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Debt-Equity Financing Guidelines: Capital Problems for Closely Held Businesses

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DEBT-EQUITY FINANCING GUIDELINES: CAPITAL PROBLEMS FOR CLOSELY HELD BUSINESSES

I. Introduction

In the late 1940's and early 1950's, courts became increasingly aware that many small, closely held corporations were inadequately capitalized.[1] During the late 1960's, an increasing number of large corporate mergers were financed through the use of debt instruments instead of stock offerings.[2] Problems such as these led Congress to enact Internal Revenue Code section 385.[3]

Section 385 authorized the Treasury to prescribe regulations to help both courts and taxpayers determine whether an interest in a corporation qualified as debt or equity for federal income tax purposes.[4] In drafting the regulations, the Treasury was to take into account "whether there [was] a written unconditional promise to pay on demand, or on a specified date, a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest."[5] The Treasury was also to consider the ratio of debt to equity of the corporation,[6] whether the

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1. Adams v. Commissioner, 58 T.C. 41, 57 (1972) (debt/equity ratio of 17:1); Baker Commodities, Inc. v. Commissioner, 48 T.C. 374 (1967), *aff'd*, 415 F.2d 519 (9th Cir. 1969), *cert. denied*, 397 U.S. 988 (1970) (ratio of 692:1); Huffstutler v. Commissioner, 12 T.C.M. 1422, 1427 (1953) (ratio of 5:1); Ruspyn Corp. v. Commissioner, 18 T.C. 769, 777 (1952) (ratio of 3:1 during the Depression); Matthiessen v. Commissioner, 16 T.C. 781, 785 (1951) (ratio of 3:1 with continuing unsecured loans made to the corporation); Dobkin v. Commissioner, 15 T.C. 31 (1950), *aff'd*, 192 F.2d 392 (2d Cir. 1951) (ratio of 13:1); Schnitzer v. Commissioner, 13 T.C. 43, 61 (1949), *aff'd*, 183 F.2d 70 (9th Cir. 1950), *cert. denied*, 340 U.S. 911 (1951) (authorized capital deemed inadequate for construction of steel mill); Swoby Corp. v. Commissioner, 9 T.C. 887 (1947) (ratio of over 1,000:1).

2. Debt instruments were used in these mergers instead of stock because financing an acquisition with debt could result in greater earnings per-share for a consolidated company after a merger. Gershman, DEBT EQUITY PROPOSALS PROVIDE GUIDANCE BUT POSE PROBLEMS FOR SMALL CORPORATIONS, 63 J. TAX. 194 (Oct. 1980) [hereinafter cited as *Problems for Small Corporations*]. Also, the interest paid on these investments was deductible under I.R.C. § 163(a). *Id.* Convertible debt was used because it paid a larger return to the shareholders of the acquired corporation than did their stock. Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1971) [hereinafter cited as *Corporate Debt*].

3. Tax Reform Act of 1969, Pub. L. No. 91-172, § 415(a), 83 Stat. 487 (1969).

4. I.R.C. § 385(a).

5. *Id.* § 385(b)(1).

6. *Id.* § 385(b)(3).

corporation's debt was convertible into stock[7] and the relationship between holdings of stock in the corporation and holdings of the interest in question.[8] Congress hoped that the regulations would bring certainty to an area which had troubled courts for years.[9] In making their judgments, courts had often relied on subjective analysis, such as inquiring into the intention of the parties.[10]

On December 29, 1980, Treasury Decision 7747 was issued stating the final regulations for determining whether certain interests in a corporation should be treated as stock or indebtedness.[11] The regulations are intended to provide certainty through objective tests for an area heretofore plagued by confusion. The use of various factors in the regulations was believed to be the means to provide objective criteria for the determination of an instrument's status.[12] The new rules generally will apply to certain interests in small, closely held corporations created after April 30, 1981.[13]

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7. *Id.* § 385(b)(4).

8. *Id.* § 385(b)(5).

9. Courts were many times confused as to whether funds advanced to a corporation represented debt or equity. Baker Commodities, Inc. v. Commissioner, 415 F.2d 519 (9th Cir. 1969); Lee Telephone Co. v. Commissioner, 260 F.2d 114 (4th Cir. 1958); Commissioner v. H.P. Hood & Sons, Inc., 141 F.2d 467 (1st Cir. 1944); Commissioner v. Meridian & Thirteenth Realty Co., 132 F.2d 182 (7th Cir. 1942); Jewel Tea Co. v. United States, 90 F.2d 451 (2d Cir. 1937); Glenmore Distilleries Co. v. Commissioner, 47 B.T.A. 213 (1942); Edward Katzinger Co. v. Commissioner, 44 B.T.A. 533 (1941).

10. Dillin v. United States, 433 F.2d 1097, 1100 (5th Cir. 1970) (intent was a factor to consider); Farley Realty Corp. v. Commissioner, 279 F.2d 701 (2d Cir. 1960) (agreement for a lower rate of interest in return for right to share in later profits); Green Bay & W.R. Co. v. Commissioner, 147 F.2d 585, 586 (7th Cir. 1945) (debenture holders accorded the same status as stockholders); Commissioner v. John Kelley Co., 146 F.2d 466 (7th Cir. 1944), *rev'd on other grounds*, 326 U.S. 521 (1945); Commissioner v. Meridian & Thirteenth Realty Co., 132 F.2d 182, 186 (7th Cir. 1942) (intent of parties is of extreme importance).

11. Notice of Final Regulations: Department of the Treasury, Internal Revenue Service Income Tax: Taxable Years Beginning After December 31, 1953; Treatment of Certain Interests in Corporation as Stock or Indebtedness, 45 Fed. Reg. 86,438 (Dec. 31, 1980) (codified at Treas. Reg. §§ 1.385.1-10 (Supp. 1981)).

12. As late as 1977, the section 385 project was a low priority in the opinion of the Legislation and Regulations Division of the IRS (the authors of the recently completed regulations). Beghe, *Redrawing the Lines Between Corporate Debt and Equity Interests: the Proposed Regulations Under Section 385*, 58 TAXES 931, 933 (Dec. 1980) [hereinafter cited as *Redrawing Debt and Equity Lines*].

13. The regulations do not apply to publicly traded and widely held corporations. Treas. Reg. § 1.385-6(a)(3)(i). In addition, the regulations will not apply to instruments issued pursuant to a plan of reorganization filed on or before December 31, 1980 or instruments, unwritten obligations, guaranteed loans, or preferred stock issued or made pursuant to a written contract which is binding on December 31, 1980. Treas. Reg. § 1.385-1(a)(2) (Supp.

The regulations, however, are a departure from the goals stated by Congress in 1969. The legislative history often refered to the development of "regulatory guidelines" setting forth "factors" to be taken into account when determining the status of an instrument.[14] However, the regulations state a series of tests to be used in making binding and conclusive determinations. The regulations will serve to eliminate controversy in numerous cases, but they will also cause problems for many corporations not publicly traded or widely held.

This Note will deal with some of the binding and conclusive determinations contained in the regulations. Section II will present some of the reasons for financing a corporation with debt. Section III will discuss the tests to be used in determining whether a debt instrument is actually equity. Debt instruments convertible into equity will be analyzed in section IV and loans made to a corporation guaranteed by its shareholders will be discussed in section V.

II. Debt v. Equity

Definite advantages exist in using debt instruments instead of equity to finance a corporation.[15] One such advantage is that the holder of a debt instrument may be entitled to an ordinary loss deduction if the obligation becomes completely or partially worthless.[16] In addition, the issuer is allowed an ordinary tax deduction for payments of interest on its debt instruments but not for the payments of dividends with respect to its stock.[17] Furthermore, the issuer will need more in earnings to pay dividends instead of interest.[18] The shareholder, however, is indifferent to the receipt of div-

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1981).

14. [1969] U.S. Code. Cong. & Ad. News 509, 663-64. *See also* Committee on Corporations, Tax Section, New York State Bar Ass'n, Report on Proposed Regs. 1.385: The Tax Distinction Between Corporate Debt and Equity A-1, A-7 (Aug. 1980) [hereinafter cited as NYSBA Report].

15. W. Hoffman, Corporations, Partnerships, Estates, and Trusts 99, 100 (1977); T. Ness & E. Vogel, Taxation of the Closely Held Corporation 2-76 to 79 (3d ed. 1976).

16. NYSBA Report, *supra* note 14, at A-1.

17. Treas. Reg. § 1.163-1(c) (1981). *See generally* Katsoris, *The Double Jeopardy of Corporate Profits*, 29 Buffalo L. Rev. 1 (1980).

18. *Corporate Debt, supra* note 2. Dividends are distributions to shareholders: they are paid after determining a corporation's income tax. Thus, assuming a tax rate of 50%, a corporation must earn $12 before taxes in order to pay a $6 dividend. Interest is paid before determining a corporation's income tax. Thus, a bond bearing $6 interest can be carried

idends or interest because both are considered to be ordinary income.[19]

Another advantage of using debt is in the treatment of discount. The issuer of a corporate bond may amortize bond discount[20] but stock issued at a discount is denied such treatment.[21] Commissions and expenses associated with issuing debt may be deducted by the issuer[22] but this deduction is denied for expenses associated with the issuance of stock.[23]

Further, the use of debt could avoid the following problem: a public corporation shareholder who needs funds can liquidate a portion of his investment, recover his cost tax-free, and pay the capital gains tax rate on the excess.[24] One whose capital is invested in the equity of a closely held corporation, however, ordinarily cannot withdraw it, short of complete or partial liquidation of the business, without paying the dividend tax at ordinary rates, to the extent of the corporation's current and accumulated earnings and profits.[25] In this situation, the investors only alternative would be to relinquish a significant part of his proportionate interest in and control of the business.[26]

Due to the advantages of using debt over equity, it became necessary to distinguish debt from equity in a corporation's capital structure. The problem became complicated when lenders were also controlling stockholders of the corporate borrower. When a lender has a large equity investment in the borrowing corporation, courts have had to consider whether the lender ever intended to assume and enforce the rights of a creditor if doing so would jeop-

with only $6 of earnings. *Id.*

19. I.R.C. § 61(a) (1980). Interest is also entitled to the exclusion which heretofore was reserved for dividends. I.R.C. § 116(a), (b).

20. Treas. Reg. § 1.163-3(a) (1980).

21. I.R.C. § 1032(a) (1980).

22. Helvering v. Union Pac. R.R., 293 U.S. 282 (1934) (when a corporation sells an issue of bonds and pays commissions for marketing them, such expense is properly chargeable to capital account); United States v. Memorial Corp., 244 F.2d 641, 644 (6th Cir. 1957); Amercian Smelting & Ref. Co. v. United States, 130 F.2d 883, 884 (3d Cir. 1942).

23. General Bancshares Corp. v. Commissioner, 326 F.2d 712 (8th Cir. 1964) (expenses associated with stock issuance are not deductible); Transamerica Corp. v. United States, 254 F. Supp. 504, 509 (N.D. Cal. 1966).

24. *Corporate Debt*, *supra* note 2, at 378.

25. *Id.*

26. *Id.*

ardize the value of the lender's equity investment. This is only one of many factors, however, which the courts considered in determining whether an instrument was debt or equity.[27] The courts found that the same factor could indicate either debt or equity depending upon the absence or presence of other indicia.[28] In *Stevenhagen v. Commissioner,* the court framed the basic issue in such cases: "was there a genuine intention to create a debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor — creditor relationship?"[29]

Although courts consider a corporation's debt to equity ratio in

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27. Fin Hay Realty Co. v. United States, 398 F.2d 694, 696 (3d Cir. 1968). The factors noted are: 1) the intent of the parties; 2) the identity between creditors and shareholders; 3) the extent of participation in management by the holder of the instrument; 4) the ability of the corporation to obtain funds from outside sources; 5) the "thinness" of the capital structure in relation to debt; 6) the risk involved; 7) the formal indicia of the arrangements; 8) the relative position of the obligees as to other creditors regarding the payment of interest and principal; 9) the voting power of the holder of the instrument; 10) the provision of a fixed rate; 11) a contingency on the obligation to repay; 12) the source of the interest payments; 13) the presence or absence of a fixed maturity date; 14) a provision for redemption by the corporation; 15) a provision for redemption at the option of the holder; and 16) the timing of the advance with reference to the organization of the corporation.

As many as 38 factors have been considered by courts. Holzman, *The Interest Dividend Guidelines,* 47 TAXES 4 (1969). The factors are: 1) formal authorization; 2) ascertainable principal amount; 3) time of maturity; 4) postponement of maturity; 5) default provision; 6) uncontested default; 7) spelling out of interest provision; 8) source of interest; 9) interest payments leave no discretion to the obligor; 10) there was no "understandings" as to nonobservance of terms; 11) cumulativeness of interest; 12) unilateral modification must not be possible; 13) rights upon dissolution must be spelled out; 14) subordination; 15) dependency of repayment on success of untried business venture; 16) identity of interests of stockholders and bondholders; 17) to whom was the indebtedness; 18) dependency of interest upon director action; 19) participation of bondholders in the profits; 20) participation in management; 21) package financing of the corporation; 22) did the bonds represent new money; 23) was the original capital adequate; 24) timing of creation of indebtedness; 25) thinness of capital; 26) form of the instrument; 27) uncertainty of obligor as to what the security is; 28) ability of corporation to obtain funds from non-stockholders; 29) creditors' expectation of repayment; 30) how the obligor carried the "debt" on its books; 31) corroborative evidence; 32) convertibility of indebtedness; 33) nomenclature; 34) industry practice; 35) was the indebtedness secured; 36) existence of a sinking fund; 37) pattern of stockholder borrowing; and 38) intent.

28. Scriptomatic, Inc. v. United States, 555 F.2d 364 (3d Cir. 1977); Fischer v. United States, 441 F. Supp. 32, 37 (E.D. Pa. 1977) (intent can only be ascertained from objective factors).

29. J.F. Stevenhagen Co. v. Commissioner, 34 T.C.M. 852, 857 (1975), *aff'd,* 551 F.2d 106 (6th Cir. 1977) (quoting Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367, 377 (1973)).

determining whether an interest is debt or equity,[30] it is not the controlling factor. An illustration of this is provided by *Baker Commodities, Inc. v. Commissioner.*[31] In *Baker*, a dispute arose concerning the assets of an established partnership purchased by some of the partnership's younger employees who had formed a new corporation.[32] Notes of the new corporation were exchanged for the assets.[33] The agreement included an unconditional promise to pay the notes with interest at stated periods.[34] In return, holders of the notes had the right to accelerate the entire balance upon any default.[35] The court refused to reclassify the indebtedness as stock even though the debt to equity ratio was almost 700 to 1.[36] A reasonable expectation of repayment was found to exist due to the stable revenues of the business.[37] Thus, the capital structure in *Baker* was upheld despite the high debt to equity ratio.

III. Reclassifying Debt Instruments

A. Proportionality

The regulations will reclassify debt instruments if the holdings of stock and debt among the shareholders are considered to be substantially proportionate.[38] This approach is a departure from case law which held that proportionality *per se* cannot be viewed

30. *See* NYSBA REPORT, *supra* note 14, at A-15. This method acknowledges "the intent of the parties as relevant in characterizing the transaction." It was noted that there was much similarity between this approach and the statements of congressional intent in connection with the adoption of section 385. *Id. See* note 27 *supra*. The Treasury made this factor determinative for all intents and purposes in the proposed regulation. 45 Fed. Reg. 18,957, 18,958 (Mar. 24, 1980). The Treasury retreated from this position in drafting the final regulations.

31. 48 T.C. 374 (1967), *aff'd*, 415 F.2d 519, 522 (9th Cir. 1969), *cert. denied*, 397 U.S. 988 (1970).

32. *Id.* at 380.

33. *Id.*

34. *Id.*

35. *Id.* at 384.

36. *Id.* at 396 n.20.

37. *Id.* at 397. No ratio has been found determinative. *See* Caplin, *The Caloric Count of a Thin Incorporation*, 17 N.Y.U. INST. 771, 784-88 (1959). In one instance, a ratio of 20,000:1 was upheld. Byerlite Corp. v. Williams, 286 F.2d 285, 287-89 (6th Cir. 1960).

38. Treas. Reg. § 1.385-6(a) (Supp. 1981). No precise definition is contained in the regulations regarding proportionality. This omission by the Treasury will create a great deal of uncertainty because no specific percentage is given. It appears that if more than 50% of a corporation's debt is held by shareholders, then these holdings will be regarded as substantially proportionate. *See* note 41 *infra*.

as affirmative evidence for treating purported debt as equity.[39] Nevertheless, substantially proportionate holdings of debt and stock among shareholders will make the reclassification rules operative.[40] Unfortunately for the taxpayer, no specific percentages are stated in the regulations for determining proportionate holdings. A Revenue Procedure is needed because the examples provided do not offer certainty.[41]

One can infer that the regulations are intended to create arms-length dealings between debtor and creditor.[42] For example, instruments not issued for money will be treated as stock if these instruments do not carry a "reasonable interest rate."[43] In addition, the instrument must not give rise to original issue discount.[44]

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39. Wilshire & Western Sandwiches, Inc. v. Commissioner, 175 F.2d 718, 721 (9th Cir. 1949) (proportionality is merely a factor to consider but is not controlling). *See also* Harlan v. United States, 409 F.2d 904, 909 (5th Cir. 1969); Gooding Amusement Co. v. Commissioner, 236 F.2d 159, 165 (6th Cir. 1956).

40. This section of the regulations applies to hybrid instruments, Treas. Reg. § 1.385-3(f) (Supp. 1981), instruments not issued for money, *id.* § 1.385-6(d) (Supp. 1981), instruments payable on demand, *id.* § 1.385-6(a)(1) (Supp. 1981), other instruments where there is a change in terms or a failure to pay principal or interest, *id.* § 1.385-6(j) and (k) (Supp. 1981), and where a corporation's debt to equity ratio is excessive, *id.* § 1.385-6(f) (Supp. 1981).

41. Treas. Reg. § 1.385-6(a)(6), Examples (2) and (3) (Supp. 1981). In these examples, three shareholders hold equal amounts of stock. In Example (2), 90% of the debt is held in different amounts by the three shareholders and an independent creditor holds 10% of the debt. In this example, the shareholder debt is rule proportionate. In Example (3), the three shareholders own equal amounts of stock and debt and an independent creditor holds 70% of the debt. Here, the holdings of debt and equity are not ruled proportionate.

Based on these examples, one can infer that if an independent creditor holds 50% or more of a corporation's debt, the shareholder debt will not be ruled proportionate. Note that exact proportionality is not required and more than one class of instruments may be considered in determining substantial proportionality. Treas. Reg. § 1.385-6(a)(6), Example (4) (Supp. 1981).

42. *See, e.g.*, Treas. Reg. §§ 1.385-6(a)(7)(A), (d), (e), (k), 6(1)-(3) (Supp. 1981).

43. "A rate of interest is reasonable if it is within the normal range of rates paid to independent creditors on similar instruments by corporations of the same general size and in the same general industry, geographic location, and financial condition on the date the determination is made." *Id.* § 1.385-6(e)(1) (Supp. 1981). Even though a reasonable rate could be quite high in certain situations, the Treasury feels that this requirement will enable small, closely held corporations to borrow at the same rates as the largest corporations. 45 Fed. Reg. 86,443 (1980).

44. Treas. Reg. § 1.385-6(d)(1)(iii) (Supp. 1981). If the yield of an instrument is less than is deemed proper, its face value will be reduced by the amount required to make the yield proper. The amount by which the instrument is reduced is its original issue discount. For example, assume an instrument (face value $100) yielding eight percent (eight dollars interest paid annually to holders of the instrument) is issued. Assume, further, that the proper

The intent of the Treasury in drafting the new regulations was to provide taxpayers with certainty through objective tests. The problem with the reasonable interest rate requirement is that a small, closely held corporation may not always be able to compare the interest rate on its obligations with that of another corporation because similar corporations may not exist for purposes of comparison. Thus, there will be uncertainty regarding the reasonableness of the interest rate.

B. Excessive Debt

Treasury Regulation section 1.385-6(f)(2) provides that an instrument will be treated as equity if the instrument's terms and conditions and the issuing corporation's financial structure, taken together, would not be satisfactory to a legitimate lending institution.[45] Similar to the proportionality rule above, this rule does not promote uniformity and certainty. As long as the issuing corporation can show that a legitimate lending institution would have agreed to the loan in question, the instrument will retain its debt status.[46] A criticism of this rule is that circumstances which will affect a lender's willingness to lend will vary from one geographic area to another.[47] Thus, subjective criteria will be employed where objective criteria were sought.

If a corporation can show that its debt to equity ratio does not exceed 10:1 and its inside ratio[48] does not exceed 3:1, it will be held not to have excessive debt regardless of the rule in subsection 6(f)(2).[49] Should an issuing corporation be unable to meet this test,

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yield is 10%. The instrument would have its face value reduced by $20 to make the yield proper ($8/$80=10%). The $20 represents original issue discount.

45. In other words, a bank, insurance company, or similiar lending institution which makes ordinary commercial loans. *Id.* § 1.385-6(f)(2)(ii) (Supp. 1981).

46. *Id.* § 1.385-6(f)(2).

47. Often, the prime rate is lower in the south and west than in the major banks of New York and Chicago. A corporation doing business with several banks throughout the country could literally shop for the bank which would have found the terms acceptable.

48. The definition of the ratio of shareholder debt to equity is derived through a process of elimination. Current liabilities are excluded in computing the debt to equity ratio. *Id.* § 1.385-6(g)(1)(i) (Supp. 1981). Any debt held by independent creditors is also excluded in computing the inside ratio. *Id.* § 1.385-6(f)(4) (Supp. 1981). What remains is shareholder debt.

49. *Id.* § 1.385-6(f)(3) (Supp. 1981). Note that this rule prevents reclassification but it does not prevent fragmentation. Fragmentation involves reduction of the face value of an instrument (or increasing it) to make the stated interest rate a reasonable rate of interest.

all proportionately held shareholder debt will be converted to equity unless the holders can show that the terms and conditions of the instrument would have been acceptable to an independent creditor.[50]

The reclassification rule for excessive debt seems harsh. If debt is reclassified as equity for this reason, its status can never change.[51] The Treasury's approach is a rejection of case law which held that obligations freely transferable should not be reclassified as stock because the obligation could pass into the hands of someone who would be more inclined than a shareholder to enforce it according to its terms.[52] In addition, this rule does not seem to be in the spirit of section 385 which stated that the Treasury was to develop factors to be taken into account in drafting regulations.[53]

C. Change in Terms of the Instrument

Treasury Regulation section 1.385-6(j)(1) states that if a holder of a debt instrument agrees to postpone the maturity date or otherwise to make a substantial change[54] in the terms of the instrument, the instrument is treated as newly issued in exchange for property on the day of agreement. This provision may adversely affect small, closely held corporations.

Occasionally, shareholders in closely held corporations subordinate their claims to obtain additional financing.[55] Unless a shareholder can show that an independent creditor would have agreed to subordinate his claim, however, the debt instruments will be reclassified as stock.[56] A problem with this approach is that it

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Id. § 1.385-3(a) (Supp. 1981).

50. *See* note 45 *supra* and accompanying text.

51. Treas. Reg. § 1.385-4(b)(1) (Supp. 1981). Status is not affected by a mere change in ownership. *Id.*

52. Fin Hay Realty Co. v. United States, 398 F.2d 694, 702 (3d Cir. 1968) (Van Dusen, J., dissenting) (transferability is an argument for allowing debt status); United States v. Haskel Eng'r & Supply Co., 380 F.2d 786, 788 (9th Cir. 1967) (transferability could terminate proportionate holdings); Tomlinson v. 1661 Corp., 377 F.2d 291, 297 (5th Cir. 1967) (right of free transferability substantially dispels element of proportional control).

53. *See* notes 4-8 *supra* and accompanying text.

54. "[E]ach change in the terms of an instrument is substantial if the fair market value of the instrument could be materially affected by that change." Treas. Reg. § 1.385-6(j)(2) (Supp. 1981).

55. NYSBA REPORT, *supra* note 14, at B-45.

56. Treas. Reg. § 1.385-6(j)(4), Example (3) (Supp. 1981). Critics of this rule can find some solace in that the regulations would have automatically reclassified the instrument

will not always be easy to find an independent creditor who would have agreed to subordinate had he held the note.[57]

If a substantial change in terms is made in an instrument, it will be reclassified as stock.[58] However, two individual changes will be substantial "even if the two changes are mutually offsetting in the sense that, taken together, they have no material effect on the fair market value of the note."[59] This conclusion seems contrary to the definition of a substantial change because the fair market value of the instrument will not be affected if the two changes are mutually offsetting. Parties should be entitled to make arms-length modifications such as postponing maturity in consideration of an increase in the interest rate without having to fear reclassification.[60]

Although not explicity stated in the regulations, it may be assumed that reclassification can be avoided if an independent creditor would have agreed to the mutually offsetting changes. If this is not the case, then the regulations do not promote arms-length dealings between a debtor and a creditor — one of the intentions of the regulations. An inquiry as to what an independent creditor would have done in this situation seems unnecessary here because the fair market value would not be affected by the two mutually offsetting changes. Only when the overall change could materially affect the fair market value should the change be termed substantial.[61]

D. Failure to Pay Interest and Principal When Due

If a corporation fails to pay all or part of the interest due and payable on an instrument during a taxable year and the owner fails to pursue available remedies with the ordinary diligence of an in-

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upon an agreement to subordinate. *Id.* § 1.385-7(b) (Supp. 1981).

57. Another problem not considered by the Treasury is the condition of the nation's economy at the time of a change in terms. During periods of prosperity, a business might find it easier to locate an independent creditor who would agree to a change in terms than during a recession where creditors are usually much more cautious in making loans.

58. *See* note 54 *supra* and accompanying text.

59. Treas. Reg. § 1.385-6(j)(4), Example (2) (Supp. 1981).

60. NYSBA Report, *supra* note 14, at B-46.

61. Even though the regulations apply only to instruments issued after April 30, 1981, it seems that if an instrument issued before the effective date had a substantial change in terms, the instrument could then be covered by the regulations. This is because under the regulations, the old instrument is treated as newly issued in exchange for property on the day of agreement. Treas. Reg. § 1.385-6(j)(1)(iii) (Supp. 1981).

dependent creditor, then the instrument will be reclassified as stock.[62] This rule places an administrative burden on shareholders who own the indebtedness of small corporations. The shareholders will be responsible for showing that interest was paid within ninety days, either in money or with property other than money.[63] If the interest was not paid, the shareholders must show that they pursued available remedies with the ordinary diligence of an independent creditor.

Prior to the drafting of the regulations, it was not uncommon to see debt instruments of closely held corporations bearing little or no interest at all.[64] This was because the shareholder's tax bracket and financial position made interest income unattractive to him.[65] Another consideration in the decision whether or not to pay interest was whether the payment of interest would deprive the corporation of needed funds or decelerate the tax free payment of the principal of the purported debt.[66] Often an interest-free arrangement would be used in years where the interest obligation would be more than the corporation could conveniently meet.[67] If more than fifty percent of the stock was held by creditors who were members of one family unit or partnership, the deduction for the accrued but unpaid interest might have been lost to the corporation without relieving the shareholders of the tax thereon when payment finally occurred.[68]

The Treasury seems justified in seeking to ensure the payment of interest on instruments. Case law indicates that the failure to make interest payments, the sporadic payments of interest when earnings are available, or the payment of interest with funds supplied by the purported creditor himself, are regarded as evidence that the purported creditor was more concerned with increasing

62. The instrument will be reclassified at the later of the first day of the taxable year during which the failure to pay occurs or the first day on which this section applied to the instrument. *Id.* § 1.385-6(k)(1)(iii) (Supp. 1981).

63. *Id.* § 1.385-6(k)(3) (Supp. 1981). A drawback to the payment of interest with property other than money is that the recipient of the property is taxed immediately upon receipt even though the recipient did not receive cash.

64. *Corporate Debt, supra* note 2, at 433.

65. *Id.* at 432.

66. *Id.* at 432-33.

67. *Id.* at 433 n.349.

68. *Id.*

the earnings and market value of his stock by means of his advances than in earning a return on a fixed obligation.[69]

While the Treasury seems correct in seeking to ensure the payment of interest, if a closely held corporation has no independent creditors, it will be unable to show that its shareholders acted as an independent creditor would have acted. A closely held corporation will not ordinarily do business with an independent creditor therefore making it difficult to use an independent creditor as a reference for its behavior.[70] In addition, if a corporation has no independent creditors, its shareholder/creditors could be discouraged from aiding their distressed companies. The reason for this is that few investors would be willing to lend money to a financially distressed company knowing that interest would be paid at a later date because these investors would be concerned that their debt might be reclassified as stock.[71]

E. Unwritten Obligations

Treasury Regulation section 1.385-7 provides that unless the debt to equity ratio of the borrowing corporation is not greater than 1:1 at the end of the taxable year in which the loan is made and interest is paid at a reasonable rate while the obligation is outstanding, the unwritten obligation will be reclassified as a contribution to capital.[72] The Treasury is therefore, requiring virtual au-

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69. Dillin v. United States, 433 F.2d 1097, 1102 (5th Cir. 1970); Tyler v. Tomlinson, 414 F.2d 844, 849 (5th Cir. 1969); Curry v. United States, 396 F.2d 630, 634 (5th Cir.), *cert. denied*, 393 U.S. 967 (1968); Jewell Ridge Coal Corp. v. Commissioner, 318 F.2d 695, 699 (4th Cir. 1963).

70. The regulations state that a shareholder is to act as an independent creditor would have acted. Treas. Reg. § 1.385-6(k)(1)(iii) (Supp. 1981). Also, the independent creditor must be one with whom the corporation does business, *id.* § 1.385-6(e)(4) (Supp. 1981), and 45 Fed. Reg. 86,441 (1980). Thus, if the corporation has no independent creditors, it will be unable to establish that it acted as an independent creditor would have acted.

71. M. Ivy & R. Willens, *Proposed Section 385 Regs. Bring Order From Chaos*, CPA J. 14 (Oct. 1980). This provision is not clear regarding its application to instruments issued at a discount. NYSBA REPORT, *supra* note 14, at B-49. The discount is not due and payable until maturity and there is no requirement to pay the discount even though it accrues currently for income tax purposes. Instead of referring to interest which has accrued during the taxable year, the regulations should refer to a failure to pay interest which is due and payable. *Id.* The same result may be accomplished indirectly because an independent creditor could not sue to collect the discount until it was payable at the maturity of the debt. *Id.*

72. A corporation's capital is the amount of money or property used to finance the corporation (excluding debt). It is composed of capital stock issued in exchange for money or property and contributions by shareholders and non-shareholders. W. HOFFMAN, *supra* note

tomatic classification of unwritten obligations.[73] This approach, however, is not supported by case law.[74] These obligations have been held to be bona fide debts deductible by the taxpayer for income tax purposes and not capital contributions.[75] Flexibility is permitted because formal written instruments are believed to be unnecessary to ensure repayment.[76] Noninterest bearing unwritten obligations resulting from mutual trading are a commercial commonplace.[77] "Formal indicia of indebtedness are merely clues to, but are not indisputable proof of, the ultimate fact."[78]

In view of the fact that such loans are common in commercial practice, the exception to the rule noted above seems narrow. As long as interest is being paid at a reasonable rate, either with money or property other than money,[79] the obligation should be treated as indebtedness. Otherwise, the means suggested would be a harsh way of promoting arms-length relationships between shareholder/creditors and corporations.

If an unwritten obligation is treated as a capital contribution, then all repayments of principal and interest will be treated as distributions.[80] Although it was suggested that principal repayments should be treated as redemptions and tested for dividend equivalence,[81] the Treasury has elected to do otherwise. Due to the severe tax consequences of reclassifying a loan as a capital contribution, it was also suggested, although later rejected by the Treasury, that a shareholder be permitted to correct whatever defect which led to his obligation being reclassified within a specified amount of time.[82] It is questionable whether Congress intended the Treasury to draft such a harsh regulation.

15, at 98. A contribution to capital made by a shareholder represents an additional price paid for the shares held by the shareholder. Treas. Reg. § 1.118-1 (Supp. 1981).

73. NYSBA REPORT, *supra* note 14, at B-58.

74. *In re* Breit, 460 F. Supp. 873, 877 (E.D. Va. 1978); American Processing and Sales Co. v. United States, 371 F.2d 842, 856 (Ct. Cl. 1967).

75. American Processing and Sales Co. v. United States, 371 F.2d at 857.

76. *Id.*

77. *Id.*

78. *Id.*

79. Treas. Reg. § 1.385-7(c)(2) (Supp. 1981).

80. *Id.* § 1.385-7(d)(1) (Supp. 1981). Section 385 would apply to any of these distributions.

81. NYSBA REPORT, *supra* note 14, at B-60.

82. *Problems for Small Corporation, supra* note 2, at 200.

F. Reclassifying Preferred Stock as Debt

Treasury Regulation section 1.385-10(a) provides for fixed payments in the nature of principal or interest.[83] In such a case, the preferred stock could be treated as an instrument.[84] Several problems arise as a result of this subsection, particularly for utilities. Many preferred stocks which have provided for fixed dividends or have contained mandatory redemption provisions have been treated by the Treasury as stock.[85]

It seems inequitable to treat preferred stock as indebtedness if it provides for fixed payments of interest *or* principal, when the usual test for indebtedness is for the unconditional payment of interest *and* return principal.[86] Another factor to consider is that the claim of a holder of preferred stock is subordinate to all of the creditors

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83. Treas. Reg. § 1.385-10(a) (Supp. 1981).

84. *Id.* § 1.385-10(b) (Supp. 1981). The Regulation provides:

> Notwithstanding paragraph (a) of this section, preferred stock is treated as stock (and not as an instrument) if it satisfies each of the following conditions:
>
> (1) The preferred stock is denominated preferred stock and is treated as preferred stock under applicable nontax law.
>
> (2) The excess (if any) of the preferred stock's redemption price over its issue price is a reasonable redemption premium under § 1.385-5.
>
> (3) Current dividends on the preferred stock are contingent (*e.g.*, payable only out of earned surplus or only at the board of directors' discretion).
>
> (4) The right to receive dividend payments and payments in redemption of the preferred stock may not be enforced under applicable nontax law if either (i) the issuing corporation is insolvent or would be rendered insolvent by such payments or (ii) the making of such payments would impair the issuing corporation's capital (*i.e.*, the fair market value of the remaining assets of the issuing corporation would be less than the sum of its liabilities and the liquidation value of its other classes of preferred stock that are senior or equal in rank).
>
> (5) Default in the making of a dividend payment or a payment in redemption of the preferred stock does not entitle the holder to accelerate redemption payments.
>
> (6) The preferred stock has a term (during which the holder cannot compel redemption) of at least 10 years. In the case of an issue of preferred stock which provides for redemption over a period of years, the term shall be the weighted average life of the issue.

Id. § 1.385-10(b)(1)-(6) (Supp. 1981).

85. Rev. Rul. 78-142, 1978-1 C.B. 111. Although noble, the Treasury's effort seems unnecessary because there is no real controversy in this area. NYSBA REPORT, *supra* note 14, at B-74. Regarding utilities, the use of redemptions through the establishment of a sinking fund is very common. Even though issues such as these will be unaffected by the regulations because of their effective date, it seems unlikely that Congress could have intended such a drastic change in the law. *Id.*

86. Treas. Reg. § 1.385-10(a) (Supp. 1981).

of the issuing corporation.[87] It appears that subordination is not a factor to consider in determining whether an instrument is debt or stock. By eliminating this factor, the Treasury is rejecting the long-standing rule that shareholders do not have the right to share with general creditors in the assets in the event of dissolution or liquidation.[88]

Dividends may not be paid if such payment would impair the rights of any creditor.[89] Therefore, because every mandatory redemption provision is subject to the condition that funds legally available for repurchase exist at the time of redemption,[90] there is no unconditional obligation to pay dividends or make redemptions.

Preferred stock, it should be noted is reclassified as an instrument, not as debt.[91] The status of the instrument is then tested under the other sections of the regulations. If it is considered to be hybrid[92] and is issued proportionately to shareholders, it would automatically be reclassified as preferred stock.[93] Again, it appears that the Treasury has drafted another section which was not intended by Congress. In particular, this section provides for reclassification where the parties clearly intended the security to be preferred stock. It is doubtful that Congress ever intended such a result.

G. Effect of Reclassification on Subchapter S Corporations

At present, the Treasury has reserved any rule-making concerning the application of the regulations on Subchapter S corpora-

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87. NYSBA REPORT, *supra* note 14, at B-75.

88. P.M. Finance Corp. v. Commissioner, 302 F.2d 786, 789-90 (3d Cir. 1962) (a stockholder's right is subordinate to a creditor's right to share in the assets in the event of dissolution or liquidation); John Wanamaker Philadelphia v. Commissioner, 139 F.2d 644, 647 (3d Cir. 1943); Burton v. Bowers, 79 F. Supp. 418, 420 (E.D. S.C. 1948).

89. NYSBA REPORT, *supra* note 14, at B-78 to B-79.

90. *Id.* Another problem to consider if the preferred stock is treated as debt is that it will likely produce original issue discount. This result is due to preferred stock yields being traditionally less than similar debt instruments because of the corporate dividend exclusion which subjects only 15% of the dividend received to corporate income tax. I.R.C. § 243(a). The maximum corporate tax rate is 46%. I.R.C. 11(b)(5). Thus, the maximum tax which a corporation will pay for dividends received is 6.9% (15% x 46%).

91. Treas. Reg. § 1.385-10(a) (Supp. 1981).

92. *Id.* § 1.385-5(a) (Supp. 1981).

93. *Id.* § 1.385-6(c) (Supp. 1981).

tions.[94] In this instance, the Treasury's approach is proper because if the regulations were to apply to Subchapter S corporations in the regulations' present form, many of these corporations would lose the favorable tax treatment of an exemption from income taxes.[95]

In order to qualify for such favorable treatment, the corporation can only have one class of stock.[96] If the regulations were to apply, as currently drafted, then any debt reclassified would be treated as preferred stock which would terminate the corporation's Subchapter S status.[97] The Treasury's use of the earlier version of Treasury Regulation section 1.1371-1(g), which would reclassify debt obligations as contributions to capital rather than as a second class of stock in order to preserve Subchapter S status appears preferable.[98] Due to the large number of cases dealing with the issue of debt being a second class of stock,[99] Congress enacted the original version Treasury Regulation section 1.1371-1(g). It is

94. *Id.* § 1.1371-1(h) (Supp. 1981).

95. I.R.C. § 1372(b); 45 Fed. Reg. 86,444 (1980).

96. I.R.C. § 1371(a). The other requirements include: maximum of 15 shareholders, the shareholder must be a person who is an individual and the shareholder must not be a nonresident alien. *Id.* § 1371(a)(1)-(3).

97. Treas. Reg. § 1.385-4(b)(2)(c) (Supp. 1981), states that if an instrument is treated as stock, it will be treated as preferred stock for all purposes of the Code. This preferred stock would be a second class of stock which would terminate the corporation's Subchapter S status.

98. Prior to T.D. 7747, the last three sentences read as follows:

> Obligations which purport to represent debt but which actually represent equity capital will generally constitute a second class of stock. However, if such purported debt obligations are owned solely by the owners of the nominal stock of the corporation in substantially the same proportion as they own such nominal stock, such purported debt obligations will be treated as contributions to capital rather than a second class of stock. But, if an issuance, redemption, sale, or other transfer of nominal stock, or of purported debt obligations which actually represent equity capital, results in a change in . . . purported debt, a new determination shall be made as to whether the corporation has more than one class of stock as of the time of such change.

Treas. Reg. § 1.1371-1(g) (Supp. 1981). After T.D. 7747, these sentences have been deleted from Treas. Reg. § 1.1371-1(g) (Supp. 1981).

99. *See, e.g.*, Shores Realty Co. v. United States, 468 F.2d 572 (5th Cir. 1972); Kaplan v. Commissioner, 59 T.C. 178 (1972); Stinnett v. Commissioner, 54 T.C. 221 (1970); Novell v. Commissioner, 28 T.C.M. (CCH) 1307 (1969); Raynor v. Commissioner, 50 T.C. 762 (1968); Hollenbeck v. Commissioner, 50 T.C. 740 (1968), *aff'd*, 422 F.2d 2 (9th Cir. 1970); Hoffman v. Commissioner, 47 T.C. 218 (1966), *aff'd*, 391 F.2d 930 (5th Cir. 1968); Gamman v. Commissioner, 46 T.C. 1 (1966).

hoped that section 1.1371-1(h) will be drafted with this problem in mind.

IV. Hybrid Instruments

Hybrid instruments are convertible into stock or provide a payment which is not fixed.[100] Although the hybrid instrument may look like preferred stock to creditors, the issuer hopes it will be treated as debt for tax purposes.[101] The thrust of this subsection of the regulations is determining the fair value of a convertible instrument both with and without its equity features.[102]

The fair market value of an instrument[103] is the price a willing buyer would pay a willing seller and is determined by using present value and standard bond tables.[104] The figure which is to be compared with the price paid is the hypothetical value of a similar instrument of the same issuer (or similar issuers) simultaneously issued under comparable circumstances and possessing only the defined debt characteristics of the instrument in question.[105] This hypothetical amount is then subtracted from the price paid for the instrument with the difference being the instrument's equity characteristics.[106] If the fair market value of the equity characteristics is greater than fifty percent of the fair market value of the instrument with those features, the instrument will be treated as stock because the equity characteristics predominate.[107]

This approach has been criticized because of the difficulty in applying the standard with certainty even to publicly marketed instruments.[108] The difficulty arises from the inability to obtain timely and accurate information concerning the terms of the securities of similar borrowers when an established market is not

100. Treas. Reg. § 1.385-5(a), (b), (d) (Supp. 1981).

101. *Corporate Debt, supra* note 2, at 405.

102. Treas. Reg. § 1.385-5(e) (Supp. 1981), provides many examples of the Treasury's intent to eliminate much of the uncertainty in this area.

103. *Id.* § 1.385-5(a) (Supp. 1981).

104. *Id.* § 1.385-3(b) (Supp. 1981).

105. NYSBA REPORT, *supra* note 14, at B-26 to B-27.

106. Treas. Reg. § 1.385-5(a), (b) (Supp. 1981).

107. *Id.* § 1.385-5(a) (Supp. 1981). If the holder and issuer, in good faith, reasonably believed that the 50% test was satisfied, the instrument will be treated as debt provided the fair market value without the equity features is at least 45% of the fair market value with those features. *Id.* § 1.385-5(c) (Supp. 1981).

108. NYSBA REPORT, *supra* note 14, at B-24.

present.[109]

This section could also create difficulties for Subchapter S corporations if special rules are not promulgated. If a Subchapter S corporation issues a debenture convertible into the same class of stock as held by the shareholder, it would create a hybrid instrument.[110] If, as is often the case, the hybrid instrument is issued solely to the shareholders, it would immediately be converted into preferred stock.[111] Thus, as presently drafted, the regulations prevent Subchapter S corporations from issuing hybrid securities.

Unfortunately, the hybrid instrument section of the regulations is another example of the Treasury's failure to achieve certainty. In order to value a hybrid instrument, the sophisticated appraisal required will force small, closely held corporations to consult investment bankers.[112] It seems unfair that small corporations will be forced to incur the added cost of an investment banker's services in order to offer debt holders the opportunity to share in the corporation's growth while also receiving a fixed rate of return.

V. Guaranteed Loans

Section 1.385-9(a) of the regulations, requires that a loan made to a corporation and guaranteed by a shareholder be treated as if the loan were made to the shareholder and the shareholder contributed the proceeds to the corporation's capital, if at the time of the guarantee it is not reasonable to expect that the loan can be enforced against the corporation according to its terms. If enforcement is unlikely, payments of interest and principal by the corporation to the creditor will be treated as a distribution to the share-

109. The valuation problem is further complicated when one considers that preferred stock may have a maturity or retirement date coupled with an unconditional right to dividends. Gloucester Ice & Cold Storage Co. v. Commissioner, 19 T.C.M.(CCH) 1015, 1021 (1960), *rev'd on other grounds*, 298 F.2d 183 (1st Cir. 1962) (debenture bonds could be exchanged for preferred stock with same terms as bonds); Crown Iron Works Co. v. Commissioner, 15 T.C.M.(CCH) 1046, 1046-47 (1956), *aff'd*, 245 F.2d 357 (8th Cir. 1957) (preferred stock had a maturity date); Charles L. Huisking & Co. v. Commissioner, 4 T.C. 595, 599 (1945) (not unusual for preferred stock to have a fixed maturity date).

110. Treas. Reg. § 1.385-3(e) (Supp. 1981).

111. *Id.* § 1.385-6(c) (Supp. 1981).

112. Investment bankers will be needed because these instruments will be compared with instruments which previously had never been marketed. Most likely, only investment bankers would have the knowledge needed to design a hybrid instrument whose equity features are less than 50% of the fair value of an instrument without those features.

holder guarantor and the interest deduction would belong to the shareholder.[113] Should the corporation default, the shareholder then must honor the obligation.[114]

There are several reasons why guaranteed loans are common. "The funds shareholders might have advanced [to the corporation] could be retained in other investments, perhaps pledged to the bank but still earning individual income comparable to the interest the shareholders would have derived from loans to the corporation."[115] Meanwhile, the corporation's deduction for the interest paid to the bank can not easily be challenged as being improper because the corporation's need to repay the bank debt would justify the accumulation of earnings.[116] Those earnings could then be drawn off to the bank with less fear that the payment of debt would be reclassified as a dividend taxable to shareholders.[117]

The Treasury's approach here seems inconsistent with the rest of the regulations in that it requires automatic classification instead of objectively analyzing the transfer to determine whether it is debt or equity.[118] Thus, regardless of the guarantee, it is suggested that the instrument be treated as debt provided it would have been treated as debt in the absence of such a guarantee. In other words, the Treasury should treat the transfer as a back-to-back loan.[119] Should a financial weakness in the corporation be detected, then original issue discount should be created pursuant to regulation section 1.385-3(a).

There is a significant difference in tax results under the Treasury's approach and the suggested back-to-back loan approach. Under the suggested approach, the corporation would deduct all interest payments to the shareholder/guarantor, who would have offsetting interest income and deductions. In addition, the shareholder/guarantor would receive original issue discount income

113. *Redrawing Debt and Equity Lines*, *supra* note 11, at 941.

114. This section does not apply to federally guaranteed loans, only to shareholder guaranteed loans.

115. *Corporate Debt*, *supra* note 2, at 482.

116. *Id.*

117. *Id.* at 483. If the business were to fail, the payments by the shareholder/guarantor to the bank would be more likely to result in bad debt deductions than if the shareholders held corporate notes directly. *Id.*

118. NYSBA REPORT, *supra* note 14, at B-64.

119. *Id.*

which would be deductible by the corporation if the valuation of the instrument produced original issue discount. If the corporation defaulted, the shareholder would be able to claim a bad debt or worthless security loss deduction on the obligation.[120] The Supreme Court implicitly supported this suggestion when it stated "[t]here is no real or economic difference between the loss of an investment made in the form of a direct loan to a corporation and one made indirectly in the form of a guaranteed bank loan. The tax consequences should in all reason be the same."[121]

V. Conclusion

The new regulations were intended to aid in the determination of whether an interest in a corporation was debt or equity: to provide certainty in an area which for years had been plagued by uncertainty. The regulations, unfortunately, have failed to accomplish what the Treasury was directed to do. As written, the regulations provide harsh consequences for small, closely held corporations. The results are disappointing, especially at a time when business investment should be encouraged.

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120. Treas. Reg. § 1.166-3(b) (Supp. 1981).

121. Putnam v. Commissioner, 352 U.S. 82, 92-93 (1956). *See also* United States v. Hoffman, 423 F.2d 1217, 1218 (9th Cir. 1970); Nelson v. Commissioner, 281 F.2d 1, 4 (5th Cir. 1960); Ferguson v. Commissioner, 253 F.2d 403, 407 (4th Cir. 1958).

Under the Treasury's approach no deduction would be allowed because interest payments by the corporation are treated as nondeductible dividends to the shareholder. Treas. Reg. § 1.385-9(a) (Supp. 1981). It is likely that the shareholder has dividend income equal to the full amount of principal payments. Thus, no one would receive an interest deduction. NYSBA REPORT, *supra* note 14, at B-66.

Should the corporation default, the shareholder would be unable to claim a bad debt or worthless loss deduction. *Problems for Small Corporations, supra* note 2, at 200. The rule on shareholder loan guarantees could restrict commercial financing of small, closely held corporations. It is not unusual for a lender to require the stockholders of a small business to guarantee a loan, particularly in the real estate construction industry. Frequently, loans here are guaranteed by the shareholders because if there is a failure to complete construction, the incomplete project may not be adequate security for a loan. NYSBA REPORT, *supra* note 14, at B-67. When the project is completed, the construction loan is usually replaced by a permanent mortgage and no further guarantee is required. *Id.* If a reasonable expectation requiring the corporation to be able to pay the construction debt in full, by itself, even if it fails to complete the project, then the shareholder/guarantor will frequently be deemed to be the real borrower on the loan. Thus, the shareholder would receive the harsh tax consequences discussed above. As a result, lenders may be unwilling to finance projects because this rule could make shareholders unwilling to give such guarantees. *Id.* at B-68.