VALUATION OBSERVATIONS

Some practical observations from a practicing business appraiser.

VLC

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IS IT REALLY A LOAN?

When shareholders make advances to their companies, they typically want these advances to be classified as debt, rather than a contribution to equity. There are many advantages to having these funds treated as corporate obligations instead of contributions to capital. For example, receipt of repayment may be treated as the retirement of a loan rather than a taxable dividend; and interest payments are tax deductible to the corporation, whereas dividends are not. Furthermore, a loss resulting from the worthlessness of stock is a capital loss, whereas a bad debt may be treated as an ordinary loss if it qualifies as a business bad debt. The difference being the preferred tax treatment of the ordinary loss.

"A bona fide debt is debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. . . A gift or contribution to capital shall not be considered a debt. . ." *Treas. Reg. section 1.166-1(c).*

Tax implications are motivating factors for how a shareholder may desire the classification of the advance of funds. Because of the advantages in having the advanced funds treated as debt obligations instead of contributions to capital, the courts look beyond the literal terms of the transaction in order to determine the substantive nature – substance over form.

A number of criteria have been isolated in an attempt to judge the true nature of an investment which is in the form of a debt:

1. Intent of the parties.
2. Relationship between creditors and shareholders.
3. Extent of participation in management by the holder of the instrument.
4. Ability of the corporation to obtain funds from outside sources.
5. The "thinness" of the capital structure in relation to debt.
6. Risk involved.
7. The formal indicia of the arrangement.
8. Subordination to other creditors.
9. Voting power of the holder of the instrument.
10. Provision of a fixed rate of interest.
11. Source of payments (interest and/or principal).
12. Right to enforce payments.
13. The presence or absence of a fixed maturity date.

14. Provision for redemption by either the corporation or at the option of the holder.
15. Timing of the advance with reference to the organization of the corporation.
16. Use to which the advances were put.

The list is not absolute. It is used as a guide to assist in determining the economic reality of the relationships and the transaction. And, whether or not the advance had a business purpose or a tax avoidance motive may also be critical if the creation of the debt was used solely to obtain a double deduction. Keep in mind that even when the formal criteria of an obligation are met, the totality of the circumstances surrounding the advances are the true determinative factors as to whether the advances indicate contributions to capital or creation of a bona fide debt.

Under an objective test of economic reality, it is useful to compare the form in which a similar transaction would have taken had it been between the corporation and an outside lender. If the shareholder's advance is far more speculative that what an outsider would make, it is probably a loan in name only.

In one case, and in the simplest form, debt classification was denied because of: (1) lack of supporting loan documentation; (2) failure to report advances on tax returns; (3) failure to charge interest; and (4) failure to provide security.

But remember, following protocol does not always help. In the following example, all the formal indicia of an obligation were meticulously satisfied. The company, however, was the complete creature of the two shareholders who had the power to create whatever appearance would be of tax benefit to them despite the economic reality of the transaction. Each shareholder owned an equal proportion of stock and was making an equal additional contribution, so that whether the two shareholders designated any part of their additional contributions as debt or as stock would not dilute their proportionate equity interests. There was no restriction because of the possible excessive debt structure, for the company had been created to acquire real estate and had no outside creditors except mortgagees who, of course, would have no concern for general creditors because they had priority in the security of the real estate.

Although the company issued demand notes for the advances, nevertheless, as the court found, it could not have repaid them for a number of years. The economic reality was that the company used the proceeds of the notes to purchase its original assets, and the advances represented a long term commitment dependent on the future value of the real estate and the ability of the corporation to sell or refinance it. Only because the relationship between the two shareholders and the company were so interwoven, so different from the arm's-length relationship between a corporation and an outside creditor, were they willing to invest in the notes and allow them to go unpaid for so many years while the company continued to enjoy the advantages of uninterrupted ownership of its real estate. The notes were equity in disguise.

The valuation world is no different than the tax world when it comes to this loan versus equity debate. Substance over form rules.

And let's not forget about the banks' view on debt. When a shareholder loan shows up on the balance sheet of a company, that loan goes in to the various calculations considered in loan covenants. This should be considered carefully before deciding to classify an advance from a shareholder as debt.

If you would like additional information, or have a question, please do not hesitate to call.

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Terri Lastovka is the founder of Valuation & Litigation Consulting, LLC. Her practice focuses on business valuations and litigation consulting in the areas of domestic relations, gift and estate tax, probate, shareholder disputes, economic damages, and forensic accounting. She draws from a wide range of experiences, including public accounting, law, banking, and CFO. She has received extensive training from the American Society of Appraisers in the area of business valuation and works closely with members of the bar to effectuate practical settlements. Terri also serves as the Director of Legal & Finance for Journey of Hope, a grass roots non-profit organization providing financial support to cancer survivors.