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THE PHILOSOPHY UNDERLYING SECTION 385 REGULATIONS: A CRITICAL EVALUATION

Jesse V. Boyles III*

In the Tax Reform Act of 19691 Congress expressed concern regarding the economic and social consequences of the increase in corporate mergers and the frequent use of debt in corporate acquisitions.2 Since such activity was encouraged, in part, by the favorable tax consequences accorded debt as opposed to stock,3 the House enacted section 279 of the Internal Revenue Code.4 In general, this provision disallows a corporate interest deduction with respect to certain types of indebtedness issued in conjunction with corporate acquisitions.5 Thus, section 279 resolves the question of whether interest payments are deductible as interest in the limited context of corporate acquisitions. The Senate, in addition to adopting section 279, appreciated the necessity of providing rules for distinguishing debt from equity in situations other than corporate acquisitions.6 It was acknowledged, however, that the variety of contexts where this distinction mattered made it too difficult to enact comprehensive and specific statutory rules.7 Therefore, section 385 was enacted to authorize the Secretary of the Treasury to prescribe appropriate regulations to determine whether an interest in a corporation is to be treated, for all taxation purposes, as stock or indebtedness.8 Congressional intent was that the regulations set forth factors to determine the existence of either a debtor-creditor or a corporation-share-
DEBT-EQUITY CLASSIFICATION

holder relationship. More than ten years after the enactment of section 385 the Secretary issued proposed regulations, and on December 29, 1980, the Secretary issued final regulations under this Code provision. However, due to the controversial nature of these regulations, the Secretary extended the original deadline for application of these regulations from May 1, 1981, until January 1, 1982, in order to provide more time for the public to understand these regulations and for the Secretary to consider their effectiveness. Then, on January 5, 1982, the Secretary proposed changes in these regulations and extended the deadline for application until June 30, 1982.

In light of the problems encountered in drafting and implementing these regulations, it seems appropriate to question the propriety of the Secretary's philosophical approach to this very difficult area. This Article will identify and evaluate the theoretical justifications for the specific rules contained within the regulations distinguishing debt from equity. This Article is concerned with identifying and evaluating the appropriateness of the theoretical concepts upon which the Secretary's regulatory rules are based without addressing the mechanics of the

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The classification of an interest as stock or indebtedness is significant to the corporation because of the resulting tax consequences. A debt arrangement allows the corporation to deduct all interest paid, whereas under an equity arrangement, no deduction is allowed for distributed dividends.\(^{16}\) Properly structured debt permits the shareholder in a closely-held corporation to withdraw capital either tax-free or at favorable, long-term capital gain tax rates rather than as ordinary dividend income.\(^{17}\) Although in some cases, debt does not create any tax advantage over stock if the investment becomes worthless, there are some situations in which debt losses are treated more favorably than equity losses.\(^{18}\) The classification of an interest in a corporation as stock or indebtedness may be significant when a corporation attempts to qualify for subchapter S treatment.\(^{19}\) The tax status accorded the various interests in a liquidated subsidiary will determine whether that entity is insolvent. This determination can vitally affect the tax results associated with the liquidation transaction.\(^{20}\) These examples illustrate the significance of the debt-equity classification to businessmen and tax practitioners.\(^{21}\)

I. IDENTIFICATION OF THE UNDERLYING PHILOSOPHICAL APPROACH

An early case distinguished a shareholder from a creditor as follows: "The shareholder is an adventurer in the corporate business; he takes the risk, and profits from success. The creditor, in compensation for not sharing the profits, is to be paid independently of the risk of success, and gets a right to dip into the capital when the payment date arrives."\(^{22}\) Debt is "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in..."
interest payable regardless of the debtor's income or lack thereof. 23

Courts generally treat the debt-equity classification issue as a fact question, analyzing all of the relevant facts and circumstances associated with the creation of a particular interest in order to reach an informed conclusion regarding whether a shareholder or a creditor relationship was established based upon a theoretical distinction between the two relationships. 24

Early cases indicate that courts distinguished debt from equity by construing the documents associated with the transaction or, if there were no documents, by examining the corporation's accounting entries. 25 The formal rights and remedies of creditors, as distinguished from those available to stockholders, include the following evidentiary factors: A fixed maturity date within a reasonable time from the creation of the interest; 26 specifically stated remedies for default; 27 subordination of the particular interest in question relative to other interests in the corporation; 28 certainty of payment to the interest holder; 29 absence of interest or interest at a nominal rate; 30 terms allowing the holder of the interest to participate in the success of the venture; 31 provisions indicating that the holder of an interest is participating in both the success and the failure of the venture; 32 participation in management of the venture; 33 language used in the documents; 34 rights upon dissolution of the venture; 35 and rights to modify the terms of the documents. 36

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24. See supra notes 22-23 and accompanying text.
25. Plumb, supra note 14, at 405-06.
26. Id. at 413-20.
27. Id. at 420-21.
28. Id. at 421-30.
29. Id. at 430-32.
30. Id. at 432-34.
31. Id. at 434-41.
32. Id. at 442-47.
33. Id. at 447-50.
34. Id. at 450-57.
It soon became apparent that the limitations upon the rights of creditors, which must be carefully spelled out in instruments involving outside investors, may exist as tacit understandings when common shareholders or closely related parties themselves apply funds. Thus, in these situations courts must look beyond the terms contained within the relevant documents to ascertain whether a particular investment "constitutes risk capital entirely subject to the fortunes of the corporate venture, or represents a strict debtor-creditor relationship." Specifically, courts consider evidence relating to the intention of the parties to create a debtor-creditor relationship. Factors indicating this intent include the following: Writings specifying the rights and remedies of the investor; declarations of the parties; security interests placing the investor in a position superior to general creditors; the presence of a sinking fund, or some other similar device to provide for the ultimate retirement of the debt; debt holdings of shareholders in substantially the same proportions as their holdings of corporate stock; guarantees made by shareholders; payment history of the interest; failure to enforce the terms of an instrument in default; voluntary subordination to other creditors; the results of a change of ownership; an ascertainable principal amount; package financing consisting of debt and equity with free transferability of the various components; timing of the creation of the particular interest; and, the effect of the particular interest in providing additional resources to the corporation.

38. Fin Hay Realty Co. v. United States, 398 F.2d 694, 697 (3d Cir. 1968).
39. Plumb, supra note 14, at 461-64.
40. Id. at 465-66.
41. Id. at 466-70.
42. Id. at 470-82.
43. Id. at 482-90.
44. Id. at 490-92.
45. Id. at 493-96.
46. Id. at 497-99.
47. Id. at 500-503.
51. Sayles Finishing Plants, Inc. v. United States, 399 F.2d 214, 218 (Cl. Cl. 1968); see also
Additionally, courts consider evidence regarding economic risk.\textsuperscript{52} Business or economic risk may prevent judicial recognition of debt even when an analysis of the facts and circumstances reveals unambiguous intentions of the parties to create a debt. Evidentiary factors concerning business risk include the following: Subordination of the particular interest to other corporate interests;\textsuperscript{53} protection of the interest by adequate security;\textsuperscript{54} proportionate holdings of the particular interest by the shareholders in substantially the same proportion as stock holdings;\textsuperscript{55} payment history of the interest;\textsuperscript{56} thin or inadequate capitalization;\textsuperscript{57} corporate use of the advanced funds;\textsuperscript{58} expected source of the principal and interest;\textsuperscript{59} probability of a loan on similar terms by an independent creditor;\textsuperscript{60} and the survival prospects of the corporation.\textsuperscript{61}

This procedure concentrates upon evidence regarding the terms in the documents, the actions of the parties to the transaction, and the risk of the business, to ascertain whether the investor can collect, regardless of the success of the venture. However, this procedure is virtually impossible to apply in a logical sense because any investment involves some risk of loss, and its subsequent recoupment is thus dependent, to some extent upon the success of the venture. Essentially, there are high-risk equity investment possibilities as well as conservative equity investment possibilities. Similarly, there are conservative, relatively safe loans as well as risky loans. Furthermore, some investors are willing to accept a greater amount of risk for a greater potential return, while others are not. Therefore, the distinction between risk capital and a risky loan is an elusive categorization.\textsuperscript{62} One judicial opinion

\textsuperscript{52} Is the risk the type of risk that a reasonable and prudent creditor would take or is it more in the nature of a risk which would be associated with a stockholder? See generally Gilbert v. Commissioner, 248 F.2d 399, 407 (2d Cir. 1957).

\textsuperscript{53} Plumb, \textit{supra} note 14, at 506.

\textsuperscript{54} \textit{Id.}

\textsuperscript{55} \textit{Id.}

\textsuperscript{56} \textit{Id.}

\textsuperscript{57} \textit{Id.} at 507-19.

\textsuperscript{58} \textit{Id.} at 520-25.

\textsuperscript{59} \textit{Id.} at 526-29.

\textsuperscript{60} \textit{Id.} at 530-35.

\textsuperscript{61} \textit{Id.} at 535-37.

\textsuperscript{62} In Slappey Drive Indus. Park v. United States, 561 F.2d 572, 581 (5th Cir. 1977) the court observed: "Generally, shareholders place their money 'at the risk of the business' while lenders seek a more reliable return." This statement of course, glosses over a good many considerations with which even the most inexperienced investor is usually familiar. For example, a purchase of General Motors stock may bear less risk than a bona fide loan to a small corporation. Therefore,
concluded, "It does not help in the solution of the problem to speak of the man who invests in stock of a corporation as the one who takes the risks and the creditor as the one who seeks a definite obligation payable in any event." 63

It is possible to argue that the difference between a shareholder and a creditor lies in the nature 64 and degree 65 of the risk assumed. 66 If this is the case, it seems clear that each situation involving the debt-equity issue must be resolved on the basis of its own unique set of facts. A great deal of confusion results if one specific fact is examined out of context. For example, in one case the court observed a 692:1 ratio and still determined that a particular interest was debt; 67 yet in another case the court observed a 1:1 ratio and determined that a particular interest was equity. 68 It follows that courts, in deciding particular cases, have not been able to establish objective guidelines with respect to specific evidentiary factors. 69 As a result of this situation, commentators seeking to identify objective standards in this field by analyzing judicial

the amount of risk in an advance to a corporation is never determinative of whether the advance is a contribution to capital or a bona fide loan.


64. Concerning the question whether it is the creditor's risk that the business will become insolvent and ultimately fail or will alternately prosper and endure, see generally, e.g., Sherwood Memorial Gardens, Inc. v. Commissioner, 42 T.C. 211, 229 n.10 (1964), aff'd, 350 F.2d 225 (7th Cir. 1965).

65. If the interest is to be considered a debt there must be a reasonable expectation of repayment regardless of the success of the venture. See Santa Anita Consol., Inc. v. Commissioner, 50 T.C. 356, 352 (1968).


68. Gooding Amusement Co. v. Commissioner, 23 T.C. 408, 419 (1954), aff'd, 236 F.2d 159 (6th Cir. 1956), cert. denied, 352 U.S. 1031 (1957); see Caplin, supra note 37, at 784-88 (outlining the Gooding case).

69. One court has described the decisions as "defying symmetry." Tyler v. Tomlinson, 414 F.2d 844, 847 (5th Cir. 1969); see Plumb, supra note 14, at 407-08. The drafters of the regulations also acknowledge this point. Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,958 (1980); see also United States v. Uneco, Inc., 532 F.2d 1204, 1207 (8th Cir. 1976) (a court may apply various relevant factors to one case but not to another); Gooding Amusement Co. v. Commissioner, 236 F.2d 159, 165 (6th Cir. 1956), cert. denied, 352 U.S. 1031 (1957) (each case is to be determined on its own set of facts). Perhaps the most famous judicial reaction to the task of distinguishing debt from equity is found in Sansberry v. United States, 70-1 U.S. Tax Cas. (CCH) ¶ 9216 n.4 (S.C. Ind. 1970), in which Judge Dillin cites the definition of pornography by Justice Stewart: "[P]erhaps I could never succeed in intelligibly defining it. But I know it when I see it. . . . . ." Id. at 82,862 (citing Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (Stewart, J., concurring); see also Note, Toward New Modes of Tax Decisionmaking—The Debt-Equity Imbroglio and Dislocations in Tax Lawmaking Responsibility, 83 HARV. L. REV. 1695, 1705-07 (1970) (Without legislative guidance, courts would never arrive at an absolute solution to debt-equity issue because there exists no overriding policy or principle to guide their decisions.).
decisions have tended to conclude that such standards do not exist. 70

A review of the regulations discloses that the Secretary has attempted to distinguish between capital and debt by utilizing a philosophical approach which may be described as "substantial conformity with economic reality" or "conformity with arm's length standards." 71

In fact, there are twelve classification provisions, 72 ten of which classify the interest based upon the parties' conformity to arm's length standards. 73 This theoretical approach is probably derived from the judicial concept of substance over form. 74 Many courts have held that application of substance over form to the debt-equity controversy requires an inquiry concerning the conformity of the stated classification to substantial economic reality. 75

When the lenders are also the shareholders of a closely-held corporation, application of the doctrine of substance over form may be particularly appropriate. One appellate court has commented:

In a corporation which has numerous shareholders with varying interests, the arm's length relationship between the corporation and a shareholder who supplies funds to it inevitably results in a transaction whose form mirrors its substance. When the corporation is closely held, however, and the same persons occupy both sides of the bargaining table, form does not necessarily correspond to the intrinsic economic nature of

70. See Dixon, supra note 14, at 1267-68; Plumb, supra note 14, at 407-10; see also, Note supra note 69, at 1703-07.
71. Supplementary Information to Proposed Regulations, supra note 69, at 18,958; see Supplementary Information to Proposed Regulations, infra note 78, at 169.
72. See Treas. Reg. § 1.385 (1982). The regulations contain both "operational" and "classification" provisions. As used in this Article, the term "operational provision" will encompass any test or rule employed by a classification provision. "Classification provision" will mean any provision which actually classifies a specific interest as debt or equity.
73. Six of the ten provisions deal with the creation of arm's length terms by the parties. See Treas. Reg. § 1.385-5(a), -6(c), -6(e), -6(g), -6(m)(1), -7 (1982). The other four deal with the arm's length enforcement of an instrument's terms. See id. § 1.385-6(1), -6(m)(2), -6(m)(3), -6(k). The other two provisions do not appear to involve arm's length relationships. See id. § 1.385-6(d), -8(a).
74. Gregory v. Helvering, 293 U.S. 465, 469-70 (1935), explaining:
The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and deprive the statutory provision in question of all serious purpose.
Id. at 470.
the transaction, for the parties may mold it at their will with no countervailing pull.\textsuperscript{76}

Therefore, when instruments are issued to shareholders of a closely-held corporation, the proper inquiry is whether a disinterested lender would have advanced funds on terms similar to those agreed upon by shareholders.\textsuperscript{77} The Secretary states that the regulations impact primarily upon small, closely-held corporations.\textsuperscript{78} The obvious inference from this statement is that conformity with economic reality is the appropriate theoretical standard to be applied in these regulations.

\section*{II. FACTORS TO CONSIDER IN EVALUATING THE ARM'S LENGTH STANDARD}

The drafters of the regulations intend the debt-equity provisions to provide both flexibility and certainty.\textsuperscript{79} Existing case law in the area produced a high degree of flexibility with very little certainty.\textsuperscript{80} Therefore, a proper evaluation of the Secretary's philosophical approach to the debt-equity question necessitates an inquiry regarding whether greater certainty has been provided by the imposition of the arm's length standard, while sufficient flexibility has been retained for the regulations to be responsive to "real world" investment circumstances. It is the Secretary's attempted reconciliation of the apparently conflicting demands between flexibility and certainty which will be evaluated.

Three primary factors should be considered when evaluating flexibility and certainty. One consideration is the degree of difficulty in understanding specific provisions. Rules which are difficult to understand or to apply will indicate very little certainty.

\textsuperscript{76} Fin Hay Realty Co. v. United States, 398 F.2d 694, 697 (3d Cir. 1968).

\textsuperscript{77} Scriptomatic, Inc. v. United States, 555 F.2d 364 (3d Cir. 1977) suggests an approach to debt-equity questions which seems to be consistent with this general proposition:

\textquote{Under Fin Hay, then, the ultimate issue is measurement of the transaction by objective tests of economic reality, and the touchstone of economic reality is whether the transaction would have taken the same form had it been between the corporation and an outside lender—whether, in sum, “the shareholder's advance is far more speculative than what an outsider would make.”}

\textsuperscript{...}

\textquote{As is apparent, if there is proof or agreement that an outsider would have purchased an instrument on the terms available to a shareholder, the question as to whether the form of the obligation resulted from arm's-length negotiation is irrelevant to resolution of the debt-equity issue. The crucial issue is the economic reality of the marketplace: what the market would accept as debt is debt.}

\textit{Id.} at 367-68.

\textsuperscript{78} See Supplementary Information to Proposed Regulations, 47 Fed. Reg. 164, 166 (1982).

\textsuperscript{79} Supplementary Information to Proposed Regulations, \textit{supra} note 69, at 18,958.

\textsuperscript{80} The variety and weight of the numerous evidentiary factors left little certainty. \textit{See supra} notes 25-70 and accompanying text.
Since the regulations establish safe harbors which are intended to provide certainty in treating an interest as indebtedness, the safe harbor provisions are a second factor to consider. Broad safe harbors applicable to a large proportion of corporate taxpayers may indicate adequate flexibility in establishing areas of certainty. Narrow safe harbors indicate either certainty only at the cost of flexibility or flexibility only if much uncertainty is accepted.

Flexibility is ostensibly provided by specific rules under which an interest in a corporation may be treated as indebtedness, equity, or a combination of both. However, it may be argued that this is not the appropriate interpretation of flexibility. Rather, the real issue implied by the term “flexibility” is whether the Secretary has been successful in drafting objective classification rules based upon abstractly defined arm’s length standards in order to provide greater certainty with respect to the debt-equity issue, while at the same time remaining responsive to the myriad of factual situations associated with debt-equity transactions. If this is accepted as the proper interpretation of flexibility, the third factor to consider is whether the treatments specified by particular provisions are responsive to the various fact situations associated with debt-equity transactions. Provisions which require a specific treatment and which have a wide scope of applicability allow very little flexibility. On the other hand, provisions requiring specific treatment, which have a limited scope of applicability, allow very little certainty or flexibility.

These three factors will be used to evaluate the regulations under section 385 with respect to the availability of flexibility and certainty.

III. EVALUATION OF SPECIFIC CLASSIFICATION PROVISIONS

The various classification provisions of the regulations will be divided into two categories for purposes of this discussion: those provisions applicable to all creditors, and those applicable only to creditors who are also shareholders. No attempt will be made to discuss all of the classification provisions contained within the regulations. Rather, only those which are most relevant for drawing conclusions with respect to the objective of the regulations will be discussed.

81. Id.
82. Id.
83. They are abstractly defined because they are defined independently of any specific facts and circumstances.
84. See supra notes 25-70 and accompanying text.
A. Classification Provisions Applicable to All Creditors

Only one provision is applicable to all creditors and also concerned with arm's length relationships. This provision, which operates to classify hybrid instruments as debt or equity, is based on the premise that a hybrid instrument more closely resembles stock if the value of its equity elements is greater than its value as a debt instrument. This reasoning is enhanced if the instrument's value as a debt interest is reduced by subordination of the instrument to other creditors or by a low interest rate. A mechanical test is applied to determine the predominant characteristics of the instrument. The presumption is that the total fair market value of a hybrid instrument embodies two identifiable components. One is the value of the rights to separate fixed payments of interest and principal. The second is the value of the equity features, which is measured by the right to convert the instrument into stock and the right to receive contingent payments. If at least half of the fair market value of the instrument is attributable to rights characteristic of indebtedness, the instrument may be classified as indebtedness. On the other hand, if the fair market value of the instrument without its equity features is less than half of the actual fair market value of the entire instrument, the instrument will be classified as equity.

85. Perhaps this an implicit recognition that the debt-equity problem most commonly arises in closely-held corporations where the shareholders, often also acting as officers of the corporation, are able to control what label the corporation gives to the shareholder advance. See supra notes 75-77 and accompanying text.

Public corporations occasionally find the Service challenging the validity of purported debt, but it would seem easier for a corporation with a large number of shareholders to survive the attack. See, e.g., Monon R.R. v. Commissioner, 55 T.C. 345 (1970), acquiesced in, 1973-2 C.B. 3.

The regulations under section 385 recognize this dichotomy by creating safe harbors which operate to exempt the instruments of public corporations from several of the classification rules presumably on the grounds that the form of the instrument was the result of an arm's length relationship. See, e.g., Treas. Reg. § 1.385-3(a)(2)(ii), -6(a)(3)(i), -6(a)(3)(ii) (1982).

86. A hybrid instrument is defined in Treas. Reg. § 1.385-3(d) (1982) as an instrument that is convertible into stock or one that provides for a contingent payment of interest or principal to the holder. See Plumb, supra note 14, at 405 for a more complete explanation of the Secretary's concern for hybrid instruments. These concerns provide the justification for the treatment specified under the regulations.

88. See Supplementary Information to Proposed Regulations, supra note 69, at 18,960.
90. An instrument which escapes classification as stock under Treas. Reg. § 1.385-5(a) (1982) is treated as a straight debt instrument under § 1.385-2(b)(2). Therefore, it is subject to any of the other special classification rules that are applicable to straight debt instruments. However, it should be noted that the other classification rules will always operate to classify such an instrument as debt unless the instrument is held by a shareholder, in which case there is a possibility that the instrument may be classified as equity.
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as stock.\footnote{1} This test is intended to replace the subjective multi-factor analysis employed by the courts\footnote{2} with an objective test while remaining responsive to relevant judicially developed factors.\footnote{3}

Two observations may be made regarding this standard objective. First, the test is purely mechanical and thus precludes any flexibility. The Secretary undoubtedly recognized that the primary purpose for issuing a hybrid instrument is to obtain a lower interest rate than that available under a straight debt instrument. Yet, the fact remains that reduced interest paid on the hybrid instrument operates to lower the debt value of the instrument without its equity features and thus increases the possibility that the instrument will be classified as stock. The Secretary indicates an acceptance of corporations using sophisticated financing instruments to lower their effective interest expense as long as the interest costs are not reduced too much. In this connection, it must be noted that section 1.385-8(a) does allow favorable treatment of some debt instruments with an "equity-kicker." To obtain this favored status the corporation is required only to issue debt instruments with nondetachable warrants rather than convertible debt instruments. By use of this provision, a corporation may avoid the potential adverse classification under section 1.385-5(a).

Second, the purely mechanical test will not provide greater certainty because it will be difficult to apply. Two separate calculations must be made: the actual fair market value of the entire instrument, and the fair market value of the instrument without its equity features. Once the two values have been determined, the mechanical test objectively determines whether the debt features or equity features are predominant. Although fair market value is generally understood\footnote{4} it is difficult to determine in specific fact situations.\footnote{5} This is likely to create numerous disputes between the Service and taxpayers regarding valuation of debt and equity and fails to provide much certainty.

The fair market value of the entire instrument is apparently deter-

\footnote{1} Id. § 1.385-5(a).
\footnote{2} See supra notes 22-70 and accompanying text.
\footnote{3} It remains responsive to these factors because the fair market value of an instrument without its equity features is affected by the same factors that the courts have taken into account when determining whether an instrument is debt or equity. Supplementary Information to Proposed Regulations, supra note 69, at 18,960.
\footnote{4} Fair market value is generally considered to be equal to the price at which an item would change hands between a willing buyer and a willing seller, both having a reasonable knowledge of all relevant facts and neither being under any compulsion to buy or sell. See, e.g., Treas. Reg. § 1.385-5(b)(1) (1982).
\footnote{5} See infra notes 96-154 and accompanying text.
mined under an operational provision which is stated in section 1.385-3(a).96 This provision states that the fair market value of an instrument is the price at which the instrument changes hands between a willing buyer and willing seller, both having reasonable knowledge of all the relevant facts.97 In an attempt to add certainty, the fair market value of an instrument may be determined by using the present value and standard bond tables under section 1232 regulations.98 Furthermore, two rules of convenience are provided. First, the fair market value of a straight debt instrument on the day of issue is assumed to be equal to the face amount if the stated annual interest rate is reasonable within section 1.385-6(f),99 and the consideration paid for the instrument is equal to the face amount.100 Second, the fair market value of an instrument on the day of issue is the issue price, as defined in section 1232(b)(2), if the instrument is registered with the Securities and Exchange Commission and sold to the public for money.101

The drafters of section 1.385-3(a) claim that the difficulties normally associated with valuation are largely avoided for four reasons.102 First, appraisal is limited almost exclusively to straight debt instruments, presumably because most of the hybrid instruments requiring valuation will come within the rule of convenience of section 1.385-3(a)(2)(ii) dealing with instruments registered with the SEC.103 However, there is no data readily available to evaluate the accuracy of this assertion. Second, the appraisal of a straight debt instrument is simplified by using standard bond tables.104 However, in order to use the tables the proper discount rate must be determined. In the case of a small closely-held corporation, the determination of the proper discount rate may require as thorough an analysis of the corporation's financial history and condition as that necessary to determine the fair market value of its stock. Moreover, even the drafters of the provision point out that many of the factors that a willing buyer and seller would consider in arriving at an arm's length interest rate and, thus, a fair market price for the instrument, are the same as the factors developed

96. Id. § 1.385-5(e)(9)(i).
97. Id. § 1.385-3 (a)(1)(i).
98. Id. § 1.385-3(a)(1)(ii).
99. Id. § 1.385-3(a)(1)(i)(A).
100. Id. § 1.385-3(a)(2)(i)(A).
101. Id. § 1.385-3(a)(2)(ii).
102. Supplementary Information to Proposed Regulations, supra note 69, at 18,959.
103. Id.
104. Id.
by case law for distinguishing stock from indebtedness. Thus, the determination of the fair market value of even a straight debt instrument is not a simple procedure and the stated objective of replacing "the subjective analysis of case law with a definitive question" has not been attained. The third suggestion, that no great accuracy of appraisal is required, appears to be misleading since revenue agents may define accuracy differently than the taxpayer. Fourth, the drafters argue that the broad safe harbor under section 1.385-3(a)(2)(i) for straight debt instruments will make it possible to avoid the need for valuation altogether. In fact, the safe harbor rule itself is difficult to apply because of the requirement of a reasonable rate of interest on the instrument within section 1.385-6(f).

The regulations establish the general rule that a stated annual rate of interest is reasonable if it is comparable to the range of rates paid to independent creditors on similar instruments by corporations in the same general industry, geographic location, and financial condition on the date the determination is made provided it is not less than the rate specified in section 1.385-6(f)(2)(i)(A) for instruments of comparable maturity. In addition, an alternative in the form of a rule of convenience is provided so that corporations can avoid the uncertainty of the general definition. The stated rate of interest is presumed to be reasonable if two conditions are satisfied. First, on the date the determination is made, the stated rate must be equal to the rate in effect under section 6621, the prime rate in effect at any local commercial bank or a rate two points above such rate, either of the endpoints of the range of rates set forth in section 1.482-2(a)(2)(iii)(B)(1), or at a rate determined from time to time by the Secretary, taking into consideration the average yield on outstanding marketable obligations of the United

105. Id.
106. Id.
107. Id.
108. Id.
110. Id. § 1.385-6(f)(2).
111. Under § 6621(b), the Secretary may adjust the interest rate in October of every second year based on the adjusted prime rate charged by banks in September. The adjusted prime rate is 90% of the average predominant prime rate quoted by banks to large businesses, as determined by the Board of Governors of the Federal Reserve System. Treas. Reg. § 301.6621(b)(2) (1975). In 1982, the § 6621 interest rate is 20%. Rev. Rul. 80-260, 1980-44 I.R.B. 19.
States of comparable maturity. Alternatively, the rate can be in between any two of the four rates described above. Second, at the end of the taxable year in which the determination is made, the debt-equity ratio of the issuing corporation must not be greater than 3:1.

Requirements under the general rule are difficult to ascertain. Read literally, the general rule would make it necessary for a corporation to find other corporations that have issued similar instruments in the same general industry, geographic location, and financial condition. Such a determination would seem to be extremely difficult and, in some cases, impossible to make. For example, a determination of the financial condition would necessarily include an examination of the corporation's earnings history. Since a new corporation would have no earnings history, it would be difficult to find a corporation in a similar financial condition in the same geographic location which would also satisfy the other conditions mentioned. The regulations do not indicate that the rule is to be interpreted any way but literally. On the other hand, the drafters point out that only in rare cases would a corporation have borrowed money from its shareholders and not from an independent creditor.

The implication is that evidence of a quote from a bank or similar lending institution to the corporation will fulfill the requirements of the general rule. If this is a correct interpretation of the Secretary's intent concerning the general rule, perhaps some examples should be added to illustrate the point. Additionally, these examples could explore the evidence required to prove the quote and methods for obtaining this evidence. Without these illustrations it may be argued that the list of factors in the general rule are so broad and indefinite that very little certainty exists under the regulations. Little useful guidance is provided to either taxpayers or the Service any time it is necessary to determine whether a particular interest rate is reasonable by applying the nebulous general rule.

Perhaps the general rule is intended to codify existing case law with respect to a reasonable rate of interest. If this assertion is correct, certainty is even less apparent since courts have recognized that no one

113. The Service plans to announce this rate by issuing a Revenue Procedure. T.D. 7747, supra note 11, at 86,443.
114. Treas. Reg. § 1.385-6(f)(2)(i)(B) (1982). This provision requires that an interest rate be equal to or between the four rates identified therein; therefore, an interest rate will not be considered reasonable under the rule of convenience if it is too high or too low.
115. Defined in id. § 1.385-6(h). See infra notes 125-28 and accompanying text.
117. T.D. 7747, supra note 11, at 86,442.
factor is determinative of the reasonableness issue. In other words, a comparison of interest rates from existing case law would not be informative because the courts considered other relevant factors when deciding whether an instrument described in a particular case is debt or equity. Therefore, no definite conclusions can be drawn concerning the reasonableness of any specific interest rate described in a case.

In summary, the general rule seems to provide a great deal of flexibility with respect to determining the reasonableness of an interest rate, but virtually no certainty. Clearly, what is needed is a rule that provides both flexibility and certainty.

Unfortunately, the rule of convenience may have as many shortcomings, if not more, than the general rule. These shortcomings involve the use of the debt-equity ratio in the rule of convenience. Assuming that an instrument's interest rate satisfies the conditions of the rule of convenience, a stated interest rate will fail to qualify as reasonable under the safe harbor if the debt-equity ratio of the issuing corporation exceeds 3:1. Given the confusion which will result from including a debt-equity test in the rule of convenience for a reasonable interest rate, it is difficult to understand what purpose is served by adding such a requirement. Apparently, the Secretary is treating the debt-equity ratio as a measure of risk and feels that a 3:1 ratio is appropriate given the mechanics of the interest rate test specified in the rule of convenience. However, the corporation debt-equity ratio is but one indication of risk, and even if the need for such a measure is

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118. See supra notes 22-70 and accompanying text.
119. In Gooding Amusement Co. v. Commissioner, 236 F.2d 159 (6th Cir. 1956), cert. denied, 352 U.S. 1031 (1957), the court merely listed the cases which had dealt with the debt-equity problem, and stated that because each case was decided on the basis of its own particular facts, "no good purpose would be served by entering upon a review of the decided cases." Id. at 165; see also Campbell v. Carter Found. Prod. Co., 322 F.2d 827, 832 (5th Cir. 1963).
120. See supra notes 110-14 and accompanying text.
122. The debt-equity ratio has been described as a measure of risk, in that the "greater the capital of a corporation and the lower its debt, the less subject will the corporation be to the 'strain and pressure' of financial crises, and the better able to withstand financial setbacks." Spanbock, Carr & Katz, Nourishing the Thin Corporation, 34 Taxes 687, 688-89 (1956).
123. Because the safe harbor interest rates were criticized as too low and below market rates, the drafters of the regulations did not feel it necessary to raise the ratio required above 3:1. In addition, the drafters state that the failure to meet the safe harbor test means only that the corporation must prove that the interest rate was reasonable under the general rule of Treas. Reg. § 1.385-6(0)(1) (1982). T.D. 7747, supra note 11, at 86,443. Of course, this would mean that the certainty which is the aim of the regulations would be sacrificed.
124. Two commentators have recently employed the techniques of factor analysis and multiple discriminant analysis to study judicial decisions on the classification of debt versus equity in closely-held corporations. One conclusion is that the courts have placed great significance on the
conceded, serious questions may be raised regarding the appropriateness of the particular computation procedure selected.

In general, the debt-equity ratio is defined as the ratio of a corporation's liabilities to the equity held by stockholders of the corporation. When computing the corporation's liabilities, trade accounts payable, accrued operating expenses, taxes, and similar items are excluded. Stockholder's equity is defined as the excess of the adjusted basis of a corporation's assets over all of its liabilities, computed without excluding any of the liabilities. The adjusted basis of a corporation's assets and the amount of its liabilities are to be determined in accordance with the tax accounting principles properly used by the corporation in determining its taxable income, without regard to the classification of any interest as stock or indebtedness by reason of section 385, except that preferred stock is considered a liability if it is treated as indebtedness under the section 385 regulations.

Clearly, the determination of the carrying value of a corporation's assets is critical to the computation of a proper debt-equity ratio. The Secretary has selected the adjusted tax basis of the assets as the appropriate carrying value based upon the justification that such a carrying value is a readily determinable and objective amount which provides certainty to the computations. Ease of application and certainty are clearly important goals, but not at the cost of fairness to the taxpayer. Moreover, the use of adjusted basis may not even provide the

financial condition of the corporation at the time when the instrument was issued. However, financial condition was evaluated by considering the availability of external financing, the absence of contingent payments, the business purpose for debt creation, and regular dividend payments, in addition to the ratio of debt to equity. Moreover, except for regular dividend payments these other factors seem to be just as significant as the debt-equity ratio. Whittington & Whittenburg, Judicial Classification of Debt Versus Equity—An Empirical Study, ACCCG. Rev. 409, 415 (July, 1980). In addition, standard finance textbooks frequently caution readers against becoming overly enamored with a single measure of a company's ability to weather times of stress and also meet its obligations. It is noted that a number of measures (e.g., the current ratio, the acid test ratio, the total debt to total asset ratio, the long-term debt capitalization ratio, the total debt to total equity ratio, and the times interest earned ratio) taken together and interpreted in light of competent professional judgment will "supply some insight into the relative size of the cushion of ownership funds creditors can rely upon to absorb" the results of any financial setbacks. E. HELFERT, TECHNIQUES OF FINANCIAL ANALYSIS 58-62 (1967); see also J. WESTON & E. BRIGHAM, ESSENTIALS OF MANAGERIAL FINANCE 63-64 (3d ed. 1974).

126. Id. § 1.385-6(h)(1)(i).
127. Id. § 1.385-6(h)(2). For this purpose, the adjusted basis of the assets does not include reserves for bad debts or any similar asset offsets. Id.
128. Id. § 1.385-6(h)(3).
129. Supplementary Information to Proposed Regulations, supra note 69, at 18,959.
130. In Lifans Corp. v. United States, 390 F.2d 965, 970 (Ct. Cl. 1968) the Court of Claims noted: "The prevailing view seems to be that assets are to be taken at fair market value rather
alleged certainty. The Secretary argues that, in those areas where the debt-equity ratio is a primary factor in determining the classification of instruments, the corporation can avoid any inequities by establishing that it is, in fact, adequately capitalized. However, since the debt-equity ratio is important to the operation of the safe harbor under section 1.385-6(g) as well as under section 1.385(f), an unduly restrictive method of computing the debt-equity ratio eliminates the certainty and objectivity intended by these safe harbors. In other words, the use of adjusted basis should result in a less controversial calculation and thereby promote certainty since the judgmental intricacies of valuation are avoided when dealing with the safe harbor rules. Nevertheless, the use of such a computation procedure together with the selection of the particular standard for the ratio itself will also reduce the number of corporations which qualify for the safe harbors. Therefore, the certainty created by the less controversial calculation of asset carrying values will be more than offset by the uncertainty created by the restricted availability of the associated safe harbors. Thus, section 1.385-6(f)(2) appears to be, for all practical purposes, meaningless as an objective rule of convenience because the debt-equity ratio requirement unneces-

than at book value when valuing the equity interest in order to compute the ratio."

Id. at 970 (quoting Goldstein, Corporate Indebtedness to Shareholders: "Thin Capitalization" and Related Problems, 16 Tax L. Rev. 1, 19 (1960)); accord Estate of Miller v. Commissioner, 239 F.2d 729, 733 (9th Cir. 1956); Kraft Foods Co. v. Commissioner, 232 F.2d 118, 127 (2d Cir. 1956); Nye v. Commissioner, 50 T.C. 203, 216 (1968); Swoby Corp. v. Commissioner, 9 T.C. 887, 893 (1947). The commentators seem to be in agreement that the fair market value of the assets should be used. Plumb, supra note 14, at 516; see Caplin, supra note 37, at 779; Gerver, De-emphasis of Debt-Equity Test for Thin Corporations Requires New Defense Tactics, 23 J. Tax’n 28, 29 (1965); Goldstein, Corporate Indebtedness to Shareholders: "Thin Capitalization" and Related Problems, 16 Tax L. Rev. 1, 19 (1966); Holzman, The Interest-Dividend Guidelines, 47 TaxeS 4 (1969); Spanbock, Carro & Katz, supra note 122, at 690. Even the Secretary acknowledges that the fair market value of a corporation’s assets provides a more theoretically correct measure of equity than adjusted basis. Supplementary Information to Proposed Regulations, supra note 69, at 18,959. It is expressly recognized in I.R.C. § 279(b)(2) (1976) that the historic cost of assets is often an inaccurate method for determining a corporation’s equity. This view that the fair market value of corporate assets yields a more correct measure of corporate equity than does the adjusted basis of the assets follows from the view of the essential difference between a creditor and a stockholder. In essence, a stockholder intends to make an investment and to take the risk of loss so as to enjoy the profit, if any, while a lender seeks a definite obligation, payable in any event. Thus, it is clear that the degree of risk plays a part in determining whether there is a creditor or a shareholder relationship. In determining the degree of risk, a prospective creditor is more concerned with the fair market value of a potential borrower’s assets than the basis because the creditor would want to know the extent to which a business may suffer losses without adverse consequences to his interest. The use of any amount other than the fair market value of the corporation’s assets is virtually meaningless with respect to this issue.

131. Supplementary Information to Proposed Regulations, supra note 69, at 18,958.
132. See infra notes 173-86 and accompanying text.
133. See supra notes 110-116 and accompanying text.
sarily restricts its availability. Accordingly, this safe harbor will not relieve the courts, taxpayers, or Service of the many disputes which arise when the only resort is to the subjective factors of the general rule.

In addition to the determination of asset carrying values, it is necessary to consider the computation of a corporation's liabilities. Throughout recent accounting history, the equity section of the balance sheet has been the residue obtained when liabilities are subtracted from the carrying value of the assets. Accordingly, liabilities are subtracted from the adjusted basis of the assets in order to determine stockholder's equity under section 1.385-6(h)(2). For this purpose, trade accounts payable, accrued operating expenses and taxes, and other similar items are included in the term "liabilities." However, when the debt-equity ratio is computed, by comparing liabilities with stockholder's equity, these items are excluded from the "liabilities." Therefore, the scope of the term "liabilities" is affected by trade accounts payable, accrued operating expenses, and other similar items. Such items are accorded special treatment because they vary widely during the year. If these items were included in the "liabilities" it would "defeat one of the principal purposes of the regulations, which is to provide a high degree of certainty for corporations." Although the final regulations attempt to clarify when an item will be treated in the same manner as trade accounts payable, the goal of certainty will not be attained unless "other similar items" is interpreted to encompass all of the additional categories of items which do not represent liabilities for money borrowed, liabilities for fixed assets purchased or leased, or pension liabilities. Under the final regulations, it appears that a liability must be incurred to purchase an item of inventory in order to be treated in the same manner as a trade account payable. Unless this classification issue is clarified the determination of a corporation's debt-equity ratio

134. It should be noted that the regulations do attempt to compensate for the adjusted basis inequities in that the only effect of an unfavorable debt-equity ratio will be to require that a taxpayer meet the heavier evidentiary burden of establishing an actual foundation for the reasonableness of interest charged under the general definition. Nevertheless, the question may be raised regarding why a taxpayer will be put to his proof on the factual issue of the interest rate which, in some cases, may be extremely difficult to establish, rather than on the alternative, and possibly less burdensome, issue of adequate capitalization. In this sense, it may be argued that the adjusted basis standard works arbitrarily and unnecessarily so.


136. Id. § 1.385-6(h)(1)(i).

137. Supplementary Information to Proposed Regulations, supra note 69, at 18,959.


139. Id.
DEBT-EQUITY CLASSIFICATION

will be subject to varying interpretations, resulting in further uncertainty.

In summary, the complex procedures required to compute the debt-equity ratio for a particular interest rate to be reasonable under the safe harbor rule of section 1.385-6(f)(2) suggests that many corporations will be unable to qualify under this rule of convenience. Therefore, whether a particular interest rate is reasonable will have to be determined under the general rule and its corresponding uncertainty. Although the purpose of the safe harbor for determining the fair market value of straight debt instruments under section 1.385-3(a)(2)(i) is to provide a high degree of certainty, it fails in this objective. Additionally, this particular safe harbor is not relevant for hybrid securities. In fact, if a hybrid instrument is not registered with the SEC and sold to the public for money, the fair market value of the entire instrument must be determined under the ambiguous general rule.

In addition to determining the fair market value of the entire hybrid instrument, the application of section 1.385-5(a) requires the determination of the fair market value of the straight debt payments. The Secretary has attempted to explain the proper method of determining the amount of a straight debt payment, and the examples in the regulations adequately clarify this issue in a variety of situations. Section 1.385-5(d)(3) clearly states that the fair market value of the straight debt payments is the sum of the present value, at the time of the instrument's issuance, of each individual straight debt payments. However, the calculation of such a sum requires a proper discount rate which is difficult to determine. The drafters of the regulations have attempted to provide guidance concerning this crucial issue. Specifically, the appropriate discount rate is defined as a rate equal to a reasonable rate of interest within the meaning of section 1.385-6(f)(1) for an instrument in the amount of the straight debt payment, payable on the date that the straight debt payment must be made, and payable on the terms and

140. See supra notes 125-39 and accompanying text.
141. See supra notes 117-19 and accompanying text.
142. See supra notes 99-100, 108 and accompanying text.
143. See supra note 101 and accompanying text.
144. See supra notes 96-97 and accompanying text.
146. Id. § 1.385-5(d)(2).
147. Id. § 1.385-5(f), (g).
148. Supplementary Information to Proposed Regulations, supra note 78, at 166.
conditions of such straight debt payment. In this case reference is made to the general rule under section 1.385-6(f)(1) with the result that the rule of convenience for determining a reasonable rate of interest is not available. Since the general rule does not provide certainty because it is difficult to apply, the determination of an appropriate discount rate under section 1.385-5(d)(4) will be the subject of a great deal of controversy. Therefore, it will be difficult to determine the fair market value of the straight debt payments.

The examples in the regulations do not help determine the fair market value of the entire hybrid instrument because all of the examples in section 1.385-5 are based upon assumed fair market values and all of the examples in section 1.385-3(a) deal with straight debt instruments. Similarly, the examples, with one exception, do not help determine the proper discount rate to use for valuing straight debt payments because they are based upon assumed present values. These examples illustrate only that various factors such as maturity time, subordination, and non-interest-bearing status affect the discount rate. They do not illustrate how to compute the assumed present values in light of the fact situations described. Therefore, given the importance of the various uncertainties associated with the determination of fair market value, the mechanical rule of section 1.385-5(a) is not easily applied to actual fact situations. Hence, this classification rule may not provide any greater certainty than existing case law.

B. Classification Rules Applicable Only to Shareholder-Creditors

There are five classification provisions to insure arm’s length terms when an instrument is owned by a shareholder and four others to insure arm’s length enforcement of an instrument’s terms. For purposes of this discussion these nine provisions will be classified into two
categories as follows: provisions applicable only when holdings of stock and instruments are substantially proportionate and provisions applicable to all shareholder-creditors.

1. Provisions Applicable Only When Holdings of Stock and Instruments Are Substantially Proportionate

There are eight provisions\textsuperscript{157} which apply only to situations where a taxpayer’s holdings of stock and instruments are substantially proportionate.\textsuperscript{158} The regulations state that holdings of stock and a class of instruments are substantially proportionate if the “total overlap factor with respect to the class of instruments is greater than 50 percent.”\textsuperscript{159} Holdings are not substantially proportionate if the “corporation’s stock and instruments are widely held and the instruments are separately traded and readily marketable.”\textsuperscript{160} This rule will probably exempt most publicly held corporations from the associated classification rules. Also, any instrument held by an independent creditor\textsuperscript{161} is not regarded as being held in substantial proportion to any stock holdings.\textsuperscript{162} This exception quite possibly will create uncertainty because the term “independent creditor” is not clearly defined. Section 1.385-6(b)(1) merely states that “all relevant facts and circumstances must be considered in determining whether a creditor is independent.”\textsuperscript{163} A safe harbor rule for making this determination is provided to increase certainty.\textsuperscript{164} Under this safe harbor rule a creditor is deemed to be independent first, if stock owned by the corporation would not be attributed to the creditor under the constructive ownership rules of section 318(a), as modified by section 1.385-6(b)(3),\textsuperscript{165} and second, if the creditor’s actual or constructive percentage ownership of the class of

\textsuperscript{157} See id. § 1.385-6(c), -6(e), -6(g), -6(k), -6(f), -6(m)(1), -6(m)(2), -6(m)(3).
\textsuperscript{158} Substantially proportionate as determined according to § 1.385-6(a).
\textsuperscript{159} Defined as the sum of the overlap factors of each person with respect to the class of instruments where the overlap factor of a person with respect to a class of instruments is the lesser of the percentage of stock or the percentage of the class of instruments owned, actually or constructively, by the person. Id. § 1.385-6(a)(2)(i) (emphasis added).
\textsuperscript{160} Id. § 1.385-6(a)(3)(i).
\textsuperscript{161} This term is defined in Treas. Reg. § 1.385-6(b) (1982). See infra notes 163-67 and accompanying text.
\textsuperscript{162} Id. § 1.385-6(a)(3)(ii).
\textsuperscript{163} This would mean that factors such as the lender’s relationship to the corporation and whether the lender had any loans outstanding to the corporation should be considered. See generally Hickman, Incorporation and Capitalization: The Threat of the “Potential Income” Item and a Sensible Approach to Problems of Thinness, 40 Taxes 974 (1962).
\textsuperscript{164} Treas. Reg. § 1.385-6(b)(2) (1982).
\textsuperscript{165} Id. § 1.385-6(b)(2)(i), (ii).
instruments is at least twice as great as the creditor's actual or percentage ownership of either the total combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of the corporation's stock. 166

The most troublesome aspect of the safe harbor criteria involves the application of the attribution rules of section 318(a) as modified. 167 Admittedly, a five percent interest would control many, if not most, large public corporations. If a five percent interest will control a corporation, it is reasonable to conclude that the owner of such interest is not an independent creditor. However, in many smaller corporations, it is possible for a shareholder to have a rather large equity position without having any real power to influence corporate decision-making. The minority shareholder in this position must of necessity deal with the corporation on an arm's length basis in the same manner as an independent creditor. Therefore, it may be argued that the modification is designed for situations involving publicly held corporations and that it is illogical to apply it to loans made to corporations by shareholders whose percentage ownership is so small that it is unlikely that the individual shareholder will have any significant impact upon the affairs of the corporation. As a result of such a modification, the certainty of the safe harbor is unlikely to be available with respect to most small closely-held corporations, and these entities will probably find the general rule for determining whether a creditor is independent as confusing and uncertain as existing case law. In addition, the modification of section 318(a) may create uncertainty in that an investor may be unaware that a corporation in which he has a five percent or greater equity interest is, or may become, a shareholder of a corporation with respect to which he is a lender. For example, assume B owns one hundred percent of the stock of Y corporation. Further, assume that B's son owns five percent of Z corporation. The dropping of the fifty percent rule of section 318(a)(3)(C) results in Z corporation owning one hundred percent of Y corporation's stock and being considered a shareholder of Y even though the common shareholder, B, owns only five percent of Z corporation, and even that interest is attributed through a related party, B's son. Clearly, Z corporation can hardly exert any influence over the activities of Y corporation; yet, if Z corporation ad-

166. *Id.* § 1.385-6(b)(2)(iii).
167. I.R.C. § 318 (1976). In applying the section 318 attribution rules in the context of determining whether one is an independent creditor, the 50% threshold test of section 318(a)(2)(C) and 318(a)(3)(C) is deemed to require only a 5% interest. *Treas. Reg.* § 1.385-6(b)(3) (1982).
advances money to Y corporation, Z corporation will not be considered an independent creditor of Y corporation under the safe harbor rule of section 1.385-6(b)(2).

The most troublesome aspect of the general rule for determining substantially proportionate holdings also involves the application of the modified section 318 attribution rules. Although confusion arises in many situations when the attribution rules are applied, application of the attribution rules has been simplified for purposes of the section 385 regulations since sideways attribution has been eliminated. Nevertheless, determining whether substantial proportionality is present will be subject to a great deal of uncertainty and litigation whenever the attribution rules must be applied to determine the relative holdings of stock and instruments for individual shareholders. This situation will occur when family members own stock and instruments or when affiliated corporations are involved. Thus, the provision would seem to have a rather wide scope of applicability.

If a shareholder's holdings of stock and instruments are substan-

168. See supra notes 159 and 167.
170. E.g., shares and debentures are attributed in such a way that one party ends up with the largest possible holdings and the other parties from whom the shares are attributed are not considered when the total overlap factor is calculated. See Treas. Reg. § 1.385-6(a)(2)(vii), Example (2) (1980). B's wife's 100% holding of the common stock of Corporation Y is attributed to B; B's child's 50% interest in the debentures of Corporation Y is attributed to B; and B's sister's 25% interest in the debentures of Corporation Y is attributed to B. Thus, B constructively owns 100% of Corporation Y stock and 75% of Corporation Y debentures. However, the total overlap factors is computed by considering only B's ownership and his sister's husband's ownership. B's wife, child, and sister are ignored after the attribution to B has occurred. In other words, the shares and debentures of all parties to whom the attribution rules apply are aggregated so that the combined interest is treated as the interest of a single shareholder-lender. See also the hypothetical in the same example where it is assumed that B is deceased. In this hypothetical B's child's 50% interest in the debentures is attributed to B's wife so that she is deemed to own 100% of Y Corporation stock and 50% of Y Corporation debentures. Therefore, the total overlap factor is computed as follows:

<table>
<thead>
<tr>
<th>Stock Ownership</th>
<th>Debenture Ownership</th>
<th>Factor Overlap</th>
</tr>
</thead>
<tbody>
<tr>
<td>B's wife (including B's child)</td>
<td>100%</td>
<td>50%</td>
</tr>
<tr>
<td>B's sister</td>
<td>0%</td>
<td>25%</td>
</tr>
<tr>
<td>B's sister's husband</td>
<td>0%</td>
<td>25%</td>
</tr>
<tr>
<td>Total Overlap Factor</td>
<td>50%</td>
<td></td>
</tr>
</tbody>
</table>

This result was confirmed by a telephone conversation with Carolyn Swift, Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service (Mar. 1, 1982).
ially proportionate, there are eight provisions\textsuperscript{171} which operate to classify the instruments as stock or indebtedness.\textsuperscript{172} First, section 1.385-6(g)(1) states that any instrument which is held by a stockholder of the issuing corporation, whose holdings of stock and instruments are substantially proportionate, is classified as stock if the corporation’s debt is excessive immediately after the instruments are issued by the corporation.\textsuperscript{173} A corporation’s debt is excessive if all of the instrument’s terms and conditions, together with the corporation’s financial structure, would not be satisfactory to an independent creditor.\textsuperscript{174} However, the regulations provide a safe harbor which states that a corporation’s debt is not excessive if the corporation’s outside debt-equity ratio is less than or equal to 10:1, and the corporation’s inside debt-equity ratio is less than or equal to 3:1.\textsuperscript{175} The outside debt-equity ratio is computed under section 1.385-6(h) as discussed above.\textsuperscript{176} The inside ratio is determined in the same manner, except liabilities to independent creditors are excluded when comparing the corporation’s liabilities to shareholder’s equity.\textsuperscript{177} Both ratios are to be determined at the end of the year.\textsuperscript{178}

The underlying justification for this provision is that the creditor investor has, in circumstances where his investment is subject to a high degree of risk, placed his money at the risk of the business like a shareholder, since the likelihood of his being repaid depends significantly

\textsuperscript{171} See supra note 157.

\textsuperscript{172} Since eight out of twelve classification rules require substantially proportionate holdings of stock and instruments before they are applicable, Treas. Reg. § 1.385-6 (1982) is “now the heart” of the classification rules. Substantial proportionality must exist before any of the rules of this section apply. See Beghe, An Interim Report on the Debt-Equity Regulations Under Code Section 385, 59 TAXES 203, 210 (1981). The drafters of the regulations state that proportionality plays a central role in the regulations because shareholders holding instruments in the same proportion as their holdings of stock have no economic incentive to negotiate at arm’s length when additional financing is required by the corporation; therefore, regulations were considered necessary in order to insure that the financing arrangements reflect economic reality. T.D. 7747, 45 Fed. Reg. 86,438, 86,440 (1980). In other words, shareholders holding stock and instruments in the same proportion are entitled to the corporation’s entire net profits and generally will be indifferent, if tax consequences are disregarded, as to whether the profits are withdrawn from the corporation as interest and principal payments on debt, or as dividends and payments in redemption of stock. See Stone, Debt-Equity Distinctions in the Tax Treatment of the Corporation and its Shareholders, 42 Tul. L. Rev. 251, 258 (1968).

\textsuperscript{173} Treas Reg. § 1.385-6(g) (1982). The one exception to classification as stock because the corporation has excessive debt allows instruments which are issued in exchange for an equal or greater principal amount of indebtedness to escape classification. Id. § 1.385-6(g)(5).

\textsuperscript{174} Id. § 1.385-6(g)(2).

\textsuperscript{175} Id. § 1.385-6(g)(3).

\textsuperscript{176} See supra notes 125-28 and accompanying text.

\textsuperscript{177} Treas. Reg. § 1.385-6(g)(4) (1982).

\textsuperscript{178} Id.
upon the success or failure of the corporation. However, it may be argued that a capital structure which would be acceptable to an independent creditor is debatable. In fact, there may be substantial uncertainty as to whether a particular lender is even an independent creditor because the safe harbor rule under section 1.385-6(b)(2) may be inapplicable thus forcing the determination to be made under the general rule of section 1.385-6(b)(1) which does not clearly define independent creditor. Therefore, the general rule with respect to when a corporation's debt is excessive provides little certainty, thus providing no significant improvement over existing case law. This problem is aggravated by the fact that the safe harbor determines adequate capitalization based upon a purely mechanical rule involving a single factor in the form of a debt-equity ratio. This test lacks flexibility because one set of ratios is the single standard by which corporations in many different industries, geographic locations, and financial conditions will be judged. The ratio test was developed as an analytic tool for use in the context of a particular industry rather than as an arbitrary standard. A highly leveraged industry, such as the financial or the real estate industry, has different capital needs than a manufacturing operation. The courts have taken into consideration the needs and characteristics of the particular industry which is involved when applying the ratio test. Admittedly, the failure of a corporation to pass the safe harbor test means only that it must establish adequate capitalization under the general rule, which would consider the industry involved and the other characteristics peculiar to the corporation. However, the lack of flexibility with respect to the safe harbor clearly results in a loss of certainty which is one of the goals of the regulations. In addition, the safe harbor rule may not provide the anticipated certainty because the method for determining asset carrying values is very conservative. This

179. See Spanbock, Carro & Katz, supra note 122, at 668-89; see also Gilbert v. Commissioner, 248 F.2d 399, 407 (2d Cir. 1957); Ambassador Apartments, Inc., 50 T.C. 236, 245 (1968), aff'd, 406 F.2d 288 (2d Cir. 1969).


181. See supra note 163 and accompanying text.

182. Spanbock, Carro, & Katz supra note 122, at 689; see supra note 124 and accompanying text.

183. See, e.g., Scotland Mills, Inc. v. Commissioner, 24 TAX CT. MEM. DEC. (CCH) 265 (1965), where expert testimony was received on whether the company was “adequately capitalized by the standards of the industry.” Id. at 273.

Professor Bittker has stated that what is excessive debt for one industry may be normal for another, and even within one industry, no corporation is the same as the next. Bittker, Thin Capitalization: Some Current Questions, 34 Taxes 830, 831 (1956).

has the effect of reducing the number of corporations which qualify for the safe harbor. Finally, there is uncertainty concerning the mechanics of computing the debt-equity ratio.

Another provision states that an instrument issued by a corporation to a shareholder is to be classified as stock if: 1) the shareholder-creditor's holdings of stock and the instruments are substantially proportionate; 2) the stated annual rate of interest on the instrument is not reasonable; and 3) the issuance of the instrument does not give rise to original issue discount under Code section 1232(a)(3) or amortizable bond premium under regulation section 1.61-12(c)(2). It is clear that the Secretary intends to legislate a special rule for cases that he perceives Congress has overlooked. Specifically, the Congress has exempted ratable recognition of original issue discount where, in general, a bond or other evidence of indebtedness is issued in exchange for property. Thus, in cases where the stated rate of interest is less than an arm's length market rate of interest on similar obligations, section 1232 nevertheless provides that no original issue discount exists if the obligations have been issued in exchange for property. The Secretary intends to force conformity with arm's length standards in this situation by simply treating such obligations as stock when the terms are found to be inconsistent with arm's length terms. Clearly, there is no flex-

185. See supra notes 129-34 and accompanying text.
186. See supra notes 135-36 and accompanying text.
188. As determined under id. § 1.385-6(a) and discussed supra notes 159-70 and accompanying text.
189. As determined under Treas. Reg. § 1.385-6(f) (1982) and discussed supra notes 109-41 and accompanying text. Treas. Reg. § 1.385-6(e)(2) (1982) specifies that the reasonableness of a rate of interest for purposes of § 1.385-6(e)(1) is to be determined on the date that an instrument is issued.
190. For a complete discussion of the rationale for this condition, see notes 211-19 infra and accompanying text.
191. The drafters of the regulations state:
Section 1.385-6(c) [now -6(e)] applies primarily to straight debt instruments issued proportionately by a corporation to its shareholders in exchange for property. If a straight debt instrument is issued to a shareholder for money, there is generally no need for this rule. In this case, § 1.385-3(a) [now -6(c)] ensures, through the creation of original issue discount under section 1232(a)(3) and amortizable bond premium under section 1.61-12(c)(2), that the holders will be paid principal and interest in the proper proportions . . . . However, if instruments are issued for property, section 1232(a)(3) and section 1.61-12(c)(2) generally do not apply. Consequently, a special rule is needed to ensure that the holders will be paid principal and interest in the proper proportions (i.e., in the same proportions as would be paid to outside creditors). Thus, § 1.385-6(c) imposes the requirement that interest be paid at a reasonable rate on instruments issued for property. Supplementary Information to Proposed Regulations, supra note 69, at 18,961.
192. In such a case, I.R.C. § 1232(b)(2) (1976) sets the issue price equal to maturity value to avoid dealing with discounts and the amortization of discounts.
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The rule associated with this rule. In addition, there may be a substantial degree of uncertainty associated with the rule because classification of stock occurs only if the interest rate is not reasonable. It has been previously noted that a great deal of uncertainty may be associated with the determination of a reasonable interest rate. Furthermore, the rule only applies if a shareholder-creditor's holdings of stock and the instruments are substantially proportionate, and there is little certainty with respect to this issue. It follows that section 1.385-6(e) does not achieve the desired balance of flexibility and certainty.

Under a third provision, instruments that are payable on demand, and that are owned by shareholders with substantially proportionate holdings of stock and instruments, are classified as stock if the stated annual interest rate on the instruments is not reasonable on the day of issue. The rationale for this provision may be described as follows: If an instrument is due on a fixed date, section 1.385-6(c) will operate to insure that the fair market value of an instrument is equal to the consideration paid for it. To the extent that the fair market value of an instrument differs from its face value at maturity, either original issue discount under section 1232 or amortizable bond premium under section 1.61-12(c)(2) is created. This treatment is sufficient to assure that the interest rate is reasonable. On the other hand, if an instrument is payable on demand, neither original issue discount nor bond premium will ordinarily be created under section 1.385-6(c). Thus, section 1.385-6(m)(1) is justified under the rationale that the valuation approach to demand instruments will not be adequate to assure that the interest rate is reasonable. Although section 1.385-6(m)(1) does force conformity to arm's length economic reality, it is subject to the same criticisms with respect to certainty and flexibility.

193. See supra notes 109-41 and accompanying text.
194. See supra notes 159-70 and accompanying text.
196. For a complete discussion of the rationale for this condition, see notes 211-19 infra and accompanying text.
197. As determined under Treas. Reg. § 1.385-6(a) (1982) and discussed supra at notes 159-70 and accompanying text.
198. As determined under Treas. Reg. § 1.385-6(f) (1982) and discussed supra at notes 109-41 and accompanying text.
199. This rationale is virtually identical to the justification provided for Reg. § 1.385-6(e)(1) (1982). See supra notes 190-92 and accompanying text.
200. See infra notes 206-10 and accompanying text.
201. See infra notes 211-14 and accompanying text.
202. Supplementary Information to Proposed Regulations, supra note 69, at 18,961.
as was section 1.385-6(e).\textsuperscript{203} Similarly, it may be argued that section 1.385-6(m)(1) does not achieve the desired balance of flexibility and certainty.

To assure consistency with arm's length terms,\textsuperscript{204} a fourth provision applies when proportionately held instruments have a fair market value different from the consideration paid by a shareholder-creditor.\textsuperscript{205} In general, the provisions of the regulations under section 385 classify an interest in a corporation as either indebtedness or stock. However, section 1.385-6(c) requires an interest to be treated partially as stock and partially as indebtedness. When a corporation issues instruments to its shareholders, a determination as to the debt or equity status of the instruments is made. If the instruments are classified as indebtedness and if the holdings of the stock and instruments are substantially proportionate, section 1.385-6(c) requires a comparison of the fair market value of the instruments with the consideration actually paid for the instruments. If the consideration paid for an instrument exceeds its fair market value, the excess generally\textsuperscript{206} is treated as a contribution to capital.\textsuperscript{207} If the fair market value of the instrument exceeds the consideration paid the excess is generally\textsuperscript{208} treated as a distribution to which section 301 applies.\textsuperscript{209} The effect of these specified treatments is to force the consideration deemed to have been paid for the instruments to equal the fair market value of the instrument regardless of the price set by the corporation and its shareholders. Therefore, the issue price of an instrument will equal its fair market value since issue price refers to the amount which is deemed to have been paid for the instrument.\textsuperscript{210}

\textsuperscript{203} See supra text accompanying notes 193-94.

\textsuperscript{204} It may be argued that Treas. Reg. § 1.385-6(c) (1982) is written primarily to provide the Commissioner with a final means of attack since this provision is not applied until after a determination is made as to whether an instrument is debt or equity. Therefore, assuming that a taxpayer is successful in obtaining a debt classification through the general rule of § 1.385-4(a) and the numerous exceptions that are contained in the regulations, the Commissioner may still assert § 1.385-6(c) in order to force at least part of the taxpayer's instrument to be reclassified into equity.

\textsuperscript{205} Id. § 1.385-6(c).

\textsuperscript{206} Under appropriate circumstances the excess may be treated as a gift followed by a capital contribution or as compensation for services or as otherwise determined under general principles of tax law. Id. § 1.385-6(c)(1)(ii).

\textsuperscript{207} Id.

\textsuperscript{208} Under appropriate circumstances the excess may be treated as a distribution to which section 301 applies followed by a gift or as compensation for services or as otherwise determined under general principles of tax law. Id. § 1.385-6(c)(2).

\textsuperscript{209} Id.

\textsuperscript{210} I.R.C. § 1232(b)(2) (1976).
By establishing the issue price, section 1.385-6(c) also ensures that principal and interest will be paid on the instruments in the same proportions as would be paid to outside creditors. In order to understand this point, it is necessary to consider some additional rules. Original issue discount is defined in section 1232(b)(1) as the difference between the issue price and the stated redemption price at maturity. Amortizable bond premium is defined under section 1.61-12(c)(4) as the excess of the issue price over the amount payable at maturity. If a bond is sold with original issue discount, the amount of the discount is included, ratably over the life of the bond, in the income of the bond holder. A corresponding deduction is allowed to the corporation. Likewise, if a bond is sold at a premium the amount of that premium is included, ratably over the life of the bond, in the income of the corporate issuer. A corresponding deduction is allowed to the holder of the instrument. Therefore, under the regulation the use of original issue discount and amortizable bond premium has the effect of adjusting the amount of interest income of the creditor and the interest deduction of the corporation to equal the amount of interest income and deduction which would have resulted if the issue price and interest rate had conformed to arm’s length standards. This adjustment insures that the allocation of loan repayments between principal and income is reasonable.

It should be noted that neither original issue discount nor amortizable bond premium is created when an instrument is payable on demand or is issued in exchange for property. If an instrument is payable on demand, the issue price of the instrument will always equal its stated redemption price; therefore, there is no original issue discount or bond premium by definition. Likewise, if an instrument which is not traded on an established securities market is issued for property, the issue price is deemed to be equal to the stated redemption price at maturity, with the result that there is no discount or premium. Since the mechanics of original issue discount and amortizable bond premium

213. Id. § 1.61-12(c)(3) (1980).
215. A corporation would never issue a demand instrument at a discount because the creditor could immediately demand the face amount of the instrument. A creditor would never buy a demand instrument at a premium because the corporation could immediately pay off the debt at the face amount.
are not available to regulate the interest rates of demand instruments and instruments issued for property, the Secretary has provided special rules when arm's length bargaining does not exist.\textsuperscript{217} This is the justification for section 1.385-6(e),\textsuperscript{218} dealing with an instrument issued to a shareholder whose holdings of stock and instruments are substantially proportionate, and for section 1.385-6(m)(1),\textsuperscript{219} dealing with a demand instrument issued to a shareholder whose holdings of stock and instruments are substantially proportionate.

The drafters of the regulations assert that section 1.385-6(c) attains three goals.\textsuperscript{220} First, it replaces the subjective analysis of case law with a definite inquiry concerning the fair market value of the debenture. Second, it remains responsive to the relevant factors identified in the case law since these factors have direct bearing upon fair market value. Third, it is easier for the government and the taxpayer to reach a compromise. Under case law, the instrument must be either stock or indebtedness; there is not much room for compromise.\textsuperscript{221} However, it has been noted that since the provision does not avoid or simplify the general process for classification of instruments as debt or stock,\textsuperscript{222} the flexibility touted by the drafters is lacking. This approach will have the effect of permitting an instrument to have both debt and equity features without requiring it to be characterized in its entirety as either debt or equity. The approach also operates to limit the purported tax advantage gained by treating more of any repayment as either interest or principal. However, these "benefits" are obtained as a result of rules under which the issuance of an instrument can result, constructively, in a section 301 distribution, original issue discount, amortizable bond premium, a contribution to capital, a gift, compensation, or certain other treatments determined under general principles of tax law. Unfortunately, these treatments, as well as the mechanics necessary to implement them,\textsuperscript{223} will create uncertainty, thus increasing disputes between taxpayers and the Commissioner. In fact, it is probable that the difficulties of obtaining taxpayer compliance and enforcing the rules under this provision will be greater than under existing case law.

\textsuperscript{217} Supplementary Information to Proposed Regulations, supra note 69, at 18,961.
\textsuperscript{218} See supra notes 187-94 and accompanying text.
\textsuperscript{219} See supra notes 195-203 and accompanying text.
\textsuperscript{220} Supplementary Information to Proposed Regulations, supra note 69, at 18,959.
\textsuperscript{221} Id.
\textsuperscript{222} See supra notes 204-10 and accompanying text.
\textsuperscript{223} E.g., consider the difficulties associated with determining the fair market value of the instruments. See supra notes 94-142 and accompanying text.
Therefore, it seems that the burden of imposing such a complex set of rules, to be applied to constructed facts, will in most cases outweigh any possible benefits.

In addition to these four provisions which deal with the possibility that the terms of an instrument will not reflect arm’s length economic reality, there are four other provisions which are applicable when holdings of stock and instruments are substantially proportionate and which show that there is concern that the terms of an instrument will not be enforced at arm’s length. 224 Under existing case law, a failure to enforce the terms of a debt instrument is considered evidence that the shareholder and the corporation did not intend to establish a debtor-creditor relationship at the time the instrument was issued. 225 This is one of the factors considered in determining whether the obligation is debt or equity. 226 The regulations, on the other hand, are not concerned with the subjective intent or expectation of the parties at the outset. Instead, a “wait and see” attitude is adopted toward instruments which qualify as debt instruments when issued. That is, the regulations provide for potential reclassification of debt instruments into stock if the terms of the instruments are not properly enforced. It should be noted that the rules operate to reclassify an instrument in one direction only—from indebtedness to stock. Therefore, once an instrument has been classified as stock, it can never again attain debt status. 227

224. Treas. Reg. § 1.385-6(f)(1) (1982) (This provision treats an instrument as stock if a corporation fails to pay all or part of the interest that is due on the instrument during a taxable year; a shareholder of the issuing corporation is the owner of the instrument and his holdings of stock and the instrument are substantially proportionate; and, the owner of the instrument fails to pursue available remedies with the ordinary diligence of an independent creditor.), -6(m)(3) (This provision provides that if a corporation fails to pay the principal on any instrument within 90 days after the principal is due and if the holder fails to pursue available remedies with the ordinary diligence of an independent creditor, the instrument will be treated as a demand instrument from the day after the date the principal was due), -6(m)(2) (This provision provides that a debt instrument which is payable on demand, either by its terms or by reason of section 1.385-6(m)(3), and which is owned by a shareholder of the issuing corporation whose holdings of stock and the instruments are substantially proportionate will be reclassified as stock as of the first day of the taxable year in which the interest actually paid during the year on the instrument is not reasonable as determined under section 1.385-6(f)), -6(k)(1) (This provision states that if a debt instrument is owned by a shareholder of the issuing corporation whose holdings of stock and the instruments are substantially proportionate, and if the holder agrees to make a substantive change in the terms of the instrument, then the instrument is treated as newly issued for property on the day of agreement.).

225. Dillon v. United States, 433 F.2d 1097, 1102 (5th Cir. 1970); Austin Village, Inc. v. United States, 432 F.2d 741, 745 (6th Cir. 1970); A.R. Lantz Co. v. United States, 424 F.2d 1330, 1334 (9th Cir. 1970); Tyler v. Tomlinson, 414 F.2d 844, 849 (5th Cir. 1969); Thompson v. Commissioner, 73 T.C. 878, 895 (1980); Davis v. Commissioner, 69 T.C. 814, 836-37 (1978).

226. See supra notes 22-70 and accompanying text.

Although these provisions effectively implement the "conformity with arm's length standards" philosophy, they appear to provide little flexibility. For instance, the rule relating to a change in the terms of an existing debt obligation, which provides for the reexamination of such obligation under the various tests set forth in the regulations following any substantive modification, seems reasonable and equitable upon first examination. Although this may be true with respect to large publicly-held corporations, this may not be the case with respect to small corporations. It is not at all uncommon for small business lenders to liberalize the terms of a debt instrument as the borrowing company's financial position improves, to renegotiate the terms either as a borrower’s financial condition deteriorates, or to accommodate new infusions of debt or equity capital as long as the lender’s position as a state law creditor remains intact. The rule on substantive changes in terms would appear to unduly restrict the shareholder-lender’s flexibility and ability to deal effectively with the problems of a small corporation by structuring and restructuring financing relative to the flexibility and ability of an arm’s length lender.

In addition, these provisions may not provide more certainty relative to existing case law. For instance, under two of these provisions it is necessary to determine what constitutes "the ordinary diligence of an independent creditor" in analyzing whether a debt instrument will be reclassified as stock. The evil feared by the Secretary is that a shareholder may not enforce his rights as a creditor to the detriment of his rights as a shareholder. But it is not clear what standard the Secretary will use in determining whether a shareholder has exercised the "ordinary diligence of an independent creditor" in protecting his rights as a creditor. Hopefully, the Secretary will not adopt the conservative bank lender as a model in applying this section. This would not conform with the case law, which generally does not require a shareholder-creditor to be as strict as a conservative banker, as long as he acts in the same manner as an independent creditor. This position is based on the realities of the lending industry because, in practice, all lenders are not conservative bankers. Many times a firm is unable to meet its

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228. *Id.* § 1.385-6(k)(1).
229. *Id.* § 1.385-6(f), -6(m)(3).
230. Supplementary Information to Proposed Regulations, supra note 69, at 18,962.
231. Earle v. W.J. Jones & Son, 200 F.2d 846, 850 (9th Cir. 1952); Charles E. Curry, 43 T.C. 667, 681 (1965); Motel Co. v. Commissioner, 22 Tax Ct. Mem. Dec. (CCH) 825, 833 (1963), aff’d on other grounds, 340 F.2d 445 (2d Cir. 1965).
current obligations due to temporary cash flow problems or some other unforeseen circumstances. If there is a reasonable expectation for success in the future, it is to the lender's benefit to bear with a financially troubled corporation until its financial health improves. However, if a shareholder-lender does so by foregoing interest payments or by postponing the maturity date, the Secretary could apply a conservative bank lender standard and interpret this action as a refusal to enforce creditor rights to the detriment of shareholder rights. The loan would then be reclassified as stock.

It seems that the drafters of the regulations believe that a less rigorous standard will be applied. In response to comments concerning the proposed regulations, the drafters state that the "Treasury recognizes that independent creditors do not always bring suit" to enforce their rights. To clarify this point, an example was added to the final regulations which provides that past payment history, pledge of collateral by the debtor corporation, and other unspecified facts and circumstances may warrant the shareholder-creditor's failure to file suit. However, the vagueness of the standard used by this section may allow the Secretary to insist upon more action by a shareholder-creditor where the Secretary feels that there is a tax avoidance scheme involved. In addition, as matters now stand, the subjective nature of the standard used in this provision is bound to engender numerous disputes and costly litigation by forcing a determination as to what a hypothetical creditor would do in a similar situation. Because of the cyclical operations of many small corporations, it is not unusual for an independent creditor to work with a financially troubled debtor by extending the time for payment, lowering the interest rate either temporarily or permanently, allowing lump sum payments to be made in advance of or after due dates, or making other special arrangements. How should the closely-held corporation and its creditor-shareholder assess and establish what legal remedies should be taken by an independent creditor or what concessions such a creditor should make? This question is particularly troublesome because the degree of diligence with which an independent creditor pursues available remedies will vary to a large degree depending upon numerous factors. Some of these factors include: the potential earnings of the debtor; geographic location; alternative investment opportunities for the creditor; the creditor's prior

234. Treas. Reg. § 1.385-6(f)(2) Example (3).
success or failure with the debtor corporation or similar businesses; the general state of the economy, nationwide and in the local community; and the lender's interest in the scientific or innovative aspects of the debtor's business. Therefore, it is arguable that the probable result of this provision would be to convert debt to stock whenever a corporation had financial difficulties and was unable to pay the accrued interest or principal to one of its shareholders whose holdings of stock and instruments are substantially proportionate, without regard to these factors which would mitigate this situation.

2. Provisions Applicable to All Shareholder-Creditors

There is only one relevant classification provision which is applicable to instruments held by creditors who are also shareholders even when holdings of stock and instruments are not substantially proportionate.235 Under this provision, if a loan is made to a corporation by any party other than an independent creditor,236 and within 120 days after the end of the taxable year in which the loan is made, there is not a legally enforceable written document, containing all of the material terms and conditions of the loan, section 1.385-7(b) will operate to classify the loan as debt or equity. Generally, such informal obligations are treated as indebtedness.237 However, such loans will be treated as a contribution to capital if, when the loan is made, the debtor corporation has excessive debt238 as defined in section 1.385-6(g).239 The requirement that the corporation be inadequately capitalized indicates that the danger of informal shareholder advances is not that they are per se tax avoidance vehicles, but rather that in certain circumstances they are likely to merge into the shareholder's equity and represent money which, in economic reality, is subject to the risk of the business. To further force consistency with arm's length relationships, if an unwritten obligation has been classified as indebtedness, and if the debtor-corporation fails to pay interest on the loan at a reasonable rate240 during any taxable year of the debtor-corporation, then the loan is reclassified as a contribution to capital as of the latter of the first day

235. Id. § 1.385-7.
236. As defined under id. § 1.385-6(b) and discussed supra, notes 163-67 and accompanying text.
238. Id. § 1.385-7(b)(2).
239. See supra notes 174-78 and accompanying text.
240. As determined under Treas. Reg. § 1.385-6(f) (1982) and discussed supra notes 109-41 and accompanying text.
of such taxable year or the date of the loan. 241 Once a loan is reclassified, its status as a contribution to capital can never change. 242

Since section 1.385-7 applies to all shareholder-lenders who are not independent creditors, uncertainty is created because the term "independent creditor" is not clearly defined. 243 Otherwise, the provision seems to offer a proper balance between certainty and flexibility with respect to unwritten obligations. 244

IV. CONCLUSIONS

The courts have consistently applied a multi-factor approach in order to determine the "substantive intent of the parties" when faced with the problem of distinguishing debt from equity. Essentially this approach involves analyzing the facts and circumstances surrounding the creation of an interest for the purpose of ascertaining the nature of the interest and the intent of the parties. The questionable interests are then classified as debt or equity giving due consideration to what the parties say they did, interpreted in light of the economic substance of the actual transaction. 245

Essentially, the regulations determine the proper classification by utilizing a narrower arm's length standard, even though various provisions in the regulations do allow one or more other factors which have been identified by the courts to interact with the arm's length standard. In general, the regulations employ various tests regarding an instrument's form, the relationship of the entity to instrument holders, and the entity's capital structure to determine whether the regulations are applicable. If the regulations are applicable, an interest will be classified based upon a comparison of its actual terms with abstractly defined arm's length terms. Such terms are abstractly defined in the sense that they are specified without any reference to the facts and circumstances associated with the negotiation of these terms.

Under the arm's length approach of the regulations, any interest will be treated as stock unless it either results from arm's length negotiations or unless its terms are consistent with terms which would have

242. Id. § 1.385-7(d)(2).
243. See supra notes 163-67 and accompanying text.
244. E.g., shareholder-lenders have until 120 days after the close of the tax year in which the loan is made to either pay off the loan or issue a written instrument. Treas Reg. § 1.385-7(a)(1)(ii), 7(a)(2)(i) (1982).
245. See supra notes 22-61 and accompanying text.
resulted from arm's length negotiations. An instrument issued to a shareholder will be subject to particular scrutiny and will be considered stock unless its terms clearly reflect arm's length economic reality as described by broad general rules or by various "safe harbor" provisions.

The debt versus equity question is a complex one, and there is a need for more certainty in this area. However, it may be argued that the arm's length standard is not appropriate because it depends upon the perceptions, objectives, and judgments of individual parties in light of specific facts and circumstances. Therefore, it is arguable that arm's length standards cannot be abstractly defined. Failure to consider all of the facts and circumstances in determining the existence of arm's length transactions reduces flexibility and may cause artificial transactions as taxpayers attempt to have interests reflect existing facts and circumstances as well as conform to the abstract criteria in the regulations. It follows that the arm's length standard is appropriate only if the application of such a standard will provide greater certainty than current case law, while at the same time allowing sufficient flexibility to be responsive to the individual needs of specific investors and corporate entities. Examination of the regulations discloses the intent to satisfy these conflicting objectives but little success in accomplishing this goal.

Certainty is ostensibly provided by numerous safe harbors. This certainty does not materialize for two reasons. First, the criteria which must be met in order to fall within these safe harbors tend to be so restrictive that these areas of certainty are unavailable to a significant portion of corporate taxpayers. Moreover, it may be argued that many of the safe harbors are designed to be applicable to public corporations rather than small corporations. This result is consistent

\[\text{\textsuperscript{246}}\text{ See supra notes 62-70 and accompanying text.} \\
\text{\textsuperscript{247}}\text{ Supplementary Information to Proposed Regulations, supra note 69, at 18,958.} \\
\text{\textsuperscript{248}}\text{ See Treas Reg. \$ 1.385-6(f)(2) (The debt-equity ratio requirement and the method of computing it whereby stockholder's equity is determined with reference to adjusted basis, will result in many corporations being unable to qualify under the safe harbor for a reasonable interest rate.). -6(g)(3) (Adequate capitalization is determined by debt-equity ratio computations under this safe harbor; however, there is a single ratio to be applied to all corporations and stockholder's equity is computed using adjusted basis rather than fair market value.).} \\
\text{\textsuperscript{249}}\text{ See id. \$ 1.385-3(a)(2)(ii) (safe harbor for determining the fair market value requires instruments to be registered with the SEC and sold to the public for money). -6(a)(3)(i) (specifies that holdings of instruments and stock are not substantially proportionate if the instruments and stock are widely held and the instruments are separately traded and readily marketable), -6(b)(2)(iii)(3) (safe harbor which specifies that a creditor is independent if his percentage ownership of instruments is at least twice as great as his percentage ownership of stock and if there is no attribution under section 318 as modified by substituting a 5\% threshold test for the 50\% test of} \\
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DEBT-EQUITY CLASSIFICATION

with the arm's length standard since the terms of instruments issued by
public corporations are likely to have been negotiated at arm’s length,
whereas the terms of those issued by closely-held corporations to share-
holders are not likely to be the result of arm’s length negotiations.
Nevertheless, the regulations require arm’s length terms primarily in
those situations where arm’s length negotiations are not present.
Therefore, it seems inappropriate to have the areas of certainty defined
to apply primarily to situations involving arm’s length negotiations
since these safe harbors will obviously not be available to the very cor-
porations that are most affected by the regulations. Second, the appli-
cation of numerous safe harbor provisions depends upon factors which
are highly subjective in many instances, raising the question as to
whether any significant degree of certainty is actually provided by the
safe harbors even when they are applicable.250

The actual degree of certainty provided by the regulations is also
questionable since many of the classification rules are either difficult to
understand or to apply.251 By departing from the subjective standards
of present case law in favor of an “objective” approach with its own
subjective standards, the Secretary may ultimately accomplish only the
substitution of one uncertain body of case law for another as taxpayers

250. See id. § 1.385-3(a)(2)(i) (safe harbor for determining FMV requires a reasonable interest
rate), -6(a)(3)(ii) (safe harbor specifies that holdings of stock and instruments are not substantially
proportionate if held by an independent creditor; yet determining whether a taxpayer is an in-
dependent creditor is a very subjective process), -6(f)(2) (safe harbor for a reasonable interest rate
requires computation of the corporate debt-equity ratio and the regulations are not clear as to how
to compute corporate liabilities for this purpose), -6(g)(3) (safe harbor for determining adequate
capitalization requires computation of the corporate debt-equity ratio and the regulations are not
clear as to how to compute corporate liabilities for this purpose).

251. See id. § 1.385-5(a) (A mechanical test is applied to classify hybrid instruments, but the
objective test depends upon a determination of fair market value which is a subjective factor.),
-6(f)(1) (The general rule for determining a reasonable interest rate is very ambiguous.), -6(d)(4)
(The definition of the proper discount rate to be used for valuing straight debt payments specifies
a rate equal to a reasonable interest rate within the ambiguous general rule specified in section
1.385-6(f)(1)), -6(b)(1) (the general rule for determining whether a creditor is independent is am-
biguous), -6(a)(2) (The use of attribution rules when ascertaining whether holdings of stock and
instruments are substantially proportionate is confusing and uncertain.), -6(g)(2) (The general rule
for determining whether debt is excessive depends upon a subjective evaluation by a hypothetical
independent creditor.), -6(g)(3) (The safe harbor for determining whether debt is excessive de-
pends upon computing debt-equity ratios; yet, the regulations are not clear regarding how to com-
pute corporate liabilities for this purpose.), -6(e) (Classification as stock depends upon whether an
instrument's interest rate is reasonable and that is a subjective process.), -6(m)(1) (Classification as
stock depends upon whether an instrument's interest rate is reasonable and that is a subjective
process.), -6(c) (Operation of this provision requires a determination of fair market value as well
as the creation of constructive inflows and outflows.).
are forced to resort to the courts for interpretation. The courts have spent forty years developing the present touchstones which measure "substantive intent." Under these regulations they may spend the next forty years defining the arm's length standard.

Flexibility is said to be provided by rules which allow an interest to be classified as either debt, equity, or both.252 In addition, flexibility seems to require that the arm's length standards be responsive to the facts and circumstances surrounding the issuance of the instruments in question. Under these two standards for evaluating flexibility, many of the general rules are clearly flexible; however, these rules appear to be so indefinite that more uncertainty is created than under existing case law for those taxpayers who are unfortunate enough to find the relevant safe harbors unavailable.253

In summary, the safe harbors as presently drafted appear to be too narrowly defined to afford a substantial degree of certainty to those corporations most likely to bear the burden of compliance with these regulations. On the other hand, the general rules which provide flexibility offer even less guidance and certainty than existing case law. Furthermore, other rules within the regulations provide neither flexibility nor certainty because they are purely mechanical rules which depend upon subjective factors for their operation.254

These problems indicate that the regulations focus too extensively on arm's length relationships. Therefore, another philosophical approach may be necessary before the desired balance between certainty and flexibility can be achieved. However, since courts have failed to delineate specific guidelines to distinguish debt from equity, this may indicate that this area of tax law cannot be governed by specific rules,

252. Supplementary Information to Proposed Regulations, supra note 69, at 18,958.
253. See Treas. Reg. § 1.385-3(a)(1)(i) (1982) (Fair market value is defined as the price that would be negotiated by a willing buyer and a willing seller having reasonable knowledge of all relevant facts.), -6(b)(1) (All relevant facts and circumstances must be taken into account when determining whether one is an independent creditor.), -6(f)(1) (A reasonable interest rate is within the range of rates paid to independent creditors in the same general industry, geographic location, and financial condition as the taxpayer.), -6(g)(2) (A corporation has excessive debt if all of the terms and conditions of an instrument, together with the corporation's financial structure, would not be acceptable to an arm's length lending institution.).
254. See id. § 1.385-5(a) (purely mechanical test depending upon estimates of the fair market value), -6(e)(l) (an inflexible rule depending upon substantially proportionate holdings of stock and instruments as well as determination of a reasonable interest rate), -6(m)(l) (an inflexible rule depending upon substantially proportionate holdings of stock and instruments as well as determination of a reasonable interest rate), -6(f) (an inflexible rule depending upon substantially proportionate holdings of stock and instruments as well as a determination as to what constitutes the ordinary diligence of an independent creditor).
but rather requires an analysis of the relevant factors in each case. Thus, it may be appropriate for Congress to reconsider the authority granted to by the Secretary by section 385. General public policy seems to support a reconsideration of this congressional delegation of authority.

Since the regulations tend to use market standards to determine if an instrument held by a shareholder is debt, large corporations, which obtain most of their capital from outsiders, will not generally be subjected to the regulations. Small corporations will bear the greatest burden of compliance with these regulations because they simply do not have the access to capital or debt markets that larger corporations enjoy, and therefore depend heavily upon shareholder financing, both temporary and long-term. Clearly, this result is consistent with the "conformity with economic reality" policy which the Secretary is trying to implement. On the other hand, Congress has also recognized the important role that small businesses play in our society. For example, Congress has stated that the economic well-being and security of the nation "cannot be realized unless the actual and potential capacity of small businesses is encouraged and developed." To implement this goal, laws have recently been enacted to "encourage" federal agencies to structure the regulations they issue so there will be no unnecessary adverse effects on small businesses, and to amend federal laws so that business enterprises, "particularly small, growing, and financially troubled enterprises, can . . . readily raise needed capital." Thus, it may be argued that congressional intent was not to provide a framework for rules so stringent that small business corporations, which cannot generally resort to outside financing, would be unduly penalized. Yet, it is arguable that at least some of the provisions in the regulations will have that result. It follows that the section 385 regulations may

255. Grever, supra note 130, at 28.
256. See supra notes 71-75 and accompanying text.
260. E.g., the rules requiring arm's length enforcement of an instrument's terms are based upon the premise that a shareholder will be indifferent whether he receives economic benefits from the corporation in the form of interest payments, dividends, or increases in the value of his
operate to stifle small corporations and, consequently, that they are contrary to public policy. In other words, while arm’s length dealings with one’s own corporation are theoretically desirable, the practical realities of financing such an entity may cause this goal to be unrealistic.261

stock since he owns an equity interest in the corporation as well as an interest as a creditor. It follows that the existence of indebtedness, as an interest separate and apart from the equity interest, is a sham when a shareholder fails to strictly enforce the terms of a debt instrument. With the exception of the “ordinary diligence of an independent creditor” standard, the meaning of which is extremely subjective, this reasoning and the arm’s length enforcement rules seem to ignore the fact that shareholder-creditors of closely-held corporations may be required to postpone or change the terms of an instrument in order to keep a corporation viable. Moreover, these rules also seem to ignore the fact that nonshareholder creditors often have to modify the terms of an instrument if they hope to recover their principal. It should be noted that extensions of time to pay have been granted to Chrysler Corporation by numerous lenders of millions of dollars. Obviously, these lenders granted extensions on their loans because they believed that their financial interest would be preserved. Shareholder-creditors of small corporations may also feel that it is to their advantage to grant extensions for payment on their loans for the same reason. See supra notes 229-34 and accompanying text. In addition, the excessive debt rule stated in Reg. § 1.385-6(g) appears to reach results which are inconsistent with existing financing realities. Small corporations are likely to have excessive debt for two reasons. First, in its beginning years, a corporation generally must rely heavily upon debt as it establishes good business relations and develops a history of earning capacity. Second, it is not uncommon, and is sometimes desirable from a legal standpoint, to incorporate with as little net worth as possible. This is because most start-up situations involve the venturer’s lifetime savings plus outside debt. The idea is to minimize the proportion of personal capital at risk and also to create a means for returning those previously taxed savings to the owner tax-free. Incorporations of this type, of course, give rise to loans that have in the past created the debt or equity controversies. The regulations intend to lock those life-time savings into a taxable position if withdrawn. It may be argued that such a result is consistent with sound economic and financial theory, but that it ignores the practical realities of small corporation financing. See supra notes 173-86 and accompanying text.

261. On June 23, 1982, the Internal Revenue Service announced that the § 385 rules will not go into effect before January 1, 1983, providing additional time for Treasury Department and the Service to consider comments on proposed revisions and to publish them in final form.