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Just When You Thought It Was Safe to Go Back in The Water: Recharacterizing Debt as Equity

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For corporate tax purposes, whether an instrument is characterized as debt or equity can have a significant impact on the issuer of the instrument. Generally speaking, a corporate issuer of debt securities *may* deduct interest paid, but a corporate issuer of equity securities *may not* deduct dividends paid. Several years ago, this column reported on a notable, but unsuccessful, effort by the IRS to treat substantial intercompany loans borrowed by Nestle Holdings from its foreign affiliates as "equity" for tax purposes.[1] While each case in this area turns on its own facts, Nestle's victory made many corporate taxpayers more comfortable that their intercompany debt was less vulnerable to recharacterization. Very recently, however, on June 30, 1998, the Tax Court decided another case involving intercompany loans totaling almost $1 billion and, this time, the taxpayer lost. At issue in this recent case was the characterization of approximately $975 million in intercompany advances, which would determine the deductibility of over $133 million in payments that had been denominated as interest.[2]

Laidlaw Transportation Ltd. ("Canadian Parent"), a Canadian corporation, was the controlling parent of a group of corporations (the "Laidlaw Group") that provided a variety of services within and without the United States. The U.S. operations of the Laidlaw Group were held through Laidlaw Transportation, Inc. ("U.S. Holding Parent"), a Delaware corporation that was a wholly-owned subsidiary of Canadian Parent. U.S. Holding Parent in turn was the majority shareholder of Laidlaw Industries, Inc. ("U.S. Holding Sub"), a Delaware corporation, which served as a holding company for the U.S. solid waste services businesses of the Laidlaw Group. U.S. Holding Parent, U.S. Holding Sub, and their respective subsidiaries are collectively referred to in this article as the "Taxpayers."

From 1969 through the mid-1980's, the Laidlaw Group rapidly expanded through the acquisition of established, privately-held businesses providing solid waste services or passenger or school bus services. Canadian Parent preferred this method of expansion because an established business would already possess all of the governmental licenses and permits that would be needed to provide such services; this enabled Canadian Parent to expand faster than would otherwise be possible.

By the mid-1980's, however, the Laidlaw Group was encountering stiff competition in the acquisition of solid waste services businesses and, in the summer of 1985, consulted Coopers & Lybrand in order to develop a tax strategy that would permit it to gain an advantage over its competitors in the purchase of U.S. solid waste services businesses. Coopers & Lybrand recommended a financing structure that it believed would permit maximizing the tax benefit of interest deductions to the Laidlaw Group, which the Laidlaw Group adopted in the fall of 1985.

The structure entailed the formation by Canadian Parent of a wholly-owned Canadian subsidiary ("Canadian Holding Co."), and the formation by Canadian Holding Co. of a wholly-owned Netherlands subsidiary ("Dutch Finance Sub"). Dutch Finance Sub was funded with a combination of capital contributions and non-interest-bearing debt (treated as a capital contribution for Dutch tax purposes) from Canadian Holding Co. Dutch Finance Sub then lent these funds to the Taxpayers. This structure was intended to permit Canadian Parent to deduct interest paid on funds borrowed *and* to permit the Taxpayers to deduct interest paid on advances from Dutch Finance Sub. Thus, the anticipation was that the Laidlaw Group would obtain a deduction for interest in both the United States and Canada, without other adverse tax consequences in Canada, the Netherlands, or the United States.

From its inception in 1985 through 1988 (the taxable years at issue), Dutch Finance Sub provided advances to the Taxpayers upon request. As stated above, these advances, which totaled approximately $975 million, were funded by a combination of capital contributions and interest-free loans from Canadian Holding Co. The transfer of funds from Canadian Holding Co. to Dutch Finance Sub and the subsequent advances from Dutch Finance Sub to the Taxpayers generally occurred within one day of each other.

Initially, the loan agreements between Dutch Finance Sub and the Taxpayers contained terms similar to those found in commercial loans, such as a fixed maturity date (in most cases); a guarantee from the appropriate parent corporation; a fixed rate of interest, the payment of which was required regardless of whether the borrower or guarantor had any income or distributed any dividends; and a statement that the rights of Dutch Finance Sub were senior to those of the equity holders of the borrower and guarantor. Certain of the loan agreements also required the borrower to maintain its debt-to-equity ratio below a specified threshold (*e.g.*, 2:1 or 2.5:1). None of the loans required periodic payments of principal, and all of the loans were due on September 1, 1988. Certain of the loan agreements permitted the borrower, on or before the maturity date, to convert the loan to a term loan repayable in 10 equal, semi-annual installments; however, in the event of conversion, Dutch Finance Sub retained the right to demand repayment of the loan at any time if it needed the funds.

In October 1986, a subsidiary of U.S. Holding Sub acquired the stock of GSX Corporation ("GSX"), apparently a solid waste services company, for approximately $350 million. At the time of this acquisition, two of the principals of the Laidlaw Group approached Dean Witter, Bear Stearns, and Donaldson, Lufkin & Jenrette about the possibility of providing long-term financing for the acquisition. Each of these investment banks proposed financing the acquisition through a combination of equity (or convertible debt), subordinated debt, and bank loans. In addition, each of the proposals would have required the public issuance of stock or debt. These proposals were rejected by the Laidlaw Group because: (i) GSX did not have separately audited financial statements, so the public issuance of debt or equity was not possible; (ii) equity or convertible debt would dilute U.S. Holding Parent's interest in U.S. Holding Sub; and (iii) debt from commercial lenders could not be obtained on terms as favorable as those provided by Dutch Finance Sub. Accordingly, financing for the GSX acquisition was provided at the outset by Canadian Parent and, ultimately, by Dutch Finance Sub.

As a result of the acquisition of GSX, both U.S. Holding Parent and U.S. Holding Sub exceeded the leverage ratios that they had agreed to maintain in loan agreements with unrelated commercial lenders. To remedy this problem, Dutch Finance Sub was informed two days after the GSX acquisition that U.S. Holding Sub's repayment of advances would have to be subordinated to U.S. Holding Sub's commercial lenders. Dutch Finance Sub agreed to amend all of the outstanding loan agreements with the Taxpayers to provide, retroactively to September 1, 1986, that: (i) all sums would be due on demand at interest rates equal to the prime rate at ABN Bank in New York plus 2%; (ii) none of the Taxpayers would need to meet any financial ratios; (iii) the Taxpayers would no longer be restricted as to the amount of funds that they could request (*i.e.*, Dutch Finance Sub would be required to advance the amounts requested by the Taxpayers, subject only to the availability of funds); and (iv) Dutch Finance Sub would subordinate its advances to the bank loans of the Taxpayers.

In July 1987, the Taxpayers once again entered into new loan agreements with Dutch Finance Sub. These loan agreements contained the same terms as the agreements executed as of September 1, 1986, except that (i) the loans were changed from demand loans to term loans with a maturity date of September 1, 1989 (unless extended by written agreement) and (ii) certain enforcement provisions (including an acceleration clause) were added to the agreements.

None of the Taxpayers repaid any principal to Dutch Finance Sub on any of the advances during the taxable years at issue. Rather, the due dates for the payments of principal were routinely extended. Furthermore, on or about the same day that payments of interest were made by the Taxpayers, Dutch Finance Sub generally transferred an amount of money equal to the interest payments back to one or more of the Taxpayers by way of an "interest reinvestment loan." During the taxable years at issue, Dutch Finance Sub made interest reinvestment loans to the Taxpayers totaling more than 90% of the interest payments claimed by the Taxpayers.

The IRS disallowed a total of $133,515,459 in interest deductions taken by the Taxpayers during the taxable years at issue, arguing that Dutch Finance Sub's advances to the Taxpayers were capital contributions rather than loans. The Taxpayers contended that the advances were loans both in substance and in form, and that the payments of interest by the Taxpayers should be deductible for U.S. Federal income tax purposes.

The Tax Court found that the advances made by Dutch Finance Sub to the Taxpayers were in substance equity. In reaching its decision, the Tax Court considered some sixteen different factors. Of these sixteen factors, the Tax Court found that eleven weighed in favor of treating the advances as equity and four were neutral. The only factor that the Tax Court found to weigh in favor of treating the advances as debt was the name given to the instrument; however, this factor was of little help to the Taxpayers in a context in which all of the parties to the financing transactions were related entities controlled by the same core group of individuals. Thus, although the Tax Court did state that its "task is not to count factors, but to evaluate them,"[3] it concluded that *all* of the relevant factors weighed in favor of treating the advances as equity.

In considering the various factors, the court identified a number of facts that it considered indicative of the existence of equity rather than debt. Among these facts are: (i) repeated extension of maturity dates; (ii) lack of an expectation of repayment; (iii) lack of an intention to request repayment; (iv) changing term loans to demand loans (in the agreements dated as of September 1, 1986, mentioned above); (v) circular flow of funds resulting from the use of "interest reinvestment loans"; (vi) the high debt-to-equity ratios of the Taxpayers as compared to their competitors; (vii) the Taxpayers' inability to obtain $975 million in debt from unrelated lenders, as demonstrated by the investment banks' proposals for financing the GSX acquisition (each of which contemplated partial equity financing); and (viii) in an audit of Canadian Parent by the Canadian tax authorities, Canadian Parent's statement that it acted as a "conduit in providing funds for its operating subsidiaries" and that "[t]he loans are in the nature of capital contributions to the subsidiaries."[4]

This case is noteworthy not so much for its conclusion that the advances at issue were equity rather than debt, but for the zeal with which the Tax Court pursued that conclusion. The Tax Court ignored statements in other cases indicating that the terms of related-party debt should not be rigorously compared to those of commercial debt,[5] and found that not a single relevant factor indicated the existence of debt. The only factor that might have indicated the existence of debt (*i.e.*, the name given to the advances) was discounted by the Tax Court on the ground that the parties to the financing transactions were related entities controlled by the same core group of individuals.

The Tax Court also contradicted a position that it had taken just a few years ago in its decision in *Nestle Holdings, Inc. v. Commissioner*.[6] In *Nestle Holdings,* the Tax Court found that a reasonable expectation of repayment existed notwithstanding the fact that the debtor taxpayers planned to divest themselves of certain assets and to use the proceeds from that divestiture to repay (in part) the obligation being characterized by the court. The Tax Court in *Nestle Holdings* also rejected the IRS' argument that the taxpayers' disposal of material assets in order to repay debt was indicative of the existence of equity, on the ground that the taxpayers were viable entities and that the transfer of assets was not part of a liquidation or cessation of a business. In *Laidlaw Transportation,* on the other hand, the Tax Court summarily dismissed the Taxpayers' contention that the advances from Dutch Finance Sub could be repaid by selling tangible or intangible assets of the Taxpayers, requiring instead that the Taxpayers show that anticipated cash-flow and liquid assets were sufficient to cover payments of interest and principal before it would consider the source of payments factor to weigh in favor of treating the advances as debt.

In perhaps the most aberrant portion of its opinion, the Tax Court questioned the well-established principle that, for purposes of determining whether a corporation is thinly capitalized, the fair market value of the corporation's assets (rather than their book value) should be used in computing the corporation's debt-to-equity ratio.[7] This undermining of a well-established principle is rendered even more striking by the fact that the Tax Court's own analysis indicated that the court did not need to raise or decide the issue. As the court itself readily acknowledged, it would have found the Taxpayers to be thinly capitalized (as compared to their competitors) whether fair market value or book value was used to calculate the Taxpayers' debt-to-equity ratios.

As a result, *Laidlaw Transportation* appears to go far in proving true the old maxim that "bad facts create bad law." Whether it will prove to be pivotal in the resolution of other cases and, perhaps even more significantly, whether taxpayers will conform their behavior to the rigid strictures set out by the Tax Court remain to be seen.

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[1] *See* "Nestle Deducts Interest on More than $1.3 Billion in Debt Borrowed from Foreign Affiliates," NYLJ, ______, 1995.

[2] *Laidlaw Transportation, Inc. v. Commissioner,* 75 T.C.M. (CCH) 2598 (1998).

[3] *Id*. at 2616.

[4] *Id*. at 2615-16.

[5] *See*, *e.g.*, *Geftman v. Commissioner*, 1998 U.S. App. LEXIS 18359 n. 21 (3d Cir. 1998) ("credit may be extended between related parties on terms that differ from those that would exist on the open market"); *Nestle Holdings, Inc. v. Commissioner*, 70 T.C.M. (CCH) 682, 703 (1995) ("In evaluating the terms of related-party debt, we do not apply a mechanical test of absolute identity between the related-party advances and the debt that actually or hypothetically would have been available..., but, instead, we seek to determine whether the terms of the advances were a 'patent distortion of what would normally have been available'... . We have recognized that 'different creditors invariably undertake different degrees of risk and that, where debtor and creditor are related, the lender might understandably offer more lenient terms than could be secured elsewhere.'") (quoting *Litton Business Sys., Inc. v. Commissioner*, 61 T.C. 367, 379 (1973), *acq.* 1974-2 C.B. 3, and *G.M. Gooch Lumber Sales Co. v. Commissioner*, 49 T.C. 649, 659 (1968), respectively), *vacated and remanded on another issue*, 1998 U.S. App. LEXIS 18161 (2d Cir. 1998).

[6] 70 T.C.M. (CCH) at 701, 704.

[7] *See Kraft Foods Co. v. Commissioner*, 232 F.2d 118, 127 (2d Cir. 1956) ("We think it obvious that in the determination of debt-equity ratios, real values rather than artificial par and book values should be applied."); *Estate of Miller v. Commissioner*, 239 F.2d 729, 733 & n. 10 (9th Cir. 1956) (quoting the above language from *Kraft Foods*, and stating that this "language is in line with other decisions of the Tax Court"); *Nye v. Commissioner*, 50 T.C. 203, 216 (1968) (rejecting the use of book values by the IRS in computing the debt-to-equity ratio of a corporation, and stating that "book values [are] notoriously poor guides to fair market value"), *acq.* 1969-2 C.B. xxiv, xxv; *Harkins Bowling, Inc. v. Knox*, 164 F. Supp. 801, 804 (D. Minn. 1958) ("In determining a debt-equity ratio, real and not book value of the capital investment must be used."). *See also* William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 Tax L. Rev. 369, 516 (1971) ("Attention is not riveted on the book net worth, however, but on the fair market value of the net assets... .").