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THE REGULATIONS UNDER SECTION 385:
A REVIEW, EVALUATION, AND SUGGESTED APPROACH

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I. INTRODUCTION

EVERY TAX SCHOLAR AND PRACTITIONER IS AWARE of the problems associated with the classification of securities as debt or equity interests, particularly in closely-held corporations.¹ This tax area is abundant with litigation striving to establish distinctions between these two fundamental sources of corporate funds.² The large body of case law has established the principle that a shareholder generally intends to place his money at the risk of the business and share in the profits and losses of the enterprise in which his right to payment is contingent.³ A creditor, on the other hand, generally does not expect to share in the corporation's profits, but rather expects the debtor corporation to fulfill its "unqualified obligation to pay a sum certain at a reasonably close fixed maturity

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1. This problem most commonly arises in closely-held corporations because the shareholders, often also acting as officers of the corporation, are able to control the label the corporation gives to the shareholder in advance. Although large public corporations occasionally find the Internal Revenue Service challenging the validity of an instrument purported to be debt, it would seem easier for a corporation with a large number of shareholders to survive the attack. See *Monon R.R. v. Commissioner*, 55 T.C. 345 (1970), *acq.* 1973-2 C.B. 3 (widely-held public corporation with 1,200 shareholders established validity of debenture).

The regulations under § 385 recognize this dichotomy by exempting the instruments of public corporations from several of the rules which classify an instrument as stock. See, e.g., Treas. Reg. §§ 1.385-3(b)(2)(ii), -6(a)(3)(i), -6(a)(3)(ii) (1980).

2. This area of case law has been described as "a 'jungle' of several hundred court decisions which 'defy symmetry.'" Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 370 (1971). In the last decade alone, over 200 court decisions by the Tax Court and federal appellate courts have dealt in some way with the distinction between debt and equity.

3. See, e.g., *Slappey Drive Indus. Park v. Commissioner*, 561 F.2d 572, 581 (5th Cir. 1977); *Finance Corp. v. Commissioner*, 302 F.2d 786, 789-90 (3d Cir. 1962); *Commissioner v. O.P.P. Holding Corp.*, 76 F.2d 11, 12 (2d Cir. 1935); *Litton Business Sys., Inc. v. Commissioner*, 61 T.C. 367, 377 (1973).

date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof." ⁴ Nevertheless, the case law has failed to produce any fully satisfactory guidelines for distinguishing debt and equity instruments for tax purposes.⁵ Instead, each case is said to be determined on its own set of facts,⁶ with the courts applying as many as sixteen factors ⁷ in an effort to ascertain the intent of the parties to the transaction. The classification of the instrument as debt or equity is then based upon the intent of the parties in accordance with the general principles set forth above.⁸

4. *Gilbert v. Commissioner*, 248 F.2d 399, 402 (2d Cir. 1957).

5. See *Plumb*, *supra* note 2, at 407. The drafters of the § 385 regulations acknowledge this fact. See Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,958 (1980). One commentator has stated that there is "no more frustrating and wasteful area" in all of the tax law. See *Dixon, The Interest-Dividend Syndrome: What Are The Criteria Now?*, 24 N.Y.U. INST. FED. TAX 1267, 1267 (1966).

6. *Gooding Amusement Co. v. Commissioner*, 236 F.2d 159, 165 (6th Cir. 1956), *cert. denied*, 352 U.S. 1031 (1957). See *Plumb*, *supra* note 2, at 408.

7. See *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968). One writer has identified 38 factors which the courts have taken into account. See *Holzman, The Interest-Dividend Guidelines*, 47 TAXES 4 (1969). The Fifth Circuit has identified 13 factors which merit consideration in determining the intent of the parties:

- (1) the names given to the certificates evidencing the indebtedness;
- (2) [t]he presence or absence of a fixed maturity date;
- (3) [t]he source of payments;
- (4) [t]he right to enforce payment of principal and interest;
- (5) participation in management flowing as a result;
- (6) the status of the contribution in relation to regular corporate creditors;
- (7) the intent of the parties;
- (8) "thin" or adequate capitalization;
- (9) identity of interest between creditor and stockholder;
- (10) source of interest payments;
- (11) the ability of the corporation to obtain loans from outside lending institutions;
- (12) the extent to which the advance was used to acquire capital assets; and
- (13) the failure of the debtor to repay on the due date or to seek a postponement.

Estate of Mixon v. United States, 464 F.2d 394, 402 (5th Cir. 1972). See also *A. R. Lantz Co. v. United States*, 424 F.2d 1330, 1333 (9th Cir. 1970) (11 factors). See generally *Plumb*, *supra* note 2, at 407-555.

8. *A.R. Lantz Co. v. United States*, 424 F.2d 1330, 1333 (9th Cir. 1970). The usefulness of these criteria is limited because they rarely point in the same direction and the factors have no established relative weights. See, e.g., *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972); *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476 (1980). See generally *Plumb*, *supra* note 2, at 407-08. In addition, a court may apply various factors to one case and not to another. See, e.g., *In re Uneco, Inc.*, 532 F.2d 1204, 1207 (8th Cir. 1976); *Dixie Dairies Corp. v. Commissioner*, *supra*. Most courts precede their lists of factors with a caveat similar to the following:

Similar questions have been before this tribunal and other courts, and with each one it was necessary to consider all facts and cir-

In an attempt to reduce the uncertainty accorded the treatment of interests as stock or indebtedness, Congress enacted section 385 of the Internal Revenue Code (Code)⁹ as part of the Tax Reform Act of 1969.¹⁰ This provision authorizes the Secretary of the Treasury (Secretary) to prescribe the "necessary or appropriate" regulations to determine whether an interest in a corporation is to be treated, for all purposes of the Code, as stock or indebtedness.¹¹ The regulations were to set forth factors to determine whether a debtor-creditor or a corporation-shareholder relationship exists.¹² On December 29, 1980, over ten years after the enactment of section 385, the Secretary issued final regulations under this Code provision.¹³ This article examines sections 1.385-1 through 1.385-10 of the regulations. Each provision in the regulations is summarized and evaluated with respect to its consistency with congressional intent and administrative authority, as well as with respect to existing judicial precedent. Where appropriate, comments will also be made regarding the potential impact of the provision upon popular financ-

circumstances in the particular case in order to determine if the relationship was that of stock ownership or debtor and creditor. In some cases the determining characteristic has been one factor, while in other cases it has been another. No one factor is necessarily controlling.

John Kelley Co. v. Commissioner, 1 T.C. 457, 462 (1943), *rev'd*, 146 F.2d 466 (7th Cir. 1945), *rev'd*, 326 U.S. 521 (1946). *Accord*, *Scriptomatic, Inc. v. United States*, 555 F.2d 364, 367 (3d Cir. 1977); *Midlands Distribs., Inc. v. United States*, 481 F.2d 730, 733 (5th Cir. 1973); *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697 (3d Cir. 1968); *Georgia-Pacific Corp. v. Commissioner*, 63 T.C. 790, 796 (1975); *Family Group, Inc. v. Commissioner* 59 T.C. 660, 668 (1973).

9. I.R.C. § 385.

10. Pub. L. No. 91-172, 83 Stat. 487 (1970). Congress was concerned about the increased level of corporate mergers and the increasing use of debt in corporate acquisitions, which were due in part to the favorable tax consequences accorded debt as opposed to stock. *See* S. REP. No. 552, 91st Cong., 1st Sess. 137 (1969); H.R. REP. No. 413, 91st Cong., 1st Sess. 103 (1969). In its version of the Reform Act, the House enacted § 279 of the Code, which disallows a corporate interest deduction with respect to certain types of indebtedness which are issued as consideration for the acquisition of the debt of another corporation. *See* I.R.C. § 279(a) (1976). Thus, § 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 § 279, determined that it would be desirable to provide rules for distinguishing debt from equity in situations other than corporate acquisitions in which this problem arises. *See* S. REP. No. 552, *supra*, at 138. However, it was felt that the variety of contexts in which this distinction was significant made it too difficult to enact comprehensive and specific statutory rules. *Id.* Thus, § 385 was enacted to authorize the Secretary to promulgate guidelines. *Id.* *See* I.R.C. § 385(a).

11. *See* I.R.C. § 385(a).

12. *Id.* § 385(b).

13. *See* T.D. 7747, 1981-8 I.R.B. 15.

ing arrangements, the fairness of the particular provision, and the ability of taxpayers to understand and apply the particular provision.

This analysis should be of interest for a number of reasons. Most importantly, these regulations will have a significant impact upon tax practice because the determination as to whether an interest is debt or equity is relevant to a broad range of regularly encountered tax situations.¹⁴ Along these same lines, the enforcement of these regulations in their present form will have a substantial effect upon the availability of funds for many corporations, particularly smaller entities, and on the form such advances will take.¹⁶

Neither the statutory language nor the legislative history provides any insight with respect to the policy to be implemented by the regulations. As a result, ambiguous regulations will be difficult for taxpayers, the Internal Revenue Service (Service), and the courts to interpret and apply. Confusion may be intensified by the fact that there are no principles consistently applied by the courts in the divergent situations in which the distinction between stock and debt is crucial for tax purposes.¹⁶ Similarly, present differences in the tax treatment of debt and equity do not provide useful policy guidance. Therefore, it may be concluded that no conceptual framework exists which can provide a theoretical basis for interpretation of these regulations. Thus, if provisions in the regulations are difficult to understand and apply, it is possible that these regulations may cause as much confusion and litigation as presently exists without them.

The broad impact of these regulations may force many taxpayers into taking aggressive positions with respect to the specific provisions contained therein. Consequently, an analysis of the vulnerability of these regulations to attack may prove extremely helpful.

The Secretary's authority to issue these regulations stems from two sources. First, section 7805 of the Code vests the Secretary with the general authority to prescribe interpretive regulations for all purposes under the Code.¹⁷ Second, in section 385 Congress specifically authorized the Secretary to prescribe the "necessary or appro-

14. See notes 35-52 and accompanying text *infra*.

15. See notes 35-37 and accompanying text *infra*.

16. One court described the decisions as "defy[ing] symmetry." *Tyler v. Tomlinson*, 414 F.2d 844, 847 (5th Cir. 1969). See generally Comment, *Towards New Modes of Tax Decision Making—The Debt-Equity Imbroglia and Dislocations in the Tax Lawmaking Responsibility*, 83 HARV. L. REV. 1695, 1705-07 (1970).

17. I.R.C. § 7805(a)(1978).

priate" regulations to determine whether an interest is to be treated as indebtedness or stock for all purposes under the Code.¹⁸ However, authority to prescribe regulations is not equivalent to legislation by statute.¹⁹ The courts have not followed regulations where such regulations exceeded the Treasury's authority,²⁰ although regulations which are expressly authorized by statute carry a strong presumption of validity.²¹ As a result, it seems that taxpayers attempting to invalidate a section 385 regulation will have a heavy burden to demonstrate that the Secretary has exceeded his authority. Nevertheless, in the case of section 385, the statutory delegation of rule-making authority is unusual in that the Senate report refers to the development of "regulatory guidelines" setting forth "factors" to be "taken into account,"²² instead of simply stating that the classification of stock and debt "shall be in accordance with rules to be prescribed by the Secretary." This latter form of delegation is the most common type.²³

In light of the unusual nature of the Secretary's authority under section 385, both the New York State Bar²⁴ and the American Bar Association²⁵ suggest that taxpayers may defend their debt positions by attacking the regulations as lacking authoritative support. In

18. *Id.* § 385(a). See note 11 and accompanying text *supra*.

19. I J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 3.21 (1974).

20. *Id.* § 3.20. See, e.g., *Manhattan Gen. Equip. Co. v. Commissioner*, 297 U.S. 129 (1936); *Bates v. United States*, 581 F.2d 575 (6th Cir. 1978); *Smith v. Commissioner*, 332 F.2d 671 (9th Cir. 1964); *Arkansas-Oklahoma Gas Co. v. Commissioner*, 201 F.2d 98, 102 (8th Cir. 1953).

21. A regulation issued pursuant to a specific delegation of authority is known as a "legislative regulation" and is "binding upon a court as a statute if it is (a) within the granted power, (b) issued pursuant to proper procedure and (c) reasonable." I K. DAVIS, ADMINISTRATIVE LAW TREATISE § 5.03 (1958). As such, the courts have indicated that greater weight should be accorded to such regulations than to an interpretative regulation. I J. MERTENS, *supra* note 19, § 3.20.

22. S. REP. NO. 552, *supra* note 10, at 138.

23. See, e.g., I.R.C. §§ 44A(g) (1978), 44B(b) (1980), 105(h)(9) (1980), 125(h) (1980), 190(d) (1976), 405(h) (1976), 913(m) (1980), 2622 (1976), 3506(c) (1977), 6166(i) (1978). Other sections of the Code delegate authority in the same manner, but are more specific in detailing what subjects the regulations may deal with. See, e.g., *id.* §§ 58(h) (1980), 280A(d) (1978), 382(c) (1980), 504(b) (1976), 904(f) (1980), 995(e) (1978), 2032A(g) (1978), 3507(d) (1980), 6107(c) (1976), 6110 (f) (1976).

24. See Beghe, *Redrawing the Lines Between Corporate Debt and Equity Interests: The Proposed Regulations Under Section 385*, 58 TAXES 931, 933 & n.15 (1980), citing NEW YORK STATE BAR TAX SECTION, REPORT ON PROPOSED REGULATIONS § 1.385: THE TAX DISTINCTION BETWEEN CORPORATE DEBT AND EQUITY (August 1980).

25. Beghe, *supra* note 24, at 933 & n.16, citing AMERICAN BAR ASSOCIATION TAX SECTION REPORT, COMMENTS ON PROPOSED REGULATIONS UNDER SECTION 385 (October 1980).

other words, it may be argued that Congress intended the regulations to provide guidelines for applying a multi-factor approach along the lines of the case law, and not necessarily to prescribe binding or conclusive determinations.²⁶ If this argument is correct, then any provision in these regulations that dictates what form the various aspects of each instrument must take, or that provides for conclusive determinations of the tax consequences of various transactions by a corporate taxpayer, may be vulnerable to attack under the rationale that such provisions exceed the Secretary's statutory authority. Likewise, specific provisions in the regulations which are clearly at odds with existing case law may be vulnerable based upon the same reasoning. Nevertheless, it must be noted that the broad grant of authority and the presumption of validity granted this type of administrative enactment may make the courts unwilling to accept such arguments.

With these thoughts in mind, as well as the fact that the Secretary has recently extended the effective date of these regulations to January 1, 1982²⁷ in order to allow more time for comment and reconsideration, an analysis such as this may also be of some assistance in evaluating the appropriateness of these regulations.

The order of presentation of the various rules set forth in the regulations appears to be convoluted and difficult to interpret, even for an experienced tax practitioner. Like many provisions of the Code and regulations, some definitions and operational rules are applicable to more than one classification rule.²⁸ A general rule is given, but as is true of many Code sections, the exceptions to this general rule are the key. Some of the exceptions apply to all creditors, while others apply only to creditors who are also shareholders. Therefore, in an attempt to make it easier for the reader to understand the regulations, and to prevent unnecessary redundancy, the order of presentation in this article will differ from that of the regulations.

The effective date and scope of the regulations will be discussed.²⁹ This will be followed by an examination of the definitions of various terms which are used in more than one rule.³⁰ Next, the

26. Beghe, *supra* note 24, at 933. *But see* Eustice, *Corporations and Corporate Investors*, 25 TAX L. REV. 509, 527 (1970) (section 385 delegates virtually unlimited authority to Secretary).

27. Treas. Reg. § 1.385-1(a)(1), T.D. 7774, 1981-22 I.R.B. 6.

28. As used in this article, the term "operational rule" will encompass any test or rule used by a classification rule. "Classification rule" will mean any provision which actually classifies an interest as debt or equity.

29. *See* notes 53-73 and accompanying text *infra*.

30. *See* notes 74-93 and accompanying text *infra*.

operational rules that are applicable to more than one operational or classification rule will be identified and evaluated.³¹ The general rule for classification will be reviewed,³² followed by an enumeration and discussion of the exceptions and modifications to the general rule.³³ But, initially, the differences in the tax treatment of debt and equity will be outlined,³⁴ for one must know why classification as debt or equity makes a difference in order to understand the substance of the controversy.

II. THE EFFECTS OF CLASSIFICATION AS INDEBTEDNESS OR STOCK

There is a significant difference in the federal tax treatment of payments made with respect to stock *vis-a-vis* payments made with respect to indebtedness. For instance, although interest is included in the gross income of the recipient under section 61,³⁵ section 163 states: "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."³⁶ On the other hand, amounts distributed to a shareholder by a corporation with respect to its stock are also likely to be included in the shareholder's gross income,³⁷ but no deduction will be allowed to the corporation. The nondeductibility to the corporation of the distribution payments has the effect of substantially increasing the cost of obtaining corporate equity capital.³⁸

31. See notes 95-203 and accompanying text *infra*.

32. See notes 204-18 and accompanying text *infra*.

33. See notes 219-472 and accompanying text *infra*.

34. See notes 35-52 and accompanying text *infra*.

35. I.R.C. § 61(a)(4).

36. *Id.* § 163(a) (1976).

37. Such distributions will be included in ordinary income if they are a dividend. *Id.* § 301(c)(1) (1978). Any distribution out of a corporation's earnings and profits will be considered a dividend. *Id.* § 316(a) (1978). Thus, distributions will be included in the gross income of the shareholders to the extent of corporate earnings and profits. In general, this will result in interest being taxed no more heavily than dividends to a non-corporate shareholder. See Plumb, *supra* note 2, at 374.

38. Plumb, *supra* note 2, at 373. Plumb has described the impact of the difference between a corporation's use of debt or stock in its capital structure as follows:

In order to pay a \$6 dividend on a share of preferred or common stock, a corporation must earn approximately \$12 before taxes, whereas a bond bearing \$6 interest can be carried with only \$6 of earnings. Thus, the leverage that results from the use of debt instruments . . . to obtain capital, which it is hoped will earn a return for the common shareholders in excess of the fixed cost of carrying such securities, is magnified when the tax deduction in effect cuts that cost in half The small corporation, while its opportunities for leverage may be limited by the unavailability of outside financing, nevertheless may profit by designating part of its stockholder's interest as debt, thereby mitigating the "double taxation" of cor-

From the viewpoint of the shareholder, the principal advantage of debt over equity lies in the consequences of repayment of his investment. If an interest is found to be indebtedness, repayment of the investment will be a tax-free return of capital to the extent of the shareholder's adjusted basis in the debt instrument.³⁹ Furthermore, under section 1232, any amount received upon retirement of an obligation will be considered as received in a sale or exchange,⁴⁰ and thus any gain realized will be capital gain as opposed to ordinary income.⁴¹

In contrast, if an interest is found to be equity, any amount received upon repayment will be an amount received in redemption of the shareholder's stock.⁴² If the shareholder cannot pass the tests of section 302(b),⁴³ which he will most likely be unable to do, particularly if he is a shareholder of a closely-held corporation,⁴⁴ ordinary income will be the result.⁴⁵ Thus, payments of principal will be taxed as dividends if the investment is found to be equity, thereby decreasing the shareholder's after-tax return. If there is any possibility that the debt-equity regulations may convert debt into equity, a potential investor will probably demand a significantly higher pre-tax return in order to be assured of the same return on an after-tax basis. This will result in an increase in the cost of debt capital to corporations. In some cases, the cost of debt capital may tend to approach the cost of equity capital. Small corporations that cannot justify this increase in the cost of capital will be unable to obtain additional capital.

porate earnings through the payment of what amounts in substance to deductible dividends.

Id.

39. See I.R.C. § 1232(a) (1978) (sale or exchange of debt instruments). Under § 1001, upon a sale or exchange, gain is realized only to the extent that the amount realized exceeds the adjusted basis. *Id.* § 1001(a) (1980).

40. *Id.* § 1232(a)(1) (1978).

41. *Id.* § 1232(a) (1978). In certain circumstances, a creditor may have an adjusted basis in the debt instrument which is less than the face amount. For example, the debt may have originated in a tax-free transfer of property to a corporation under § 351, and thus will have a substituted basis under § 358(a)(1). See *id.* §§ 351 (1980), 358(a)(1) (1978).

42. *Id.* § 302(a) (1980).

43. *Id.* § 302(b) (1980).

44. Gerver, *De-Emphasis of Debt-Equity Test for Thin Corporations Requires New Defense Tactics*, 23 J. TAX. 28, 28 (1965). The shareholder will probably have to give up a large portion of his holdings and perhaps some degree of control, and his family may also have to give up some holdings. *Id.*

45. I.R.C. § 301(c)(1) (1978). If the § 302(b) tests are not satisfied, the rules of §§ 301 and 316 are applicable. *Id.* § 302(d) (1980). See note 37 and accompanying text *supra*.

Because of the potential impact upon a corporation's cost of capital, it would appear that these regulations are destined to have a significant impact upon the financing arrangements of all corporations. However, they seem to be particularly important with respect to small, closely-held corporations, whose shareholders provide the best, and often the only, source of financing.⁴⁶ This is particularly true in the current economic environment in which high interest rates and limited access to capital markets, caused by tight monetary conditions, generally restrict borrowing by small corporations.⁴⁷

In addition to those set forth above, there are additional differences between the treatment of debt and equity interests.⁴⁸ Although the courts frequently must determine whether an investment is debt or equity in order to classify a payment as a dividend or interest,⁴⁹ other issues which depend upon such a determination include whether a bad debt deduction will be allowed⁵⁰ and whether the corporation is insolvent.⁵¹ As a result, the regulations under

46. Gerver, *supra* note 44, at 28.

47. It was unclear under the proposed regulations whether the regulations would have any impact on shareholders' rights and duties outside the tax law. For example, comments were made which expressed concern that holders of purported debt, which was classified as stock under the regulations, would be considered stockholders and thus would be subject to the non-tax law liabilities which stockholders face. The drafters of the final regulations recognized this problem and § 1.385-4(c) was amended to provide that debt reclassified as stock would still "have the same terms . . . as the instrument has under applicable local law." See Treas. Reg. § 1.385-4(c) (1980).

48. See Plumb, *supra* note 2, at 383-98. Other differences occur upon the worthlessness of the investment, as a corporation liquidates, and upon the death of a purported shareholder who wishes to utilize § 303 and have the corporation redeem his stock. *Id.* at 371-404. See also Goldstein, *Corporate Indebtedness to Shareholders: "Thin Capitalization" and Related Problems*, 16 TAX L. REV. 1 (1966).

49. See, e.g., Ragland Inv. Co. v. Commissioner, 435 F.2d 118 (6th Cir. 1970); Piedmont Materials Co., Inc. v. United States, 429 F.2d 560 (4th Cir. 1970); Litton Business Sys., Inc. v. Commissioner, 61 T.C. 367 (1973); Family Group, Inc. v. Commissioner, 59 T.C. 660 (1973); Mennuto v. Commissioner, 56 T.C. 910 (1971); Motel Corp. v. Commissioner, 54 T.C. 1433 (1970).

50. See, e.g., Raymond v. United States, 511 F.2d 185 (6th Cir. 1975); Midland Distribs., Inc. v. United States, 481 F.2d 730 (5th Cir. 1973); Dixie Dairies Corp. v. Commissioner, 74 T.C. 476 (1980); Thompson v. Commissioner, 73 T.C. 878 (1980); Davis v. Commissioner, 69 T.C. 814 (1978).

51. See Yale Ave. Corp. v. Commissioner, 58 T.C. 1062 (1972). In *Yale*, the issue of whether an advance was debt or equity determined whether the corporation was insolvent. *Id.* at 1073. In a prior decision, the Tax Court had entered a judgment against the corporate taxpayer. See *id.* at 1072. This liability was later settled for a lesser amount, so that the taxpayer had income from the discharge of indebtedness. *Id.* However, if the advance was a loan, the corporation was insolvent both before and after the discharge, and no income would result. *Id.* at 1073. On the other hand, if the advance was a contribution to capital, the corporation would have been solvent, with the result that there would be income. *Id.*

section 385 are of vital importance in deciding the tax consequences in many areas of tax law.⁵²

III. SCOPE OF THE REGULATIONS AND EFFECTIVE DATE

The regulations apply to all instruments, including preferred stock, certain unwritten obligations,⁵³ and guaranteed loans, issued or made after December 31, 1981.⁵⁴ Other interests, such as bank deposits, insurance policies, claims for wages, and trade accounts payable are outside the scope of the regulations.⁵⁵ Any interest that is outside the scope of the regulations is to be treated as stock or indebtedness under applicable principles of existing case law without reference to the regulations.⁵⁶

It must be noted that these regulations will exert an influence over broad areas of the Code. While they were issued under section 385, they will be effective for all purposes of the Internal Revenue Code.⁵⁷ Thus, a section 385 determination may produce tax consequences affecting transactions addressed by many sections in all parts of the Code.⁵⁸

52. Recent court decisions illustrate this point. In *Georgia-Pacific Corp. v. Commissioner*, 63 T.C. 790 (1975), the taxpayer argued that stockholder advances were contributions to capital rather than loans, and thus could offset excess losses of the corporation in the computation of its affiliated group's consolidated income. *Id.* at 795. Two other cases in which the debt versus equity question dictated the result involved the issue of whether § 1244 stock issued in return for cash advances was exchanged for an equity interest, in which case the stock would not qualify as § 1244 stock. See *Hollenbeck v. Commissioner*, 422 F.2d 2 (9th Cir. 1970); *Smyers v. Commissioner*, 57 T.C. 189 (1971).

The debt versus equity question can affect non-tax law as well. For example, in one case the focus was upon whether a taxpayer's deduction for a bad debt was improper. This in turn determined whether a tax claim in a bankruptcy proceeding was valid. See *In re Uneco, Inc.*, 532 F.2d 1204 (8th Cir. 1976). See also *In re Indian Lakes Estates, Inc.*, 448 F.2d 574 (5th Cir. 1971) (trustee in bankruptcy challenged validity of priority tax claims on basis that deficiency assessments disallowing interest deduction on purported debt were improper).

53. Obligations which are described in § 1.385-7(a) are subject to the regulations. See note 326 and accompanying text *infra*.

54. Treas. Reg. § 1.385-1(a)(1), T.D. 7774, 1981-22 I.R.B. 6.

An exception is made for instruments issued pursuant to a written contract which is binding on December 29, 1980 and at all times thereafter. *Id.* § 1.385-1(a)(2)(ii). There is also an exception for instruments issued pursuant to a plan of reorganization in a bankruptcy proceeding. *Id.* § 1.385-1(a)(2)(i). The Secretary has stated that the December 29, 1980 date would be changed, but did not specify the amended date. See T.D. 7774, 1981-22 I.R.B. 6.

55. Treas. Reg. § 1.385-1(b)(1) (1980).

56. *Id.*

57. See I.R.C. § 385(a).

58. These sections include *id.* §§ 165 (1971), 166 (1976), 243 (1976), 267 (1978), 269 (1976), 279 (1976), 302 (1980), 303 (1976), 304 (1964), 318 (1964), 332 (1976), 341 (1976), 351 (1980), 368 (1980), 482 (1976), 531, 542 (1980), 1239 (1980), 1372 (1978), 1504 (1980).

It is hard to imagine that any corporation, public or closely held, will be unaffected by these regulations since they encompass all aspects of corporate financing except trade accounts payable and similar items. Yet, there can be no doubt that their greatest effect will be felt by small companies because some of the most significant rules do not apply to public corporations. For example, the fair market value rules of section 1.385-3(a) are not applicable to instruments registered with the Securities and Exchange Commission,⁵⁹ and the proportionality rules of section 1.385-6 do not apply to instruments that are widely held and readily marketable,⁶⁰ nor to any instrument held by an independent creditor.⁶¹ In addition, many of the safe harbors provided by the regulations will protect the large corporation to a greater degree than its smaller counterparts.⁶² Perhaps more importantly, the regulations focus on instruments which are issued to shareholders, with the result that instruments held by non-shareholders generally will not be affected.⁶³ Thus, large corporations, which obtain most of their capital from outsiders, will be largely unaffected by the regulations. However, small corporations will generally be subject to the regulations. These smaller entities depend heavily upon shareholder financing, both temporary and long term, because they simply do not have the access to capital or debt markets which larger companies enjoy.⁶⁴

It is ironic that, given the legislative history of section 385, small business operations and closely-held corporations will face the greatest burden in complying with the new regulations. It is clear that Congress initially was concerned with the rapid increase in mergers and consolidations in the late 1960's and, in particular, with the use of securities such as subordinated and convertible debentures in structuring such transactions.⁶⁵ The grant of authority to prescribe regulations was not, however, limited to cases involving acquisitions,⁶⁶ and the result is regulations which will be of concern primarily to closely-held corporations.

59. Treas. Reg. § 1.385-3(b)(2)(ii) (1980).

60. *Id.* § 1.385-6(a)(3)(i).

61. *Id.* § 1.385-6(a)(3)(ii).

62. See notes 103, 185-89, & 344-59 and accompanying text *infra*.

63. Treas. Reg. §§ 1.385-5(a), -8(a) (1980). The non-shareholder instruments which are subject to the regulations are hybrid instruments and locked instruments. *Id.* See notes 223-56 & 257-63 and accompanying text *infra*.

64. See Gerver, *supra* note 44, at 28.

65. S. REP. NO. 552, *supra* note 10, at 137-38. See note 10 *supra*.

66. The Senate Report notes that, in providing guidelines, the Secretary was not to be limited to promulgating rules which would apply only in the corporate acquisition context. S. REP. NO. 552, *supra* note 10, at 138-39. The Senate, where § 385 of the Code originated, wanted to authorize guidelines for distinguishing debt from equity in the "numerous situations other

Obviously, closely-held corporations are not free from sin in the debt-equity area. In fact, it is the smaller corporation whose capitalization has generally been the subject of IRS attack under the purely subjective standards of the past. Shareholder abuses, including extreme cases of debt-equity relationships, are documented in the case law.⁶⁷ However, while arm's length dealings with one's own corporation are desirable, such a goal is impractical and not very realistic for most closely-held corporations. Section 385 was enacted by Congress to provide the Secretary with the means of promulgating regulations to help define certain interests in corporations as stock or indebtedness. It does not seem that the intent was to provide a framework for rules so stringent that small business corporations, which generally cannot resort to outside financing, would be unduly penalized. Yet it may be argued that at least some of the provisions in the regulations will have that result.⁶⁸ If this is the case, the Secretary should recognize the critical importance which these regulations will take in the small business arena and give special consideration to their effect on such businesses. Some provisions should be added to exempt small corporations, similar to the provisions of section 279 of the Code.⁶⁹ Also, it is suggested that exemptions should be granted to newly-formed corporations for a number of years after their formation. This is particularly true since the economy of the nation significantly depends upon small business. It is clear that Congress has recognized the important role that small businesses play in our society.⁷⁰ 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."⁷¹ More recently, laws

than those involving corporate acquisitions." *Id.* at 138. Presumably, these other situations would include advances to closely-held corporations, but, given the fact that the impetus for the delegation of authority by § 385 was the use of debt in large corporate mergers, it can be argued that Congress did not intend that large, public corporations should be virtually exempted from the new regulations. See H.R. REP. NO. 413, 91st Cong., 1st Sess. 101 (1969).

67. See, e.g., *Tampa & G.C. R.R. Co. v. Commissioner*, 56 T.C. 1393 (1971), *aff'd*, 469 F.2d 263 (5th Cir. 1972) (no interest paid on "bonds" for over 30 years); *250 Hudson St. Corp. v. Commissioner*, 5 T.C.M. (CCH) 722 (1946) (debt-equity ratio of 150,000:1).

68. See notes 188-89, 289-91, 389, & 465-72 and accompanying text *infra*.

69. See I.R.C. § 279 (1976). Section 279(a)(1) has the practical effect of exempting small corporations by restricting the application of § 279 to those situations in which the interest paid or incurred on indebtedness related to corporate acquisitions exceeds \$5,000,000. *Id.* § 279(a)(1) (1976).

70. See S. REP. NO. 878, 97th Cong., 2d Sess. 1 (1980).

71. 15 U.S.C. § 631 (1976). This statement is part of the declaration of policy underlying the Small Business Act, *id.* §§ 631-47, which established the Small Business Administration. See *id.* § 633.

have been enacted that will encourage Federal agencies to structure the regulations they issue in a manner which avoids any unnecessary adverse effect on small businesses,⁷² and that amend federal laws so that business enterprises, "particularly small, growing, and financially troubled enterprises, can . . . readily raise needed capital."⁷³ It follows that regulations which recognize the informality of the closely-held corporation would not be inconsistent with federal policy. In fact, since the accumulation of capital in the small business world is no easy task, consistency would favor rules creating more freedom from taxation for the movement of funds between shareholders and their closely-owned corporations.

IV. DEFINITIONS APPLICABLE TO MORE THAN ONE CLASSIFICATION RULE

The regulations specifically define several terms which are applicable to more than one operational or classification rule within the regulations.⁷⁴ Rather than redefine these terms each time they appear in the regulations, these terms will be discussed here. However, since some of the definitions seem self-explanatory,⁷⁵ only those which might confuse a taxpayer will be discussed here.

An "instrument" is "any bond, note, debenture, or similar written evidence of an obligation."⁷⁶ Preferred stock may be treated as an instrument under section 1.385-10(a) if its terms provide for fixed payments in the nature of principal or interest.⁷⁷ Apparently, the analysis with respect to preferred stock begins with a determination of whether the stock is an instrument.⁷⁸ If it is not an instrument, then it is considered to be an equity interest. If it is determined to be an instrument, then there must be an evaluation under the section 385 regulations in order to determine whether the preferred stock is to be classified as debt or equity.⁷⁹

72. See The Regulatory Flexibility Act, Pub. L. No. 96-354, 94 Stat. 1164 (1980). See generally S. REP. No. 878, 97th Cong. 2d Sess. (1980).

73. See The Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (1980). See generally H.R. REP. No. 1341, 96th Cong., 2d Sess. 19 (1980).

74. See note 28 and accompanying text *supra*.

75. The regulations' definitions of the terms "obligation," "hybrid instrument," and "straight debt instrument" are straightforward and do not seem to require explanation. See Treas. Reg. § 1.385-3(d), -3(f) (1980).

76. *Id.* § 1.385-3(c).

77. *Id.* § 1.385-10(a). For a discussion of what constitutes fixed payments of principal or interest, see notes 85-93 and accompanying text *infra*.

78. Treas. Reg. § 1.385-10(a) (1980).

79. *Id.*

The term "independent creditor" is not precisely defined. Section 1.385-6(b)(1) merely states that all relevant facts and circumstances must be taken into account in determining whether a creditor is independent.⁸⁰ However, section 1.385-6(b)(2) provides a safe harbor for making this determination.⁸¹ Under this safe harbor rule, a creditor is deemed to be independent if stock owned by the corporation would not be attributed to the creditor under the constructive ownership rules of section 318(a) of the Code⁸² as modified by section 1.385-6(b)(3),⁸³ and if the creditor's holdings of stock and instruments issued by the corporation are not substantially proportionate.⁸⁴

A "fixed payment of interest" is defined as interest payable at a definitely ascertainable rate and due on definitely ascertainable dates, in which the holder's right to payment cannot be impaired without his consent.⁸⁵ Likewise, a "fixed payment of principal" is defined as a definitely ascertainable principal sum, payable on demand or due on definitely ascertainable dates, in which the holder's right to receive the principal when due cannot be impaired without his consent.⁸⁶ A principal sum is definitely ascertainable if it is either an invariable sum or a variable sum determined according to an external standard that is not subject to the borrower's control and is not related to the success or failure of the borrower's business.⁸⁷ Furthermore, a principal sum is not variable simply because it is within the borrower's control to prepay all or a portion of the principal sum.⁸⁸ Similarly, a rate of interest is definitely ascertainable if it is applied to a definitely ascertainable principal sum, and is either an invariable rate or a variable rate determined according to an external standard that is not subject to the borrow-

80. *Id.* § 1.385-6(b)(1). 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).

81. Treas. Reg. § 1.385-6(b)(2) (1980).

82. I.R.C. § 318(a) (1964).

83. Treas. Reg. § 1.385-6(b)(3) (1980). In applying the § 318 attribution rules in the context of determining whether one is an independent creditor, the 50% threshold test contained in § 318 is deemed to require only a 5% interest. *Id.* See I.R.C. § 318(a)(2)(c), (a)(3)(c) (1964).

84. See notes 344-74 and accompanying text *infra*.

85. Treas. Reg. § 1.385-5(d)(2) (1980).

86. *Id.* § 1.385-5(d)(3). There are three minor exceptions to the requirement that the holder's rights cannot be impaired. See *id.* § 1.385-5(d)(5).

87. *Id.* § 1.385-5(d)(4)(ii).

88. *Id.*

er's control and is not related to the success or failure of the borrower's business.⁸⁹ A "contingent payment" is defined as any payment other than a fixed payment of principal or interest.⁹⁰ Examples of contingent payments include payments which are payable at the discretion of the board of directors or are dependent upon the net profit of the corporation.⁹¹ However, the Commissioner of Internal Revenue (Commissioner) may disregard a contingency where there is no reasonably foreseeable circumstance in which the contingency could affect the likelihood of payment.⁹² In addition, if a payment is not "fixed" under the requirements of the definitions stated above, the Commissioner may treat the payment as fixed provided the payment is directly or indirectly guaranteed by any person.⁹³

V. OPERATIONAL RULES APPLICABLE TO MORE THAN ONE CLASSIFICATION RULE

There are three operational rules which the Secretary has made applicable to more than one classification rule.⁹⁴ These three rules will be discussed in this section, and the classification rules to which a specific operational rule is applicable will be identified.

A. *Determination of the Fair Market Value of an Instrument*

The determination of the fair market value of an instrument is necessary in order to decide: 1) whether excessive or inadequate consideration has been paid for an instrument under section 1.385-3(a);⁹⁵ 2) whether there has been a substantive change in the terms of an instrument under section 1.385-6(j);⁹⁶ and 3) the proper classification of a hybrid instrument under section 1.385-5(a) when holdings of stock and instruments are not substantially proportionate.⁹⁷

Section 1.385-3(b)(1)(i) provides, in general, that the fair market value of an instrument is the price at which it would change hands between a willing buyer and a willing seller, both having a reason-

89. *Id.* § 1.385-5(d)(4)(i). An example of an external standard which meets these requirements is an interest rate which "floats" with the rise and fall of the prime rate. *Id.* § 1.385-5(e), Example 10.

90. *Id.* § 1.385-5(d)(1).

91. *Id.* § 1.385-5(e), Example 2.

92. *Id.* § 1.385-5(d)(6). No example is given of when this rule would be applied. Hopefully, the Commissioner will not expand this rule beyond appropriate bounds.

93. *Id.* § 1.385-5(d)(7)(ii).

94. *See* note 28 and accompanying text *supra*.

95. Treas. Reg. § 1.385-3(a) (1980).

96. *Id.* § 1.385-6(j).

97. *Id.* § 1.385-5(a).

able knowledge of all the relevant facts.⁹⁸ In an attempt to add some certainty, it is pointed out that the fair market value of an instrument may be determined by using the present value and standard bond tables of the section 1232 regulations.⁹⁹ Furthermore, two rules of convenience are provided. First, the fair market value of a straight debt instrument on the day of its issue is assumed to be equal to its face amount if the stated annual interest rate is reasonable¹⁰⁰ and the consideration paid for the instrument is equal to its face amount.¹⁰¹ Second, the fair market value of an instrument on the day of its issue is the issue price, as defined in section 1232 of the Code,¹⁰² if the instrument is registered with the Securities and Exchange Commission and sold to the public for money.¹⁰³ In determining the fair market value of an instrument, the Commissioner may disregard a non-commercial term of the instrument if the principal purpose of the inclusion of the term is to increase or decrease the fair market value of the instrument.¹⁰⁴

B. Computation of the Debt-Equity Ratio

The determination of a corporation's debt-to-equity ratio is necessary in order to decide: 1) whether a particular rate of interest is reasonable under the rule of convenience described in section 1.385-6(e);¹⁰⁵ 2) whether a corporation has excessive debt for the purpose of classification under section 1.385-6(f);¹⁰⁶ and 3) whether a corporation has excessive debt for the purpose of classifying certain other obligations as equity under section 1.385-7(b)(2).¹⁰⁷

98. *Id.* § 1.385-3(b)(1)(i).

99. *Id.* § 1.385-3(b)(1)(ii). See *id.* § 1.1232-3(b)(2)(ii)(d), T.D. 7663, 1980-1 C.B. 101.

100. *Id.* § 1.385-6(e). For a discussion of the analysis used to determine whether an interest rate is reasonable, see notes 153-204 and accompanying text *infra*.

101. Treas. Reg. § 1.385-3(b)(2)(i) (1980).

102. See I.R.C. § 1232(b)(2) (1976).

103. Treas. Reg. § 1.385-3(b)(2)(ii) (1980).

104. *Id.* § 1.385-3(b)(1)(iii)(A). The example given to illustrate this rule, involving a debenture which provides that an action to enforce the debenture can be maintained only in the "village court" of a foreign country, is too extreme to be of any use. See *id.* § 1.385-3(b)(1)(iii)(B). Hopefully, this rule will not be used in situations in which its use is not warranted, such as when a shareholder's holdings of stock and debt are not proportionate and there is an arm's length transaction. It may be argued that the regulations should be amended to provide other examples to clarify this rule so that the Service will not be able to expand its use beyond reasonable bounds.

105. *Id.* § 1.385-6(e).

106. *Id.* § 1.385-6(f).

107. *Id.* § 1.385-7(b)(2).

In general, the debt-equity ratio is defined as the ratio of a corporation's liabilities to its stockholders' equity.¹⁰⁸ When computing the corporation's liabilities, trade accounts payable, accrued operating expenses and taxes, and similar items are excluded.¹⁰⁹ Stockholders' equity is defined as the excess of the adjusted basis of a corporation's assets over its liabilities without exclusion of any of these liabilities.¹¹⁰ 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 and without regard to the classification of any interest as stock or indebtedness under the provisions of section 385, except that preferred stock is considered a liability if it is treated as indebtedness under the section 385 regulations.¹¹¹

The use of the adjusted basis of the corporation's assets in computing shareholders' equity may be criticized on the basis that it is inconsistent with the existing case law. In *Liflans Corp. v. United States*,¹¹² the Court of Claims stated that the "prevailing view seems to be that assets are to be taken at fair market value rather than at book value when valuing the equity interest in order to compute the [debt-to-equity] ratio."¹¹³ Tax Court opinions,¹¹⁴ as well as appellate decisions,¹¹⁵ have expressed a similar view, and the commentators seem to be in agreement that the fair market value of the corporation's assets should be used.¹¹⁶ Even the Secretary acknowledges that the fair market value of a corporation's assets is the theoretically correct measure of equity.¹¹⁷

The position taken by the courts that the fair market value of corporate assets yields a more correct measure of corporate equity

108. *Id.* § 1.385-6(g)(1).

109. *Id.* § 1.385-6(g)(1)(i).

110. *Id.* § 1.385-6(g)(2). For this purpose, the adjusted basis of the assets does not include reserves for bad debts or similar asset offsets. *Id.*

111. *Id.* § 1.385-6(g)(3).

112. 390 F.2d 965 (Ct. Cl. 1968).

113. *Id.* at 970, quoting Goldstein, *supra* note 48, at 19.

114. *See, e.g.,* Nye v. Commissioner, 50 T.C. 203, 216 (1968); Swoby Corp. v. Commissioner, 9 T.C. 887, 893-96 (1947).

115. *See, e.g.,* 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).

116. *See, e.g.,* Caplin, *The Caloric Count of a Thin Incorporation*, 17 N.Y.U. INST. FED. TAX. 771, 779 (1959); Gerver, *supra* note 44, at 29; Goldstein, *supra* note 48, at 19; Holzman, *supra* note 7, at 4; Plumb, *supra* note 2, at 516; Spanbock, Carro, and Katz, *Nourishing the Thin Corporation*, 34 TAXES 687, 690 (1956).

117. *See* Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,959 (1980).

than does adjusted basis follows from the courts' view of the essential difference between a creditor and a stockholder. In essence, a stockholder intends to make an investment and takes the risk of loss in order to share in the business' profits, if any, while a lender seeks a definite obligation payable in any event.¹¹⁸ Thus, it is clear that the assumption 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 he is with the basis of the assets 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 would be virtually meaningless with respect to this issue.

It may also be argued that the use of adjusted basis results in applying a financial accounting device reflecting historical cost to an economic concept founded on value. Clearly, in today's inflationary economy, adjusted basis is an inaccurate measure of capitalization and it has no necessary correlation to economic reality. Rather, adjusted basis is primarily a reflection of the past tax treatment of assets. The Financial Accounting Standards Board has explicitly recognized this in requiring public enterprises to reflect current costs and values in financial reports.¹¹⁹ The accounting community's flexibility is in sharp contrast to the Secretary's position. It should be noted that the certainty which the Secretary claims is promoted by the use of adjusted basis rather than fair market value would also exist if financial accounting carrying values were used to compute stockholder's equity. More importantly, the regulations do not even consider the effect of assets with no adjusted basis, such as goodwill. Clearly, this may substantially distort the equity portion of the debt-equity ratio, particularly when a service business, trade name, or patent is involved.

Having considered the shortcomings associated with the use of adjusted tax basis as the asset carrying value when computing stockholder's equity, it is appropriate to consider the possible alternatives. The most promising alternatives include using the fair market value of either the individual assets or the corporation's outstanding stock, or the book value assigned to individual assets for financial statement purposes.

118. See notes 3-4 and accompanying text *supra*.

119. See FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 33: FINANCIAL REPORTING AND CHANGING PRICES (Sept. 1979).

First, if stockholders' equity is to be computed based upon fair market value rather than adjusted basis, the question arises as to whether equity is to be determined by using the sum of the fair market values of individual assets less the liabilities, or whether equity is to be equal to the fair market value of a corporation's outstanding stock.¹²⁰ For many corporations, it is much easier to determine the fair market value of their assets than to determine the value of their outstanding stock. It is generally recognized that one of the most difficult appraisal exercises is to estimate the value of closely-held stock which is seldom, if ever, traded in arm's length transactions.¹²¹ Therefore, it may be argued that corporations issuing instruments should be provided with an option under which the ratio could be computed using either measure of equity.

Second, both adjusted basis and fair market value figures may be difficult to obtain, particularly for corporations which are members of affiliated groups¹²² and have to make the difficult calculations required by section 1.385-6(h) of the regulations¹²³ and section 279 of the Code.¹²⁴ Thus, it may be argued that the corporation should have the option to compute equity by using the amounts appearing in year end certified financial statements as the asset carrying values. There are several arguments in favor of such an approach. Such figures would be readily available, and such an election would provide a corporation with the option of avoiding the burden of duplicate records. It may also be pointed out that the use of the adjusted tax basis of assets will create significant variations among taxpayers in similar economic circumstances since different tax elections and tax accounting methods may be adopted by different taxpayers. It is suggested that the use of book values, based upon generally accepted accounting principles, would tend to produce more uniformity among taxpayers. In addition, it is more equitable and practical to determine asset carrying values on the basis of a corporation's financial statements since credit is ordinarily extended on the basis of certified financial statements rather than tax returns. Finally, the Secretary states that the particular ratios selected in the rules requiring the determination of a debt-equity ratio were de-

120. The Proposed Regulations used this latter approach as an alternate test. See Prop. Reg. § 1.385-8(a)(2).

121. See generally G. MCCARTHY & R. HEALY, *VALUING A COMPANY* (1971); Krahmer & Henderer, *Valuation of Shares of Closely Held Corporations*, 221 *TAX MNGM'T PORTFOLIO* (BNA) (1973).

122. See I.R.C. § 1504(a) (1980).

123. See Treas. Reg. § 1.385-6(h) (1980).

124. See I.R.C. § 279(g) (1976).

rived from extensive statistical analysis.¹²⁵ Presumably, this analysis was performed upon the balance sheet data contained in corporate tax returns. It must be observed, however, that the balance sheets set forth on corporate income tax returns are prepared on the basis of generally accepted accounting principles; therefore, such data does not reflect the adjusted tax basis of a corporation's assets. It follows that the use of adjusted tax basis to determine the asset carrying values used in computing the debt-equity ratio would appear to be inappropriate since the ratio "norms" have been derived from a data base involving primarily generally accepted accounting principles which are then applied to a data base derived entirely by applying another set of accounting principles, tax elections, and tax methods of accounting.¹²⁶

Only one exception is provided by the regulations to the use of adjusted tax basis of assets in computing the generally applicable debt-equity ratio.¹²⁷ This exception permits a cash method corporation to use the face amount of trade accounts receivable, less an appropriate reserve for uncollectibles, as the adjusted basis of the receivables.¹²⁸ Thus, only in the case of trade accounts receivable is the fair market value of the assets to be used. Yet, the arguments presented above support the proposition that all four of the possible methods to compute equity should be available to a corporate taxpayer.¹²⁹ That is, section 1.385-6(g)¹³⁰ should permit a corporation, at its election, to compute stockholders' equity on the basis of 1) data contained in certified year-end financial statements; 2) the fair market value of its outstanding stock on the day the instruments in question were issued; 3) the fair market value of individual assets; or 4) the adjusted tax basis of its assets. Clearly, if a fair market value approach is selected, it would be appropriate for the corporation to carry the burden of proof as to the values used. However, if the valuation process is too expensive or uncertain, it seems reasonable to allow the company the option of using more objective and readily obtainable data such as the adjusted tax basis of assets or their values for purposes of certified financial statements. Allowing these alternatives would be consistent with the policy of allowing a corporation to "avoid the negative implications of a

125. See Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,962 (1980).

126. See note 187 and accompanying text *infra*.

127. See Treas. Reg. § 1.385-6(g)(5)(i) (1980).

128. *Id.*

129. See notes 120-26 and accompanying text *supra*.

130. Treas. Reg. § 1.385-6(g) (1980).

high debt-to-equity ratio by establishing that it is, in fact, adequately capitalized."¹³¹

Having addressed the issues associated with the determination of asset carrying values, it is necessary to consider the amounts that are included in computing liabilities. Throughout recent accounting history, the equity section of the balance sheet has represented the residual obtained when liabilities are subtracted from the carrying value of assets. Accordingly, liabilities are subtracted from the adjusted basis of the assets in order to determine stockholders' equity under section 1.385-6(g)(2).¹³² For this purpose, trade accounts payable, accrued operating expenses and taxes, and other similar items are included in the term "liabilities."¹³³ However, when the debt-equity ratio is computed, by comparing liabilities with stockholders' equity, these items are excluded from the term "liabilities."¹³⁴ Therefore, it is appropriate to address two questions. First, what is the general concept of liabilities, since that term is not defined in the regulations? In addition, it is appropriate to inquire as to what constitutes trade accounts payable, accrued operating expenses and taxes, and other similar items.

In financial accounting, liabilities include all items which represent a sum certain due to another person or legal entity on some date, as well as amounts collected in advance for services to be rendered in the future or goods to be delivered in the future, estimates of amounts that may be due under contingencies, prepayments under construction contracts, deferred income taxes, deferred income items,¹³⁵ and any other similar item that represents an obligation of a particular enterprise to transfer economic resources to other entities in the future as a result of a past transaction or event affecting the enterprise.¹³⁶ The uncertainty of the scope of the term "liabilities," as used in section 1.385-6(g), occurs with respect to these latter items.¹³⁷ Additional guidance is needed with respect

131. Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,958 (1980).

132. Treas. Reg. § 1.385-6(g)(2) (1980).

133. *Id.* § 1.385-6(g)(2)(ii).

134. *Id.* § 1.385-6(g)(1) (i).

135. Under generally accepted accounting principles, deferred income items would not be considered to be liabilities although they would be so treated under certain tax accounting principles.

136. See FINANCIAL ACCOUNTING STANDARDS BOARD, OBJECTIVES OF FINANCIAL REPORTING AND ELEMENTS OF FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES, PROPOSED STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS ¶ 49 (1977). See also D. KIESO & J. WEYGANDT, INTERMEDIATE ACCOUNTING 428-29 (3d ed. 1980).

137. See Treas. Reg. § 1.385-6(g) (1980).

to which of these items are liabilities for purposes of the debt-equity ratio computation. One possible solution would be to specify in the regulations that only "instruments," "obligations," and "certain other obligations," as defined in the regulations,¹³⁸ would be considered liabilities.

The scope of the term "liabilities" is affected by "trade accounts payable," "accrued operating expenses," and "other similar items" as these terms are defined in the regulations. It is stated that such items are accorded special treatment because they vary widely during the year, and, if these items were included in the liabilities, "one of the principal purposes of the regulations, which is to provide a high degree of certainty for corporations" would be defeated.¹³⁹ Although the final regulations attempt to clarify when an item will be treated in the same manner as trade accounts payable,¹⁴⁰ it may be argued that the goal of certainty will not be attained unless the term "other similar items" is interpreted as encompassing all 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, in order for a liability to be treated in the same manner as a trade account payable, it must have been incurred for the purchase of an item of inventory.¹⁴¹ It is suggested that this provision is too restrictive, and should be broadened.

For purposes of determining the debt-equity ratio, a corporation's liabilities are to be determined without regard to whether any interest is treated as stock or indebtedness under section 385.¹⁴² Because the regulations refer to *any* interest, and not to just the instrument in question, it appears that, if a certain debt instrument has previously been reclassified as stock under the regulations, it will still be debt for the computation of the debt-equity ratios. This is illogical, and contrary to other provisions of the regulations.¹⁴³ For instance, section 1.385-4(c)(1) provides that an instrument classified as stock under section 385 shall be preferred stock for all purposes of the Code.¹⁴⁴ Section 1.385-4(b) provides that the status of an instrument is determined as of the time of its issuance,

138. *See id.* §§ 1.385-3 (c), -3 (d), -6 (a).

139. Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,959 (1980).

140. *See* Treas. Reg. § 1.385-6(g)(5)(v) (1980).

141. *See id.*

142. *Id.* § 1.385-6(g)(3)(ii).

143. *See* notes 144-47 and accompanying text *infra*.

144. Treas. Reg. § 1.385-4(c)(1) (1980).

and, once determined to be stock, its status can never change.¹⁴⁵ More importantly, the required treatment appears inconsistent with section 385(a), which applies the section 385 classification for all purposes of the Code.¹⁴⁶ The Secretary states that the reason for this rule is that a liability's effect on a corporation's financial stability is largely independent of its treatment for tax purposes.¹⁴⁷ However, it is fundamentally unfair to treat an instrument as equity for all other tax purposes but as a liability for purposes of applying the debt-equity ratio to determine the classification of another instrument.

C. Determination of a Reasonable Rate of Interest

Determining what constitutes a reasonable rate of interest is necessary in order to decide: 1) whether the rule of convenience stated in section 1.385-3(b)(2)(i) may be used for determining the fair market value of an instrument;¹⁴⁸ 2) whether an instrument issued for property other than money is to be classified as stock or debt under section 1.385-6(d);¹⁴⁹ 3) whether a demand instrument is to be classified as stock or debt under section 1.385-6(l)(1);¹⁵⁰ 4) whether a demand instrument that has been classified as debt is to be reclassified as stock under section 1.385-6(l)(2),¹⁵¹ and 5) whether certain other obligations, as defined in section 1.385-7(a), that have been classified as debt must be reclassified as stock under section 1.385-7(c)(1).¹⁵² This determination is the primary factor for ascertaining whether the terms of an instrument conform to the arm's length standards in each of the above classification rules. Conformity with the arm's length standards is required in order for an instrument to be classified as debt under these provisions.

Given this state of affairs, it may be argued that such an emphasis upon a reasonable rate of interest is inconsistent with existing case law. This argument is supported by the fact that the courts clearly recognize that no one factor is controlling,¹⁵³ and that the lack of a reasonable interest rate alone could not be given as the

145. *Id.* § 1.385-4(b).

146. I.R.C. § 385(a).

147. Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,959 (1980).

148. Treas. Reg. § 1.385-3(b)(2)(i) (1980).

149. *Id.* § 1.385-6(d).

150. *Id.* § 1.385-6(l)(1).

151. *Id.* § 1.385-6(l)(2).

152. *Id.* § 1.385-7(a), -7(c)(1).

153. See note 8 *supra* and authorities cited therein.

reason for characterizing an interest as equity rather than debt.¹⁵⁴ In addition, section 385(b) appears to make it clear that Congress intended to leave the Secretary a "blank check" to set forth factors to distinguish between debt and equity instruments.¹⁵⁵ However, in attempting to regulate interest rates under section 1.385-6(e), the Secretary appears, in substance, to be legislating valuation.¹⁵⁶ It is not clear that this factor aids in distinguishing debtor-creditor relationships from corporation-shareholder relationships, which is the task that was delegated to the Secretary by Congress in section 385.¹⁵⁷ Therefore, it may also be argued that section 1.385-6(e) exceeds the Secretary's grant of authority under section 385.

Under the regulations, 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.¹⁵⁸ In addition, a safe harbor alternative is offered so that corporations can avoid the uncertainty of the general definition.¹⁵⁹ 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 6621,¹⁶⁰ the prime rate in effect at any local commercial bank,¹⁶¹ or a rate determined from time to time by the Secretary, taking into consideration the average yield on outstanding marketable obligations of the United States of comparable maturity.¹⁶² Alternatively, the rate may fall between any two of

154. See *Gordon Lubricating Co. v. Commissioner*, 24 T.C.M. (CCH) 697, 710 (1965); *Curry v. Commissioner*, 43 T.C. 667, 692 (1963).

155. See I.R.C. § 385(b). The legislative history also makes this clear. See S. REP. NO. 552, *supra* note 10, at 138.

156. See Treas. Reg. § 1.385-6(e) (1980).

157. I.R.C. § 385.

158. Treas. Reg. § 1.385-6(e)(1) (1980).

159. *Id.* § 1.385-6(e)(2).

160. I.R.C. § 6621(b) (1979). 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 during the preceding September. *Id.* 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. See 26 C.F.R. § 301.6621-1 (1980). In 1980, for example, the § 6621 interest rate was 12%. See Rev. Rul. 79-366, 1979-2 C.B. 402.

161. The term "local commercial bank" includes any commercial bank at which the issuing corporation ordinarily does business. Treas. Reg. § 1.385-6(e)(4) (1980).

162. The Service plans to announce this rate by issuing a Revenue Procedure. See T.D. 7747, 1981-8 I.R.B. 15.

the three rates described above.¹⁶³ Second, at the end of the taxable year in which the determination is made, the debt-equity ratio¹⁶⁴ of the issuing corporation must not be greater than 1:1.¹⁶⁵

It is difficult to ascertain exactly what the general rule requires.¹⁶⁶ Read literally, it would be necessary for a corporation to find other corporations which have issued similar instruments and which are in the same general industry, geographic location, and financial condition.¹⁶⁷ Such a determination would seem to be extremely difficult and, in some cases, impossible to make. For example, a determination of 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 similar financial condition which also qualifies with respect to geographic location and the other factors mentioned. There is certainly no indication in the regulations 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 borrow money from its shareholders rather than from an independent creditor.¹⁶⁸ The implication is that evidence of a quotation from a bank or similar lending institution to the corporation will be a sufficient benchmark to meet the requirements of the general rule. If this is a correct interpretation of the Secretary's intent with respect to the general rule, some examples should be added to illustrate the point. Those examples should also emphasize what evidence is required and state how such evidence could be obtained. Otherwise, the list of factors in the general rule seems to be so broad and indefinite that very little certainty results, with very little useful guidance being provided to either taxpayers or the Service.

Perhaps the general rule is intended to codify existing case law with respect to a reasonable rate of interest. If this assertion is correct, the result will still be uncertain since the courts recognize that no one factor is controlling.¹⁶⁹ In other words, a collection and comparison of interest rates from existing case law would not be

163. Treas. Reg. § 1.385-6(e)(2)(i) (1980). This provision requires that an interest rate must be equal to or within the range of the three 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. *Id.*

164. For a definition of the debt-equity ratio, *see id.* § 1.385-6(g). *See also* notes 108-47 and accompanying text *supra*.

165. Treas. Reg. § 1.385-6(e)(2)(ii) (1980).

166. *See id.* § 1.385-6(a)(1).

167. *Id.*

168. *See* T.D. 7747, 1981-8 I.R.B. 15.

169. *See* note 8 *supra* and authorities cited therein.

informative because the courts also considered other factors when deciding whether an instrument described in a particular case was to be classified as debt or equity. It follows that no definite conclusions can be drawn concerning the reasonableness of any specific interest rate described in a case.¹⁷⁰

In light of these shortcomings, it is suggested that the general rule for reasonableness under section 1.385-6(e)(1) should be reconsidered.¹⁷¹ Clearly, what is needed is a rule that provides both flexibility and certainty.

Unfortunately, the rule of convenience may have as many, if not more, shortcomings than the general rule. These shortcomings involve the use of the debt-equity ratio in the rule of convenience. Even if an instrument's interest rate satisfies the conditions of the rule of convenience,¹⁷² a stated interest rate will still fail to qualify as reasonable under the safe harbor if the debt-equity ratio of the issuing corporation exceeds 1:1.¹⁷³ Given the confusion which would result from including a debt-equity test in the rule of convenience for a reasonable interest rate, it is very difficult to understand what purpose is served by adding such a requirement. It is true that this is one of the five factors specifically enumerated by Congress in section 385 for consideration in drafting the proposals.¹⁷⁴ However, great reliance upon a corporation's debt-equity ratio as a means of classifying an instrument should not serve to obscure the central issue in existing case law, which is whether the parties intended to create a bona fide debt at the time that an instrument was issued.¹⁷⁵ Apparently, the Secretary is treating the debt-equity ratio as a measure of risk,¹⁷⁶ and feels that a 1:1 ratio is appropriate given the mechanics of the interest rate test specified in

170. See *Gooding Amusement Co. v. Commissioner*, 236 F.2d 159 (6th Cir. 1956), *cert. denied*, 352 U.S. 1031 (1957). In *Gooding*, 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." 236 F.2d at 165. See also *Campbell v. Carter Foundation Prod. Co.*, 322 F.2d 827, 832 (5th Cir. 1963).

171. Treas. Reg. § 1.385-6(e)(1) (1980).

172. See notes 159-65 and accompanying text *supra*.

173. Treas. Reg. § 1.385-6(e)(2)(ii) (1980).

174. See I.R.C. § 385(b)(3).

175. See Aarons, *Debt vs. Equity: Special Hazards in Setting Up the Corporate Structure*, 23 J. TAX. 194, 194 (1965).

176. The debt-equity ratio has been described as a measure of risk in that the "greater the capital and lower the 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, Carro, & Katz, *supra* note 116 at 688-89.

the rule of convenience.¹⁷⁷ However, the corporate debt-equity ratio is but one indication of risk,¹⁷⁸ and, even if the need for such a measure is conceded, serious questions may be raised as to the appropriateness of the particular test chosen.

First, the elevation of the debt-equity ratio test to a position of such great importance in the rule of convenience is not consistent with current case law. Although there once was a period in which the ratio test was the primary factor considered by the courts,¹⁷⁹ it no longer commands this respect. The ratio is but one factor used by the courts to distinguish debt from equity,¹⁸⁰ and no single factor is controlling.¹⁸¹ Thus, it would seem that placing so much emphasis on the relative amounts of debt and equity of a corporation is inconsistent with judicial precedent.¹⁸²

177. 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 1:1. 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(e)(1) (1980). See T.D. 7747, 1981-8 I.R.B. 15. Of course, this would mean that the certainty which is the aim of the regulations would be sacrificed.

178. 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. See Whittington & Whittenburg, *Judicial Classification of Debt versus Equity—An Empirical Study*, 55 ACCOUNTING REV. 409 (1980). One conclusion is that the courts have placed great significance on the financial condition of the corporation at the time when the instrument was issued. *Id.* at 415. 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. See *id.* 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 meet its obligations. It is noted that a number of measures such as 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, when 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).

179. See Caplin, *supra* note 116, at 778; Dixon, *supra* note 5, at 1269; Plumb, *supra* note 2, at 507-08.

180. *John Kelley Co. v. Commissioner*, 326 U.S. 521, 526 (1946). See also Plumb, *supra* note 2, at 512. The Service acknowledges that the ratio is but one factor to be considered. See Rev. Rul. 77-437, 1977-2 C.B. 28; Rev. Rul. 68-54, 1968-1 C.B. 69.

181. See note 8 *supra*.

182. See Treas. Reg. § 1.385-6(e)(1) (1980). Admittedly, if a corporation cannot meet the 1:1 test, only the rule of convenience is not available to it. The interest rate can still be shown to be reasonable under the general rule

Second, a single ratio made applicable to all corporate entities fails to consider the capital intensity of the business in which the issuing corporation is engaged.¹⁸³ In certain types of businesses, there is a need for large investments in machinery and equipment, which may be financed by debt when demand for the output is relatively definite.¹⁸⁴ It seems particularly harsh to require these companies to either maintain a specified debt-equity ratio or find the rule of convenience with respect to a reasonable interest rate unavailable, when the economics of the particular industry will support a higher leverage.

Third, the clear disregard for giving consideration to the capital intensity of specific industries is aggravated by the fact that the test specified is such a conservative debt-equity ratio. The drafters of section 1.385-6(e) stated:

The ratio of 1:1 in Section 1.385-6(e) was chosen for two reasons. First, it covers a majority of all corporations. Extensive statistical analysis indicates that more than fifty-five percent of all corporations filing tax returns in a recent year and more than sixty percent of all new corporations had debt to equity ratios of less than 1:1. Second, a debt to equity ratio of 1:1 is exceptionally high by the standard of public corporations.¹⁸⁵

It is not clear where the Treasury obtained the data for this analysis. Balance sheets filed as part of a corporate income tax return (Form 1120) are financial accounting balance sheets, but section 1.385-6(g) requires the use of the adjusted tax basis of a corporation's assets rather than financial book value to compute the debt-equity ratio.¹⁸⁶

of § 1.385-6(e)(1). However, this would place a great strain on a corporation to establish that the interest rate charged by lenders to similar corporations is not materially different from the interest rate in question. It can thus be argued that there is too much emphasis on the debt-equity ratio test.

183. The ratio test was developed as an analytical tool for use in the context of a particular industry and a given business, rather than for use as an "arbitrary standard." Spanbock, Carro, & Katz, *supra* note 116, at 689. See also Bittker, *Thin Capitalization: Some Current Questions*, 34 TAXES 830, 831 (1956) (what is excessive debt for one industry may be normal for another).

184. Many of the cases which helped elevate the debt-equity ratio test to its former position of primary importance involved corporations which owned or operated real estate. The working capital needs of such corporations are generally less stringent than those of many other types of corporations. Spanbock, Carro, & Katz, *supra* note 116, at 689. See *Scotland Mills, Inc. v. Commissioner*, 24 T.C.M. (CCH) 265, 273 (1965) (expert testimony received as to whether company was adequately capitalized by industry standards).

185. Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,961 (1980).

186. See note 110 and accompanying text *supra*.

Thus, the ratio settled upon by the Secretary was determined by using a data base different from the one used by taxpayers in computing their ratios under the regulations.¹⁸⁷ Moreover, even if the statistical analysis is valid, a finding that forty-five percent of all corporations filing tax returns failed to meet the 1:1 test shows that the rule of convenience is not very convenient in that it will create financing problems for a large portion of corporate taxpayers.

In addition, while it may be true that a debt-equity ratio of 1:1 is exceptionally high by the standards of public corporations (although by the Secretary's own analysis this statement is questionable), this may not be true in the case of smaller corporations. Given the fact that smaller corporations are more in need of the safe harbor and will enjoy the greatest benefit if the regulations achieve their stated goals of providing greater certainty, lower compliance cost, and greater administrative efficiency,¹⁸⁸ it is ironic that the Secretary apparently intends to standardize the financing of corporations without adequately taking into account the legitimate methods of financing which are widely used by smaller corporations. Since smaller corporations have great difficulty in obtaining access to the equity markets in order to meet their capital needs,¹⁸⁹ they have been forced to rely more heavily on debt than equity to meet their needs. This great reliance on debt makes it unlikely that the small corporation would typically have a 1:1 debt-equity ratio. For example, if a corporation owns its own building subject to a mortgage, as is typically the case, it is not likely to qualify. Therefore, it is suggested that a standard which appears to be adequate only to large corporations is too conservative to achieve the stated objectives of the regulations.

Furthermore, examination of the existing case law clearly shows that the courts have not required such conservative ratios¹⁹⁰ even though the debt-equity ratio has generally been computed using the fair market values of assets rather than adjusted basis.¹⁹¹ While the ratio is but one factor to consider,¹⁹² a corporation with

187. See notes 125-26 and accompanying text *supra*.

188. See notes 59-73 and accompanying text *supra*.

189. See note 64 and accompanying text *supra*.

190. See, e.g., *Lifans Corp. v. United States*, 390 F.2d 965, 970 (Ct. Cl. 1968) (17:1); *Sun Properties, Inc. v. United States*, 220 F.2d 171, 175 (5th Cir. 1955) (310:1); *Baker Commodities v. Commissioner*, 48 T.C. 374, 396 n.20 (1967) (692:1); *Curry v. Commissioner*, 43 T.C. 667 (1965) (30:1); *J. I. Morgan, Inc. v. Commissioner*, 30 T.C. 881 (1958) (50:1).

191. The use of fair market value would generally result in a ratio higher than that which would result from the use of the adjusted basis. See notes 406-09 and accompanying text *infra*.

192. See note 180 and accompanying text *supra*.

a relatively conservative ratio of between 3:1 and 5:1¹⁹³ should be able to meet the rule of convenience. If not, then the rule of convenience is too narrowly drafted and will not relieve the courts, taxpayers, or the Service of the many disputes which will arise when the only resort is to the subjective factors of the general rule. In other words, section 1.385-6(e)(2) appears to be, for all practical purposes, meaningless as an objective rule of convenience because of the debt-equity ratio requirement.

Fourth, it must again be pointed out that the courts have used the fair market value of assets in determining debt-equity ratios.¹⁹⁴ In the current inflationary environment, the use of adjusted tax basis is unlikely to provide a very accurate measure of leverage. The use of adjusted basis will no doubt result in a less controversial calculation, but, with the safe harbor ratio pegged at a very conservative 1:1, the regulations will fail to achieve their purpose of a "high degree of certainty."¹⁹⁵ This is so because many corporations will be forced into the more subjective general rule.

The simplest solution to the shortcomings indicated with respect to the presence of a debt-equity ratio test in the rule of convenience is to eliminate the ratio requirement altogether. Alternatively, a higher ratio may be adopted. The courts have allowed interest deductions in cases where the debt-equity ratio was well in excess of 1:1.¹⁹⁶ In 1957, an Advisory Group on Subchapter C, appointed by the House Ways and Means Committee, examined the debt-equity problems and recommended a 5:1 safe harbor.¹⁹⁷ There do not appear to be any fundamental economic, legal, or accounting changes which have occurred during the intervening time span in the area of corporate financing that would make the recommendation less valid today. The Service has accepted a 20:1 ratio, as long as capital is sufficient for normal business operations.¹⁹⁸ Congress, in enacting section 279,¹⁹⁹ initially considered a 4:1 debt-equity ratio²⁰⁰ before finally agreeing on a 2:1 compro-

193. See notes 196-204 and accompanying text *infra*.

194. See notes 113-18 and accompanying text *supra*.

195. See note 139 and accompanying text *supra*.

196. See note 190 *supra*.

197. *Hearings on Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code Before the House Committee on Ways and Means*, 86th Cong., 1st Sess. 579 (1959).

198. See Rev. Rul. 68-54, 1968-1 C.B. 69.

199. I.R.C. § 279 (1976).

200. See S. REP. No. 552, 91st Cong., 1st Sess. 140 (1969). It must be noted that the legislative history indicates that the Secretary, in developing the § 385 regulations, was not to be limited by the specific rules for distinguishing debt from equity in the corporate acquisition context of § 279. *Id.* at 138-39.

mise.²⁰¹ Finally, it is no secret that tax practitioners have, for a number of years, worked under a rule of thumb that a debt-equity ratio of 3:1 was unlikely to invite challenge.²⁰² Therefore, the use of a ratio of between 3:1 and 5:1 in the rule of convenience would seem to generate the greatest support.²⁰³

VI. THE GENERAL RULE FOR CLASSIFICATION

Section 1.385-4(a) sets forth the general rule that all instruments are treated as indebtedness for all purposes of the Code.²⁰⁴ Where there is a general rule, there are, of course, exceptions to the rule. If an instrument is classified as stock under one of the exceptions, it is treated as preferred stock for all purposes of the Code.²⁰⁵ The status of an instrument as stock or indebtedness is to be determined as of the time the instrument is issued, and that status ordinarily will never change.²⁰⁶ However, debt instruments held substantially proportionately to holdings of stock may be reclassified as stock under certain circumstances.²⁰⁷ If an instrument becomes stock under any of these provisions, the instrument is treated as having been exchanged for preferred stock in a tax-free recapitalization under section 368(a)(1)(E).²⁰⁸

It is not clear why an instrument that is to be classified as stock must be preferred stock rather than common stock. Such treatment could result in the preferred stock being treated as section 306 stock, which could bring that provision's rules of income characterization

201. See I.R.C. § 279(b)(4)(A) (1976). This section resolves the question of whether corporate payments are deductible as an interest expense in the limited context of corporate acquisitions. It was considered by the Senate as a companion to § 385 of the Code. See S. REP. NO. 552, 91st Cong., 1st Sess. 144 (1969).

202. See B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 4.04(2) (4th ed. 1979); Caplin, *supra* note 116, at 783; Plumb, *supra* note 2, at 508.

203. Because of the low range of interest rates allowed by the rule of convenience, a conservative ratio of 3:1 to 5:1 is proper. Such a low ratio is not as acceptable, however, in the context of the nominal capital rule of § 1.385-6(f). See notes 404-13 and accompanying text *infra*.

Another alternative would be to apply one ratio to publicly-held corporations and a higher ratio to closely-held corporations, with real estate holdings and consequent liabilities excluded from the calculation of the ratio of the small corporations.

204. Treas. Reg. § 1.385-4(a) (1980).

205. *Id.* § 1.385-4(c)(1).

206. *Id.* § 1.385-4(b)(1).

207. *Id.* §§ 1.385-4(b)(2), -6(j), -6(k), -6(l). See notes 440-72 and accompanying text *infra*.

208. Treas. Reg. § 1.385-4(c)(1)(ii) (1980). See I.R.C. § 368(a)(1)(E) (1980).

into play.²⁰⁹ Moreover, under present law, the creation of preferred stock may cause the corporation's original stock to fail to qualify under section 1244.²¹⁰ Such treatment may also have an unintended impact in such areas as multiple tax benefits, consolidated return eligibility, and the tax-free liquidations of subsidiaries. These potential problems could possibly be eliminated if the regulations deemed the preferred stock to be non-voting stock which is limited and preferred as to dividends, within the meaning of sections 1563(c)(1)(A), 1504(a), and 332(b)(1).²¹¹ Finally, the classification into preferred stock for all purposes of the Code may be interpreted as the creation of a second class of stock, which would invalidate a Subchapter S election.²¹²

The issue of whether the reclassification of debt as preferred stock creates a second class of stock which terminates a Subchapter S election has been reserved by the Secretary.²¹³ The specific references to the issue of reclassification of stock in a Subchapter S corporation which were contained in section 1.1371-1(g) have been deleted.²¹⁴ This issue is reserved because Congress is in the process of reviewing the Subchapter S election, including the one class of stock requirement. The Secretary recommends that the Subchapter S rules allow a second class of stock in certain cases:

Although the Joint Committee Staff has recommended no statutory change in this regard, we think that under the present state of the law a change is necessary. A rational regulatory scheme under section 385 should apply the debt-equity classification throughout the Code, including the status of securities issued by Subchapter S corporations. But, as the case law suggests, the loss of Subchapter S qualification is often a harsh result when a corporation issues nominal debt that is treated as equity under section 385. It is a result that flows from the current Subchapter S requirement of section 1371(a)(4): it should not be a classification problem under section 385. Therefore, the problem should not be solved by overriding the rules of section 385. Rather, the solution is to change the Sub-

209. I.R.C. § 306 (1980). Under § 306(a), a subsequent sale or redemption of § 306 stock, as defined by § 306(c), may result in a portion of the gain being characterized as ordinary income. *Id.*

210. *Id.* § 1244 (1980).

211. *Id.* §§ 332(b)(1) (1980), 1504(a) (1980), 1563(c)(1)(A) (1980).

212. In order for a corporation to be eligible for the Subchapter S election, the corporation is permitted to have only one class of stock. *Id.* § 1371(a)(4) (1978).

213. See 45 Fed. Reg. 18,953 (1980). See also T.D. 7747, 1981-8 I.R.B. 15.

214. See 45 Fed. Reg. 18,953, 18,973 (1980).

chapter S qualification requirements directly by amending the statute to allow a second class of stock with delineated characteristics.²¹⁵

Until such time, however, it may be argued that the "for all purposes" language of section 385(a) automatically governs the Subchapter S question, given the one class of stock rule of section 1371(a)(4).²¹⁶

In light of the potential for the reclassification of instruments originally classified as debt, the lack of a "second look" for instruments originally classified as equity seems to be a serious flaw. The stated justifications for not permitting reclassification from equity to debt are simplicity and to "avoid the need to recognize gain or loss."²¹⁷ However, to the extent that reclassification of debt as equity is allowed under section 1.385-6,²¹⁸ reclassification should operate as a two way street rather than work only against the taxpayer.

VII. MODIFICATIONS AND EXCEPTIONS TO THE GENERAL RULE

Since the general rule states that all instruments are to be treated as indebtedness for all purposes of the Code, the truly significant aspects of the regulations are to be found in the provisions which describe the numerous modifications and exceptions to the general rule. These provisions operate to classify particular instruments as stock and can be classified into two general categories: 1) provisions applicable to interests held by all creditors,²¹⁹ and 2) provisions applicable to interests held by shareholder-creditors.²²⁰

A. Provisions Applicable to Interests Held by All Creditors

There are two provisions which are applicable to interests held by all creditors, each of which expresses concern as to the type or form of the instrument. Section 1.385-5(a) deals with hybrid instruments,²²¹ and section 1.385-8(a) deals with locked interests.²²²

215. Staff of the Joint Committee on Taxation, *Report on Staff Recommendations for Simplification of Tax Rules Relating to Subchapter S Corporations*, 96th Cong., 2d Sess. 9-10 app. (1980).

216. I.R.C. §§ 385(a), 1371(a)(4) (1980).

217. Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,960 (1980).

218. Treas. Reg. § 1.385-6 (1980).

219. See notes 221-63 and accompanying text *infra*.

220. See notes 269-472 and accompanying text *infra*.

221. Treas. Reg. § 1.385-5(a) (1980). See notes 223-56 and accompanying text *infra*.

222. Treas. Reg. § 1.385-8(a) (1980). See notes 257-63 and accompanying text *infra*.

1. *Hybrid Instruments*

Hybrid instruments are instruments which contain both debt and equity elements. Such instruments may have become popular because they offer a corporation the opportunity to achieve the best of both worlds by issuing an instrument that will be classified as debt under tax law, but which provides extra equity benefits to the corporation and its shareholders.²²³ For instance, a corporation wishing to protect itself from insolvency may issue a debt instrument to shareholders or other cooperative creditors which pays interest at a rate dependent upon the earnings of the corporation. By using an instrument which provides for contingent payments of interest, the corporation receives a deduction for the interest paid in the years when it has sufficient earnings to pay interest and it can avoid insolvency by not paying interest in years when it has insufficient earnings.²²⁴ The discretionary power to pay interest closely resembles a corporation's discretionary power to pay dividends to holders of an equity interest. In addition, a corporation may attempt to attract investors by issuing debt instruments which are convertible into the common stock of the corporation in order to allow creditors to share in the future growth of the company. Clearly, these types of debt instruments may be difficult to distinguish from stock.²²⁵

Section 1.385-5(a) operates to classify hybrid instruments as debt or equity.²²⁶ It is based upon the premise that a hybrid instrument more closely resembles stock if the value of its equity elements is greater than its value solely as a debt instrument, particularly if the instrument's value as a debt instrument is reduced by subordination of the instrument to other creditors or by a low interest rate.²²⁷ Accordingly, a mechanical test is applied in order to determine the predominant characteristics of the instrument.²²⁸ The presumption is that the total fair market value of a hybrid instrument embodies two separately identifiable components: 1) the value of the right to fixed payments of interest and principal; and 2) the

223. See Plumb, *supra* note 2, at 405.

224. *Id.*

225. *Id.*

226. Treas. Reg. § 1.385-5(a) (1980).

227. Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,960 (1980).

228. See notes 229-37 and accompanying text *infra*.

value of its equity features, defined as the right to convert the instrument into stock and the right to receive contingent payments.²²⁹ 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.²³⁰ On the other hand, if the fair market value of the instrument without its equity features is less than one-half of the actual fair market value of the instrument, the instrument is to be classified as stock.²³¹ Two separate calculations must be made: 1) the actual fair market value of the entire instrument, and 2) the fair market value of the instrument without its equity features.²³² If the instrument is registered with the Securities and Exchange Commission and sold to the public, the fair market value of the total instrument on the day of its issue is the issue price.²³³ Otherwise, the fair market value is "the price at which the instrument would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of all relevant facts."²³⁴ The fair market value of an instrument without its equity features apparently is to be calculated using standard bond tables and present value methods since the rights being valued consist solely of rights to fixed payments of interest and principal.²³⁵ The proper discount rate is to be determined by comparing the instrument to other instruments which are freely traded in the bond market and which have similar terms, a similar maturity date, and a similar risk classification or financial credit rating.²³⁶ The fair market value of the

229. Treas. Reg. § 1.385-5(b) (1980).

230. *Id.* § 1.385-4(a).

231. *Id.* § 1.385-5(a).

232. *See* notes 230-31 and accompanying text *supra*.

233. Treas. Reg. § 1.385-3(b)(2)(ii) (1980).

234. *Id.* § 1.385-3(b)(1). *See* notes 99-104 and accompanying text *supra*.

235. The regulations under § 1232 explain how to determine the fair market value of the debt portion of an obligation containing mixed debt and equity characteristics which is sold as an investment unit:

The assumed price of the obligation shall be ascertained by comparison to the yields at which obligations of a similar character which are not issued as part of an investment unit are sold in arm's length transactions, and by adjusting the price of the obligation in question to this yield. The adjustment may be made by subtracting from the face amount of the obligation the total present value of the interest foregone by the purchaser as a result of purchasing the obligation at a lower yield as part of an investment unit.

Id. § 1.1232-3(b)(2)(ii)(a), T.D. 7663, 1980-1 C.B. 101.

236. Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,960 (1980).

instrument without its equity features may be reduced if the instrument is subordinated to general creditors of the corporation or has a distant maturity date, or by other factors affecting the value of the rights characteristic of indebtedness.²³⁷

When the fair market value of the instrument without its equity features and the actual fair market value of the entire instrument have been determined, the mechanical test determines whether the debt features or the equity features are predominant. However, if clear and convincing evidence shows that both the issuer and the holder of the instrument, on the day of issue, reasonably believe that the fair market value of the instrument without its equity features would be greater than fifty percent of the actual fair market value of the entire instrument, the mechanical test is modified as follows: "A hybrid instrument is treated as stock if, on the day of issue, the fair market value of the instrument without its equity features is less than forty-five percent of the actual fair market value of the instrument."²³⁸ Thus, a five percent margin of error is permitted.

A hybrid instrument which escapes classification as stock under section 1.385-5(a) is treated as a straight debt instrument.²³⁹ Obviously, it is subject to any of the other exceptions to the general rule which are applicable to straight debt instruments.²⁴⁰

In evaluating this provision, a few comments seem appropriate. First, it may be argued that the special rule which, based upon the issuer's and the holder's reasonable beliefs, increases the portion of the instrument which is allowed to represent an equity interest from fifty percent to fifty-five percent, places an undeserved premium on knowledge of the rule. Certainly, anyone aware of the rule will both develop and document such a "reasonable belief," thereby earning the more favorable standard. Those not aware of the rule will be held to the stricter standard. This represents an unnecessary trap for the unwary or unadvised taxpayer. Moreover, the "reasonable belief" standard is not very clear. Questions arise as to the type and quantum of evidence needed to support such a belief.

Second, it may be argued that a non-shareholder creditor who deals on an arm's length basis with a corporation should never be treated as a shareholder. An exception for independent creditors

237. *Id.*

238. Treas. Reg. § 1.385-5(c) (1980).

239. *Id.* § 1.385-5(a). A straight debt instrument is defined as "any instrument other than a hybrid instrument." *Id.* § 1.385-3(g).

240. *Id.* § 1.385-2(b)(2).

has been included for other provisions,²⁴¹ and perhaps a similar exception is needed for section 1.385-5(a).²⁴² Alternatively, the regulations could specify that the only situation in which non-shareholders will be treated as owning equity instruments would be when such instruments are subordinated to the rights of general creditors and thus are on the borderline between debt and preferred stock. Otherwise, section 1.385-5(a) may operate to completely eliminate the use of hybrid instruments.²⁴³

Third, the Secretary surely recognizes that the primary purpose of a hybrid instrument is to obtain a lower interest rate than would be possible with a straight debt instrument. Yet, the fact that reduced interest is being paid on the hybrid instrument operates to lower the value of the instrument without its equity features, which increases the possibility that the instrument will be classified as stock. The Secretary seems to be saying that it is acceptable for corporations to use sophisticated financing instruments to lower their effective interest expense as long as their interest costs are not lowered 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."²⁴⁴ To obtain this favored status, all that is necessary is for the corporation to issue debt instruments with non-detachable warrants rather than convertible debt instruments. In this way, potential adverse classification under section 1.385-5(a) may be avoided entirely.²⁴⁵

Fourth, while the concept of fair market value is generally understood, it is not readily determinable when applied to specific fact situations. Therefore, there is a great likelihood of numerous disputes between the Service and taxpayers with regard to valuation. The examples are not helpful in this regard as they are all based upon an assumption of an established fair market value.²⁴⁶ All that is indicated by these examples is that various factors such as time to maturity, subordination, and non-interest bearing status affect the valuation of an instrument without its equity features. They do not illustrate how to compute the specified fair market values in light of the fact situations described. Conflicts concerning valuation could be reduced if the regulations were modified to illustrate spe-

241. None of the classification rules which apply if there is substantial proportionality are applicable if the instrument is held by an independent creditor. *Id.* § 1.385-6(a)(3)(ii).

242. *Id.* § 1.385-5(a).

243. *Id.*

244. *Id.* § 1.385-8(a).

245. See notes 258-62 and accompanying text *infra*.

246. Treas. Reg. § 1.385-5(e), -5(f) (1980).

cifically how the fair market values that are specified in the examples were determined, with appropriate explanation of the mechanics.

Finally, the objective test used in section 1.385-5(a) is not consistent with the approach used by the courts in determining whether a hybrid instrument is debt or equity.²⁴⁷ Although the facts of the examples in this section are said to be variations on facts taken from various court decisions,²⁴⁸ the test adopted by this regulation is not the same as the one used by the courts. At one time, courts would determine if hybrid instruments were debt or equity by closely examining the formal characteristics of the instrument in question²⁴⁹ in an attempt to determine the intent of the parties.²⁵⁰ Thus, shareholders of closely-held corporations could obtain the tax advantages of debt by formally providing for unconditional obligations payable with fixed interest at fixed dates, while the corporation and the shareholder tacitly understood that the shareholder would not enforce these rights.²⁵¹ However, in response to this abuse, the courts began to look beyond the four corners of the instrument and started using a set of factors to distinguish debt from equity.²⁵² Some of the factors which the regulations use to define hybrid instruments have been used by the courts to determine if such instruments are debt or equity,²⁵³ but the comparison of value test adopted by the regulations finds no support in the case law. The courts examine hybrid instruments as they would any other type of instrument, applying a set of factors²⁵⁴ in order to determine whether there was an intent to create a bona fide debt.²⁵⁵ While it is true

247. *Id.* § 1.385-5(a).

248. Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,960 (1980).

249. *See, e.g.*, Commissioner v. Meredian & 13th Realty Co., 132 F.2d 182 (7th Cir. 1942); Commissioner v. Proctor Shop, 82 F.2d 792, 794 (9th Cir. 1936); 250 Hudson St. Corp. v. Commissioner, 5 T.C.M. (CCH) 722, 727-28 (1946); Glenmore Distilleries Co., Inc. v. Commissioner, 47 B.T.A. 213, 227-28 (1942).

250. *See* Caplin, *supra* note 116, at 775; Gerver, *supra* note 44, at 29; Morris, *Intent Test Grows as Determinant of Thin Incorporation Safety*, 13 J. TAX. 130, 131 (1960).

251. Plumb, *supra* note 2, at 406-07.

252. *Id.* at 407. For a list of the factors typically used by the courts, *see* note 7 *supra*.

253. Among the factors considered by the courts are whether the payments of interest and principal are contingent and whether the interest rate is definitely ascertainable. Plumb, *supra* note 2, at 430-42.

254. *See* note 8 *supra*.

255. Aarons, *supra* note 175, at 194. *See, e.g.*, Dixie Dairies Corp. v. Commissioner, 74 T.C. 476 (1980); Litton Business Sys., Inc. v. Commissioner, 61 T.C. 367, 377 (1973), *acq.* 1974-2 C.B. 3.

that the regulations are trying to replace a set of subjective factors with an objective test,²⁵⁶ the mechanical test chosen has no basis in the existing case law.

2. *Locked Interests*

Section 1.385-8 deals with the classification of locked interests.²⁵⁷ This type of interest consists of a note or other evidence of indebtedness that is inseparable from an option to acquire stock. In general, the regulations classify this type of interest as two separate and distinct interests even though title to one cannot be transferred without transferring title to the other.²⁵⁸ This result is contrary to the view previously expressed by the Tax Court that the fact that notes are locked into stock is an indication that the notes are really stock.²⁵⁹ The reason specified for this divergence is that most hybrid instruments issued by closely-held corporations will be treated as stock under section 1.385-6(c)(1).²⁶⁰ Yet, such a corporation may have a valid business reason for issuing interests containing both equity and indebtedness features to its shareholders. Section 1.385-8(a) makes this possible because the corporation may simply create two separate interests locked together rather than one hybrid interest.²⁶¹ The creation of two separate interests makes possible a natural classification of one interest as stock and the other as indebtedness.²⁶²

The apparent thrust of this provision is that a taxpayer can avoid adverse classification under sections 1.385-5(a) and 1.385-6(c)(1) simply by restructuring instruments from convertible debt instruments to debt instruments with non-detachable warrants.²⁶³ Although such a provision is undoubtedly favorable to taxpayers, such exaltation of form over substance appears to be but another trap for the unwary or unadvised taxpayer.

256. Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,960 (1980).

257. Treas. Reg. § 1.385-8 (1980).

258. *Id.* § 1.385-8(a).

259. See *Universal Castings Corp. v. Commissioner*, 37 T.C. 107 (1961), *aff'd*, 303 F.2d 620 (7th Cir. 1962). The Secretary recognizes that the regulations diverge from the Tax Court's position. Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,962 (1980).

260. Treas. Reg. § 1.385-6(c)(1) (1980).

261. *Id.* § 1.385-8(a).

262. Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,962 (1980).

263. Treas. Reg. §§ 1.385-5(a), -6(c)(1) (1980).

B. *Provisions Applicable to Interests Held by
Shareholder-Creditors*

The overwhelming majority of the classification provisions contained in the regulations are devoted to interests held by shareholder-creditors. These provisions deal with several diverse types of transactions, including loans by third parties which are guaranteed by shareholders,²⁶⁴ instruments with a fair market value different from the consideration paid by the shareholder for the instrument,²⁶⁵ unwritten loans and cash advances made by a shareholder,²⁶⁶ and instruments issued to shareholders whose holdings of stock and the instruments are substantially proportionate.²⁶⁷

1. *Guaranteed Loans*

If a shareholder either directly or indirectly guarantees a loan made to his corporation by an independent third party lender and, under relevant legal principles applied without reference to the regulations under section 385, the loan would be treated as made to the shareholder,²⁶⁸ the shareholder is treated as making a contribution to the capital of the corporation.²⁶⁹ It may be argued that this regulation is an interpretative rather than a legislative regulation²⁷⁰ and is therefore more open to attack on the theory that the Secretary has exceeded his authority. In section 385, Congress delegated to the Secretary the authority to promulgate regulations which would "determine whether an interest in a corporation is to be treated . . . as stock or indebtedness."²⁷¹ Therefore, the regulations should focus upon an interest in the corporation, and, in the guaranteed loan situation, the inquiry should be directed to the actual loan from the third party, not upon the hypothetical contribution to capital by the shareholder-guarantor. By restructuring the transaction and treating the loan as being made to a shareholder, who in turn makes a contribution of capital, section 1.385-9 creates a new interest in the corporation.²⁷² It is submitted that such a restructuring goes beyond the authority delegated by section 385. It follows that the regulation is an inter-

264. See notes 268-91 and accompanying text *infra*.

265. See notes 292-325 and accompanying text *infra*.

266. See notes 326-42 and accompanying text *infra*.

267. See notes 343-472 and accompanying text *infra*.

268. See notes 279-80 and accompanying text *infra*.

269. Treas. Reg. § 1.385-9(a) (1980).

270. See note 21 and accompanying text *supra*.

271. I.R.C. § 385(a).

272. Treas. Reg. § 1.385-9 (1980).

pretative regulation issued under the authority of section 7805.²⁷³ As such, the strong presumption of validity judicially granted to legislative regulations would not apply to section 1.385-9, leaving it more vulnerable to taxpayer attack.²⁷⁴

In addition, it is suggested that the provision will create more problems than it will resolve. It is recognized that the provision is nothing more than an application of the basic tax doctrine of substance over form to the guaranteed loan area.²⁷⁵ As such, the provision adds nothing to this area of the tax law. In view of the notation by the drafters that "nothing in the regulations under section 385 is intended to preclude the application of general tax law principles such as substance over form, step transaction, and so on,"²⁷⁶ the provision clearly is not needed. Furthermore, section 1.385-9(a), as finally issued,²⁷⁷ is considered by the drafters to be merely a "restatement of existing case law."²⁷⁸ Under *Plantation Patterns, Inc. v. Commissioner*,²⁷⁹ specifically used as authority for this regulation by the Treasury, loans to corporations by outsiders which are guaranteed by shareholders may be treated as loans to the shareholder, who then is considered to have advanced the proceeds to the corporation as a contribution to capital.²⁸⁰ Section 1.385-9(a) is therefore harmless to the extent that it does not create

273. I.R.C. § 7805 (1976).

274. This does not mean that it will be a simple task to have this particular regulation invalidated. The Treasury may not promulgate an arbitrary or unreasonable regulation, nor can it change the scope of the statute or rectify a supposed omission. See 1 J. MERTENS, *supra* note 19, § 3.21. However, the courts give considerable weight to the Treasury's construction of a statute and, unless contrary to the statute, interpretative regulations will be upheld if they are reasonable interpretations. *Id.*

275. See *Gregory v. Helvering*, 293 U.S. 465 (1935).

276. Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,960 (1980).

277. The comparable provision of the proposed regulations provided that if it was not reasonable to expect that the loan would be enforced according to its terms, the loan would be treated as a contribution to capital. See Prop. Reg. § 1.385-11. This standard was taken from a case which involved a father's guarantee of a loan to his son. See *Ellisberg v. Commissioner*, 9 T.C. 463 (1947). The drafters of the final regulations responded to critical comments concerning this confusing test and its application to the area of shareholder guarantees by changing the regulation to its current form. See Treas. Reg. § 1.385-9(a) (1980).

278. Treas. Reg. § 1.385-9(a) (1980).

279. 29 T.C.M. (CCH) 817 (1970), *aff'd*, 462 F.2d 712 (5th Cir.), *cert. denied*, 409 U.S. 1076 (1972). See also *Barclay Co. v. Commissioner*, 23 T.C.M. (CCH) 1695 (1964); *J. A. Maurer, Inc. v. Commissioner*, 30 T.C. 1273 (1958); *Markle v. Commissioner*, 17 T.C. 1593 (1952).

280. See 29 T.C.M. (CCH) at 825. *But see* *Murphy Logging Co. v. United States*, 378 F.2d 222 (9th Cir. 1967) (refused to collapse transaction).

any new problems for the shareholder of a closely-held corporation. Yet, because it does not add any certainty to this area, relying instead on the maze of factors applied by the courts,²⁸¹ the utility of this part of the regulations should be questioned.

Finally, this "restatement" of the case law may tend to influence courts addressing the issue of whether a loan should be treated as made to a guarantor-shareholder rather than to a corporation. Clearly, the courts recognize that banks and other commercial lenders frequently require the guarantees of shareholders when a loan is being made to a small corporation.²⁸² It is also recognized that the fact that the loan would not have been made without a shareholder's guaranty does not alone warrant a finding that the loan is really a contribution of capital.²⁸³ However, courts may ostensibly rely on section 1.385-9(a) to buttress their conclusion that the loan was made to the shareholder when in reality their decision is based on little more than "an internal reaction to the propriety of the transaction."²⁸⁴ Existing case law makes it clear that the issue of whether a guaranteed loan should be treated as a contribution of capital is to be decided by utilizing the traditional factors used by the courts in distinguishing debt from equity.²⁸⁵ Commentators have noted that the use of this often conflicting set of factors allows a court to justify any conclusion.²⁸⁶ Therefore, the courts may also use section 1.385-9(a) to add "official" weight to a decision that a guaranteed loan was a contribution of capital.²⁸⁷ Because of this potential misuse and the lack of utility of a provision which does no more than restate the case law, it can be strongly asserted that section 1.385-9 should be eliminated from these regulations.²⁸⁸

More importantly to small corporations, section 1.385-9 does not reflect the realities of financing available to such entities. Due to the size of loans to small corporations, many lenders cannot afford to have a negotiated lending agreement on every loan since these agreements can be very elaborate and usually contain restrictions of various types, including limitations on salaries, dividends, and asset

281. See note 7 *supra*. See also Plumb, *supra* note 2, at 411-555.

282. See Plumb, *supra* note 2, at 369.

283. *Smyers v. Commissioner*, 57 T.C. 189, 199 (1971); *Santa Anita Consol., Inc. v. Commissioner*, 50 T.C. 536, 552 (1968).

284. *Caplin*, *supra* note 116, at 811.

285. See note 279 *supra* and authorities cited therein.

286. See *Caplin*, *supra* note 116, at 811; *Plumb*, *supra* note 2, at 408.

287. *Treas. Reg. § 1.385-9(a)* (1980).

288. *Id.* § 1.385-9.

purchases, designation of management personnel, and working capital requirements. To avoid the time and difficulties of negotiating the many provisions that might otherwise appear in a loan agreement, a lender will usually either provide the loan on a short term, renewable basis, giving the lending institution the option to call the loan if it feels insecure, or provide the loan with no supporting lending agreement and have one or more of the shareholders guarantee the loan.²⁸⁹ Furthermore, since it is convenient to request and obtain shareholder guarantees, a lender will frequently receive such guarantees even though they are not considered absolutely necessary by the lender and are a negotiable aspect of the transaction.²⁹⁰ Therefore, many, if not most, new and small corporations are requested by independent lenders to have corporate notes guaranteed by shareholders. Section 1.385-9(a) can serve to make this common formality become a taxable event to the guarantors upon the subsequent repayment of the note by the borrowing corporation.²⁹¹

2. *Instruments With a Fair Market Value Different from the Consideration Paid by the Shareholder-Creditor*

In general, the provisions of the regulations under section 385 classify an interest in a corporation as either indebtedness or stock. However, section 1.385-3(a) requires an interest to be treated in part as stock and in part as indebtedness.²⁹² When a corporation issues instruments to its shareholders, a determination as to the debt or equity status of the instruments is made, after which section 1.385-3(a) requires a comparison of the fair market value of the instruments with the consideration paid for the instruments.²⁹³ If the consideration paid for an instrument exceeds its fair market value, the excess is treated as a contribution to capital whether the instrument is classified as stock or indebtedness.²⁹⁴ If the fair market value of the instrument exceeds the consideration paid, and if

289. See Plumb, *supra* note 2, at 487. See also Santa Anita Consol., Inc. v. Commissioner, 50 T.C. 536, 552 (1968).

290. Hickman, *The Thin Corporation: Another Look at An Old Disease*, 44 TAXES 883, 890 (1966).

291. Treas. Reg. § 1.385-9(a) (1980). The ultimate consequence is the denial of an interest deduction to the corporation and the taxation of the shareholder on the receipt of the principal payment. See Bittker, *supra* note 183, at 835.

292. Treas. Reg. § 1.385-3(a) (1980). Section 1.385-8(a), dealing with locked interests, also requires an interest to be treated as part stock and part debt. See notes 258-62 and accompanying text *supra*.

293. Treas. Reg. § 1.385-3(a) (1980).

294. *Id.* § 1.385-3(a)(1).

the instrument is classified as indebtedness, the excess is treated as a distribution to which section 301 applies.²⁹⁵ Finally, if the fair market value of the instrument exceeds the consideration paid, and if the instrument is classified as preferred stock, this excess is treated as a distribution to which section 305 applies.²⁹⁶ The effect of these specified treatments is to require the consideration deemed to have been paid for the instrument to equal the fair market value of the instrument, regardless of the price set by the corporation and its shareholders. It follows that the issue price of an instrument will then equal its fair market value since issue price refers to the amount that is considered to have been paid for the instrument.²⁹⁷

By establishing the issue price, section 1.385-3(a) also has the effect of insuring that principal and interest will be paid on the instruments in the same proportions as would be paid to outside creditors.²⁹⁸ 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.²⁹⁹ Amortizable bond premium is defined in section 1.61-12(c)(4) as the excess of the issue price over the amount payable at maturity.³⁰⁰ If a bond is sold with original issue discount, the amount of the discount must be included ratably over the life of the bond in the income of the holder of the bond.³⁰¹ A corresponding deduction is allowed to the corporation.³⁰² Likewise, if a bond is sold at a premium, the amount of the premium is included ratably over the life of the bond in the income of the corporate issuer.³⁰³ A corresponding deduction is allowed to the holder of the instrument.³⁰⁴ Therefore, the creation by the regulations 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 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.

295. *Id.* § 1.385-3(a)(2)(i). See I.R.C. § 301 (1978).

296. Treas. Reg. § 1.385-3(a)(2)(ii) (1980). See I.R.C. § 305 (1976).

297. See I.R.C. § 1232(b)(2) (1976).

298. Treas. Reg. § 1.385-3(a) (1980).

299. I.R.C. § 1232(b)(1) (1976).

300. Treas. Reg. § 1.61-12(c)(4), T.D. 6984, 1969-1 C.B. 38.

301. I.R.C. § 1232(a)(3)(A) (1976).

302. Treas. Reg. § 1.163-4(a), T.D. 7259, 1973-1 C.B. 143.

303. *Id.* § 1.61-12(c)(2), T.D. 6984, 1969-1 C.B. 38.

304. I.R.C. § 171(a)(1) (1976).

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 by definition, no original issue discount or bond premium.³⁰⁵ 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.³⁰⁶ Since the mechanics of original issue discount and amortizable bond premium are not available to regulate the interest rates of demand instruments and instruments issued for property, the Secretary has provided special rules for when arm's length bargaining does not exist.³⁰⁷ This is the justification for section 1.385-6(d), which deals with an instrument issued for property to a shareholder whose holdings of stock and instruments are substantially proportionate,³⁰⁸ and for section 1.385-6(l)(1), which deals with a demand instrument issued to a shareholder whose holdings of stock and instruments are substantially proportionate.³⁰⁹

The treatment specified in section 1.385-3(a) appears to be derived from a critical evaluation of the analytical approach applied by the courts in cases similar to *Tomlinson v. 1661 Corporation*.³¹⁰ In resolving conflicts in this area, the courts generally start with an enumeration of factors, some of which tend to show that an instrument is stock while others tend to support a finding that it is indebtedness.³¹¹ In the end, the courts must decide whether the instruments involved are stock or debt. However, the method by which the courts weigh the competing evidence is not entirely clear. Consequently, the conclusions reached provide little guidance for the

305. A corporation would not issue a demand instrument at a discount because its creditor could immediately demand the face amount of the instrument. A creditor would not buy a demand instrument at a premium because the corporation could immediately retire the debt at the face amount.

306. I.R.C. § 1232(b)(2) (1976).

307. Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,961 (1980).

308. Treas. Reg. § 1.385-6(d) (1980). See notes 414-30 and accompanying text *infra*.

309. Treas. Reg. § 1.385-6(e)(1) (1980). See notes 432-39 and accompanying text *infra*.

310. 377 F.2d 291 (5th Cir. 1967). See Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,958 (1980).

311. See note 8 *supra*.

future, even for similar fact situations.³¹² Section 1.385-3(a) attempts to substitute a fair market value test for the predominant characteristics test generally applied by the courts.³¹³ Thus, the analysis under section 1.385-3(a) differs from that contained in the case law in that the inquiry does not focus upon whether the nature of the instrument is stock or indebtedness. Instead, the focus is upon whether the payment to the corporation is payment for indebtedness or part payment for stock and part payment for debt.³¹⁴ By posturing the inquiry in this manner, section 1.385-3(a) supposedly attains three goals. First, the subjective analysis of the case law is replaced with the definitive inquiry into the fair market value of the debenture. Second, it remains responsive to the relevant factors identified in the case law since these factors have a direct bearing upon the fair market value. Finally, the provision makes it easier for the government and the taxpayer to reach a compromise.³¹⁵

Under the existing case law, an instrument must be classified as either stock or indebtedness, leaving little room for compromise.³¹⁶ However, section 1.385-3(a) does not replace the classification process.³¹⁷ That is, the full face amount of an instrument is always classified as either stock or indebtedness before its issue price is determined under this provision. Therefore, it is very difficult to identify the claimed avenue of compromise. It may be argued that section 1.385-3(a) provides the Commissioner with an incentive to agree with the taxpayer that an instrument is indebtedness in those situations in which it is questionable whether one of the exceptions to the general rule operates to classify an instrument en-

312. See *Gooding Amusement Co. v. Commissioner*, 236 F.2d 159, 165 (6th Cir. 1956), *cert. denied*, 352 U.S. 1031 (1957). See also Comment, *supra* note 16, at 1705-07.

313. Treas. Reg. § 1.385-3(a) (1980).

314. Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,959 (1980).

315. *Id.*

316. This all or nothing approach has been criticized by several commentators. See, e.g., Aarons, *supra* note 175, at 197; Plumb, *supra* note 2, at 611. Aarons suggests using an approach by which part of an interest can be classified as stock and the other part as debt. Aarons, *supra* note 175, at 197. The impropriety of this all or nothing approach is illustrated in *American Processing & Sales Co. v. United States*, 317 F.2d 842 (Ct. Cl. 1967). In *American Processing*, rather than imposing the all capital structure upon the corporation which would result from application of the government's all or nothing argument, the court found for the taxpayer and criticized the government's position as "a more absurd result than reason permits be entertained." *Id.* at 856.

317. Treas. Reg. § 1.385-3(a) (1980).

tirely as stock. Having conceded indebtedness to the taxpayer in these questionable situations, the Commissioner could then apply this rule to convert part of the payment to equity. If this is what the drafters intended, then the section does offer an avenue of negotiation. However, it seems risky to read into the regulations such an intent on the part of the Secretary. A more plausible interpretation of section 1.385-3(a) is that it was written to provide the Commissioner with a final means of attack in the debt-equity classification area. In other words, assuming that a taxpayer is successful in obtaining his desired classification through the general rule of section 1.385-4(a) and the numerous exceptions that are contained in the regulations, the Commissioner can still assert section 1.385-3(a) to salvage a small victory in that at least part of the taxpayer's instrument will be reclassified into the unfavorable classification.³¹⁸

Section 385 authorizes the Secretary to promulgate regulations for the purpose of determining "whether an interest in a corporation is to be treated . . . as stock or indebtedness."³¹⁹ In this regard, the Senate Finance Committee stated that "the provision specifies that these guidelines are to set forth factors to be taken into account in determining . . . whether a debtor-creditor relationship exists or whether a corporation-shareholder relationship exists."³²⁰ It therefore appears that the congressional delegation of authority under section 385, although broad, does not extend beyond providing rules for determining whether an interest is to be treated as debt or equity. It follows that neither congressional mandate nor intent authorizes that rules for the determination of issue price be prescribed under section 385. If this position is correct, section 1.385-3 is not a legislative regulation, but is rather an interpretative regulation.³²¹ As such, it does not have the authority of a regulation under section 385,³²² and may be attacked, with a somewhat greater chance of success, as being beyond the Secretary's authority. Even the drafters of the provision acknowledge that section 1.385-3 does not inquire into the nature of the instrument.³²³ Thus, it can be asserted that this provision is statutory in nature and that it goes beyond the authority delegated to the Secretary because its purpose

318. *Id.* §§ 1.385-4(a), -3(a).

319. I.R.C. § 385(a).

320. S. REP. NO. 552, 91st Cong., 1st Sess. 138 (1969). See also I.R.C. § 385(b).

321. *Treas. Reg.* § 1.385-3 (1980). See *Beghe*, *supra* note 24, at 933. See also notes 21 & 274 *supra*.

322. As an interpretative regulation, it is issued under the authority of § 7805(a) of the Code. See I.R.C. § 7805(a) (1976).

323. Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,959 (1980).

is to determine the issue price of an instrument regardless of whether it is debt or equity.

Section 1.385-3(a) is applicable to all loans made to corporations by shareholders, regardless of the percentage of ownership of any particular shareholder.³²⁴ Yet, it is suggested that the section serves no useful purpose in distinguishing between debt and equity interests when the shareholder and the corporation are dealing with each other on an arm's length basis. Moreover, applying such rules in arm's length situations appears to add needless complications to an already complex set of rules. Therefore, this section should be made applicable to shareholder loans only when there exists "substantial proportionality" between holdings of the instrument in question and the outstanding stock of the corporation under the rules provided in section 1.385-6(a).³²⁵ In all other circumstances, the price of the instruments issued and the creation of original issue discount or amortizable bond premium should be decided without reference to section 385 or the regulations thereunder.

3. *Unwritten Loans and Cash Advances by One who is not an Independent Creditor*

If a loan is made to a corporation by any party other than an independent creditor, and if within six months after the loan is made there is no written document, enforceable under applicable non-tax law, containing all 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.³²⁶ However, such loans will be treated as contributions to capital if, when the loan is made, the debtor corporation has excessive debt³²⁷ as defined in section 1.385-6(f).³²⁸ The requirement that the corporation must be inadequately capitalized indicates that the danger of informal shareholder advances is not that they are tax avoidance vehicles *per se*, but rather that in certain circumstances they are likely to merge into the shareholders' equity and represent money which has been placed at the risk of the business.

In addition, even when an unwritten obligation has been classified as indebtedness, if the debtor corporation fails to pay interest

324. Treas. Reg. § 1.385-3(a) (1980).

325. *Id.* § 1.385-6(a). See notes 357-74 and accompanying text *infra*.

326. Treas. Reg. § 1.385-7(b)(1) (1980).

327. See *id.* § 1.385-7(b)(2).

328. *Id.* § 1.385-6(f). For a discussion of this rule, see notes 392-413 and accompanying text *infra*.

on the loan at a reasonable rate³²⁹ during any taxable year of the debtor corporation, the loan is reclassified as a contribution to capital as of the later of the first day of such taxable year or the date of the loan.³³⁰ For purposes of this provision, a rate is considered to be reasonable if it is reasonable as of any day of the taxable year.³³¹ If a loan is originally classified as a contribution to capital, or is reclassified as such, all payments of principal and interest made on the loan after the date of reclassification are treated as distributions to which section 301 of the Code applies.³³² Once a loan is reclassified, its status as a contribution to capital can never change.³³³

As originally drafted, section 1.385-7(b) applied to all unwritten loans made by all shareholders.³³⁴ However, in the final regulations this rule applies to "certain other obligations"³³⁵ made by one who is not an independent creditor.³³⁶ This change produces some results which deserve comment. First, the term "certain other obligations" is considered to be broader than unwritten loans in that it applies to loans where the material terms and conditions are contained in a document other than the instrument, such as a board of directors resolution or an entry in the corporation's books, as well as to all unwritten loans.³³⁷ Second, by applying the rule only if the lender is not an independent creditor, the Secretary accomplished two purposes; he assured that section 1.385-7(b) generally will not apply to shareholders owning minimal amounts of stock,³³⁸ and he made it clear that section 1.385-7 would apply to unwritten loans between brother-sister corporations wholly-owned by a common parent.

329. What constitutes a reasonable rate is defined in § 1.385-6(e). For a discussion of this regulation, see notes 153-204 and accompanying text *supra*.

330. Treas. Reg. § 1.385-7(c)(1) (1980).

331. *Id.*

332. *Id.* § 1.385-7(d)(2). Thus, instead of receiving a tax-free return of capital in the form of a repayment of principal, a shareholder will have ordinary income to the extent of the corporation's earnings and profits. See note 37 and accompanying text *supra*.

333. Treas. Reg. § 1.385-7(d)(2) (1980).

334. See Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,971 (1980).

335. Treas. Reg. § 1.385-7(a) (1980).

336. *Id.*

337. See T.D. 7747, 1981-8 I.R.B. 15.

338. Unless a lender actually or constructively owns more than five percent of a corporation's stock, or unless his holdings of stock and instruments issued by the corporation are substantially proportionate, the lender will be an independent creditor under the safe harbor found in section 1.385-6(b)(2). See notes 80-84 and accompanying text *supra*.

As has been noted previously, the central issue in debt versus equity cases is the intent of the parties as determined in the light of economic reality.³³⁹ Objective evidence of intent is generally not to be accorded special weight.³⁴⁰ The documentation of the advance is considered to be an example of objective evidence and therefore the lack of a written agreement is not considered to carry great weight by the courts.³⁴¹ The courts have been more interested in subjective evidence of the intent of the parties, and many factors are examined to determine this intent.³⁴² The reliance of section 1.385-7 on only one such factor, the lack of adequate capitalization, is therefore inconsistent with the case law. It is suggested that the Secretary reconsider the regulations' approach to unwritten obligations and amend them to be more consistent with existing case law. It is true that some certainty will be sacrificed, but in this case, the price of certainty is too high.

4. *Instruments Held by Shareholders whose Holdings of Stock and Instruments are Substantially Proportionate*

The drafters of the regulations state that proportionality plays a central role in the regulations because it generally makes little economic difference whether proportionate shareholder advances are made as debt or equity.³⁴³ 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, 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.³⁴⁴ Similarly, in the case of debt, such shareholders are generally indifferent to the allocation between principal and interest except for the tax consequences. On the other hand, a decision to receive debt instead of stock is very significant from a tax viewpoint.³⁴⁵ Moreover, once the shareholders have elected to receive debt, the allocation of the repayments between principal and interest can have important tax consequences.³⁴⁶

339. See note 8 and accompanying text *supra*.

340. See *A. R. Lantz Co., Inc. v. United States*, 424 F.2d 1330, 1333 (9th Cir. 1970).

341. See *id.*

342. See Plumb, *supra* note 2, at 462.

343. See T.D. 7747, 1981-8 I.R.B. 15.

344. See Stone, *Debt-Equity Distinctions in the Tax Treatment of the Corporation and its Shareholders*, 42 TUL. L. REV. 251, 258 (1968).

345. See notes 35-52 and accompanying text *supra*.

346. *Id.*

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, regulations were considered necessary in order to insure that financing arrangements reflect economic reality.³⁴⁷ Where possible, the regulations recast particular transactions to reflect economic reality. However, if a proper recasting cannot take place, the regulations classify proportionally-held instruments as stock. Although the drafters magnanimously state that the regulations could have provided that all proportionally-held shareholder debt could be treated as stock under the regulations,³⁴⁸ proportionality has clearly not been given such overpowering weight by the main body of case law. Proportionality raises a "strong inference" that the interest is not debt,³⁴⁹ but no one factor controls,³⁵⁰ and "ordinarily there must be 'something more'"³⁵¹ than proportionality to convince a court that an interest is stock.³⁵² Therefore, the reliance on the existence of substantial proportionality alone to classify instruments as stock would be inconsistent with the case law. It is uncertain whether a regulation requiring such treatment would be upheld by the courts. At the very least, such a regulation would be eroded by construction. Consequently, the Secretary's rationale for elevating the existence of substantial proportionality to such a position of importance in the regulations is unsound.

There are eight provisions under section 1.385-6 and they can be classified into four categories: 1) a provision relating to proportionally-held hybrid instruments;³⁵³ 2) a provision to insure adequate capitalization;³⁵⁴ 3) provisions to insure an arm's length interest rate;³⁵⁵ and 4) provisions to insure arm's length enforcement of an instrument's terms.³⁵⁶ Before discussing the specific classification rules within each of these four categories, it is necessary

347. See T.D. 7747, 1981-8 I.R.B. 15.

348. *Id.*

349. See *Charter Wire, Inc. v. United States*, 309 F.2d 878, 880 (7th Cir. 1962), *cert. denied*, 372 U.S. 965 (1965).

350. See note 8 *supra*.

351. Plumb, *supra* note 2, at 471.

352. *Id.* The American Law Institute's proposal for a safe harbor which, if its requirements were met, would treat an interest as indebtedness, did not treat proportionality as a relevant factor. See ALI FEDERAL INCOME TAX STATUTE § X500(g) (Feb. 1954 Draft).

353. See notes 375-90 and accompanying text *infra*.

354. See notes 391-413 and accompanying text *infra*.

355. See notes 414-39 and accompanying text *infra*.

356. See notes 440-72 and accompanying text *infra*.

to first consider how to determine whether a shareholder's holdings of stock and instruments are substantially proportionate.

a. Determining Whether Holdings of Stock and Instruments are Substantially Proportionate

Substantial proportionality is determined from "all relevant facts and circumstances, including family or other relationships described in section 318(a)." ³⁵⁷ Thus, the regulations do not provide a mechanical test for determining whether holdings of stock and holdings of a class of instruments are substantially proportionate. In fact, proportionality is not even defined. It is provided, however, that holdings are not substantially proportionate if a corporation's stock and instruments are widely held and the instruments are separately traded and readily marketable.³⁵⁸ This rule will probably exempt most publicly-held corporations from the associated classification rules. Additionally, any instrument held by an independent creditor ³⁵⁹ is not regarded as being held in substantial proportion to any stock holdings.³⁶⁰ Aside from these two exceptions, the only guidance is set forth in the examples found in section 1.385-6(a). However, the examples do not provide much assistance for determining from "all relevant facts and circumstances" ³⁶¹ whether substantial proportionality exists. The holdings of stock and indebtedness in the examples are either clearly proportionate or just as obviously disproportionate.³⁶² None of the additional examples added to the final regulations, included to help define when substantial proportionality exists,³⁶³ seem to fall within the indistinct middle range in which many corporations will find themselves as their shareholders attempt to come as close to the line as possible. The Secretary has announced that the Service will establish numerical guidelines, and will publish them in a revenue procedure.³⁶⁴ However, because proportionality plays such a central role in the final regulations,³⁶⁵ both the term "substantial propor-

357. Treas. Reg. § 1.385-6(a)(2) (1980). See I.R.C. § 318(a) (1964).

358. Treas. Reg. § 1.385-6(a)(3)(i) (1980).

359. The term "independent creditor" is defined in § 1.385-6(b). See notes 80-84 and accompanying text *supra*.

360. Treas. Reg. § 1.385-6(a)(3)(ii) (1980).

361. *Id.* § 1.385-6(a)(2).

362. See Beghe, *An Interim Report on the Debt-Equity Regulations under Code Section 385*, 59 TAXES 203, 211 n.63 (1981).

363. See T.D. 7747, 1981-8 I.R.B. 15.

364. *Id.*

365. *Id.*

tionality" and how it will be applied demand clarification in the regulations themselves.

It has been suggested that the Secretary should provide objective standards for determining substantial proportionality by applying the familiar statistical concept of standard deviation.³⁶⁶ Absolute proportionality would exist if the stock percentage and the instrument percentage of each holder were identical. Any change from absolute proportionality produces a deviation. The regulations could provide that unless the standard deviation of the group of shareholders as a whole is sufficiently large, substantial proportionality exists.

The court decisions in this area are not of much help in defining substantial proportionality. Like the examples in the regulations, the relationship between the holdings of stock and purported debt seem to be either identical or clearly not pro rata.³⁶⁷

The regulations indicate that "family or other relationships described in section 318(a)"³⁶⁸ should be considered in determining whether substantial proportionality exists.³⁶⁹ Because applicability of the attribution rules of section 318 to any specific context depends upon their incorporation by another Code provision,³⁷⁰ this reference in the regulations does not technically make section 318 applicable.³⁷¹ However, the attribution rules have been considered by the courts in determining whether proportionality exists,³⁷² and are a relevant consideration under the regulations. Because of this "unofficial" application of section 318, it is submitted that if special circumstances can be shown, such as family hostility,³⁷³ the family

366. Letter from Robert J. McGee to the Commissioner of Internal Revenue (April 1, 1980) cited in Beghe, *supra* note 362, at 211.

367. See, e.g., Estate of Mixon v. United States, 464 F.2d 394, 409 (5th Cir. 1972) (15% shareholder advanced 80% of loans, while two 2% shareholders contributed remaining 20% in equal shares); Miele v. Commissioner, 56 T.C. 556 (1971), *aff'd*, 474 F.2d 1338 (3d Cir. 1972), *cert. denied*, 414 U.S. 826 (1973), *acq.* 1972-2 C.B. 2 (exact proportionality); Stinnett v. Commissioner, 54 T.C. 221, 229 n.4 (1970) (each stockholder owned approximately 25% of stock but advances ranged from 10% to 60%).

368. See note 357 and accompanying text *supra*.

369. Treas. Reg. § 1.385-6(a)(2)(i) (1980).

370. See I.R.C. § 318(a) (1964).

371. See Slappey Drive Indus. Park v. United States, 561 F.2d 572, 584 n.21 (5th Cir. 1977).

372. See, e.g., *id.* at 584; Estate of Mixon v. United States, 464 F.2d 394, 398 n.3, 409 (5th Cir. 1972).

373. The family hostility doctrine has been used to nullify the family attribution rules in the § 302 redemption area. See Haft Trust v. Commissioner, 510 F.2d 43 (1st Cir. 1975). See I.R.C. § 302 (1980). This case was distinguished in a recent Tax Court opinion which did not allow the use of the family hostility doctrine in the redemption area. See Metzger Trust v.

attribution rules should not be applied merely because the regulation specifically makes reference to them.³⁷⁴

b. Proportionately-Held Hybrid Instruments

There are two provisions in the regulations which deal with the classification of hybrid instruments³⁷⁵ as stock or indebtedness. Section 1.385-5³⁷⁶ applies primarily to hybrid instruments issued by public corporations and section 1.385-6(c) generally applies to hybrid instruments issued by closely-held corporations.³⁷⁷ Under this latter section, hybrid instruments issued to shareholders whose holdings of stock and instruments are substantially proportionate³⁷⁸ will be classified as stock.³⁷⁹

Three reasons are stated for this flat rule.³⁸⁰ First, since hybrid instruments which are issued to the shareholders of closely-held corporations are difficult to value, it is impractical to attempt to apply the calculation specified in section 1.385-5(a), which requires a comparison of the fair market value of an instrument with its equity features with its fair market value without such features.³⁸¹ Second, a closely-held corporation can avoid section 1.385-6(c) entirely while achieving the same result that is obtained with a hybrid instrument by issuing bonds with non-detachable warrants or shares of stock as a locked interest.³⁸² Third, discretionary payments or payments of a share of profits to holders of instruments closely resemble dividends.³⁸³

Commissioner, 76 T.C. 42 (1981). However, the "unofficial" status of the attribution rules in the definition of substantial proportionality means that the rules should not be technically applied when special circumstances warrant otherwise.

374. See Beghe, *supra* note 362, at 210.

375. A hybrid instrument is one which is convertible into stock or provides for contingent payments to the holder. See Treas. Reg. § 1.385-3(e) (1980). See also notes 223-25 and accompanying text *supra*.

376. For a discussion of § 1.385-5, see notes 223-56 and accompanying text *supra*.

377. Treas. Reg. § 1.385-6(c) (1980). See Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,960 (1980).

378. For a discussion of the determination of substantial proportionality, see notes 357-74 and accompanying text *supra*.

379. Treas. Reg. § 1.385-6(c)(i) (1980).

380. See Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,960 (1980).

381. Treas. Reg. § 1.385-5(a) (1980). See notes 229-40 and accompanying text *supra*.

382. See Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,960 (1980). Thus, this provision does not interfere with legitimate business practices. See notes 258-62 and accompanying text *supra*.

383. See Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,960 (1980).

The evil that the rule was designed to eliminate is the pro rata issuance of hybrid instruments. For example, assume that the fair market value, on the date of issue, of the equity features associated with the \$100,000 of convertible debentures described in the illustration in section 1.385-6(c)(3) was anything less than \$45,000.³⁸⁴ Why should the debentures be characterized as stock? The value of the convertible debenture would be predominantly due to its debt characteristics, and, under section 1.385-5(a), such an instrument would be treated as debt for tax purposes.³⁸⁵ The reason why this instrument, which would be treated as debt if issued by a public corporation, is treated as stock when issued by a closely-held corporation, is the existence of substantial proportionality. Substantial proportionality is consequently elevated to a position of primary importance by section 1.385-6(c).³⁸⁶ There does not appear to be any conclusive justification for a single factor to attain such a significant position in the resolution of the debt-equity controversy.³⁸⁷ Moreover, because the conversion feature of an instrument is not viewed by the courts as a significant factor indicating that an interest is stock and not debt,³⁸⁸ the regulations have departed from the case law by elevating this factor to such a level of significance.

Finally, because of the difficulty of obtaining financing from conventional sources,³⁸⁹ generally the only market for the hybrid securities of a closely-held corporation would be its own shareholders. A flat rule which treats these instruments as stock, thereby prohibiting a deduction for interest payments, unduly burdens closely-held corporations. The drafters suggest that such a rule does not impose a hardship upon taxpayers since the same result that a hybrid instrument obtains could also be achieved by issuing a locked interest. However, to the extent that the locked interests rule provides relief, it is difficult to see the necessity for section 1.385-6(c) in the first place.³⁹⁰ It is simply a trap for the unwary.

c. Adequate Capitalization

Under section 1.385-6(f)(1),³⁹¹ any instrument that is held by a stockholder of the issuing corporation whose holdings of stock and

384. See Treas. Reg. § 1.385-6(c)(3) (1980).

385. See *id.* § 1.385-5(a).

386. See *id.* § 1.385-6(c).

387. See note 8 *supra* and authorities cited therein.

388. Plumb, *supra* note 2, at 612.

389. See note 46 and accompanying text *supra*.

390. Treas. Reg. § 1.385-6(c) (1980).

391. *Id.* § 1.385-6(f)(1).

instruments are substantially proportionate³⁹² is classified as stock if the corporation's debt is excessive immediately after the instrument is issued by the corporation.³⁹³ A corporation's debt is excessive if all the instrument's terms and conditions, together with the corporation's financial structure, would not be satisfactory to an arm's length lending institution.³⁹⁴ However, a safe harbor is provided 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 3:1.³⁹⁵ The outside debt-equity ratio is computed under section 1.385-6(g).³⁹⁶ The inside ratio is determined in the same manner, except liabilities to independent creditors are excluded when comparing the corporation's liabilities to its shareholders' equity.³⁹⁷ Both ratios are to be determined at the end of the year.³⁹⁸

The justification for this provision is that the creditor investor has, in circumstances in which 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 significantly depends upon the success or failure of the corporation.³⁹⁹ However, the debt-equity ratio test specified by the safe harbor has several deficiencies. First, the rule is not flexible. Only one set of ratios is employed as the standard by which corporations in many different industries, geographic locations, and financial conditions will be judged. The ratio test was developed as an analytical tool for use in the context of a particular industry rather than as an arbitrary standard.⁴⁰⁰ A highly leveraged industry, such as the financial or real estate industries, has different capital needs than a manufacturing operation. The courts have taken into consideration the

392. For a discussion of substantial proportionality, see notes 344-74 and accompanying text *supra*.

393. Treas. Reg. § 1.385-6(f)(1) (1980).

394. *Id.* § 1.385-6(f)(2). The one exception to classification as stock when the corporation has excessive debt allows instruments which are issued in exchange for an equal or greater principal amount of indebtedness. *Id.* § 1.385-6(f)(5).

395. *Id.* § 1.385-6(f)(3).

396. For a discussion of how to compute the outside debt-equity ratio, see notes 108-47 and accompanying text *supra*.

397. Treas. Reg. § 1.385-6(f)(4) (1980).

398. *Id.*

399. See Spanbock, Carro, & Katz, *supra* note 116, at 688-89. See also *Gilbert v. Commissioner*, 248 F.2d 399, 407 (2d Cir. 1957); *Ambassador Apartments, Inc. v. Commissioner*, 50 T.C. 236, 245 (1968), *aff'd*, 406 F.2d 288 (2d Cir. 1969).

400. Spanbock, Carro, & Katz, *supra* note 116, at 689.

needs and characteristics of a particular industry when applying the ratio test.⁴⁰¹ The lack of flexibility in the safe harbor is at odds with the congressional intent that regulations should be drafted which could accommodate a range of circumstances.⁴⁰² Admittedly, the failure of a corporation to pass the safe harbor test means only that it must establish that it is adequately capitalized under the general rule, which would take into account the industry involved and other characteristics peculiar to that corporation.⁴⁰³ However, the lack of flexibility of the safe harbor results in unnecessary uncertainty and should be corrected.

Second, the safe harbor rule determines if adequate capitalization exists by using an inappropriately conservative standard. Ratios considerably higher than 10:1 have been accepted by the courts.⁴⁰⁴ In addition, the Service has accepted a ratio of 20:1, as long as capital is sufficient for normal business operations.⁴⁰⁵ Furthermore, these ratios have been computed by using the fair market values of individual assets to determine stockholders' equity,⁴⁰⁶ whereas the regulations mandate the use of adjusted basis to determine the equity portion of the safe harbor ratio.⁴⁰⁷ In an inflationary economy, the use of adjusted basis will generally result in a higher ratio than if the fair market value of the assets were used. The use of such a conservative computation procedure, as well as the selection of such a conservative ratio, is inappropriate when compared with the existing judicial authority. For this reason, the ratio used should be raised,⁴⁰⁸ perhaps to 15:1 or 20:1, or, alternatively, the computation procedure should be modified.⁴⁰⁹

401. See *Scotland Mills, Inc. v. Commissioner*, 24 T.C.M. (CCH) 265, 273 (1965) (expert testimony received on whether company was adequately capitalized by industry standards). Professor Bittker has stated that what is excessive debt for one industry may be normal for another, and, even within the same industry, no corporation is the same as another. Bittker, *supra* note 183, at 831.

402. See S. REP. NO. 552, 91st Cong., 1st Sess. 138 (1969) (rules should distinguish debt from equity in "variety of contexts in which this problem can arise"). See also Gersham, *Debt-Equity Proposals Provide Guidance but Pose Problems for Small Corporations*, 53 J. TAX. 194, 200 (1980).

403. Treas. Reg. § 1.385-6(f)(2) (1980).

404. See, e.g., *Liflans Corp. v. United States*, 390 F.2d 965 (Ct. Cl. 1968) (17:1); *Curry v. Commissioner*, 43 T.C. 667 (1965) (30:1); *J. I. Morgan, Inc. v. Commissioner*, 30 T.C. 881 (1958) (50:1); *McDermott v. Commissioner*, 13 T.C. 468 (1949) (19:1).

405. See Rev. Rul. 68-54, 1968-1 C.B. 69.

406. See notes 113-18 and accompanying text *supra*.

407. See notes 110-11 and accompanying text *supra*.

408. See Gersham, *supra* note 402, at 201.

409. See notes 120-31 and accompanying text *supra*.

Third, extremely high debt-equity ratios have been accepted by both the courts and the Service because the ratio is just one factor to be considered. The United States Supreme Court has stated that the debt-equity ratio may not be relevant in light of other factors.⁴¹⁰ The Tax Court has upheld the validity of indebtedness when a corporation had a ratio of nearly 700:1 by relying upon other factors and finding the ratio not to be controlling.⁴¹¹ Moreover, even the Service recognizes that the ratio is just one factor among many to be considered.⁴¹² In addition, some courts have never taken the position that the ratio test is to be given significant weight.⁴¹³ In light of these facts, the safe harbor's great reliance upon the debt-equity ratio, coupled with the use of such a conservative standard, is a significant change from the position traditionally taken by the courts and the Service.

d. Arm's Length Interest Rate

Under section 1.385-6(d)(1),⁴¹⁴ an instrument issued to a shareholder in exchange for property is to be classified as stock if the shareholder-creditor's holdings of stock and the instruments are substantially proportionate,⁴¹⁵ the stated annual rate of interest on the instrument is not reasonable,⁴¹⁶ and the issuance of the instrument does not give rise to original issue discount under section 1232(a)(3) of the Code⁴¹⁷ or amortizable bond premium under sec-

410. See *John Kelley Co. v. Commissioner*, 326 U.S. 521, 526 (1946).

411. See *Baker Commodities, Inc. v. Commissioner*, 48 T.C. 374, 396 & n.20 (1967) (692½:1).

412. See Rev. Rul. 77-437, 1977-2 C.B. 28; Rev. Rul. 63-54, 1968-1 C.B. 69.

413. See *Rowan v. United States*, 219 F.2d 51 (5th Cir. 1955). In *Rowan*, the Fifth Circuit stated:

[S]tockholders of corporations have always been free to commit to corporate operations such capital as they choose and to lend such additional amounts as they may elect to assist in the operation if that is their true intent It would obviously work an unwarranted interference by the courts . . . for us to say that there can be established, as a matter of hindsight a ratio of stockholder owned debt to the capital of the debtor corporation.

Id. at 55. The ratio in *Rowan* was 28:1 at its peak and 14:1 at the corporation's dissolution. See *id.* at 52. See also *Sun Properties, Inc. v. United States*, 220 F.2d 171, 175 (5th Cir. 1955) (310:1).

414. Treas. Reg. § 1.385-6(d)(1) (1980). An exception to classification under this rule is provided, but, because it uses ambiguous standards, the exception is of limited use. See *id.* § 1.385-6(d)(3).

415. See *id.* § 1.385-6(d)(1)(i). For a discussion of substantial proportionality and § 1.385-6(a), see notes 344-74 and accompanying text *supra*.

416. See Treas. Reg. § 1.385-6(d)(1)(ii) (1980). For a discussion of § 1.385-6(e) and what constitutes a reasonable rate, see notes 153-204 and accompanying text *supra*.

417. See I.R.C. § 1232(a)(3) (1976).

tion 1.61-12(c)(2) of the regulations.⁴¹⁸ For purposes of applying this provision, the reasonableness of a rate of interest is determined as of the day an instrument is issued.⁴¹⁹

The Secretary apparently intends to legislate a special rule for cases he believes Congress has overlooked.⁴²⁰ In this case, 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.⁴²¹ Thus, in cases where the stated rate of interest is less than a market rate of interest on similar obligations, section 1232 provides that no original issue discount exists on obligations issued in exchange for property.⁴²² The Secretary, on the other hand, purports to deal with such transactions by treating the obligations as stock. It is not clear that the Secretary's regulatory authority under one provision of the Code prevails over situations where Congress, in another section, has clearly dictated the income tax consequences of a transaction. In an analogous situation, *Tilford v. Commissioner*,⁴²³ the Tax Court invalidated a regulation as contrary to the express terms of another part of the Code.⁴²⁴ The majority in *Tilford* held section 1.83-6(d) of the regulations invalid as outside the scope of the statutory provisions of section 83 of the

418. See Treas. Reg. § 1.61-12(c)(2), T.D. 6984, 1969-1 C.B. 143. If instruments are issued for property, § 1232(a)(3) of the Code and § 1.61-12(c)(2) of the regulations generally do not apply. See I.R.C. § 1232(a)(3) (1976); Treas. Reg. § 1.61-12(c)(2), T.D. 6984, 1969-1 C.B. 143. See also note 306 and accompanying text *supra*.

419. Treas. Reg. § 1.385-6(d)(2) (1980).

420. The drafters of the regulations stated:

Section [1.385-6(d)] 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) 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 portions 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(d)] imposes the requirement that interest be paid at a reasonable rate on instruments issued for property.

Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,961 (1980).

421. See I.R.C. § 1232 (1976). In such a case, § 1232(b)(2) sets the issue price equal to maturity value to avoid dealing with discounts and the amortization of discount. *Id.* See note 228 and accompanying text *supra*.

422. I.R.C. § 1232 (1976).

423. 75 T.C. 134 (1980).

424. *Id.* at 150-51.

Code.⁴²⁵ The regulation, which provided that the transaction involved must be treated as a contribution to capital and not as a transaction upon which gain or loss may be realized, was held to be contrary to an express provision of section 1001 of the Code.⁴²⁶ *Tilford*, then, supports the view that the Secretary may not fill in a perceived gap in a statute through section 1.385-6(d).⁴²⁷

If the Secretary must attempt to establish a rule for instruments issued for property, the all or nothing approach to classification under section 1.385-6(d) seems to be particularly questionable.⁴²⁸ An approach similar to that set forth in section 1232 of the Code and section 1.61-12(c)(2) of the regulations could be adopted as to these types of instruments. This approach would compute the valuation of an instrument given for property as though it had been given for cash. This position is more desirable from the standpoint of the Secretary's authority, although it does sacrifice some certainty by requiring valuation.

In any event, a period should be provided during which the interest rate could be adjusted to come within the reasonable range of interest rates of the rule of convenience⁴²⁹ so that the stated interest rate on the date of issuance will not have the potential of causing an instrument to be forever classified as stock. There does not seem to be any reason why the rule that is applicable to demand loans should not be made applicable to section 1.385-6(d). The interest rate, therefore, would be treated as reasonable if it is within the reasonable range on any day of the taxable year in which the instrument was issued.⁴³⁰

The second provision which attempts to insure an arm's length interest rate is section 1.385-6(l)(1).⁴³¹ Under this regulation, instruments that are payable on demand and are owned by shareholders whose holdings of stock and the instruments are substantially pro-

425. *Id.*

426. *Id.* at 145. For a discussion of *Tilford*, see Arlinghaus, *Tax Court Questions Validity of Restricted Property Regulations*, 59 TAXES 261, 262 (1981).

427. See also *Bates v. United States*, 581 F.2d 575, 579 (6th Cir. 1978) (regulations may not be used to supply supposed omissions in revenue act or enlarge scope of statute); *Smith v. Commissioner*, 332 F.2d 671, 673 (9th Cir. 1964) (Commissioner may not prescribe regulations inconsistent with statute nor add restrictions to statute).

428. Treas. Reg. § 1.385-6(d) (1980).

429. See notes 159-65 and accompanying text *supra*.

430. See Treas. Reg. § 1.385-6(l)(2) (1980).

431. *Id.* § 1.385-6(l)(1).

portionate⁴³² are classified as stock if the stated annual interest rate on the instruments is not reasonable on the day of issue.⁴³³

If an instrument is due on a fixed date, section 1.385-3(a) will operate to insure that the fair market value of the instrument is equal to the consideration paid for it.⁴³⁴ In addition, 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 of the Code or amortizable bond premium under section 1.61-12(c) (2) of the regulations is created. This treatment is sufficient to assure that the interest rate is reasonable.⁴³⁵ On the other hand, if an instrument is payable on demand, neither original issue discount nor bond premium will ordinarily be created under section 1.385-3(a).⁴³⁶ Thus, section 1.385-6(l)(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 this rationale may be technically correct, the characterization of a demand note as stock if the stated interest rate is not reasonable is harsh and unwarranted. A preferable approach would be the imposition of a presumptive one-year term to maturity with respect to a demand note. The note could then be revalued under section 1.385-3(a) on that basis and the rules associated with original issue discount and amortizable bond premium could be made applicable to any resulting discount or premium. Such an approach would insure that a reasonable, arm's length interest rate was being enforced with respect to a demand instrument without classifying the entire instrument as stock, although by requiring valuation it sacrifices some certainty.

Criticism of a rule which classifies a demand instrument as stock rather than indebtedness when the interest rate is unreasonable also seems appropriate since it is often difficult to determine the rate at which independent creditors would loan money on similar terms to companies in the same general business, geographic loca-

432. *Id.* For a discussion of substantial proportionality, see notes 357-74 and accompanying text *supra*.

433. Treas. Reg. § 1.385-6(e)(1) (1980). For a discussion of what constitutes a reasonable rate, see notes 153-204 and accompanying text *supra*.

434. Treas. Reg. § 1.385-3(a) (1980). See note 297 and accompanying text *supra*.

435. See notes 301-04 and accompanying text *supra*.

436. Treas. Reg. § 1.385-3(a) (1980). See Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,961 (1980). See also note 305 and accompanying text *supra*.

tion, and financial condition as the borrower.⁴³⁷ Moreover, if the loan represents risk capital to a young, promising business, the rule of convenience under the reasonable interest rate test⁴³⁸ will probably not be available because such corporations generally have debt-equity ratios greater than 1:1. Therefore, section 1.385-6(l)(1) should be amended to provide a rule of convenience for all corporations, irrespective of their debt-equity ratios, thus making the section 1.385-6(e)(2) rule of convenience and its debt-equity ratio test inapplicable. Alternatively, the provision could provide that, if the interest rate paid on demand debt is not considered to be an arm's length rate, then an arm's length rate would be imputed to both the corporation and the shareholder-creditor. For example, if the interest charged is ten percent and an arm's length rate is determined to be fourteen percent, the additional four percent could be imputed as income to the shareholder-creditor and an equal amount could be deductible to the corporation.⁴³⁹

e. Arm's Length Enforcement of an Instrument's Terms

The modifications and exceptions to the general rule examined thus far deal with the possibility that the terms of an instrument might not reflect arm's length economic reality. Four provisions discussed in this section of this article demonstrate that there is also concern that the terms of an instrument might not be enforced at arm's length.

Under the existing case law, a failure to enforce the term 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.⁴⁴⁰ This fact is one of the factors considered in determining whether there is a reasonable

437. This is the standard used by the general rule to determine whether an interest rate is reasonable. See Treas. Reg. § 1.385-6(e) (1980).

438. *Id.* § 1.385-6(e)(2). See notes 159-65 and accompanying text *supra*.

439. *Cf.* I.R.C. § 483 (1976). Section 1.385-6(l)(4) provides one exception to classification under § 1.385-6(l)(1). Section 1.385-6(l)(1) does not apply to an instrument that is actually repaid within six months, provided that the total outstanding principal amounts of the demand loans plus the total outstanding balance of all loans described in § 1.385-7(a)(2)(i) does not exceed \$25,000 on the day of issue. For this purpose, an instrument is not considered to be actually retired if it is reissued, renewed, or offset in any manner. See Treas. Reg. § 1.385-6(l)(4) (1980). This rule is consistent with judicial precedent. See Plumb, *supra* note 2, at 481.

440. See *Dillin 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); *Thompson v. Commissioner*, 73 T.C. 878, 895 (1980); *Davis v. Commissioner*, 69 T.C. 814, 836-37 (1978).

expectation of repayment.⁴⁴¹ 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. The provisions provide for potential reclassification of debt instruments into stock if the terms of the instruments are not properly enforced. Additionally, the rules operate to reclassify an instrument only from indebtedness to stock. Once an instrument has been classified as stock, it can never again attain debt status.⁴⁴²

The first of these provisions is section 1.385-6(k)(1), which treats an instrument as stock if: 1) a corporation fails to pay all or part of the interest that is due on the instrument during a taxable year;⁴⁴³ 2) a shareholder of the issuing corporation is the owner of the instrument and his holdings of stock and the instruments are substantially proportionate,⁴⁴⁴ and 3) the owner of the instrument fails to pursue available remedies with the ordinary diligence of an independent creditor.⁴⁴⁵ Reclassification of the instrument from indebtedness to stock is retroactive to the later of the first day of the taxable year in which the failure to pay occurs or the first day on which section 1.385-6(k)(1) is applied to the instrument.⁴⁴⁶ A failure to pay interest means failure actually to pay within ninety days after the end of the year accrual.⁴⁴⁷ However, for purposes of classifica-

441. See note 7 *supra*.

442. Treas. Reg. § 1.385-4(b)(1) (1980).

443. See notes 447-48 and accompanying text *infra*.

444. See notes 357-74 and accompanying text *supra*.

445. Treas. Reg. § 1.385-4(b)(1) (1980).

446. *Id.* § 1.385-6(k)(1). The regulations, at first glance, seem to favor the taxpayer in this instance. Under the case law, failure to pay interest or repay principal is considered evidence that the parties did not intend to create debt in the original transaction. *Santa Anita Consol., Inc. v. Commissioner*, 50 T.C. 536, 554 (1968). In *Gooding Amusement Co. v. Commissioner*, 23 T.C. 419 (1954), *aff'd*, 23 F.2d 159 (6th Cir. 1957), the Tax Court stated:

The fact that the majority of the notes here involved, all of which have long since matured, have not been paid lends corroboration to our finding that at no time material to our consideration did the noteholders intend to enforce payment of their notes or assert the rights of bona fide creditors.

23 T.C. at 426. Thus, if an advance is determined by the court to be equity, it is treated as equity from the beginning. On the other hand, the regulations do not go back so far in time and therefore seem to be in the taxpayer's favor. It must be realized, however, that the instrument has already satisfied the other sections and rules of the § 385 regulations and therefore will bear a reasonable rate of interest and possess the other characteristics required to come under the general rule that interests are treated as debt. The Service is not as generous as it first appears.

447. Treas. Reg. § 1.385-6(k)(3) (1980). Payment of interest with property other than money will constitute an actual payment, but only to the extent of the property's fair market value. *Id.*

tion under section 1.385-6(k)(1), interest which accrues while this section does not apply to the instrument is disregarded.⁴⁴⁸

Given the current state of the national economy and the current disarray of the capital markets, the ninety day grace period for non-payment of interest is too short for many small businesses and should be expanded to provide greater flexibility.⁴⁴⁹

It is necessary to determine what constitutes "the ordinary diligence of an independent creditor" in analyzing whether this provision will operate to reclassify a debt instrument into stock. The evil feared by the Secretary is that a shareholder will not enforce his creditor rights 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. Such a standard would not conform with the case law, which generally does not require a shareholder-creditor to be as strict as a conservative banker⁴⁵⁰ as long as he acts in the same manner as an independent creditor.⁴⁵¹ This position is based on the realities of the lending industry for, in practice, all lenders are not conservative bankers. Often a firm is unable to meet its 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 would be 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.

The drafters of the regulations apparently believe that a less rigorous standard will be applied. In response to comments con-

448. *Id.* § 1.385-6(k)(4)(i). Thus, the fact that the corporation has not paid interest on debt which is held by an independent creditor or a shareholder whose holdings of stock and debt are not proportionate will not cause the instrument to be treated as stock if a shareholder buys the instrument from the independent creditor, or the holdings become proportional. See *id.* § 1.385-6(k)(4)(ii).

449. See Gersham, *supra* note 402, at 199.

450. See *Earle v. W.J. Jones & Son, Inc.*, 200 F.2d 846, 850 (9th Cir. 1952); *Curry v. Commissioner*, 43 T.C. 667, 681 (1965); *Motel Co. v. Commissioner*, 22 T.C.M. (CCH) 825, 833 (1963), *aff'd on other grounds*, 340 F.2d 445 (2d Cir. 1965).

451. See Plumb, *supra* note 2, at 495-96.

cerning the proposed regulations, the drafters stated that the Treasury "recognizes that independent creditors do not always bring suit" to enforce their rights.⁴⁵² An example was added to the final regulations to clarify this point. It provides that past payment history, a pledge of collateral by the debtor corporation, and other unspecified facts and circumstances may warrant the shareholder-creditor's failure to file suit.⁴⁵³ However, the ambiguity of the standard used by this section of the regulations may allow the Secretary to insist upon more action by a shareholder-creditor where the Secretary feels there is a tax avoidance scheme involved.

In addition, 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 temporarily or permanently, allowing lump sum payments to be made in advance of or after due dates, or making other special arrangements. It is impossible for a closely-held corporation or its creditor-shareholder to determine accurately what legal remedies would have been taken by an independent creditor or what concessions such a creditor would have made. The degree of diligence with which an independent creditor pursues available remedies will depend upon a plethora of factors. Some of these factors include the debtor's potential earnings and geographic location, alternative investment opportunities of the creditor, the creditor's prior 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. The probable result of this provision will be to convert debt to stock whenever a corporation has financial difficulties and is unable to pay the accrued interest or principal on a debt instrument held by one of its shareholders. Therefore, the Secretary should clarify what standard will be used in applying section 1.385-6(k). Alternatively, the regulation could be amended to provide a more equitable and objective rule.

The second provision is section 1.385-6(l)(3), which provides that if a corporation fails to pay the principal on any instrument within ninety days after the principal is due, and the holder fails

452. T.D. 7747, 1981-8 I.R.B. 15.

453. See Treas. Reg. § 1.385-6(k)(2), Example 3 (1980).

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.⁴⁵⁴ Therefore, the instrument becomes subject to reclassification as stock under the provisions of sections 1.385-6(l)(1) and 1.385-6(l)(2). This provision does provide a ninety day grace period for nonpayment of principal. However, given the chaotic nature of current capital markets, this period is too short to provide any flexibility to a business with liquidity problems. A grace period of six months, or even twelve months, would probably be more reasonable.

The third provision concerned with arm's length enforcement is section 1.385-6(l)(2), which provides that a debt instrument that is payable on demand, either by its terms or by reason of section 1.385-6(l)(3), and which is owned by a shareholder of the issuing corporation whose holdings of stock and the instruments are substantially proportionate,⁴⁵⁵ may be reclassified as stock.⁴⁵⁶ This reclassification would be effective as of the first day of the taxable year in which the interest actually paid during the year on the instrument is not reasonable⁴⁵⁷ as determined under section 1.385-6(e).⁴⁵⁸ In other words, in the case of a demand instrument, the reasonableness of the interest rate must be re-determined for each taxable year in which the instrument is owned by a shareholder with substantially proportionate holdings of stock and instruments, and that amount of interest must actually be paid by the corporation during the year. For example, if a corporation issues a demand instrument which is treated as indebtedness when issued because it provides a stated annual rate of interest that is reasonable on the date of issue, and, in a subsequent year, the rate of interest considered reasonable under section 1.385-6(e) rises or falls, the corporation must actually pay interest at the new reasonable rate. For purposes of reclassification, a rate of interest is considered to be reasonable if it is reasonable as of any day of the particular taxable year.⁴⁵⁹

There are two exceptions to reclassification under this subsection. First, reclassification does not apply to an instrument that is actually retired within six months after the day of issue, provided

454. *Id.* § 1.385(6)(l)(3). See notes 450-53 and accompanying text *supra*.

455. See notes 357-74 and accompanying text *supra*.

456. Treas. Reg. § 1.385-6(l)(2) (1980).

457. *Id.*

458. See notes 153-204 and accompanying text *supra*.

459. Treas. Reg. § 1.385-6(l)(2) (1980).

that the sum of the outstanding principal amount of all demand instruments plus the outstanding balance of all "certain other obligations," as defined in section 1.385-7(a)(2)(i), does not exceed \$25,000 on the day of the issue.⁴⁶⁰ For this purpose, an instrument is not considered to be actually retired if it is reissued, renewed, or offset in any manner.⁴⁶¹ The second exception makes section 1.386-6(l)(2) inapplicable if a failure to pay interest on an instrument at a reasonable rate is caused solely by a failure to pay interest when due. In that situation, it is noted that section 1.385-6(k) will be applicable.⁴⁶²

It may be recalled from the discussion above dealing with the provisions to insure an arm's length interest rate that section 1.385-6(l)(1) operates to classify a demand instrument as stock if the shareholder-lender's holdings are substantially proportionate and if the stated rate of interest is not reasonable under section 1.385-6(e) at the time of issuance.⁴⁶³ Section 1.385-6(l)(2) implements the same rule, with the additional requirement that the reasonable interest must actually be paid. This is consistent with ordinary commercial practice when demand instruments are held by independent creditors.⁴⁶⁴

The fourth and final rule which deals with the enforcement of the terms of an instrument recognizes that the regulations would be useless if the corporation and the shareholder could change the terms of an instrument at will. Accordingly, section 1.385-6(j)(1) states that if a debt instrument is owned by a shareholder of the issuing corporation whose holdings of stock and the instruments are substantially proportionate⁴⁶⁵ and if the holder agrees to make a substantial change in the terms of the instrument, then the instrument is treated as newly issued for property on the day of the agreement.⁴⁶⁶

The day of agreement is the day on which the issuer and the holder enter into a binding contract to change the terms of an instrument.⁴⁶⁷ On that date, a new determination must be made as to whether the instrument conforms to arm's length standards by

460. *Id.* § 1.385-6(e)(4)(i).

461. *Id.*

462. *See* notes 446-53 and accompanying text *supra*.

463. *See* notes 433-44 and accompanying text *supra*.

464. Supplementary Information to Proposed Regulations, 45 Fed. Reg. 18,957, 18,963 (1980).

465. *See* notes 357-74 and accompanying text *supra*.

466. Treas. Reg. § 1.385-6(j)(1) (1980).

467. *Id.* § 1.385-6(j)(3).

applying the rules regarding the issuance of an instrument for property.⁴⁶⁸ For example, if the change of terms converts the instrument into a hybrid instrument by a change of fixed payments of interest or principal into contingent payments or by an addition of conversion rights, the rules regarding the issuance of hybrid instruments will be applied.

The regulations define a substantial change in the terms of an instrument as any change which materially affects the fair market value of the instrument.⁴⁶⁹ Examples of substantial changes include postponement of the maturity date,⁴⁷⁰ a change in the interest rate, and subordination.⁴⁷¹ On the other hand, neither a substitution of collateral nor a prepayment is ordinarily considered to be a substantial change.⁴⁷²

Upon first examination, the rules relating to a change in the terms of an existing debt obligation, which basically provide for the re-examination of the obligation under the various tests set forth in the regulations following any substantial modification of the obligation, seem reasonable and equitable. Indeed, with respect to large, publicly-held corporations, these rules probably are appropriate. However, small businesses require flexibility in structuring and restructuring financing. It is not uncommon for small business lenders to liberalize the terms of a debt instrument as the borrowing company's financial position improves, renegotiate the terms as a borrower's financial condition deteriorates, or renegotiate to accommodate new infusions of debt or equity capital as long as the lender's position as a creditor under state law remains intact. The rule on substantial changes in terms would appear to restrict unnecessarily the shareholder-lender's flexibility and ability to deal effectively with the problems of a small business.

VIII. CONCLUSION: A SUGGESTED APPROACH

This article has argued that the courts will probably find some of the provisions of the section 385 regulations invalid either because they exceed the Secretary's authority⁴⁷³ or are inconsistent with ju-

468. *Id.* § 1.385-6(j)(1).

469. *Id.* § 1.385-6(j)(2).

470. *Id.* § 1.385-6(j)(1).

471. *Id.* § 1.385-6(j)(4), Examples 2 & 3. *See also id.* § 1.385-6(j)(2).

472. *Id.* § 1.385-6(j)(2).

473. *See id.* §§ 1.385-3(a), -6(d), -9(a). For discussion of these sections of the regulations, *see* notes 319-23, 420-30, & 269-74 and accompanying text *supra*.

dicial authority.⁴⁷⁴ At the very least, the offending provisions will probably be eroded by construction in the courts.⁴⁷⁵ It has also been argued that while the criteria in some provisions are difficult to understand and apply,⁴⁷⁶ other regulations provide significant certainty at the unnecessary expense of flexibility.⁴⁷⁷

Moreover, the regulations are biased against the small, closely-held corporation. For example, the regulations focus upon interests held by shareholders.⁴⁷⁸ Large corporations, which do not depend on shareholder capital alone, are consequently not affected by many of the rules. Furthermore, large publicly-held corporations seem to be protected by the safe harbors from onerous provisions to a greater extent than their smaller counterparts.⁴⁷⁹ Finally, many provisions are inconsistent with the realities of financing small, closely-held enterprises.⁴⁸⁰ Curiously, the Secretary has expended a great deal of effort to prevent the regulations from adversely impacting upon the normal financing of large corporations.⁴⁸¹

474. See Treas. Reg. §§ 1.385-5(a), -6(f), -7(b)(2), -8(a) (1980). For discussion of these sections of the regulations, see notes 248-56, 399-413, 339-41, & 259-62 and accompanying text *supra*.

475. Manifestly, a court has three options when confronted with a regulation which produces a result apparently inconsistent with the terms of a statute. It can: 1) determine that the regulation is inconsistent with the terms of the statute and hold the regulation invalid; 2) find that the regulation is not applicable to the particular facts and circumstances of the case; or 3) it can hold the regulation valid but interpret it so that it produces a result consistent with the terms of the statute. Since there is a presumption of validity associated with Treasury regulations, the courts many times opt for a strained interpretation of a regulation rather than a sensible reading of the regulation combined with a finding of invalidity. See, e.g., *Commissioner v. Sternberger's Estate*, 348 U.S. 187 (1955); *United Telecommunications Inc. v. Commissioner*, 589 F.2d 1348 (10th Cir. 1978), *aff'g* 65 T.C. 278 (1975); *House v. Commissioner*, 453 F.2d 982 (5th Cir. 1972); *Ballance v. United States*, 347 F.2d 419 (7th Cir. 1965).

476. See Treas. Reg. §§ 1.385-5(a), -6(a), -6(f), -6(k)(1), -6(e)(1), -9(a) (1980). For discussion of these sections of the regulations, see notes 246, 269, 344-74, 394, 450-54, 437, & 285-86 and accompanying text *supra*.

477. See Treas. Reg. §§ 1.385-5(a), -6(f), -6(j) (1980). For discussion of these sections of the regulations, see notes 241-56, 395-403, & 465-72 and accompanying text *supra*.

478. See note 63 and accompanying text *supra*.

479. See notes 59-62 & 359 and accompanying text *supra*.

480. See Treas. Reg. §§ 1.385-3(a), -6(c), -6(e), -6(j), -9(a) (1980). For discussion of these sections of the regulations, see notes 316, 389, 465-72, 432-39, & 289-91 and accompanying text *supra*.

481. The fact that many safe harbors protect the normal financing arrangements of large corporations from potential attack may be evidence of this fact. See notes 59-62 & 359 and accompanying text *supra*. In addition, the Secretary has interpreted § 1.385-10 in a way that commonly encountered preferred stock issues of large corporations will not be within the scope of that provision. See T.D. 7747, 1981-8 I.R.B. 15.

In light of these problems, it is suggested that these regulations should be withdrawn and reconsidered. It would seem that an expanded version of the approach suggested by Professors Whittington and Whittenberg would be appropriate.⁴⁸² Under their approach, all the factors utilized by the courts would be identified.⁴⁸³ These factors would then be used to determine the broad characteristics of pure indebtedness.⁴⁸⁴ As part of this process, specific factors would be associated with each of the broad characteristics identified. These factors would indicate what evidence is important with respect to analyzing each broad characteristic. Having identified the appropriate characteristics of indebtedness and the factual evidence relevant for analyzing each characteristic, the regulations could specify a mechanical test similar to the test specified in section 301.7701-2(a)(1) of the regulations for determining whether an association is a corporation.⁴⁸⁵ An interest would therefore be treated as debt if the interest exhibited more characteristics of debt than equity.⁴⁸⁶

This approach would be a significant improvement over the regulations for a number of reasons. First, such an approach would clearly be within the authority delegated to the Secretary by section 385. Second, it would be consistent with the existing case law. The regulations would attempt to ascertain whether creditors intended to place their capital at the risk of the business, like a shareholder, or whether they intended to create a debt interest. The determina-

482. See Whittington & Whittenburg, *supra* note 178, at 417.

483. *Id.* at 411-13. See note 7 *supra*.

484. Whittington & Whittenburg, *supra* note 178, at 411-13. Whittington and Whittenburg have applied the statistical technique of factor analysis to twelve variables which the courts have considered in distinguishing debt from equity, and ascertained four broad considerations useful for making such a distinction: 1) creating, in substance, a debt transaction; 2) instrument form and provisions; 3) the financial condition of the corporation when the instrument was issued; and 4) maintaining the separation of interests of shareholders and holders of the instrument in question. *Id.* at 413-15. In addition, factor analysis showed which variables would be important with respect to making determinations for each broad consideration. *Id.* For example, regular payments, subordination of the security, relationship of stock holdings to security holdings, contingent payments, and the business purpose for debt creation were determined to be important factors to consider when drawing conclusions concerning the creation, in substance, of a debt transaction. *Id.*

485. See Treas. Reg. § 301.7701-2(a)(1), T.D. 7515, 1977-2 C.B. 482. The regulations identify six major characteristics present in a pure corporation which, if taken together, distinguish it from other organizations. *Id.* The regulations provide that an association which is not incorporated under state law will not be classified as a corporation unless it possesses more corporate than noncorporate characteristics, disregarding those characteristics that are common to both corporate and noncorporate entities. *Id.*

486. *Id.*

tion of this intent would be made with reference to the characteristics of the interests created by the parties to the transaction. It is true that such an approach is not an exact science. However, in light of the heavily factual nature of the debt-equity classification issue, it seems reasonable to focus on all the facts and circumstances in an attempt to determine whether the interest in question resembles debt or whether its characteristics require classification as equity.⁴⁸⁷

In addition, such an approach would provide more certainty than exists under current case law by organizing the factors presently considered by the courts and using them to determine which of the characteristics of pure indebtedness are present in any given case. In this way, evidence which is important for resolving the debt-equity classification issue will be described. In order to provide even more certainty, objective safe harbors similar to those contained in the current regulations could be formulated with respect to each characteristic identified in the regulations. This approach would provide as much certainty as is provided by the current regulations and at the same time would retain the flexibility of the current case law. Moreover, establishing evidence concerning the intent of the parties within this suggested framework would not be any more difficult than working with the current difficult to understand mechanical rules.

487. See *Casco Bank & Trust Co. v. United States*, 544 F.2d 528, 534 n.9 (1st Cir. 1976), *cert. denied*, 430 U.S. 907 (1978) (section 385 cited as evidence that Congress acknowledged that debt-equity problem should be handled by using factual approach).