minimum rate of return necessary to attract an investor to purchase or hold a security). ARTHUR J. KEOWN ET AL., *FOUNDATIONS OF FINANCE: THE LOGIC AND PRACTICE OF FINANCIAL MANAGEMENT* 208 (4th ed. 2002). The return must be great enough to compensate investors for the perceived risk in the asset's future cash flows. *Id.* Several factors concerning the asset, such as whether it is an unsecured debenture rather than a secured bond, if there is subordination, whether the bond is a low coupon or zero bond, the term, remedies upon default, etc., will impact the investor's required rate of return. *See id.* at 200–05.

<sup>187</sup> Very generally, distributions treated as interest for financial accounting purposes will reduce reported earnings while dividends will not. Schizer, *supra* note 117, at 1324. On the other hand, equity instruments, as well as convertible securities, may dilute earnings per share by creating more shares. SCHROEDER, *supra* note 118, at 367. Capital contributions treated as debt impact financial ratios (such as the debt-to-equity ratio) and credit ratings. *See generally id.* at 505. Thus, as debt increases, the market perceives the risk associated with investing in the company as also increasing. *Id.* Since investors and security analysts monitor company performance through the use of financial ratios, it is important that the corporation maintain favorable ratios compared to previous years, competitors, industry averages, or benchmarks. *Id.* at 233. In May 2003 the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 150: Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity; this statement is notable because it can require that mandatorily redeemable preferred stock be treated as a liability on the issuer's balance sheet. FIN. ACCT. STANDARDS BD., *STATEMENT OF FINANCIAL ACCOUNTING NO. 150* (May 2003), available at [http://www.fasb.org/pdf/aop\\_FAS150.pdf](http://www.fasb.org/pdf/aop_FAS150.pdf).

<sup>188</sup> In regulated sectors such as banking and investment businesses, the issuer may seek equity status for regulatory purposes to meet capital requirements. The Federal Reserve System has adopted a minimum ratio of Tier 1 capital to total assets to assess

ligations of creditworthy public corporations would infrequently fail a third-party lender test because third-party capital providers supply a market for such obligations, unlike closely held corporations where the shareholders and the lenders are often the same parties.

As applied to public corporations, which would more likely have opportunities to attract capital through debt or equity infusions, a “form and labels” test<sup>189</sup> in tandem with the arm’s length lender test would produce a largely elective regime with respect to “straight” debt that is not directly or indirectly convertible into equity.<sup>190</sup> Indeed, the withdrawn § 385 regulations produced a similar result by treating publicly traded corporations gently with respect to straight debt, and such instruments not issued to principal shareholders were ordinarily classified as debt.<sup>191</sup>

This electivity would produce a more certain result, which would further the goals of compliance, simplicity, and administrabili-

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the capital adequacy of bank holding companies. A *Wall Street Journal* article reported that

hybrid securities became a vital funding tool for banks, boosting Tier 1 capital ratios but costing less than true equity. . . .

....

For investors, the bonds were considered debt. For issuers, they were equity—under certain circumstances coupon payments can be deferred like dividends, and if the bonds aren’t called after 10 years, they generally remain outstanding in perpetuity. As a result, they contributed toward Tier 1 capital, a key reserve against losses.

Richard Barley, *Hybrids Laid Low by Crisis at Banks*, WALL ST. J., Feb. 7, 2009, at B10. Reportedly, U.S. and European bank regulators have encouraged the banks’ use of bonds (so-called “contingent convertibles”) that convert into equity in times of financial exigency. See David Henry, *The Second Coming of “Safer” Securities*, BUS. WK., Dec. 7, 2009, at 56, 56. In Notice 94-47, described *infra* this Part, the Service identified as an additional consideration in debt or equity classification: “whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.” I.R.S. Notice 94-97, 1994-1 C.B. 357. Although there are drawbacks, some commentators have suggested that more conformity between the financial accounting rules (or results) and the tax rules (or results) is appropriate. See generally John J. Ensminger, *Concerto for Piano vs. Orchestra: Can Tax and Financial Accounting Harmonize on Hedges?*, 16 AKRON TAX J. 23 (2001); Yoram Keinan, *Book Tax Conformity for Financial Instruments*, 6 FLA. TAX REV. 676 (2004); Shaviro, *supra* note 112.

<sup>189</sup> The proposed test also incorporates the formal requirements of 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. See *supra* notes 76–77 and accompanying text.

<sup>190</sup> While convertible debt instruments are one matter, there is an administrability issue of whether a prohibition on indirect convertibility can be effectively applied in light of other opportunities to maintain a long position in the issuer’s stock.

<sup>191</sup> See Prop. Treas. Reg. § 1.385-2, 45 Fed. Reg. 18957, 18963 (Mar. 24, 1980).

ty and would also lower transaction costs.<sup>192</sup> Even if the line between debt and equity is more favorably predictable for public corporations, Congress could still continue to exercise its prerogative to address specific instances of perceived abuse.<sup>193</sup> As discussed below, however, the classification of straight debt probably is not a significant issue for public corporations. Instruments with contingent payments or convertibility features present greater challenges. Nevertheless, the proposed test ignores the unreasonably long maturity aspect of the Service's position announced in Notice 94-47,<sup>194</sup> its last major pronouncement in this area.

In Notice 94-47, the Service stated that features of particular concern in the debt classification analysis included "long maturities with substantial equity characteristics."<sup>195</sup> Referring to its acquiescence in *Monon Railroad v. Commissioner*,<sup>196</sup> which involved an instrument with a 50-year term, the Service cautioned taxpayers that even with instruments of a term of less than 50 years, the case does not support debt classification if the instrument contains significant equity characteristics not present in that case.<sup>197</sup> In that respect, while the

<sup>192</sup> See *supra* Part IV.C.1.

<sup>193</sup> See, e.g., I.R.C. § 163(e)(5) (2006) (limitations of interest expense deduction for certain high yield debt obligations); *id.* § 163(j) (limitation of interest expense deduction on certain thinly capitalized affiliates of foreign corporations); *id.* § 163(l)(1)–(2) (limitations of interest expense deduction on certain debt instruments payable in equity); *id.* § 279 (limitations of interest expense deduction on certain corporate acquisition debt).

<sup>194</sup> I.R.S. Notice 94-47, 1994-1 C.B. 357.

<sup>195</sup> *Id.*

<sup>196</sup> 55 T.C. 345 (1970), *acq.* 1973-2 C.B. 3.

<sup>197</sup> The Notice lists, in addition to convertibility, the following traditional equity factors:

- (a) whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future; (b) whether holders of the instruments possess the right to enforce the payment of principal and interest; (c) whether the rights of the holders of the instruments are subordinate to rights of general creditors; (d) whether the instruments give the holders the right to participate in the management of the issuer; (e) whether the issuer is thinly capitalized; (f) whether there is identity between holders of the instruments and stockholders of the issuer; [and] (g) the label placed upon the instruments by the parties . . . .

I.R.S. Notice 94-47, 1994-1 C.B. 357. Factor (d) includes management participation. In comparison, the preamble to the March 24, 1980, proposed regulations stated that "[v]oting rights are not given independent weight under" the regulations and observed that "[t]his treatment is not inconsistent with the case law. It is difficult to

proposed arm's length test dispenses with the unreasonably long maturity concept, the "forms and labels" test and limitations on convertibility effectively eliminate many of the otherwise "significant equity characteristics."

## 2. Hybrid Securities

I.R.S. Notice 94-47 also singled out instruments that are mandatorily redeemable with stock. The prior holding in Revenue Ruling 85-119,<sup>198</sup> which treated as debt an obligation that was mandatorily convertible into equity (but which gave the holder a right to demand that the equity be sold and converted into cash) was limited to its facts. The Notice indicated that instruments will be scrutinized where the right to elect cash is structured to ensure that the holder would choose the stock<sup>199</sup> or where the instrument is nominally paya-

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find a case in which voting rights are the decisive factor." Prop. Treas. Reg. § 1.385-12, 45 Fed. Reg. 18957, 18960 (March 24, 1980) (citing Plumb, *supra* note 7, at 447).

<sup>198</sup> Rev. Rul. 85-119, 1985-2 C.B. 60. The Service adopted a liberal debt classification stance toward convertible debt in this ruling. The obligations were issued by a regulated bank holding company to satisfy required capital requirements. *Id.* The obligations had a number of debt features. The notes were issued in a public offering and would not be held proportionately to the issuer's stock. *Id.* The notes were transferable and had a twelve-year maturity date. *Id.* Holders of the notes could not vote or participate in management, and interest was computed at a floating rate comparable to the market rate on similar instruments. *Id.* The issuer was not thinly capitalized, but the notes could not be accelerated but upon bankruptcy, insolvency, or reorganization of the issuer. *Id.* Consequently, the principal equity feature was that upon maturity, the issuer was unconditionally obligated to issue its common or perpetual preferred stock in an appraised amount equal to the notes' principal amount. *Id.* Noteholders, however, could elect to receive the stock and have the issuer immediately sell the stock in a secondary offering. *Id.* at 60-61.

<sup>199</sup> Rev. Rul. 83-98, 1983-2 C.B. 40, which treated so-called "adjustable rate convertible notes" (ARCNs) as equity, represented an extreme situation of such probability. Although the holder paid \$1000 for each note, at maturity the holder would receive only \$600 cash or fifty shares of the issuer's common stock. *Id.* As noted in the ruling, "[t]he ARCNs in this case are structured so that under most likely eventualities they will be converted into X common stock." *Id.* "Because of the very high probability that all of the [ARCNs] issued will be converted into stock, the [ARCNs] do not in reality present a promise to pay a sum certain." *Id.* In addition, the rate of "interest" was computed as an amount equal to the dividends paid on fifty shares of common stock plus two percent of the \$1000 issue price of the note. *Id.* Consequently, "more than 65 percent of the future annual yield may be discretionary based on the level of discretionary dividends paid on X common stock." *Id.* Although the interest on the debt in Revenue Ruling 68-54, 1968-1 C.B. 69 was in part tied to the issuer's earnings, the Service stated that it "was determinable according to a formula and did not float in tandem with discretionary common stock dividends." The Revenue Ruling 83-98 "interest" was also "determinable according to a formula," so that observation was of little consequence, but the direct linkage to common stock dividends, as opposed to overall profit levels, was a significant distinguishing factor in

ble in cash but does not, in substance, give the holder the right to receive cash because, for example, the instrument is secured by the stock and is nonrecourse to the issuer. The interest deductibility aspect was subsequently addressed by the addition of I.R.C. § 163(*l*) in the Taxpayer Relief Act of 1997.<sup>200</sup> The larger issue of whether an instrument is debt or equity for other purposes, however, is still impacted by this position.

Notice 94-47 did not focus on the role of contingent payments, although they were included in its general list of equity characteristics.<sup>201</sup> In comparison, the March 24, 1980, proposed regulations addressed this factor as part of its definition of a “hybrid” instrument. The regulations would have defined a “hybrid instrument” as “an instrument that is convertible into stock or one (such as an income bond or a participating bond) that provides for any contingent payment to the holder (other than a call premium).”<sup>202</sup> Further, the regulations would have defined fixed interest payments as “interest at a definitely ascertainable rate[,] . . . due on definitely ascertainable dates[,] . . . [with] the holder’s right to receive interest when due (or within 90 days thereafter) . . . [un]impaired without the holder’s consent.”<sup>203</sup> The December 31, 1980, regulations refined “definitely ascertainable” to include an invariable rate or a variable rate “determined according to an external standard that is not subject to the borrower’s control and that is not related to the success or failure of

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this inquiry for which certain facts, on the margin, make a difference. The ARCIN in Revenue Ruling 83-98 was reportedly inspired by the Service’s proposed § 385 regulations, which would permit debt classification; the regulations were withdrawn soon after the promulgation of the ruling. *See, e.g.,* Gergen & Schmitz, *supra* note 40, at 161 (“The clarity of the § 385 regulations made ARCINs possible; the withdrawal of the regulations and the warning shot of the revenue ruling stopped developments along the lines of ARCINs for almost a decade.”).

<sup>200</sup> The overall arrangement would invoke this provision. *See* I.R.C. § 163(*l*)(3)(C) (2006) (“For purposes of this paragraph, principal or interest shall be treated as required to be so paid, converted, or determined if it may be required at the option of the holder or a related party and there is a substantial certainty the option will be exercised.”). While Notice 94-47 speaks to the broader debt or equity characterization of an instrument, the impact of I.R.C. § 163(*l*) is limited to denying an interest expense deduction on an instrument that is otherwise considered to qualify as debt.

<sup>201</sup> *See* I.R.S. Notice 94-47, 1994-1 C.B. 357.

<sup>202</sup> Prop. Treas. Reg. § 1.385-3(f), 45 Fed. Reg. 18957, 18965 (Mar. 24, 1980); *see also* Prop. Treas. Reg. § 1.385-5(b), 45 Fed. Reg. at 18966 (“The equity features of an instrument are the right to convert it into stock and the right to contingent payments (other than a call premium).”).

<sup>203</sup> Prop. Treas. Reg. § 1.385-5(d)(2), 45 Fed. Reg. at 18966.

the borrower's business or activities."<sup>204</sup> The December 31, 1980, regulations were more restrictive than prior revenue rulings in this respect.<sup>205</sup> The definition of fixed principal payments was similar: "A definitely ascertainable principal sum . . . payable on demand or due on definitely ascertainable dates . . . [and] the holder's right to receive principal when due cannot be impaired without the holder's consent."<sup>206</sup>

In spite of the proposed regulations' treatment of contingent payments, the Service's continuing position following Notice 94-47 with respect to interest deferral is apparently unspoken acquiescence.

While Treasury has strenuously objected to characterizing long-maturity obligations as debt, it has never objected to the interest deferral feature [of Monthly Income Preferred Shares (MIPS)].

. . . .  
. . . [T]he effect of the Treasury pronouncements that were interpreted as blessing MIPS as debt so long as the maturity was not overlong was to make it possible for a corporation to provide for

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<sup>204</sup> Prop. Treas. Reg. § 1.385-5(d)(4), 45 Fed. Reg. 86438, 86448 (Dec. 30, 1980).

<sup>205</sup> In Revenue Ruling 68-54, 1968-1 C.B. 69, the Service ruled that the subordinated debentures of a broker dealer were to be classified as debt in the face of many equity-like features. The debentures were subordinated to all creditors of the issuer. *Id.* The debentures provided for a fixed rate of interest, but additional interest of one percent per annum would be payable on a contingent basis if a certain level of net profits were enjoyed by the issuer. *Id.* The Service's response was that while the interest was dependent upon earnings, the additional interest was determined by a fixed formula and the decision whether to pay interest was not discretionary with the issuer. *Id.* Although the Service did not speak in terms of whether a third-party lender would have made a loan to the issuer, that appears to clearly be the case. In the same year, the Tax Court addressed subordinated borrowings by another broker dealer in *Copley v. Commissioner*, 27 T.C.M. (CCH) 383, 386 (1968), finding that the "loans" were to be treated as capital contributions, thereby denying a bad debt loss to the lender. The four-page opinion is somewhat cryptic, but it is reasonably clear from the record that the borrower could not have obtained the funds from an independent lender. *See generally id.* The borrower was in financial trouble and undercapitalized, and the National Association of Securities Dealers and Securities and Exchange Commission required it to suspend operations until additional capital was obtained. *Id.* at 384. Even with the taxpayer's "loans," the borrower failed in the same year. *Id.*

<sup>206</sup> Prop. Treas. Reg. § 1.385-5(d)(3), 45 Fed. Reg. at 18966. The December 31, 1980, regulations refined "definitely ascertainable" to include an invariable sum or a variable rate "determined according to an external standard that is not subject to the borrower's control and that is not related to the success or failure of the borrower's business or activities." Prop. Treas. Reg. § 1.385-5(d)(4)(ii)(B), 45 Fed. Reg. at 86448.



limited deferral of interest payments in a security without imperiling classification of the security as debt for tax purposes.<sup>207</sup>

By insisting on a fixed payment obligation and limiting any direct or indirect convertibility into equity, the arm's length test proposed by this Article would treat such instruments as equity. The proposed regulations under § 385 recognized that this would not be a realistic solution, and they treated hybrid instruments as debt or equity based on the aggregate fair market value that was predominant of the two classes of interests.<sup>208</sup> It was an all or nothing test, as the authority for Treasury to adopt regulations that bifurcate instruments was added later with the enactment of the Omnibus Budget Reconciliation Act of 1989.<sup>209</sup> It also is questionable whether such an unforgiving treatment of convertible debt, as suggested by the proposed arm's length test, is appropriate as a policy or doctrinal matter.<sup>210</sup> Even if a strict fixed payment or convertibility limitation is embraced, it is doubtful whether that alone will be successful as an administrative

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<sup>207</sup> Gergen & Schmitz, *supra* note 40, at 170, 185; *see also* Humphreys, *supra* note 14, at 1205 ("Deferral on debt instruments has been one of those unique features that gives the non-tax audience comfort but does not cause the tax advisor too much pain."). For a description of the terms of mandatory and optional deferral provisions plus the reasons why the income tax consequences are considered to be benign, *see id.* at 1204–07. Notably, I.R.S. Tech. Adv. Mem. 99-10-046 (Nov. 16, 1998) approved payment postponement provisions of a MIPS arrangement, although ostensibly applying the guidelines of Notice 94-47.

<sup>208</sup> *See* Prop. Treas. Reg. § 1.385-5, 45 Fed. Reg. at 18966–68.

<sup>209</sup> *See supra* note 33 and accompanying text.

<sup>210</sup> *See, e.g.*, Edward D. Kleinbard, *Taxing Convertible Debt: A Layman's Perspective*, 56 SMU L. REV. 453, 467–68 (2003); Jeff Strnad, *Taxing Convertible Debt*, 56 SMU L. REV. 399, 447 (2003) (arguing that because convertible debt serves an important financial signaling function and the impact of tax changes would be hard to predict, the best course is to do nothing).

[B]ecause convertible debt has a fixed maturity date, a fixed minimum return equal to or greater than its issue price, and affords its holders creditors' remedies, convertible debt satisfies the formal criteria of indebtedness. It is therefore taxed under the same regimes as apply to senior nonconvertible bonds—not the regimes applicable to equity. . . .

Kleinbard, *supra*, at 467–68. Assorted Code provisions treat convertible securities as equity in order to buttress the provisions' roles apart from the conventional debt versus equity arena. *See, e.g.*, I.R.C. § 544(b)(1) (2006) (convertible securities considered outstanding stock in determining personal holding company status); *id.* § 305(d)(2) ("shareholder" includes a holder of stock rights or convertible securities). The S corporation rules dictate a strict safe harbor test that eschews convertibility, but the purpose is to patrol the one-class-of-stock requirement, which is a different regime involving a different set of considerations. *See generally id.* § 1361(c)(5) (S corporation straight debt safe harbor).

matter due to taxpayer use of multiple entity structures.<sup>211</sup> Finally, there are international tax and competitiveness consequences of the structures that also must be considered.<sup>212</sup>

A fair and effective response to those larger issues is beyond the scope of a doctrinal reworking of the debt classification test. That conclusion prompted this Article's earlier introductory statements that an arm's length third-party lender test is not a complete solution to the classification issues of public corporations' capital infusions.

There has been no shortage of proposals for addressing the debt classification issue in the context of public corporations. The Clinton administration, most notably, proposed partial legislative remedies that were not adopted.<sup>213</sup> Other proposals range from doctrinal fixes for § 385<sup>214</sup> and calls from practitioners for more administrative direction from the Service<sup>215</sup> to broader approaches, such as supplant-

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<sup>211</sup> In an announcement issued on the same day as Notice 94-47, the Service questioned the debt treatment of a structure in which the corporation issued preferred stock to a related partnership which then issued promissory notes to investors. See I.R.S. Notice 94-48, 1994-1 C.B. 357. The current multiple-entity structures, however, generally avoid this approach and instead have the related entity issue the equity-like instruments. See, e.g., DAVID C. GARLOCK ET AL., FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS 1033-38 (5th ed. 2006) (describing multi-entity structures); GEORGE MUNDSTOCK, A FINANCE APPROACH TO ACCOUNTING FOR LAWYERS 248-49 (2d. ed. 2006) (describing accounting consolidation rules for special purpose borrowing entities); Humphreys, *supra* note 14, at 1217-27 (describing the use of stacked and side-by-side entity structures).

<sup>212</sup> See, e.g., Humphreys, *supra* note 14, at 1227-33 (comparing the treatment of debt by other countries); Andriy Krahmal, *International Hybrid Instruments: Jurisdiction Dependent Characterization*, 5 HOUS. BUS. & TAX L.J. 98 (2005).

<sup>213</sup> See, e.g., James S. Eustice, "Debt-Like" Equity & "Equity-Like" Debt: Treasury's Anti-Hybrid Proposals, 71 TAX NOTES 1657 (1996) (discussing proposals to deny interest deduction for long-maturity debt and some hybrids, as well as limit the original issue discount deduction until the discount was paid); Humphreys, *supra* note 14, at 1149-53 (discussing the 1990s proposed changes).

<sup>214</sup> See, e.g., Adam O. Emmerich, Comment, *Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation*, 52 U. CHI. L. REV. 118 (1985) (proposing that debt instruments be limited to unconditional promises to pay a sum certain in money on demand or on a specified date; hybrids would not qualify and the test would apply only to publicly held corporations); Gibson, *supra* note 33 (proposing a three-part analytical test referring to the corporation's and shareholder's objective intent to create a binding instrument, the shareholder's objective intent to enforce payment rights, and the reasonableness of the shareholder's repayment expectations).

<sup>215</sup> See David P. Hariton, *Distinguishing Between Equity and Debt in the New Financial Environment*, 49 TAX L. REV. 499, 523-24 (1994) ("In the long run, however, I do not think Treasury can replace a practitioner's judgment with a formula or list of factors. Far more useful will be the occasional published ruling explaining why a specific instrument is equity or debt."); Humphreys, *supra* note 14, at 1246 ("The capital markets would benefit from clear guidance from the Treasury Department on the treat-

ing the interest expense deduction with a cost of capital allowance<sup>216</sup> or other structural changes aimed at eliminating the double taxation of corporate profits or the debt/equity distinction.<sup>217</sup> With continued

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ment of hybrid securities through published rulings that are focused on market developments and that set new markers for today's new securities."). Of course, while simplicity in regulation is an attribute almost beyond reproach, the elimination of taxpayer flexibility may nevertheless be unwelcome. See, e.g., Richard J. Kovach, *The Janus-Like Nature of Treasury Regulations: Recent Promulgations Illustrate How Regulators Can Simplify as Well as Complicate Administration*, 29 OHIO N.U. L. REV. 89, 101 (2002) ("The proposed regulations under I.R.C. § 385 failed because taxpayer representatives overwhelmingly thought them both too complex and ungenerous. Simplification of abstruse concepts alone will not engender public acceptance if taxpayers believe they are substantially advantaged under existing vague standards by comparison."). The Service currently has placed the issue of "whether an interest in a corporation is to be treated as stock or indebtedness" as a general area in which rulings or determination letters will not be ordinarily issued as the determination is primarily one of fact. See Rev. Proc. 2009-3, 2009-1 I.R.B. 107.

<sup>216</sup> See, e.g., Channing E. Brackey, *Choices of Capital: Reducing Their Impact on Taxpayers and the Government*, 22 SETON HALL L. REV. 320 (1992) (discussing the Cost of Capital Allowance (COCA), which would replace the interest expense deduction with a deduction based on a percentage of the corporation's total capital); Pratt, *supra* note 164 (discussing several proposals but concluding that COCA is the most desirable).

<sup>217</sup> The competing proposals are well known and have been thoroughly discussed elsewhere. They include a pass-through shareholder allocation method, an imputed shareholder credit for dividends, a shareholder dividend exclusion, a corporate dividend deduction, and a comprehensive business income tax (CBIT). See, e.g., SHAVIRO, *supra* note 24, at 151-65 (discussing the leading corporate integration proposals); Humphreys, *supra* note 14, at 1233-37 (discussing the November 1, 2005 Simplified Income Tax Plan and Growth and Investment Tax Plan proposed by the Advisory Panel on Federal Tax Reform); Michael S. Knoll, *Taxing Prometheus: How the Corporate Interest Deduction Discourages Innovation and Risk-Taking*, 38 VILL. L. REV. 1461, 1506-15 (1993) (discussing a corporate full-loss offset in which the corporation would receive an income tax refund on account of net losses, accompanied by elimination of the interest deduction, corporate integration proposals, tax credits, and capital gains reductions); Pratt, *supra* note 164, at 1117-58 (discussing the leading proposals); George K. Yin, *Corporate Tax Integration and the Search for the Pragmatic Ideal*, 47 TAX L. REV. 431, 436-49 (1992) (discussing the American Law Institute's proposal for the integration of individual and corporate income taxes). *Contra* Herwig J. Schlunk, *The Zen of Corporate Capital Structure Neutrality*, 99 MICH. L. REV. 410, 411 (2000) (accepting double taxation of corporate profits as a political reality and proposing that the interest expense deduction be abolished).

As a theoretical matter, there is no limit to the number of new instruments that can be created from the deconstruction and reconstruction of debt and equity instruments. Thus, there is no theoretical limit to the number of new instruments that can be created in an attempt to exploit the inconsistency in the tax treatment of corporate debt and equity. . . . Faced with such a reality, legislators and tax administrators might want to consider what they have in the past felt unable to consider: whether, rather than trying to defend the line between debt and equity, they would simply be better served by abolishing it. . . . [A]s fi-

evolution of financial instruments, it is questionable whether a doctrinal solution can be successful, and hopes for a fundamental reappraisal of the double taxation of corporate profits and the income tax distinctions between debt and equity are yet to be realized. Nevertheless, in the interim,<sup>218</sup> the proposed test does improve the debt/equity doctrine, at least as applied to shareholder loans.

## V. CONCLUSION

This Article proposes that an arm's length third-party lender test be employed in the classification of shareholder loans as debt or equity. The proposed test would be implemented by the issuance of regulations. Even if such regulations were not adopted, embracing this proposal would refine the courts' approach to their multifactor tests. In that regard, the proposed test would simplify and focus the approach to this issue, introducing more reliability and fairness of outcomes. Happily, the test would not be that far removed from what is *in substance* already applied by many of the courts and the Service. By consistently focusing on the lending market's receptiveness to a particular instrument, the proposed test would be an improvement over the current multifactor approach in terms of shareholder loans to closely held corporations, including subsidiaries, and the straight debt obligations of public corporations. The proper treatment of more complex obligations of public corporations, however, is beyond the scope of this proposal.

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nancial innovation becomes cheaper and cheaper . . . the debt-equity distinction will be exploitable by taxpayers to such an extent that their choice of tax treatment will be effectively elective.

Herwig J. Schlunk, *Little Boxes: Can Optimal Commodity Tax Methodology Save the Debt-Equity Distinction?*, 80 TEX. L. REV. 859, 861–62 (2002). Some proposals would supplant the corporate income tax with a shareholder tax roughly based on annual mark-to-market determinations. See, e.g., Joseph M. Dodge, *A Combined Mark-to-Market and Pass-Through Corporate Integration Proposal*, 50 TAX L. REV. 265, 266–67 (1995).

<sup>218</sup> While predictions of the path of future tax legislation are unreliable and of little value, I would expect that the future of corporate taxation will be much like the past two decades, allowing changes only on the margins. One might expect that changes to reduce the nominal income tax rates on public corporations would be adopted far before any real effort to tackle the debt/equity divide. The CBIT, for example, noted *supra* note 217, promised to resolve the debt/equity distinctions. But, transition rules, global capital flow implications, and short-term fiscal costs (which is a common factor in many of the reform proposals) are some of the obstacles. The “interim” may be a long time.