New Debt-Equity Regulations under the Internal Revenue Code, The

Christopher R. Hoyt

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THE NEW DEBT-EQUITY
REGULATIONS UNDER THE
INTERNAL REVENUE CODE

CHRISTOPHER R. HOYT*†

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EDITOR'S NOTE: Just prior to publication of this issue, the Treasury Department  
announced that it would reconsider the regulations discussed in this Article, but  
did not disclose the changes being considered.

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I. INTRODUCTION

One of the most litigated tax issues is whether an interest in a corporation is stock or debt.\(^1\) Although stock and debt have many similar characteristics, the tax consequences can vary drastically depending on which interest exists. Recognizing the need to end this uncertainty, Congress enacted section 385 of the Internal Revenue Code as part of the Tax Reform Act of 1969.\(^2\) That section authorized the Treasury Department to issue regulations distinguishing debt from equity for all tax purposes\(^3\) and listed five factors that may be considered.\(^4\) On December 29, 1980, the department filed final regulations scheduled to become effective on

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1. See generally B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 4.01-.11 (4th ed. 1979) (comprehensive overview of the cases distinguishing debt from equity).


4. The Senate report stated that the factors in § 385 need not be given any more weight than other factors. S. REP. No. 552, 91st Cong., 1st Sess. 138, reprinted in [1969] U.S. CODE CONG. & AD. NEWS 2027, 2170. The factors listed in I.R.C. § 385(b) are:
   (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.
Although the regulations do not clarify all uncertainties, they do establish rules for the taxpayer to determine which interests the Internal Revenue Service will treat as stock and which it will treat as debt.

II. TAX ADVANTAGES OF DEBT

A corporation and its shareholders usually will benefit if an interest in a corporation is classified as debt instead of stock for a variety of reasons. The most commonly cited benefits are that the interest paid on debt is deductible and repayment of the principal has no tax consequences. Dividends paid to stockholders, on the other hand, are not deductible by the corporation and are taxable income for the stockholders. For example, an individual might contribute $200,000 to form a corporation. The corporation earns $110,000 of taxable income in each of the next ten years, before any payments to the shareholder are deducted. During each of the ten years, the corporation pays the shareholder $10,000, and in the tenth year, it pays him an additional $100,000. If the original contribution is classified as stock, the payments will be treated as dividends. Consequently, the repayments will be taxed twice: the corporation will pay income tax on its earnings and cannot deduct the repayments, and the shareholder will have to report the payments as dividend income.

In contrast, if the individual pays $100,000 of the original contribution in exchange for a ten percent, ten year note, the $10,000 annual payments would be characterized as interest paid on debt instead of as dividends. Although the individual will still have to recognize those payments as income, the corporation can deduct them as interest.


7. Id. § 301(c). Unless granted capital gain or tax deferral status as a redemption or liquidation by another Code provision, a distribution to a shareholder by a corporation made with respect to its stock is taxed as ordinary income to the extent that the distribution is a dividend. Id. § 301(c)(1). A dividend is “any distribution of property made by a corporation to its shareholders” out of current and accumulated earnings and profits. Id. § 316(a). If the amount of the distribution exceeds the corporation’s earnings and profits, the excess reduces the shareholder’s stock basis to the extent thereof. Id. § 301(c)(2). Any excess distribution over the earnings and profits and the basis is recognized as a capital gain to the shareholder. Id. § 301(c)(3)(A).

8. Id. § 61(a)(4).
payments on a loan. Thus, the corporation will save $4,600 in taxes each year, assuming it is in the forty-six percent marginal income tax bracket. The $100,000 payment in the tenth year will be treated as a return of the loan principal. Although the corporation cannot deduct this payment, the individual will not report it in his income, and if he is in the fifty percent marginal income tax bracket, he will save $50,000 in taxes. Thus, without affecting the cash flow, the corporation and individual can save up to $96,000 in taxes over ten years by characterizing $100,000 of the contribution as debt.

Debt is not always preferable to stock. For example, a corporation may prefer to hold stock in order to obtain the eighty-five percent or one hundred percent dividends-received exclusion. A parent corporation that files consolidated returns with a wholly owned subsidiary will not be affected by the classification of the instrument as debt or stock.

Even if an issuer is indifferent to receiving the interest deduction, the distinction may have important consequences in a corporate liquidation or reorganization. For example, in a liquidation under section 337 of the Internal Revenue Code, a corporation is required to distribute all of its assets to its shareholders within twelve months to avoid a tax on the corporation's gain from the sale of its assets. A corporation may retain certain assets to satisfy liabilities after the twelve month period, but if those liabilities are reclassified as equity, the assets will not be retained to satisfy liabilities. Thus, the corporation could lose the tax benefits of section 337 because it would not have distributed all of its assets to shareholders within twelve months.

The debt-equity distinction also is important in stock redemptions under section 302 of the Internal Revenue Code. For example, a family member can obtain capital gain or loss treatment in a stock redemption if he completely terminates all interest in the corporation, except as a creditor. If an instrument that was classified initially as debt is

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9. Id. § 163(a).
10. Id. § 11(b)(5).
11. See note 16 infra (other situations where debt is not preferable to stock).
12. Treas. Reg. § 1.337-2(b) (1955). That regulation, however, expressly provides that amounts retained to meet the claims of shareholders may not be retained in a liquidation that qualifies under I.R.C. § 337. Treas. Reg. § 1.337-2(b) (1955). See generally B. BITTKER & J. EUSTICE, supra note 1, ¶ 5.06.
13. I.R.C. § 302(b)(3). The family attribution rules of id. § 318(a)(1) may be waived for purposes of determining if a shareholder's interest has been completely terminated in a redemption under id. § 302(b)(3), if the requirements of id. § 302(c)(2) are met.
reclassified as stock, these benefits may be lost. The reclassified instrument may constitute an "interest in the corporation . . . other than an interest as a creditor"\textsuperscript{14} that violates the section 302(c) requirements for waiving the family attribution rules under section 318(a)(1) of the Internal Revenue Code. Thus, the distribution will be taxed as ordinary income to the extent the corporation has earnings and profits.\textsuperscript{15} There are other situations when the classification of an instrument as debt or equity will have significant tax consequences.\textsuperscript{16}

III. OVERVIEW OF THE REGULATIONS

A. Scope

The debt-equity regulations apply to instruments, certain loans not evidenced by instruments, guaranteed loans, and certain preferred stock.\textsuperscript{17} All other interests in corporations, such as trade payables, claims for wages, insurance policies, and instruments issued pursuant to a bankruptcy reorganization,\textsuperscript{18} are outside the scope of the regulations, and their character is determined by existing law.\textsuperscript{19} The regulations apply to loans, instruments, and preferred stock issued after December 31, 1981,\textsuperscript{20} except those made pursuant to contracts that were binding on December 29, 1980.\textsuperscript{21} An instrument issued before the effective date will not be subject to the regulations, even if its terms are changed later or not enforced.\textsuperscript{22} If there is a substantial change in terms, however, the Internal Revenue Service could characterize the change as an exchange of instruments to which the regulations apply.\textsuperscript{23}

\begin{itemize}
\item \textsuperscript{14} Id. § 302(c)(2)(A)(i).
\item \textsuperscript{15} See note 7 supra.
\item \textsuperscript{16} See, e.g., I.R.C. § 332(b) (parent-subsidiary liquidations; loss of net operating loss carryover and carryover basis if subsidiary's debt exceeds basis in its stock); id. § 333 (one month liquidations; reserve to pay liabilities allowed); id. § 351 (no gain or loss recognized if property exchanged with corporation solely for stock and after exchange transferor controls corporation); id. § 533(a) (accumulated earnings tax; accumulations allowed to pay debts); id. § 1371(a)(4) (Subchapter S election terminated if more than one class of stock).
\item \textsuperscript{17} Treas. Reg. § 1.385-1(a)(1) (1981).
\item \textsuperscript{18} Id. § 1.385-1(a)(2)(i) (1980).
\item \textsuperscript{19} Id. § 1.385-1(b)(1).
\item \textsuperscript{20} Id. § 1.385-1(a)(1) (1981).
\item \textsuperscript{21} Id. § 1.385-1(a)(2)(ii) (1980).
\item \textsuperscript{22} 45 Fed. Reg. 86,439 (1980).
\item \textsuperscript{23} Id.
\end{itemize}
B. Effect

Although debt obligations generally will be treated as debt for tax purposes,24 the regulations are designed to force shareholders to act as independent creditors. Therefore, the regulations classify certain debt instruments, loans not evidenced by a writing, and guaranteed loans as stock and certain preferred stock as debt. In determining whether an instrument25 is to be classified as debt or stock at the time it is issued, the regulations focus on key criteria. These criteria, which are fully discussed in Parts IV and V of this Article, are summarized here.

The first criterion is the type of debt the instrument represents: straight debt or hybrid debt.26 A hybrid instrument is one convertible into stock or providing for contingent payments.27 A straight debt instrument is any instrument other than a hybrid instrument.28 The second criterion is whether the investors' holdings of stock are substantially proportionate to their holdings of instruments.29 If there is substantial proportionality, hybrid instruments automatically are classified as stock,30 and straight debt instruments must pass certain tests to be classified as debt.31 If the instruments are not held in proportion to the stock held, straight debt instruments automatically are classified as debt,32 and hybrid instruments are classified as debt only if their fair market value without the equity feature is equal to at least one-half of their fair market value with the feature.33

In addition to these classifications at issuance, the regulations provide that an instrument initially classified as debt later may be reclassified as stock in certain circumstances.34 Reclassification may occur if, at a time when the instrument is held proportionately to stock, there is a substantial change in terms,35 a failure to pay interest,36 or a failure to pay a reasonable rate of interest on instruments that are payable on demand.37 The regulations also permit the Commissioner of the Internal Revenue

25. Id. § 1.385-3(c) provides, "The term 'instrument' means any bond, note, debenture, or similar written evidence of an obligation."
26. See notes 50-75 and accompanying text infra.
28. Id. § 1.385-3(f).
29. Id. § 1.385-6(a)(1). See notes 91-102 and accompanying text infra.
30. See notes 116 & 117 and accompanying text infra.
31. See notes 118-51 and accompanying text infra.
32. See notes 114 & 115 and accompanying text infra.
34. See notes 152-69 and accompanying text infra.
36. Id. § 1.385-6(k)(1).
37. Id. § 1.385-6(1)(2).
Service to ignore noncommercial terms or artificial arrangements.\textsuperscript{38} For example, instruments that are not held proportionately may be treated as proportionately held if there is an arrangement under which the terms will not be enforced at arm's length.\textsuperscript{39}

An instrument classified or reclassified as stock under the analysis summarized above is treated as a separate class of preferred stock.\textsuperscript{40} Payments that purport to be interest payments are treated as dividend distributions, and payments that purport to be payments of principal are treated as distributions in redemption of stock.\textsuperscript{41} If a debt instrument is reclassified as stock, the stock is treated as stock received in a tax-free recapitalization.\textsuperscript{42} The Treasury Department has not determined yet if such preferred stock constitutes a second class of stock that would violate the Subchapter S proscription against more than one class of stock.\textsuperscript{43} This issue will be covered exclusively by a Treasury regulation to be promulgated in the future.\textsuperscript{44}

Unlike the reclassification of an instrument from debt to stock, once an instrument is classified as stock, it can never be reclassified as debt.\textsuperscript{45} This can be a trap for an unwary independent creditor who purchases an installment note from a shareholder only to learn later that the note had

\begin{itemize}
  \item \textsuperscript{38} Id. § 1.385-3(b)(1)(iii). See 45 Fed. Reg. 86,439 (1980).
  \item \textsuperscript{39} Treas. Reg. § 1.385-6(a)(7) (1980).
  \item \textsuperscript{40} Id. § 1.385-4(c)(1)(i).
  \item \textsuperscript{41} Id.
  \item \textsuperscript{42} Id. § 1.385-4(c)(1)(ii).
  \item \textsuperscript{43} I.R.C. § 1371(a)(4).
  \item \textsuperscript{44} Prior to December 29, 1980, Treas. Reg. § 1.1371-1(g) (repealed 1980) provided automatic "second class of stock" treatment for debt reclassified as stock, unless the "debt" holdings were substantially proportionate to the stock holdings. In Amory Cotton Oil Co. v. United States, 468 F.2d 1046 (5th Cir. 1972), the court held the regulation invalid because it was arbitrary and did not relate to the criteria appropriate to the second class of stock determination: the debt versus equity factors, the purpose of Subchapter S tax status, and the rationale of the "one class" requirement. Id. at 1054. See Stinnett v. Commissioner, 54 T.C. 221 (1970); Gamman v. Commissioner, 46 T.C. 1 (1966). The Amory Cotton court stated, "[W]e do not accept the conceptualistic view that every contribution to the capital of a subchapter S corporation which is not authorized and issued stock must be a second class of stock within the meaning of § 1371(a)(4)." 468 F.2d at 1054. Amory Cotton and other similar holdings may influence the stand the Treasury Department takes when it issues Treas. Reg. § 1.1371(h). See generally I. GRANT, SUBCHAPTER S TAXATION §§ 9.4-.7 (2d ed. 1981) (summary of cases).
  \item \textsuperscript{45} The position to be taken in Treas. Reg. § 1.1371(h) also may be influenced by the position taken on the "second class" issue in other factual settings. See generally Rev. Rul. 611, 1973-2 C.B. 312 (stock with nonproportional voting rights constitutes new class of stock only if disparity is derived from corporate charter).
\end{itemize}
been reclassified as stock. Each principal installment payment will be a dividend, unless it qualifies as an exchange under section 302(b) of the Internal Revenue Code.

It is interesting that the regulations do not consider certain factors that have been important to the debt-equity classification process in prior cases. For example, one factor frequently examined by the courts was whether the proceeds were used to acquire the capital assets needed to start a business. Other factors, such as subordination, have not been emphasized as much as might have been expected.46

C. "Safe Harbor" Escape

The regulations contain a highly publicized "safe harbor" provision that results in automatic classification as debt for straight debt instruments with a fixed maturity date. Such instruments will be treated as

46. The language of I.R.C. § 385(b) is permissive and nonexclusive regarding the list of factors that the regulations "may include among other factors." Id. See note 4 supra. The Senate Finance Committee commented:

It is not intended that only these factors be included in the guidelines or that, with respect to a particular situation, any of these factors must be included in the guidelines, or that any of the factors which are included by statute must necessarily be given any more weight than other factors added by regulations.


In J.S. Biritz Constr. Co. v. Commissioner, 387 F.2d 451, 457 (8th Cir. 1967), the court noted the following indicia used in distinguishing debt from equity: (1) "thin" capitalization, (2) proportion of debt to stock holdings, (3) repayment contingent on corporate profits, (4) reasonable expectation of repayment on a fixed date, (5) subordination to other debts, (6) whether a third party would have extended credit under the same circumstances, (7) whether the claimed loan is secured by a mortgage or otherwise, (8) sinking fund provisions to retire the loan, (9) creditor-management identity, and (10) a large debt-to-equity ratio.

In reversing the tax court, the Biritz court held there was no evidence that the instrument was not a loan and stated that an instrument, intrinsically clear on its face, should not be challenged unless it is a sham or has only a tax avoidance purpose. Id. at 459. Evidentiary factors influencing the decision were a 2:1 debt-to-equity ratio, a legitimate business purpose for the loan, payment of reasonable and fixed interest, and the irrelevance of proportionality in the sole shareholder corporation. The demand feature and the lack of security for the loan, although indicating that the loan would not have been acceptable to a third party creditor, were not sufficient to cause the court to classify the instrument as stock. Id.

See generally Fin Hay Realty Co. v. United States, 398 F.2d 694, 696 (3d Cir. 1968) (16 factor list); In re Uneco, Inc., 532 F.2d 1204, 1207-09 (8th Cir. 1976) (discussion of several sets of factors). But see Ambassador Apartments, Inc. v. Commissioner, 406 F.2d 288, 290 (2d Cir. 1968) (rejects application of Biritz factors in thin capitalization case).
debt if three requirements are satisfied. First, at the time the instruments are issued, the stated interest rate must be at or between two of the following: the rate the Internal Revenue Service charges on underpayments of taxes under section 6621 of the Internal Revenue Code (presently twelve percent, to become twenty percent on February 1, 1982), the prime rate charged by a local commercial bank, or a rate determined by interest paid on federal obligations, which rate will be published periodically in revenue procedures. Second, at the end of the taxable year in which the instruments are issued, the debt-to-equity ratio must not exceed 1:1. Finally, principal and interest payments must be made when due.  

The requirements of this safe harbor are conservative; few instruments will qualify. The regulations, however, assure that instruments with much more liberal terms will be treated as debt. For example, straight debt instruments with a fixed maturity date issued in exchange for money will be treated as debt if the total debt-to-equity ratio at the end of the taxable year is less than 10:1 and the inside debt-to-equity ratio, which only takes into account debt held by shareholders, is less than 3:1.  

In addition, straight debt instruments not proportionately held usually will be treated as debt.  

IV. KEY FACTORS IN THE DEBT-EQUITY DETERMINATION

To determine whether an instrument is debt or stock, the regulations focus on four factors: whether it is a hybrid instrument or a straight debt instrument, excessive or inadequate consideration, independent creditor status, and the substantial proportionality of the instrument holdings to the stock holdings. The classification of the instrument also may be influenced if the issuer is a family corporation.

A. Hybrid Instruments versus Straight Debt Instruments

The regulations classify instruments as either hybrid or straight debt. Hybrid instruments are convertible into stock or provide for contingent payments, other than a call premium. A straight debt instrument is any instrument other than a hybrid instrument. Because of their equity features, hybrid instruments are more likely to be classified as stock than are straight debt instruments.

To avoid issuing a hybrid instrument, a corporation may consider issuing two locked interests, such as a bond with a nondetachable warrant.

48. Id. § 1.385-6(f)(3).
49. Id. § 1.385-2(b)(1).
50. Id. § 1.385-3(e).
51. Id. § 1.385-3(f).
52. Locked interests are defined in id. § 1.385-8(a) as two or more distinct interests in a corporation whereby title to one cannot be transferred without transferring title to the other.
Even though title to one interest cannot be transferred without transferring title to the other, the interests will be treated as separate.\textsuperscript{53}

1. Contingent Payments versus Fixed Payments

A contingent payment is defined as any payment other than a fixed payment of interest or principal.\textsuperscript{54} An interest or principal payment is fixed, which indicates that the instrument is straight debt, if (1) it can be calculated based on a definitely ascertainable standard, (2) it is due on a definitely ascertainable date, and (3) the holder has a right to collect it when due or, in the case of interest, within ninety days thereafter.\textsuperscript{55} Payments of interest or principal are definitely ascertainable if they either are fixed dollar amounts or are based on external standards not subject to the borrower's control.\textsuperscript{56} Thus, interest rates based on the prime rate and principal payments based on the consumer price index or payable in a foreign currency are definitely ascertainable;\textsuperscript{57} an instrument with these provisions is a straight debt instrument. If any portion of the payment is conditioned on earnings, however, the payment is contingent, and the instrument is a hybrid instrument.\textsuperscript{58} For example, a note that provides for fixed interest of ten percent plus additional interest of four percent if the corporation has net profits is a hybrid instrument.\textsuperscript{59}

There are exceptions under which certain contingent payments may be treated as fixed. For example, the Commissioner may treat a contingent payment as fixed if it is guaranteed.\textsuperscript{60} The same result may occur if there is no reasonably foreseeable circumstance in which the contingency could affect the likelihood of payment.\textsuperscript{61} Thus, nonrecourse debt is not necessarily a hybrid instrument.\textsuperscript{62} In addition, payments are not contingent merely because a holder's right to receive interest or principal may be impaired by the federal bankruptcy laws, the possibility of corporate insolvency, or the issuance of an indenture under section 316 of the Trust Indenture Act of 1939.\textsuperscript{63}

\textsuperscript{53} Id.
\textsuperscript{54} Id. § 1.385-5(d)(1).
\textsuperscript{55} Id. § 1.385-5(d)(2), -5(d)(3).
\textsuperscript{56} Id. § 1.385-5(d)(4).
\textsuperscript{57} Id. § 1.385-5(e) (example 5).
\textsuperscript{58} See id. § 1.385-5(d)(4)(ii)(B).
\textsuperscript{59} See id. § 1.385-5(e) (example 7).
\textsuperscript{60} Id. §§ 1.385-5(d)(7) & -10(c) (example 5).
\textsuperscript{61} Id. § 1.385-5(d)(6).
\textsuperscript{62} Id. § 1.385-5(e) (example 14).
\textsuperscript{63} Id. § 1.385-5(d)(5). See 15 U.S.C. § 77ppp (1976). Under Treas. Reg. § 15A.453-1(c)(8) (1981), a temporary regulation, if instruments are not held in proportion to stock, instruments issued in deferred payment sales that provide for contingent payments of principal will not be subject to the debt-equity regulations. Thus, existing case law will apply to these instruments.
2. Effect of State Law Limits on Stock Redemptions

The insolvency exception provided by the regulations may be important for instruments that are issued during stock redemptions. Some states prohibit payments of principal and interest on instruments issued in a stock redemption if the payments would render the corporation insolvent. The insolvency exception would keep this restriction from making an instrument a hybrid instrument. Instruments issued in states where statutes require that payments be made only out of a corporation's earned surplus, however, automatically are stock. Thus, in these states, the regulations might preclude the tax advantages to be gained from redeeming stock with debt instruments.

The regulations do not address the character of stock redeemed from corporations organized in states such as Delaware, Missouri, and Kansas, where state law prohibits a payment in redemption of stock if it would impair the corporation's capital. This situation lies between the two situations addressed in the regulations: insolvency and payments from earned surplus. Although these laws would prohibit payments before a corpora-

67. See, e.g., ALA. CODE § 10-2A-22 (1980); OKLA. STAT. ANN. tit. 18, § 1.136(a)(1) (West 1953). The statutes provide that domestic corporations may purchase only their own shares out of earned surplus. Corporations and shareholders in these states can argue that debt instruments issued in stock redemptions are not stock because payments can be made out of unearned surplus or stated capital in some circumstances. For example, Alabama law permits payments out of capital surplus if the articles of incorporation so provide. ALA. CODE § 10-2A-22 (1980). The Alabama statute supports the argument that this regulation is unreasonable.
68. See Treas. Reg. § 1.385-5(e) (example 12) (1980). The regulation provides that if state law requires redemption payments to be made from earned surplus, an instrument issued in a stock redemption is stock because the entire value of the instrument is its equity feature. Applied literally, the regulation would prohibit the tax benefits of stock redemptions with debt instruments in those states. The redemption would be treated as a recapitalization of the surrendered common or preferred stock. See id. § 1.385-4(c)(1).
69. Delaware and Kansas law provide that a corporation cannot purchase its own shares of capital stock when the capital of the corporation is impaired or when the purchase would cause any impairment of the capital of the corporation. DEL. CODE ANN. tit. 8, § 160 (Cum. Supp. 1980); KAN. STAT. ANN. § 17-6410 (1974). Missouri law presents a stronger case that redemption payments can be made from surplus other than earned surplus. The statute only prohibits payments that would cause a corporation's net assets to be reduced below stated capital, i.e., par value or stated value. RSMO § 351.390 (1978).
tion became insolvent, they do not require that payments be made from earned surplus. Payments could, for example, be made from paid-in surplus, appreciation surplus, or donated surplus.

The United States Court of Appeals for the Fourth Circuit rebuffed the Internal Revenue Service when it attempted to classify a debt instrument as stock in a jurisdiction with such a law. In *Mountain State Steel Foundries, Inc. v. Commissioner,* the court held that redemption payments could be made from appreciation surplus without impairing a corporation's capital. The Internal Revenue Service did not contend that the state law made the instrument stock per se, but attempted to show that the taxpayer had impaired its capital. It remains to be seen how the new regulations will affect instruments issued in states with similar laws, but it is likely that the failure to address this issue will mean that *Mountain State* is still good law.

3. Subordination

Subordination of an instrument to other debt will not necessarily cause it to be a hybrid instrument. The Treasury Department has stated that subordination is not considered a contingency because it is similar to the possibility of insolvency. In fact, the regulations place little weight on whether an instrument is subordinated to other liabilities, even though subordination is one of the five factors listed in section 385(b) of the Internal Revenue Code and has been an important factor in prior judicial decisions. Subordination is mentioned only in several examples in the regulations as a factor in determining the fair market value of an instrument and as a factor that, if later added to an instrument, would constitute a "substantial change in terms."

B. Excessive or Inadequate Consideration

If a shareholder contributes more than the fair market value of the instrument to a corporation, the excess consideration is treated as a capital

71. 284 F.2d 737 (4th Cir. 1960).
72. Id. at 743.

An insolvency limitation in the bankruptcy sense (i.e., that interest or principal payments cannot be made if liabilities exceed, or would as a result of the payments exceed, assets) is in substance a form of subordination. Since subordination is not generally considered a contingency for purposes of the regulations, it is appropriate that subordination not be a contingency in this context.

_Id._

74. See notes 4 & 46 supra.
75. Subordination is a factor in valuing the nonequity portion of a hybrid instrument. Treas. Reg. § 1.385-5(e) (examples 1, 2, 4 & 7); -5(f) (examples 4 & 9) (1980). It is considered to be a substantial change in terms. _Id._ § 1.385-6(j)(2), -6(j)(4) (example 3).
contribution, regardless of whether the instrument is treated as stock or debt. If the consideration paid by a shareholder is inadequate, the shortfall is treated as a dividend distribution under section 301 of the Internal Revenue Code if the instrument is debt or as a stock distribution under section 305 of the Internal Revenue Code if the instrument is stock.

To determine if the consideration is excessive or inadequate, the consideration paid for the instrument is compared with the fair market value of the instrument. Fair market value is defined as the price to which a willing buyer and seller would agree, and it may be determined by using the present value from standard bond tables. In determining fair market value, the Commissioner may disregard a noncommercial term if its principal purpose is to increase or decrease the market value of the instrument. The fair market value of an instrument registered with the Securities Exchange Commission and sold to the public for money is its issue price.

As an administrative rule of convenience, the fair market value of a straight debt instrument will be its face value if (1) the stated interest rate is "reasonable," defined by the regulations as an interest rate that an independent creditor would pay for a similar instrument, and (2) the consideration paid for the instrument equals its face value. This rule applies only to shareholders who receive instruments, and the Internal Revenue

76. Id. § 1.385-3(a)(1).
77. See note 7 supra.
78. Treas. Reg. § 1.385-3(a)(2) (1980). I.R.C. § 305(a) provides nonrecognition status for distributions of common stock by a corporation to its shareholders. A distribution will, however, be treated as a distribution under id. § 301 and be taxable as a dividend to the extent the corporation has earnings and profits if it (1) could be taken in other property by any shareholder, (2) is disproportionate to the shareholder's interest, (3) is in addition to a distribution of preferred stock to any shareholder, or (4) is of convertible preferred stock. Id. § 305(b).
80. Id. § 1.385-3(b)(1)(iii)(A). The preliminary comments to the revised regulations define noncommercial terms:

[N]oncommercial terms [are those] which would make it very difficult for the holder to enforce his rights thereunder and which were designed to reduce the fair market value of the instrument for tax purposes. This provision enables the Commissioner to disregard these noncommercial terms in determining the fair market value of the instrument and the reasonableness of the interest rate.

82. Id. § 1.385-6(e)(1).
83. Id. § 1.385-3(b)(2)(i).
84. Id. § 1.385-3(a).
Service still can use the existing case law to treat a bargain sale to a non-shareholder as a dividend.\footnote{85}

C. Independent Creditors

Because an independent creditor is likely to enforce the terms of an instrument, there is less concern that an instrument issued to him actually is stock. Consequently, the regulations exempt loans made by independent creditors from the tests applied to proportionately held instruments and to loans not evidenced by a writing.\footnote{86} Straight debt instruments issued to an independent creditor, therefore, always are classified as debt, even if a class of straight debt instruments is held by shareholders and independent creditors, and the instruments held by the shareholders are classified as stock.\footnote{87}

The regulations contain a vague statement regarding identification of independent creditors: "[A]ll relevant facts and circumstances must be taken into account in determining whether a creditor is independent."\footnote{88} The regulations provide a safe harbor, however, so that a creditor is independent if his actual and constructive stock ownership is less than five percent and his holdings of stock and instruments are not substantially proportionate.\footnote{89} Thus, even a shareholder can be an independent creditor if he comes within the safe harbor. The Treasury Department reasoned that certain minority shareholders would have sufficient economic incentives to act as independent creditors. With safe harbor protection, a shareholder who owns or has an option to acquire less than five percent of the outstanding shares will be an independent creditor if he does not own a proportionate amount of stock. For example, if a two percent shareholder owns two percent of the instruments, he will not be an independent creditor. An individual who owns no stock will not be an independent creditor if five percent or more of the corporation's stock is attributed to him from a related person.\footnote{90}

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\footnote{85}{The preliminary comment to the revised regulation provides: [T]he regulations are not intended to deviate from present law as to when a bargain sale to a nonshareholder may be treated as a dividend (see \textit{Harry L. Epstein}, 53 T.C. 459 (1969); \textit{Sammons v. United States}, 433 F.2d 728 (5th Cir. 1970), \textit{cert. denied} 402 U.S. 945 (1971); \textit{George W. Knipe}, 24 CCH Tax Ct. Memo 668 (1965), \textit{Aff'd per curiam sub nom. Equitable Publishing Co. v. Commissioner}, 356 F.2d. 514 (3d Cir. 1966), \textit{cert. denied} 385 U.S. 822 (1966); Rev. Rul. 69-630, 1969-2 Cum. Bull. 112) or as to how purchases by nonshareholders at prices in excess of fair market value are treated. 45 Fed. Reg. 86,439 (1980).}

\footnote{86}{Treas. Reg. § 1.385-6(a)(3)(ii) (1980).}

\footnote{87}{\textit{Id.} § 1.385-6(a)(6) (example 2).}

\footnote{88}{\textit{Id.} § 1.385-6(b)(1).}

\footnote{89}{\textit{Id.} § 1.385-6(b)(2).}

\footnote{90}{\textit{See id.} § 1.385-6(b)(4) (examples).}
D. "Substantial Proportionality" to Stock Holdings

The most crucial factor in determining whether an instrument is debt or equity is whether the instrument holdings are substantially proportionate to the stock holdings. The Treasury Department reasoned that creditors would be more likely to enforce instruments at arm's length if the instruments were not held in proportion to stock. For that reason, the tests imposed on instruments that are held proportionately do not apply to independent creditors or to marketable instruments that are widely held and separately traded.

Considering the importance of the substantial proportionality factor, the regulations introduce uncertainty by the vague statement that "substantial proportionality is determined from all relevant facts and circumstances, including family or other relationships described in section 318(a)." The Treasury Department expects that numerical guidelines will be published in a revenue procedure; until then taxpayers must rely on the fifteen examples contained in the regulations, which provide the following illustrations.

If three unrelated individuals, A, B, and C, each own one-third of a corporation that has $100,000 of straight debt debentures outstanding, the holdings of the debentures and the stock will be substantially proportionate if A owns $40,000, B owns $30,000, C owns $20,000, and an independent creditor owns the remaining $10,000. The holdings are substantially proportionate because A, B, and C each own one-third of the stock and approximately one-third of the debt. If the instrument is classified as stock, the classification will apply only to the shareholders, not to the independent creditor. If, however, each shareholder owns $10,000 of debentures and the independent creditor owns $70,000, the holdings of stock and debentures will not be substantially proportionate. In this case, A, B, and C each hold one-third of the stock but only one-tenth of the debt. The same is true if A owns all of the debentures.

To complicate the matter further, two classes of instruments can be treated as one if they are issued pursuant to a plan whereby the total holdings of stock and instruments will be substantially proportionate. For

93. Id. § 1.385-6(a)(2)(i). Stock constructively owned under I.R.C. § 318(a)(4), relating to options, is taken into account to the extent it is reasonable to expect that the options may be exercised. Treas. Reg. § 1.385-6(a)(2)(ii) (1980).
96. Id. (example 2).
97. Id. (example 3).
98. Id. (example 7).
example, if different notes are issued to different shareholders at the same
time or similar notes are issued at different times, the Internal Revenue
Service can argue that the holdings of stock and instruments are substan-
tially proportionate.99 Alternatively, one class of instruments may be
treated as two classes if the holders are treated differently, such as when in-
dependent creditors are paid interest but shareholders are not.100

Finally, instruments that are not held proportionately can be treated
as proportionately held if there is an agreement not to enforce the instru-
ment's terms at arm's length.101 For example, one shareholder may agree
to forego collecting interest on his debt if the other shareholder foregoes a
salary payment.102

E. Redemptions from Family Corporations

The regulations do not expressly waive the family attribution rules on
a complete termination of a shareholder's interest.103 Until cases or rulings
resolve the waiver question, there will be considerable uncertainty as to
whether instruments issued to redeemed family members are held propor-
tionately to stock. For example, if a father and son each own 100 of their
corporation's 200 outstanding shares of common stock and the corporation
redeems all of the father's shares in exchange for several promissory notes,
the father is not an independent creditor under the safe harbor because,
under the family attribution rules of section 318(a), he would be deemed
to own all of his son's shares. In fact, unless the attribution rules are waived,
the Internal Revenue Service could argue that the father's holdings of
instruments are substantially proportionate to stock. He would own all of
the newly issued debt instruments and would be deemed to own all of the
stock by attribution. If the instruments are classified as stock, the father
may not have terminated his interest in the corporation. This redemption,
therefore, may not qualify for exchange treatment under section
302(b)(3), and the entire sale price would be a dividend, taxed under sec-

99. Id. § 1.385-6(a)(4), -6(a)(6) (examples 4 & 14).
100. Id. § 1.385-6(a)(5).
101. Id. § 1.385-6(a)(7)(i).
102. Id. § 1.385-6(a)(7)(ii) (example 1).
103. In contrast, the family attribution required by I.R.C. § 318(a)(1) may
be waived by the taxpayer under id. § 302(c)(2) for purposes of determining
redemption status under id. § 302(b)(3). The family attribution rule requires that
an individual be considered the constructive owner of any stock owned, directly or
indirectly, by his spouse, children, grandchildren, or parents. Id. § 318(a)(1)(A).
Stock constructively owned through family attribution, however, will not be reat-
tributed through a second application of the family attribution rules. Id. §
318(a)(5)(B).
104. See note 7 supra. In Duerr v. Commissioner, 30 T.C. 944 (1958), the
taxpayer surrendered all of her common stock in exchange for instruments labeled
The father has several strong arguments to counter such an attack. First, applying the family attribution rules to determine the character of the instruments frustrates Congress' intent to waive the attribution rules on a complete termination of interest under section 302(c). Second, the father may argue that he is an independent creditor, even though he does not meet the safe harbor test. Third, under the vague definition of substantial proportionality, his instruments might not be held in proportion to stock. The last argument is bolstered by Treasury Regulation section 1.385-6(a)(6) (example 7), in which instruments that were all held by one shareholder were deemed not to be held in proportion to stock. Until cases and rulings resolve this question, a cautious tax planner can achieve debt classification without resorting to these arguments by making certain that the instruments meet the tests applied to proportionately held instruments.

V. CLASSIFICATION OF INSTRUMENTS: THE REGULATIONS' ANALYTICAL FRAMEWORK

A. Character at Time of Issue

Using the factors outlined above, the regulations provide the following framework to determine if a given instrument is debt or stock.

1. Nonproportionately Held Hybrid Instruments

Nonproportionately held hybrid instruments generally will be classified as debt. If, however, the fair market value of the hybrid instrument without its equity feature is less than fifty percent of the fair market value of the entire instrument on the day it is issued, the instrument will be treated as stock. Nevertheless, if it can be shown that the issuer and

"debenture bonds," and reported a capital gain. The tax court upheld the Internal Revenue Service's characterization of the gain as ordinary income, holding that since the "debt" received was comparable to the stock "redeemed," the taxpayer had not absolutely terminated her interest in the corporation. The court relied on the instrument's provision that payments of principal and interest be made solely out of income. This indicated to the court that the taxpayer shared in the risks of the enterprise as an equity holder, and that the instruments were similar to nonvoting preferred stock. Id. at 947-48.


106. See note 93 and accompanying text supra.


109. The author has prepared a flowchart that details the operation of the regulations. Readers may obtain, at no cost, a copy of this flowchart by contacting the Missouri Law Review.


111. Id. § 1.385-5(a).
holder reasonably believed that they had met the test on the day of issue, the instrument will be classified as debt, provided the equity feature was worth no more than fifty-five percent of the instrument.\textsuperscript{112}

Under this test, the equity feature of a hybrid instrument is the right to convert that instrument into stock or the right to receive contingent payments.\textsuperscript{113} For example, if, for $1,000, a corporation issues a twenty-five year $1,000 bond with noncumulative interest of twelve percent payable only if the corporation has net earnings, the value of the instrument without the equity feature is the value of a $1,000 noninterest bearing bond. The value of the equity feature is the possibility of receiving the interest payments. Because the present value of such a noninterest bearing bond is less than fifty percent of the value of the entire instrument, the instrument will be classified as stock.

2. Nonproportionately Held Straight Debt Instruments

Nonproportionately held straight debt instruments will be classified as debt.\textsuperscript{114} Such instruments can be reclassified as stock, however, if, at a time when they are held proportionately to stock, there is a substantial change in terms, a failure to pay interest, or a failure to pay a reasonable rate of interest on a demand instrument.\textsuperscript{115} Reclassification of instruments is discussed in Part V.B. of this Article.

3. Proportionately Held Hybrid Instruments

Hybrid instruments held in substantial proportion to the stock will be treated as stock.\textsuperscript{116} If hybrid instruments are held by an independent creditor or are widely marketed, however, they still could be classified as debt if they pass the tests applied to hybrid instruments not held in proportion to stock.\textsuperscript{117}

4. Proportionately Held Straight Debt Instruments

If the holdings of straight debt instruments and stock are substantially proportionate, the instruments ordinarily are classified as debt.\textsuperscript{118} These instruments may be classified as stock, however, if the instruments are issued by a corporation that has excessive debt, are not issued for money, or are payable on demand.\textsuperscript{119} In addition, proportionately held straight

\textsuperscript{112.} Id. § 1.385-5(c). The subsection provides that, under these circumstances, the hybrid instrument is treated as stock if, at issuance, the fair market value of the instrument without its equity feature is less than 45\% of the actual fair market value of the instrument with the equity feature.

\textsuperscript{113.} Id. § 1.385-5(b).

\textsuperscript{114.} Id. § 1.385-2(b)(1).

\textsuperscript{115.} Id. § 1.385-2(a)(1).

\textsuperscript{116.} Id. § 1.385-2(a)(2).

\textsuperscript{117.} See pp. 780-81 supra.


\textsuperscript{119.} Id.
debt instruments initially classified as debt may be reclassified as stock under certain circumstances.\textsuperscript{120}

a. Excessive Debt Test

If, immediately after the instruments are issued, they are held proportionately and the corporation's debt is excessive, the instruments are treated as stock.\textsuperscript{121} The reason for this rule is that there is no basis for treating the shareholder's loan as debt if an independent creditor would not lend to such a debt-ridden company.\textsuperscript{122}

There is, however, a safe harbor providing that debt is not excessive if, at the end of the taxable year in which the instrument is issued, the corporation's outside debt-to-equity ratio is less than or equal to 10:1 and its inside debt-to-equity ratio is less than or equal to 3:1.\textsuperscript{123} The outside debt-to-equity ratio is the ratio of the corporation’s liabilities, excluding trade accounts payable and accrued expenses, to the stockholder’s equity based on the tax basis of the corporation’s assets.\textsuperscript{124} The inside debt-to-equity ratio is determined in the same manner, but liabilities owed to independent creditors are excluded.\textsuperscript{125} The use of the tax basis, as opposed to fair market value or book value, will penalize corporations using accelerated depreciation for tax purposes. The test will become even more difficult to meet as the new cost recovery provisions of the Economic Recovery Tax Act of 1981 take effect.

Corporations will not be penalized in the safe harbor calculation if they incur net operating losses in the years instruments are issued. A corporation that has incurred a net operating loss can add the amount of the loss to the equity existing at the end of the year for the safe harbor calculation.\textsuperscript{126} Thus, an instrument issued early in a year will not fail the safe harbor test solely because the stockholders' equity was reduced later in the year by operating losses. For example, on the day a corporation was formed it issued \$50,000 of stock and a \$50,000 note to the sole shareholder. At the end of the year, the corporation had assets with a tax basis of \$90,000 and liabilities of \$80,000, comprised of the \$50,000 note and \$30,000 of trade payables. If the corporation had a net operating loss of \$40,000 during its first year, its debt-to-equity ratio would be 1:1 at the end of the year. The debt would consist only of the \$50,000 note because trade payables are excluded from the calculation of liabilities. The equity (\$50,000) would be the tax basis of assets (\$90,000) less the liabilities (\$80,000) plus the net operating loss (\$40,000).\textsuperscript{127} If the corporation could

\textsuperscript{120} See pp. 786-88 infra.
\textsuperscript{121} Treas. Reg. \$ 1.385-6(f)(1) (1980).
\textsuperscript{122} 45 Fed. Reg. 86,441 (1980).
\textsuperscript{123} Treas. Reg. \$ 1.385-6(f)(3) (1980).
\textsuperscript{124} See Treas. Reg. \$ 1.385-6(f)(4), -6(g), -6(h) (1980 & 1981).
\textsuperscript{125} Id. \$ 1.385-6(f)(4) (1980).
\textsuperscript{126} Id. \$ 1.385-6(g)(5)(ii).
\textsuperscript{127} See id. \$ 1.385-6(g)(5)(ii)(B).
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not have added back the net operating loss, it would have failed the safe harbor test because its inside debt-to-equity ratio would have been 5:1 ($50,000:$10,000).

The safe harbor ratios are calculated without regard to whether an interest in a corporation is stock or debt, except that preferred stock classified as debt will be treated as a liability. The regulations thereby penalize corporations that have had debt instruments classified as stock. For example, a corporation with $100,000 of stockholder equity issued to its shareholders $200,000 of notes, having a fair market value of $300,000, which were classified as stock. If the corporation later issues another $100,000 of notes to its shareholders, the inside debt-to-equity ratio would be 4:1 and not 1:4 because the $300,000 of reclassified notes are considered debt for the purpose of calculating the debt-to-equity ratio. Consequently, the corporation would fail the safe harbor test because the inside debt-to-equity ratio is greater than 3:1. This preference for debt is illogical because the express goal of the regulations is to classify interests in corporations as either debt or equity for all tax purposes. Therefore, if an instrument has been classified as stock, it is not logical to treat it as debt for the purpose of calculating the debt-to-equity ratio.

If a corporation cannot fulfill the requirements of the safe harbor, it has not automatically failed the excessive debt test. The taxpayer may show that the debt was not excessive by proving that a bank or other independent commercial lender would have lent money to a corporation in a similar financial condition under the instrument's terms. Therefore, corporations in highly leveraged industries, such as banks or other financial lending institutions, probably could show that their debt is not excessive, even if they do not fall within the safe harbor. In addition, if the fair market value of a corporation's assets exceeds the book value, the debt may be shown not to be excessive.

Special rules apply for calculating the debt-to-equity ratio of affiliated groups, lending institutions, cash-basis corporations, insurance

128. Id. § 1.385-6(g)(3)(ii).
129. See id. § 1.385-6(g)(4) (example 3) (1981).
130. See I.R.C. § 385(a), which provides, "The Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title [Internal Revenue Code] as stock or indebtedness."
132. Id. § 1.385-6(h). The debt-to-equity ratio of a corporation owning other affiliated corporations is determined by including a ratable share of the owned corporation's assets and liabilities with those of the holding corporation and by eliminating intercorporate investments and liabilities. Id.
133. Id. § 1.385-6(g)(5)(iii). For banks or lending institutions, the adjustments mandated by I.R.C. § 279(c)(5)(A) must be made. Treas. Reg. § 1.385-6(g)(5)(iii) (1980).
134. Id. § 1.385-6(g)(5)(i): In computing the debt-to-equity ratio for a corporation that uses a cash method of accounting, the face amount of trade ac-
companies,135 and corporations having floor plan inventory arrangements.136 The excessive debt test does not apply to instruments issued in exchange for obligations of equal or greater indebtedness.137 The Internal Revenue Service is to disregard temporary contributions to equity or other similar acts when it calculates the debt-to-equity ratio.138

b. Not-Issued-for-Money Test

Even if the issuing corporation’s debt is not excessive, proportionately held instruments not issued for money will be treated as stock if they do not bear a reasonable rate of interest when issued.139 This is the Treasury Department’s method of forcing corporations to pay a reasonable rate of interest to shareholders. The requirement only applies to instruments that are not issued for money or other property, such as marketable securities, which would generate an amortizable bond premium or discount. In these situations, the Treasury Department may impose a reasonable rate of interest under the original issue discount or premium provisions of the Internal Revenue Code.140 The rule also does not apply to debt issued for an equal or greater amount of existing debt if an independent creditor would have agreed to the exchange.141

A reasonable rate of interest is defined as one within the normal range of rates paid to independent creditors on similar instruments by similar debtors.142 For guidance, corporations can look to rates they are paying to outside lenders, including rates paid on guaranteed loans.143 Such indicators, however, may be of little assistance to a newly formed corporation that lacks a borrowing history. The lowest reasonable rate probably would be the rate paid on federal obligations. An additional complication in determining a reasonable rate of interest exists because the regulations allow the Commissioner to disregard what it views as noncommercial terms.144

counts receivable, less an appropriate reserve for uncollectable receivables, is used as the adjusted basis of the trade accounts receivable. Id.

135. Id. § 1.385-6(g)(5)(iv). Insurance reserves are treated in the same manner as trade accounts payable to determine the debt-to-equity ratio for insurance companies. Id.

136. Id. § 1.385-6(g)(5)(v). The debt-to-equity ratio is determined by treating a liability in the same manner as a trade account payable if the liability is incurred under a commercial floor plan financing agreement for the purchase of an item, is secured by that item, and is due on or before sale of the item. Id.

137. Id. § 1.385-6(f)(5).

138. Id. § 1.385-6(g)(5)(vi).

139. Id. § 1.385-6(d)(1) to (2).


142. Id. § 1.385-6(e)(1).

143. Id. § 1.385-6(e)(5) (example 1).

144. Id. §§ 1.385-3(b)(1)(iii), -6(e)(6).
The regulations contain a safe harbor interest rate for instruments other than those evidencing nonrecourse debt. An interest rate is reasonable if
(a) at the end of the taxable year, the debt-to-equity ratio of the corporation is not greater than 1:1, and
(b) when the instrument is issued, the interest rate is equal to or between any two of the following:
(1) the rate the Internal Revenue Service charges under section 6621,
(2) the prime rate charged by a local commercial bank, or
(3) a rate based on the interest paid on federal obligations, which rate will be published periodically in revenue procedures.

Generally, these rates will be lower than the rates a small corporation would pay to an independent creditor.

Few corporations will be able to meet the requirements of this safe harbor, however, because many corporations will not be able to meet the 1:1 debt-to-equity test. The Treasury Department apparently included this test because it felt that only well-capitalized companies would pay such low rates. Although a corporation's inability to meet the safe harbor requirements does not mean that the instrument will be treated as stock, it places the burden on the corporation to show that an independent creditor would have charged the rate on the instrument.

The reasonable rate of interest test will be very important because many instruments are issued for consideration other than money. The situation usually arises when a corporation is formed or stock is redeemed. In these situations, shareholders should be certain that a reasonable rate is charged.

c. Payable on Demand Test

Instruments payable on demand that are held in proportion to stock holdings will be classified as stock if, immediately after they are issued, the stated interest rate is not reasonable. An interest rate is reasonable if it meets the criteria discussed under the not-issued-for-money test.

The requirement that a shareholder give adequate consideration for an instrument and the tests imposed on demand instruments and advances not evidenced by a writing will eliminate interest-free loans from shareholders to corporations, unless those loans fall within the exceptions contained in the regulations. The exception for demand instruments

145. Id. § 1.385-6(e)(2). Id. § 1.385-6(e)(3) specifically excludes nonrecourse debt instruments from the safe harbor.
146. Id. § 1.385-6(e)(2).
147. Id. § 1.385-6(e)(1).
148. Id. § 1.385-6(1)(1).
149. Id. § 1.385-6(1)(iii). See notes 139-47 and accompanying text supra.
150. Id. § 1.385-6(1)(4).
provides that the payable on demand test is not applied to demand instruments if they are retired within six months after the day they were issued, provided that the sum of the retired demand instruments plus the balance of all loans not evidenced by a writing does not exceed $25,000 on the day of issue. \(^{151}\)

**B. Reclassification of Proportionately Held Debt Instruments**

Proportionately held instruments that were classified as debt when they were issued may be reclassified as stock under the circumstances discussed below. If an instrument is reclassified as stock, the instrument is treated as having been exchanged in a tax-free recapitalization for preferred stock. \(^{152}\) Although a debt instrument may be reclassified as stock, once an instrument has been classified as stock, it cannot be reclassified as debt. \(^{153}\)

1. **Substantial Change in Terms**

If there is a substantial change in the terms of a debt instrument and the instrument is held proportionately to stock on the day the issuer and the holder agree to the change, the instrument is treated as a new issue on the day of the agreement. \(^{154}\) Thus, the instrument will undergo the same tests that applied when it was issued. \(^{155}\) A substantial change is any change that could materially affect the fair market value of the instrument. \(^{156}\) Thus, an agreement to postpone the maturity date, subordinate the debt, or change the interest rate is usually a substantial change, while a substitution of collateral or a prepayment would not be substantial. \(^{157}\)

Shareholders may be able to rely on certain exemptions that are not available for instruments issued for money or property. For example, the excessive debt test does not apply to debt issued in exchange for an equal or greater amount of existing debt. \(^{158}\) By characterizing the change in the terms of an existing instrument as the issuance of a new instrument, the excessive debt test can be avoided.

2. **Failure to Pay Interest**

Even if there has been no substantial change in terms, if a shareholder fails to exercise the ordinary diligence of an independent creditor when a corporation fails to pay interest and if the instrument is held proportionately on the last day of the taxable year, the instrument will be

\(^{151}\) *Id.* § 1.385-6(1)(4)(i).

\(^{152}\) *Id.* § 1.385-4(c)(1)(ii).

\(^{153}\) *Id.* §§ 1.385-4(b)(1), -6(j) to -6(1) (by implication).

\(^{154}\) *Id.* § 1.385-6(j).

\(^{155}\) *See* pp. 781-86 *supra*.

\(^{156}\) Treas. Reg. § 1.385-6(j)(2) (1980).

\(^{157}\) *Id*.

\(^{158}\) *Id.* § 1.385-6(f)(5).
reclassified as stock. The instrument will be treated as stock beginning the first day of the taxable year during which nonpayment occurred or the first day the instrument became proportionately held, whichever is later. The rationale is that a shareholder is not hurt by his failure to receive interest because the retention of that cash by the corporation will increase the value of the shareholder's stock. A corporation will be deemed to have paid interest if it makes payment with money or property within ninety days after the end of the year.

The regulations require only that a shareholder act as an independent creditor. If an independent creditor would not sue to recover the interest, a shareholder is not required to do so. Because the independent creditor standard is vague, shareholders may become overly conservative to avoid reclassification of the instrument as stock.

3. Demand Instruments and Failure to Pay Principal

Demand instruments held in proportion to stock holdings also will be reclassified as stock if the rate of interest actually paid is not reasonable. If reclassified, the instrument will be treated as stock from the beginning of the taxable year. To avoid reclassification, the corporation only has to prove that the interest rate paid was reasonable as of any day of the taxable year. For example, the test is met if a corporation pays interest at a rate of ten percent on its demand notes and if, on any day of the taxable year, the market rate for similar loans is ten percent. Presumably, if the market rate was ten percent in January, a corporation safely could issue ten percent notes in May, even though the market rates for that month and the remainder of the year ultimately may remain above ten percent. The corporation would have to adjust the interest rate in subsequent years to prevent the instrument from being reclassified as stock, unless interest rates decline to ten percent. If a corporation fails to pay any interest, however, the reasonable interest test is not applied. Instead, the nonpayment of interest test described above is applied.

An instrument is treated as payable on demand if the issuing corporation fails to make a payment of principal within ninety days after it is due and the holder fails to exercise the ordinary diligence of an independent creditor. The instrument is deemed to have become payable on demand.

159. Id. § 1.385-6(k)(1).
160. Id. § 1.385-6(k)(3).
161. Id. § 1.385-6(k)(1)(iii).
162. Id. § 1.385-6(1)(2).
163. Id. § 1.385-6(1)(2)(iii).
164. Id.
165. See id. § 1.385-6(1)(5) (example 3).
166. Id. § 1.385-6(1)(4)(ii). See pp. 786-87 supra.
the day after the payment was due.\textsuperscript{168} The practical effect of these re-
requirements is that corporations which fail to make a principal payment may have to adjust the interest rate in every subsequent year to assure that the instrument will not be reclassified as stock. An alternative would be to issue new debt instruments in exchange for the instruments in default.

Although the regulations do not discuss installment obligations, an install-
ment obligation might become payable on demand the first time the corporation fails to make an installment payment of principal. For example, the monthly payment for a ten year, twelve percent, $10,000 installment note is $143.47. The first payment consists of $100.00 of interest and $43.47 of principal. If the corporation pays only the interest portion, the instrument could be characterized as a demand instrument. Thus, unless the interest rate is adjusted each year to match market conditions, the instrument could be reclassified as stock and each installment payment, consisting of both principal and interest, could be treated as a dividend.\textsuperscript{169} The resulting conversion of principal and interest payments into dividend income for failure to make a $43.47 installment payment of principal is unreasonable, and the Internal Revenue Service should clarify the effect of the regulations on installment obligations.

\section*{VI. OTHER INTERESTS IN CORPORATIONS COVERED BY THE REGULATIONS}

\subsection*{A. Loans Not Evidenced by an Instrument}

Loans not made by independent creditors and not evidenced by instru-
ments may be treated as stock if the issuing corporation’s debt was ex-
cessive when the loan was made or if the corporation failed to pay a reasonable rate of interest.\textsuperscript{170} Such loans include unwritten advances and loans with terms that are in writing but not in an instrument, \textit{e.g.}, terms contained in a board of directors resolution or in an accounting entry.\textsuperscript{171} If, however, an instrument is issued within six months of the loan, this special rule will not apply.\textsuperscript{172} In addition, a loan will not be reclassified if it is repaid within six months, but only to the extent that the outstanding balance of the loan, reduced by prior qualifying loans, does not exceed $25,000.\textsuperscript{173}

Failure to pay a reasonable rate of interest will cause the loan to be reclassified as stock as of the first day of the taxable year or the day of the loan, whichever is later. A reasonable rate of interest is one that is

\begin{itemize}
\item \textsuperscript{168} Id.
\item \textsuperscript{169} See p. 766 \textit{supra}.
\item \textsuperscript{170} Treas. Reg. \textsection 1.385-7 (1980).
\item \textsuperscript{171} 45 Fed. Reg. 86,443-44 (1980).
\item \textsuperscript{172} Treas. Reg. \textsection 1.385-7(a)(1)(ii) (1980).
\item \textsuperscript{173} Id. \textsection 1.385-7(a)(2).
\end{itemize}
reasonable on any day of the taxable year.\textsuperscript{174} The test is met if, for example, interest was paid at a rate of eight percent and on any day of the taxable year the market rate for similar loans was eight percent.

If advances remain unpaid at the end of a year, the corporation should promptly pay the prior year's interest and should adjust the interest rate to reflect market rates in the subsequent year. The corporation must pay interest within ninety days after the end of the year, or it will be deemed to have paid no interest.\textsuperscript{175}

B. Preferred Stock

Although preferred stock usually will be treated as stock, it may be classified as a debt instrument if it provides for fixed payments of principal and interest.\textsuperscript{176} The most common example of this is sinking fund preferred stock. This type of preferred stock will be classified as debt, unless it qualifies as stock under the tests imposed on instruments. Notwithstanding this general rule, the regulations contain an administrative rule of convenience to assure that preferred stock will be treated as stock.\textsuperscript{177}

C. Guaranteed Loans

The regulations state that the case law continues to apply to guaranteed loans, whether or not evidenced by an instrument.\textsuperscript{178} Thus, if a shareholder guarantees a corporate loan and, under the relevant legal principles, the loan is treated as having been made to the shareholder, the shareholder is treated as having made a capital contribution to the corporation.\textsuperscript{179} This situation can result in disastrous tax consequences when the corporation repays the interest and principal on the loan because each payment will be taxed as a dividend under section 301.\textsuperscript{180}

A guaranteed loan may be treated as a capital contribution by the guarantor if, at the time the obligation was created, the corporation reasonably could not have been expected to repay it. This usually occurs if

\begin{itemize}
  \item \textsuperscript{174} See note 82 and accompanying text supra.
  \item \textsuperscript{175} Treas. Reg. § 1.385-7(c)(2) (1980).
  \item \textsuperscript{176} Id. § 1.385-10(a).
  \item \textsuperscript{177} Id. § 1.385-10(b). The rule of convenience provides that preferred stock will be treated as stock if (1) the preferred stock is labeled "preferred stock" and treated as such under nontax law, (2) the redemption price is reasonable, (3) current dividends are contingent, (4) a shareholder does not have a right to receive redemption payments if such payments would impair the corporation's capital or would render the corporation insolvent, (5) a shareholder cannot accelerate redemption payments if the corporation defaults in paying dividends or redemption proceeds, and (6) the preferred stock has a term of at least 10 years. Id. See id. § 1.385-5(e) (example 13) (preferred stock treated as debt).
  \item \textsuperscript{178} Id. § 1.385-9(a)(2).
  \item \textsuperscript{179} Id. § 1.385-9(a).
  \item \textsuperscript{180} See p. 766 supra.
\end{itemize}
the corporation is severely undercapitalized. Thus, the determination depends on the facts and circumstances of each case. The Internal Revenue Service has not always succeeded in asserting that a guaranteed loan is, in fact, a capital contribution.\textsuperscript{181}

VII. CONCLUSION

The general rule is that a debt instrument will be classified as debt, but it can be classified as stock in the following situations:

(1) it is a hybrid instrument, and the equity feature is worth more than fifty percent of the value of the entire instrument,

(2) it is a hybrid instrument held proportionately by stockholders,

(3) it is a straight debt instrument held proportionately by stockholders, and the corporation's debt was excessive when the instrument was issued,

(4) it is a straight debt instrument held proportionately by stockholders, not issued for money, and not bearing a reasonable interest rate,

(5) it is a straight debt instrument held proportionately by stockholders, payable on demand as defined by the regulations, and not stating or paying a reasonable rate of interest, or

(6) at a time when the instrument is held proportionately, there is

(a) a substantial change in the terms of the instrument, and at that time, one or more of the last four tests is not met, or

(b) a failure to act with the diligence of an ordinary creditor on a default of interest.

Shareholders who intend to form a new corporation or otherwise lend in proportion to their stock ownership can be assured that the straight debt instruments they receive will be classified as debt at the time the instruments are issued if they have fixed maturity dates and if

(1) the instruments are issued for money, the outside debt-to-equity ratio at the end of the taxable year is less than or equal to 10:1, and the inside debt-to-equity ratio is less than or equal to 3:1,

(2) the instruments are not issued for money, and

\textsuperscript{181} The regulations cite a case in which the I.R.S. was victorious: Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir.) (characterization of instrument as stock based on, \textit{inter alia}, "thin capitalization" with current "quick" assets insufficient to meet current liabilities and use of proceeds to purchase capital assets, despite timely payments on instruments), \textit{cert. denied}, 409 U.S. 1076 (1972). The IRS also won a case involving a bad debt deduction where loans were guaranteed at a time the corporation had a healthy debt-to-equity ratio. \textit{See} Kavich v. United States, 81-1 U.S.T.C. 85,562 (CCH) (D. Neb. Feb. 13, 1981). Guaranteed loans were held to be debt, however, in Murphy Logging Co. v. United States, 378 F.2d 222 (9th Cir. 1967); Smyers v. Commissioner, 57 T.C. 189 (1971); Santa Anita Consol., Inc. v. Commissioner, 50 T.C. 536 (1968).
(a) on the day the instruments are issued they state a rate of interest that is within the normal range paid to independent creditors on similar instruments issued by the corporation or by corporations in similar financial condition, and

(b) the debt-to-equity ratios in the preceding subparagraph are met, or

(3) the instruments are not issued for money, and

(a) when the instruments are issued, the interest rate is equal to or between any two of the following:

(i) the rate the Internal Revenue Service charges under section 6621,

(ii) the prime rate charged by a local commercial bank, or

(iii) a rate based on the interest paid on federal obligations, which rate will be published periodically in revenue procedures, and

(b) at the end of the taxable year the debt-to-equity ratio of the corporation is not greater than 1:1.

For the instruments to retain their classification as debt, the corporation should pay principal and interest when due, and there should not be any material change in the terms of the instruments, unless the excessive debt test, the not-issued-for-money test, and the payable on demand test are met at the time of the change. Although instruments issued for money are not subject to the reasonable interest test, if the stated interest rate is unreasonably high or low, the Internal Revenue Service can treat the difference between the value of the instruments and the amounts paid for them as either a capital contribution or a distribution. Those provisions deal only with the character of the difference in value and will not affect the classification of the instruments as debt or equity.

These regulations are "legislative regulations" because Congress specifically authorized the Treasury Department to promulgate them. Thus, they have the force of law and can be challenged only on the grounds that they are unreasonable or unconstitutional. The regulations lend certainty to the determination of whether an interest in a corporation is stock or debt for tax purposes. Some of the more crucial factors remain vague, however, such as the definitions of "substantially proportionate" and "independent creditor." In the future, more will be learned about the Internal Revenue Service's position through public and private letter rulings. Until then, the tax advisor must rely on the general terms contained in the regulations.


VIII. GLOSSARY

(All references are to Treasury Regulation Section 1.385-)

<table>
<thead>
<tr>
<th>Term</th>
<th>Section</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contingent payment</td>
<td>5(d)(1)</td>
<td>A contingent payment is any payment other than a fixed payment of principal or interest.</td>
</tr>
<tr>
<td>Debt-to-equity ratio</td>
<td>6(g)</td>
<td>The “outside” debt-to-equity ratio is the ratio of a corporation’s liabilities (excluding trade accounts payable, accrued operating expenses, and taxes) to stockholders’ equity (calculated from the tax basis of assets).</td>
</tr>
<tr>
<td>Definitely ascertainable</td>
<td>5(d)(4)</td>
<td>An interest rate is definitely ascertainable if it (1) is applied to a definitely ascertainable principal sum, and (2) is an invariable rate or is a variable rate determined according to an external standard not subject to the borrower’s control or related to his financial success or failure. A principal sum is definitely ascertainable if it is an invariable sum or is a variable sum determined according to an external standard similar to the interest rate standard.</td>
</tr>
<tr>
<td>interest rate or principal</td>
<td>6(f)(4)</td>
<td>The “inside” debt-to-equity ratio is determined in the same manner, but excludes from liabilities amounts owed to independent creditors.</td>
</tr>
<tr>
<td>sum</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity features</td>
<td>5(b)</td>
<td>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.</td>
</tr>
<tr>
<td>Excessive debt</td>
<td>6(f)(2)</td>
<td>A corporation’s debt is excessive if, at the time an instrument is issued, the instrument’s terms and conditions and the corporation’s financial structure would not be satisfactory to a lending institution that makes ordinary commercial loans. Instruments issued</td>
</tr>
<tr>
<td>Category</td>
<td>Paragraph</td>
<td>Description</td>
</tr>
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<td>--------------------------------</td>
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</tr>
<tr>
<td>Failure to pay interest</td>
<td>6(f)(3)</td>
<td>There is a safe harbor, however. Debt is not excessive if at the end of the taxable year the outside debt-to-equity ratio is less than or equal to 10:1 and the inside debt-to-equity ratio is less than or equal to 3:1.</td>
</tr>
<tr>
<td>Failure to pay principal</td>
<td>6(k)(3)</td>
<td>A corporation fails to pay interest during a taxable year if the interest is not paid, in money or property, within ninety days after the end of the year.</td>
</tr>
<tr>
<td>Failure to pay principal</td>
<td>6(1)(3)</td>
<td>A corporation fails to pay principal if it fails to make a scheduled payment within ninety days after the payment is due. If the holder of the instrument fails to exercise the ordinary diligence of an independent creditor, the instrument is considered to be payable on demand.</td>
</tr>
<tr>
<td>Fair market value</td>
<td>3(b)(1)</td>
<td>The fair market value of an instrument is the price at which it would change hands between a willing buyer and a willing seller. It may be determined by using present value and standard bond tables.</td>
</tr>
<tr>
<td>Fixed payments</td>
<td>5(d)(2)</td>
<td>A payment of interest is fixed if (1) it is due on a definitely ascertainable date at a definitely ascertainable rate, and (2) the holder's right to receive it when due (or within ninety days thereafter) cannot be impaired without the holder's consent.</td>
</tr>
<tr>
<td>Fixed payments</td>
<td>5(d)(3)</td>
<td>A payment of principal is fixed if (1) a definitely ascertainable principal sum is payable on demand or due on a definitely ascertainable date, and (2) the holder's right to receive principal when due cannot be impaired without the holder's consent.</td>
</tr>
</tbody>
</table>
Hybrid instrument

A hybrid instrument is an instrument that is convertible into stock or provides for any contingent payment other than a call premium.

Independent creditor

All relevant facts and circumstances must be taken into account in determining whether a creditor is independent. The regulations provide a safe harbor: a creditor is deemed to be independent if (1) his actual and constructive stock ownership in the corporation is less than 5%, and (2) his holdings of stock and instruments issued by the corporation are not substantially proportionate.

Instrument

An instrument is any bond, note, debenture, or similar written evidence of an obligation.

Nonpayment of interest or principal

An obligation is an interest in a corporation that is treated as indebtedness under applicable non-tax law.

Not issued for money

See “Failure to pay.”

Payable on demand

An instrument not issued for money is an instrument not-issued for money or such other property that would generate an original issue discount under section 1232(a)(3) of the Internal Revenue Code or an amortizable bond premium under Treasury Regulation section 1.61-12(c)(2). Such an instrument will be classified as stock if it is held proportionately to stock and does not state a reasonable rate of interest on the day it is issued.

An instrument is payable on demand if (1) by its terms, it is payable on demand, or (2) the issuing corporation failed to make a
scheduled payment of principal within ninety days after the payment was due and the holder failed to exercise the ordinary diligence of an independent creditor. If a corporation fails to state or pay interest at a reasonable rate, the demand instrument will be characterized as stock if it is held proportionately to stock.

An interest rate is reasonable if it is within the normal range of rates paid to independent creditors on similar instruments by corporations of the same general size and in the same general industry, geographic location, and financial condition. An interest rate is considered to be reasonable if (1) at the end of the taxable year the debt-to-equity ratio of the corporation is not greater than 1:1, and (2) on the determination date, the interest rate is equal to or between any two of the following: (a) the rate in effect under section 6621 of the Internal Revenue Code, (b) the prime rate in effect at any local commercial bank, or (c) a rate based on the interest paid on federal obligations, which rate will be published periodically in revenue procedures.

A straight debt instrument is any instrument other than a hybrid instrument.

All relevent facts and circumstances, including family or other relationships described in section 318(a) of the Internal Revenue Code, must be taken into account in determining whether holdings of instruments and stock are substantially proportionate. Stock
Substantial change in terms

6(j)(2) A change in terms is substantial if the fair market value of the instrument could be affected materially by the change. Such changes include a postponement of the maturity date, a change in the interest rate, or subordination.