

LESSON 4

Corporation's Capital Structure: Debt Versus Equity

Note: This lesson may be skipped at this point and assigned after Lesson 8 on liquidations, because it involves in part the consequences of distributions and of termination of the enterprise, which students may better understand at the later time. Alternatively, problem (5) alone can be deferred, as it is advanced. Note that 2003 legislation reducing the top rate on dividends to the same rate as capital gains (generally 15 percent) will have a major impact on the issues raised in this Lesson.

(1) This problem is taken from Example III-C from Federal Income Tax Aspects of Corporate Financial Structures, by the Joint Committee on Taxation (January 18, 1989). If you wish to spend more time on integration, this is an appropriate place to do so, and you should consider assigning portions of this document or of the many other studies of the subject. B&E ¶ 1.08. This Example is used here as a paradigm showing why LBOs have made tax and economic sense, although the interest deduction is not necessarily the cause of LBOs. The blanks (which are easily filled in) are \$1,320,000 (bond holders), \$118,800 (*Y*), and \$61,200 (corporate income taxes). The income tax reduction of \$448,800 caused by the interest deduction produces an additional \$448,800 for private investors—\$330,000 of the interest to bondholders and \$118,800 for *Y*, the new shareholder. *Y* gets a 13.4 percent return on its equity investment. Consider discussing § 279. B&E ¶¶ 4.01, 4.26[1].

(2)(a) This almost surely will be treated as debt because it is "straight debt" by its terms and not held by a shareholder. B&E ¶ 4.02[3].

(2)(b) Where the security is in the form of equity, *X* will not be able to treat it as debt because of § 385(c) and the Service normally will have no interest in recharacterization, unless the "shareholder" is a corporation that enjoys the DRD. B&E ¶¶ 4.02, 4.03[1], 4.03[2]. Since 2003, noncorporate shareholders will pay a top rate of 15 percent on their dividends (IRC § 1(h)(11)), minimizing *X*'s loss of an interest deduction (i.e., a partial integration regime). See B&E ¶ 1.08[4]. The alternative raises the issue of the "fast-pay" regulations. Regs. § 1.7701(f)-3; B&E ¶ 4.03[8].

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(2)(c) This problem presents a typical setting in which the characterization issue can arise: a hybrid instrument held by a nonshareholder. The subordination, linking of return to profits, longer term, and noncommercial nature of the transaction may encourage an equity characterization if the traditional "all or nothing" view is followed. See *Paulsen*. The only things clear about this case are that *X* will treat the note as debt and that the note's true characterization is square in the gray area until a court decides. B&E ¶ 4.03.

Note that *X* will take a deduction, saving up to 35 cents per dollar, but Mr. Jones may pay a higher rate on the interest. If Mr. Jones is a foreigner or a domestic tax-exempt organization, he may pay no tax on the interest. Consider discussing § 163(j). B&E ¶ 4.04[8]. Therefore, there is considerable temptation to "game the system" by aggressive debt characterization. On the other hand, tax lawyers should try to avoid creating ambiguity such as this unless there is no real downside exposure. The taxpayer may feel there is no great risk given the "audit lottery." A letter ruling probably will be unavailable given the factual nature of the situation. Rev. Proc. 2003-3, § 4.02(1). Ambiguous situations also present the potential for whipsaw results: If Mr. Jones is a corporation, the corporation may report dividends and take a DRD while *X* may take an interest deduction. Under § 385(c)(2), however, the holder will have to disclose on its own return that it is treating the nominal debt as equity. B&E ¶ 4.02[8][b].

(2)(d) This is Rev. Rul. 83-98. The instruments will be treated as equity by the Service due to the substantial economic pressure to convert to stock and the low guaranteed return. The adjustable rate convertible note (ARCN) apparently would have been recognized as debt by the § 385 regulations that were withdrawn about the same time this ruling was issued. The Treasury seems to have become disenchanted with "bright-line" tests in the debt/equity area. B&E ¶¶ 4.02[8], 4.03[2][e], 4.03[2][f].

(2)(e) Outside the unusual facts of (2)(d), where publicly held (nonshareholder) debt has been debt in form, but has been risky because of high leverage, such debt generally has been recognized as debt. This permitted the wave of LBOs to go forward in the 1980s and led to the 1989 enactment of §§ 163(e)(5) and 163(i), which target a particular type of such debt: debt involving a combination of high return and OID with payments deferred beyond five years. B&E ¶ 4.03[5].

This would be an "applicable high yield discount obligation" because the maturity date is more than five years from the date of issue, the AFR is less than 13

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percent and it has "significant OID." The last element is due to the fact that the OID income of the holder for the first five years would exceed the sum of the cash to be paid to him during that period (zero) plus 18 percent times \$1 million (the first year's OID accrual). Consequently, the "disqualified yield" (2 percent) portion of the OID is not deductible by *X* at all and is treated as a "dividend equivalent portion" if there is sufficient E&P in *X* so that the DRD can apply to a corporate holder; the remainder of the OID is deductible by *X* only when paid, even though the debt holder must recognize income under the normal OID rules. B&E ¶¶ 4.03[5], 4.26, 4.40[5]. Discuss the 1989 § 385(a) amendment, which coupled with the foregoing signals a movement away from the "all or nothing" view of debt/equity classification. Cf. *Paulsen*; B&E ¶ 4.03[2][j].

(3) This is not a hybrid but is "straight debt" by its terms, but the fact that it is held in proportion to stock ownership removes its classification from the near certain category of (2)(a). Because of this factor, other factors must be considered, and the one given—objective unavailability of a similar loan from a commercial lender—indicates that these notes may be equity. Because of the uncertainty of this area, however, we cannot say that the notes are equity per se. B&E ¶ 4.04.

(4) Will the corporate note be a second class of stock? Normally not. B&E ¶ 6.02[3].

Will the shareholder obtain basis against which he can deduct corporate losses? Not if lender is someone else, even if he guarantees. B&E ¶ 6.06[4].

How will repayment be taxed? Debt repayment is bifurcated between recovery of debt basis and any gain on the debt, whereas dividends are treated as nontaxable stock basis recovery to the extent thereof.

(5) *Note*: Problem (5) can be omitted (unless it is included in an advanced corporate tax course).

(5)(a)

1. *A* has § 351 nonrecognition and §§ 358(a) and 358(b)(1) exchanged basis allocated \$8 to common and \$32 to preferred. *X* has § 1032 nonrecognition and § 362(a) transferred basis of \$40.
2. *X* has no deduction for distributions, and § 311 may apply if *X* distributes the land, to cause gain recognition. *A* may recognize ordinary income upon distributions, depending on the application of

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- §§ 301, 312, and 316(a). Upon any redemption, §§ 302(d) and 301 will apply, thus denying *A* any basis offset to the extent the payment is a dividend, but taxable at a top rate of only 15 percent since 2003 (in contrast to *A*'s collection of debt having a basis). The preferred stock is described in § 306(c)(3), but for the fact that *X* has no earnings and profits and could not pay a dividend.
3. *A* recognizes \$40 of § 165(g) capital loss, unless § 1244 applies to change it to an ordinary loss (which it should, subject to amount limits). B&E ¶¶ 4.22[2], 4.24. *X* recognizes no gain or loss.
 4. No, due to multiple classes of stock. IRC § 1361(b)(1)(D).
 5. While an individual shareholder probably should not capitalize *X* entirely for stock, a corporate shareholder will enjoy the DRD allowed for dividend distributions. B&E ¶¶ 4.02[1], 4.02[2]. Upon worthlessness of securities of an affiliate, the parent can take an ordinary loss under § 165(g)(3) if *X*'s income has been principally operating income. B&E ¶ 4.22[5]. As to question (2), the preferred stock could be § 306 stock under the earnings and profits pooling rule of § 306(c)(3).

(5)(b)

1. \$60 boot gain under § 351(b)(1) reportable as capital gain under § 453(f)(6), if otherwise eligible (which would not be if § 453(e), § 453(f)(4), § 453(g), § 453(k)(2), or other limitations on use of installment method apply). See Prop. Regs. § 1.453-1(f)(3), which would allocate *A*'s \$40 land basis \$20 to the stock (its FMV) and \$20 to the bond, resulting in a 75 percent gross profit ratio and recognition of \$30 gain on each \$40 principal payment. The proposed regulation would give *X* a springing basis in the land (increasing from \$40 to \$100), with the increases for *A*'s gain recognition delayed until recognition occurs, a questionable result; *X* probably has \$100 basis in the land immediately. B&E ¶¶ 3.10, 3.11[4].
2. See answer 1 above. Interest payments are deductible by *X* (consider discussing various negative consequences, including loss of interest deduction, of not using registered form debt, B&E ¶ 4.01[6]) and

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includable by *A* (at a possibly higher tax rate) (or maybe not taxable if the holder is exempt or if the debt is portfolio debt held by a foreigner). This is do-it-yourself integration. Furthermore, basis recovery on debt collection contrasts with § 301 treatment of stock redemption. B&E ¶¶ 3.03, 3.04, 4.21[1].

3. Same as answer 3 of (5)(a) above for stock, but the loss is \$20; there is also a \$20 capital loss on bonds under §§ 165(g) and 453B(a). *X* will have COD income, excluded under § 108(a)(1)(B). B&E ¶¶ 4.22[2], 4.22[3], 4.26. Consider discussing nonsecurity debt, § 166, *Whipple*, etc., covered in B&E ¶¶ 4.22[4], 4.23.
4. The bonds are straight debt under § 1361(c)(5); therefore, there is no second class of stock and the S election could be made. The interest deduction inside *X* will in effect pass through to *A* and offset the interest income to *A* unless the deductions produce passive losses that *A* cannot deduct. Distributions with respect to stock will not be recognized as income to *A* until *A*'s stock and debt basis is exceeded. B&E ¶ 6.08.
5. Debt would be less desirable for a corporate owner, given the availability of the DRD. Otherwise, see answer 5 of (5)(a) above.

(5)(c)

1. Boot gain of \$60 is immediately recognized by *A* as ordinary income under § 1239. *A*'s basis in the stock is \$20 and in the bonds, \$80; *X*'s basis in the property is \$100.
2. *A* has no income on the principal repayment; there is the usual interest income and deduction.
3. The capital losses are \$20 and \$80 under § 165(g).
4. Same as answer 4 of (5)(b).
5. Same as answer 5 of (5)(b).

(5)(d)

1. Section 351 does not apply, because *A* does not exchange the land for stock. Installment sale treatment applies, but, because the realty basis is not pushed first into the stock as in (5)(b) above, the gross

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profit ratio is 60 percent. *X* will get a § 1012 \$100 basis in the realty. B&E ¶ 3.14.

2. 60 percent of each payment (\$30) will be recognized by *A* as capital gain.
3. *A*'s capital losses are \$20 and \$40 under §§ 165(g) and 453B(a).
4. No effect on S election.
5. No change.

(5)(e)

1. Regs. § 1.351-1(a)(1) excludes warrants from the definition of stock. This is questionable, particularly when the recipient already has control and the only result is to make warrants boot; this is also questionable when warrants are certain to be exercised. B&E ¶ 3.03[2]. Under the Treasury's view, since warrants are not stock, *A* recognizes \$20 boot gain; *A*'s basis in the stock is \$40, and in the warrants, \$20, under §§ 358(a)(1) and 358(a)(2). *X* has a \$60 basis in the property under § 362(a). B&E ¶¶ 3.03[2], 4.62.

Consider discussing tracking stock as having an ambiguity somewhat like warrants; looks like equity of issuer but may be something else? B&E ¶ 4.03[3]. Consider also discussing poison pills, to which we will return in lesson on stock dividends. B&E ¶ 8.42[3].

2. Upon exercise of warrants, *A* has no gain and a basis of \$20 in the stock issued. *X* is protected from gain by § 1032 upon exercise or lapse. B&E ¶ 4.62.
3. *A* has \$40 capital or ordinary loss on the stock, as under answer 3 of (5)(a), and \$20 long-term capital loss on the warrants under §§ 1234(a) and 165(g)(2)(B).
4. Whether warrants for the same class (and possibly a new unissued class) will violate the one class of stock rule depends on the terms of the warrant and other factors. See Regs. § 1.1361-1(1)(4)(iii); B&E ¶¶ 4.62, 6.02[3].
5. No change.