August 17, 2017

Distinguishing Equity From Debt in Related Party Contexts

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Section 385 was added to the Internal Revenue Code more than forty years ago to provide Treasury with the authority to issue regulations to assist in determining whether an interest in a corporation is to be treated as stock or as debt for tax purposes.

Regulations under Section 385 that were issued in final form last October (T.D. 9790 (Oct. 21, 2016)) address the classification of related-party debt as debt or equity, and include extensive documentation requirements for certain obligations intended to be treated as debt for tax purposes. Numerous comments were received by the IRS regarding these regulations. A little more than a month ago, these regulations were identified by the IRS, in an interim report, as among eight significant regulation projects that impose undue financial burdens on U.S. taxpayers or add undue complexity (Notice 2017-38, 2017-30 IRB 147). More recently, the effective date of portions of the new Section 385 regulations that impose documentation requirements was postponed so as to apply only to interests issued or deemed issued on or after January 1, 2019 (Notice 2017-36, 2017-33 IRB __).

Separately, the courts continue to address the distinction between debt and equity by applying factors developed in the many court decisions that have considered this issue in related party and other contexts—which cases, as federal "common law," will remain relevant even if the regulations issued last year under Section 385 remain in effect (Reg. Section 1.385-1(b)). A Tax Court memorandum decision issued in 2015 that addressed these issues in the context of incorporation of a business (*Bell v. Commissioner*, TC Memo 2015-111), and the recent affirmance of this decision by the Court of Appeals for the Ninth Circuit in an unpublished opinion (120 AFTR 2d 2017-5152 (9th Cir.)), are discussed below.

Facts in *Bell*

During the years at issue (2008 through 2010), Michael Bell was a real estate broker and his spouse Sandra Bell was a real estate appraiser and sales agent. Part of Mr. Bell's real estate business was assisting lenders with the repossession, maintenance and repair, and ultimate sale of properties acquired by lenders through foreclosure (so-called "real estate owned properties" or "REO").

The REO business was initially operated by Mr. Bell as a sole proprietorship. On August 4, 2008, Mr. Bell formed a corporation named MBA Real Estate, Inc. (MBA). MBA simultaneously executed a lease for the office used to conduct the business, and shortly thereafter renewed a franchise license agreement executed by Mr. Bell relating to the business. The Bells were appointed by MBA in its organizational minutes as the officers of the corporation.

On October 1, 2008, MBA and Mr. Bell entered into an agreement for Mr. Bell to sell to MBA all work in progress, franchise rights, and other assets relating to the REO business for $225,000 (purchase agreement). On that date MBA had no assets or shareholders. A resolution adopted by MBA several weeks later authorized the issuance of 250 shares of stock in MBA to each of the Bells in exchange for $500.

The purchase price for the REO business was payable under the purchase agreement in monthly installments of $10,000 each plus interest at 10% per annum. The Bells allocated $25,000 of the purchase price to the five-year franchise license agreement relating to the REO business. The $200,000 balance of the purchase price was allocated to 40 contracts (lender contracts) that Mr. Bell had previously entered into with lenders and other entities to assist with REO. One property had been sold under a lender contract before September 1, 2008, but the other lender contracts required Mr. Bell to provide further services after the formation of MBA, with no certainty that those services would result in income.

The price specified in the purchase agreement was ultimately paid in full, although not all the payments were made timely, and gain from the sale was reported by the Bells under the installment method as long-term capital gain. MBA

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amortized the purchase price over five years.

Under notices of deficiency ultimately issued to the Bells and MBA, the IRS asserted that the entire gain reported by the Bells under the installment method was ordinary income, and that MBA should have amortized the purchase price over 15 years. Before trial in the Tax Court, however, the government amended its answer to assert that the transfer of assets to MBA was not a sale but rather a capital contribution within Code section 351, that the payments made to the Bells under the sale contract were distributions to stockholders taxable as dividends, and that the lender contracts transferred to MBA could not be depreciated or amortized since, under the government's view of the incorporation transaction, MBA had no cost basis in them.

Analysis

The Tax Court opinion observed that an appeal would lie to the Court of Appeals for the Ninth Circuit and, therefore, that the Tax Court must apply an 11-factor test developed by the Ninth Circuit (in cases cited in the Tax Court decision) in a substance over form analysis to determine whether the transfer by Mr. Bell to MBA was a sale or a capital contribution.

Three factors were identified by the Tax Court as favoring characterization of the obligation under the purchase agreement as debt. The form of the purchase agreement, which did not have wording suggestive of an equity interest, was consistent with characterization as debt. Also, the purchase agreement obligation had, in substance, a fixed maturity date: the purchase agreement did not specify when the last payment would be made, but did specify a monthly schedule for payments. Characterization as debt was also supported by the parties' intent, as indicated by the language of the purchase agreement, to effectuate a sale.

Other factors were found to favor characterization of the payment obligation as stock or to be neutral. Factors found to favor a capital contribution were: (1) the apparent lack of any source of funds for payment other than income under the lender contracts; (2) the lack of any security for the payment obligation, of any significant capital or operating history for MBA, or of recourse to enforce the obligation other than by suing MBA under the purchase agreement; (3) that MBA had no assets when the purchase agreement was executed and, so far as is indicated in the opinion, remained thinly capitalized even after the property was transferred under the purchase agreement; (4) the relationship between the transferor and transferee, with the payment obligation having been issued to an individual who, with his spouse, became the sole shareholders of the corporation; (5) that the payment of the stated interest would be feasible only if MBA profited from the lender contracts sold to it; and (6) the near-certainty that no third party would lend $225,000 to MBA on the terms set forth in the purchase agreement.

Two factors were found to be neutral. Participation in management as a result of a transaction may be indicative of stock. Here, the Bells became the sole shareholders and managed MBA, but the purchase agreement did not affect their control of the corporation. Subordination of a related party obligation to obligations to other creditors of the corporation can also suggest that the related party obligation is not debt, but there was no express subordination in this case.

The Tax Court concluded that the 11 factors summarized above, on balance, favored the conclusion that the transfer of assets was, in substance, a capital contribution rather than a sale. Because, apparently as part of the same plan, the Bells also transferred $500 to MBA in exchange for all of its stock, the transfer by Mr. Bell of the REO business (including the lender contracts) was a transfer of property in exchange for stock within the scope of IRC section 351, such that no gain or loss was recognized on the contribution.

Because, under the substance over form analysis applied by the Tax Court and summarized above, the promise to pay under the purchase agreement was characterized as stock for tax purposes, the payments on the purchase agreement were recharacterized as distributions to one or both of the shareholders with respect to stock.

Distributions to shareholders by a corporation from its current or accumulated earnings and profits constitute dividends under Code Section 316 and related provisions. The Tax Court further concluded that MBA had sufficient earnings and profits, from income resulting from payments to it under the lender contracts, such that the payments to the Bells were dividends to them for tax purposes.

In respect of MBA, the Tax Court observed that the Bells had no basis in the lender contracts or in any goodwill transferred to MBA. Because, in a Section 351 transaction in which no gain was recognized, the basis of the corporation in the transferred property is the same as that of the transferor, MBA had no basis in the property transferred to it under the purchase agreement to depreciate or amortize.

On appeal to the Ninth Circuit Court of Appeals, the Bells argued that the Tax Court erred in failing to recognize that the right to payment under the purchase agreement was property other than stock, such that gain was required to recognized by Mr. Bell under Code Section 351(b) (concerning the receipt of property in addition to stock in a transaction otherwise described in Section 351) even if Section 351 was applicable. The Court of Appeals concluded, however, that the Tax Court properly applied the 11-factor test developed by case law for determining whether a payment right received in an incorporation transfer was stock or debt for tax purposes, and properly classified Mr. Bell's rights under the purchase agreement as stock notwithstanding its form.

Observations

Some of the factors cited by the Tax Court and the Court of Appeals in *Bell* in support of the conclusion that the right to $225,000 was not debt for tax purposes seem questionable. For example, the circumstance cited by the Court of Appeals that the payment obligation was set forth in the purchase agreement rather than a separate promissory note should not be given much, if any weight. Further, while the REO business as conducted by the Bells was no doubt somewhat speculative, the Bells may have had good reason to believe that the contracts would result in profits sufficient to pay the entire stated price (as proved to be the case).

Clearly, however, Mr. Bell's desired tax position was undermined by his establishing MBA and entering into the purchase agreement at a time when the corporation had no assets whatsoever, and by not obtaining an appraisal of the assets (which appraisal might have indicated that the value of the lender contracts and other property equaled or exceeded the purchase price). Further, the overall transaction was suggestive of an effort to transform into capital gain what would otherwise have been ordinary income, had Mr. Bell retained the lender contracts until the underlying properties were sold and the fees were collected.

Overall, the results reached in *Bell* are not surprising in light of the case law. This case is a further reminder of the courts' willingness to reclassify transactions—including reclassification as stock of obligations intended to be debt for tax purposes—even without express authorization by statute or regulation, and to plan in a manner that avoids or minimizes such risks.