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Multifactor Scorecard Analysis Helps With Debt-Versus-Equity Problem

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Editor's note: A divorce case from last year illustrated how the debt-versus-equity issue can skew a valuation [Freihage v. Freihage, *2015 Ill. App. Unpub. LEXIS 14 (see the April 2015 issue of* Business Valuation Update*)]. In this article, the author presents a scorecard analysis based on the* Mixon *case and others that analysts can use to help make a determination of whether money transferred to a company represents debt or equity.*

When valuing a closely held business, it is common to have debt on the financial statements. When questioning the debt, it often becomes apparent that the owners of the business have not adequately documented the debt. When that happens, the question becomes: Is it debt or is it equity? This can become problematic in litigation cases where the adjusted book value is used or goodwill is being determined from a base using the net asset value of the company.

If there is no supporting evidence or there is a disagreement as to how the "debt" should be classified, the valuation analyst will have to make an informed opinion as to the character of the liability. The courts have developed guidelines for determining the debt-versus-equity question in a number of cases.[1]

In the *Mixon* case, the court performed a detailed analysis and provided very insightful information that the valuation analyst can use in determining the debt-versus-equity issue. This particular case stressed at least 13 factors that merit consideration in determining this issue:

1. The name given to the certificate;
2. The presence or absence of a fixed maturity date;
3. The source of payments;
4. Right to enforce payment of principal and interest;
5. Participation increase in management;
6. Subordination;
7. Intent of the parties;
8. Thin or adequate capitalization;

1 This issue has often been considered by the 5th Circuit. *Berkowitz v. United States,* 5th Cir. 1969, 411 F.2d 818; *Curry v. United States,* 5th Cir. 1968, 396 F.2d 630, cert. denied, 393 U.S. 967, 89 S.Ct. 401, 21 L.Ed.2d 375; *Harlan v. United States,* 5th Cir. 1969, 409 F.2d 904; *Tomlinson v. The 1661 Corporation,* 5th Cir. 1967, 377 F.2d 291; *United States v. Snyder Brothers Company,* 5th Cir. 1966, 367 F.2d 980, cert. denied, 386 U.S. 956, 87 S.Ct. 1021, 18 L.Ed.2d 104; *Aronov Construction Company v. United States,* M.D.Ala.1963, 223 F.Supp. 175, aff'd, 5th Cir. 1964, 338 F.2d 337; *Montclair, Incorporated v. Commissioner of Internal Revenue,* 5th Cir. 1963, 318 F.2d 38; *Campbell v. Carter Foundation Production Company,* 5th Cir. 1963, 322 F.2d 827; *Rowan v. United States,* 5th Cir. 1955, 219 F.2d 51, *Estate of Mixon v. United States,* 5th Cir, 1972, 464 F2d 394.

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9. Identity of interest between creditor and stockholder;
10. Payment of interest only out of dividend income;
11. Ability to obtain loans from outside lending institutions;
12. The extent to which the advance was used to acquire capital assets; and
13. The failure of the corporation to repay on the due date.

These factors are presented in scorecard form in Exhibit 1 and are explained below, based on the appellate court opinion in the *Mixon* case, which involved funds advanced to a bank.

Name or type of certificate. The thrust of this factor is that the court looked to the type of certificate the parties used in considering the debt-versus-equity question. The issuance of a stock certificate indicates an equity contribution; the issuance of a bond, debenture, or note is indicative of a bona fide indebtedness. The district court found that the advance was not evidenced by any formal, unconditional promise to pay. Although the complete absence of any specific evidence of indebtedness might on first blush appear to reveal little about the quality of the transaction, the real issue for tax purposes has long been held to be the extent to which the transaction complies with arm's-length standards and normal business practice.[2]

Focusing on this as a factor, a payment to the corporation by a shareholder-director without provision for terms of repayment, interest, and consideration would undoubtedly indicate that the advances were equity bound and intended. In this case, the only conclusion discernible from the record is that the deposit was placed in a unique temporary account, and no one knew exactly what it was in an accounting sense or what to call it.

2 *Nassau Lens Company v. Commissioner,* 2d Cir. 1962, 308 F.2d 39.

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	Exhibit 1. Analysis of Debt Versus Equity		
		Indicator	
	Factor	Debt	Equity
1	The names given to the certificates that evidence indebtedness	x	
2	The presence of a fixed maturity date	x	
3	The source of payments	x	
4	The right to enforce payment of principal and interest	x	
5	Participation in management flowing as a result	x	
6	The status of the contribution in relation to regular corporate creditors	x	
7	The intent of the parties		x
8	Thin or adequate capitalization		x
9	Identifying interest between creditor and stockholder		x
10	Source of interest payments		x
11	The ability of the business to obtain credit from outside lending institutions		x
12	The extent to which the advance was used to acquire capital assets		x
13	The failure to repay on the due date or to seek a postponement		x
	Total factors	6	7
	Percentage of factors	46.20%	53.80%
	Indication of Debt or Equity		Equity

The client may instruct the accountant as to where the debt or equity needs to be placed on the balance sheet. However, when the liabilities are being adjusted to fair market value, a more in-depth analysis of the debt versus equity should be performed. It may become a matter of professional judgment as to how to classify the debt versus equity.

The presence or absence of a fixed maturity date. The presence of a fixed maturity date indicates a fixed obligation to repay, which is a characteristic of a debt obligation. On the other hand, the absence of a fixed maturity date indicates that repayment is in some way tied to the fortunes of the business, which is indicative of an equity advance. In this case, there was no fixed date of repayment expressly provided, but it was beside the point. There was uncontradicted "evidence that all concerned anticipated repayment within two years and the fact that the contributors were limited in their actions by the emergency situation existing at the time of the advance and the coercive influence of the banking authorities."[3]

The valuation analyst must have a firm understanding of any terms and repayment of any and all obligations of the company.

The source of payments. The court did not directly consider this factor, but the significance of it is that, if repayment is possible only out of corporate earnings, the transaction has the appearance of a contribution of equity capital. But if repayment is not dependent upon earnings, the transaction reflects a loan to the corporation.[4]

In this case, repayment was tied to strengthening the bank's capital account through improvement in its surplus accounts. Repayment could only be made from the surplus accounts, and, when the advances were repaid, the balance sheet indicated a decrease in the capital section of the balance sheet. These facts would appear to support an equity characterization of the transaction. "The court, however, finds otherwise here. Unlike most other cases, even those in which a debtor-creditor relationship has been found, the source of repayment in the instant case was without question not earnings or profits. It cannot be seriously disputed that the source of the repayment to taxpayer was the cash generated by the collection of the bond claim and collection of the charged-off loans. These collections had no effect on the bank's earnings. The [defendant] government's reliance on mere labels

3 *Estate of Mixon v. United States,* 5th Cir, 1972, 464 F2d 394.

4 This factor is somewhat anomalous in view of the fact that the majority of bona fide loans are likewise repaid out of earnings.

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in contending that the source of repayment was an increase in the capital accounts, which normally results from an earnings increase, is not persuasive where, as here, the source of the capital increase was without doubt something other than earnings."[5]

Right to enforce payment of principal and interest. The court noted that, if there is a definite obligation to repay the advance, the transaction would take on some "indicia of a loan."[6] In the case, the government contended that repayment was solely within the "unfettered discretion of state and federal banking authorities" and that the directors would have had no recourse against the bank in the event of default.

But the court disagreed, noting that, although repayment was dependent on collection of the bond claim and the charged-off loans, it was not dependent on the "success of the business" as that phrase is ordinarily used. "Repayment was conditioned on reasonably foreseeable events, which could almost be characterized as events certain. The only real uncertainty in the collection was a matter of 'when' rather than 'whether.' In this case, there was nothing to contradict that 'all parties involved did not consider the advance as providing permanent capital financing, which is ordinarily derived from equity advances, but rather temporary working capital to meet what was thought to be, and what proved to be, a temporary emergency. Once the determinable conditions were met, the court had little doubt that the bank was legally obligated under general principles of creditors' rights to return the funds.'"[7]

Participation increase in management. In the *Mixon* case, the contributors were not granted any increased voting power or participation in the bank's affairs by virtue of the advance. This fact served as cumulative evidence that the advances were loans, rather than a contribution of equity.

Subordination. In any determination of whether a party is dealing as a shareholder or a creditor, it is important to determine whether the advance has a status equal to or inferior to that of regular corporate creditors.[8] "The fact that an obligation to repay principal is subordinate to claims of other creditors does not, however, necessarily indicate that the purported debt is in reality an equity contribution, especially where the advance is given a superior status to that of other equity contributions."[9]

In the *Mixon* case, it was not clear where the advance stood on the preference scale. In some cases, there will be a provision for express subordination, but there was no such provision in this case.

Intent of the parties. The court noted that the parties' intent to create either a debt or equity relationship is, "in a sense, the ultimate issue to be determined here." However, the government failed to distinguish between subjective and objective intent, the court said.

It noted the case of *United States v. Snyder Brothers Company,* which quoted language from *Kraft Foods Company v. Commissioner of Internal Revenue,* 2d Cir.1956, 232 F.2d 118:

> We think the problem is not one of ascertaining "intent," since the parties have objectively manifested their intent. It is a problem of whether the intent and acts of these parties should be disregarded in characterizing the transaction for federal tax purposes (367 F.2d at 982-983).

5 *Estate of Mixon,* op. cit.

6 *Campbell v. Carter Foundation Production Company,* 5th Cir.1963, 322 F.2d 827.

7 See *Clark v. Boston-Continental National Bank,* D. Mass. 1936, 9 F.Supp. 81; *Binns v. First National Bank,* 367 Pa. 359, 80 A.2d 768 (1951); *State ex rel. Gordon v. Trimble,* 318 Mo. 341, 300 S.W. 475 (1927).

8 See *Tomlinson v. The 1661 Corporation,* 5th Cir. 1967, 377 F.2d 291; *United States v. Henderson,* 5th Cir. 1967, 375 F.2d 36; *United States v. Snyder Brothers Company,* 5th Cir. 1966, 367 F.2d 980; *Montclair, Incorporated v. Commissioner,* supra; *Rowan v. United States,* supra; Bittker and Eustice, *Federal Income Taxation of Corporations & Shareholders* 123 (2nd ed.).

9 *Harlan v. United States,* supra; *Tomlinson v. The 1661 Corporation,* supra.

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The *Mixon* court goes on to state: "This stands only for the principle, well-recognized in all areas of the law, that a subjective intent on the part of an actor will not alter the relationship or duties created by an otherwise objectively indicated intent. See *Dillin v. United States,* 5th Cir.1970, 433 F.2d 1097-1100. Judge Goldberg states the proposition thusly: 'Tax law requires that creditorship have genuine existentiality. (citation omitted) This requires more than a declaration of intention to create an indebtedness and more than the existence of corporate paper encrusted with the appropriate nomenclature captions.' *Tyler v. Tomlinson,* supra, 414 F.2d at 850."

The court also pointed out that this is in no way contrary to the proposition that, in cases in which the objective facts of the case are ambiguous as to objective intent, then subjective intent is relevant on the issue. Judge Goldberg, in *Tyler v. Tomlinson,* supra, pointed out: "If appellants mean to say that a mere showing of an intent to create an indebtedness and the existence of something called 'notes' is sufficient to take their case to the jury, we must disagree. If that were true, every debt-equity case would require a jury verdict no matter how transparent the attempt at tax avoidance. We therefore look not to mere labels or to the self-serving declarations of the parties, but to the more reliable criteria of the circumstances surrounding the transaction. If none of these circumstances are in dispute, there is no jury question. As this court recently observed: 'It is not the jury's function to determine whether the undisputed operative facts add up to debt or equity. This is question of law.' 414 F.2d 850"

The *Mixon* court concluded: "Within the confines of this case, wherein the objective signs point in all directions, there is no doubt that the district court was correct in looking to the subjective intent of the parties to ascertain the correct direction to follow." Both sides in the case agreed that the directors subjectively intended the advances to be loans.

Thin or adequate capitalization. Thin capitalization is "very strong evidence of a capital contribution where (1) the debt to equity ratio was initially high, (2) the parties realized the likelihood that it would go higher, and (3) substantial portions of these funds were used for the purchase of capital assets and for meeting expenses needed to commence operations." The subject firm fell into this category.

Identity of interest between creditor and stockholder. The court noted that advances made by stockholders in proportion to their respective stock ownership are indicative of an equity capital contribution. On the other hand, a sharply disproportionate ratio between a stockholder's percentage interest in stock and debt strongly indicates a bona fide debt. In this case, the funds advanced were not in proportion to the directors' risk capital.

Payment of interest only out of dividend income. There was no provision for the payment of interest on the advance, and the government argued that this fact alone militates strongly against a finding that the advance was a loan. "It is true, as this court stated in *Curry v. United States,* 5th Cir.1968, 396 F.2d 630, that 'a true lender is concerned with interest.'[10] The failure to insist on interest payments ordinarily indicates that the payors are not seriously expecting any substantial interest income, but are interested in the future earnings of the corporation or the increased market value of their interest."[11]

Ability to obtain loans from outside lending institutions. If a business is able to borrow funds from outside sources at the time an advance is made, the transaction has the appearance of a bona fide debt. "The purpose of this inquiry is obviously to test whether the shareholder contributors acted in the same manner toward their corporation as ordinary reasonable creditors would have acted," the court wrote. "If no reasonable creditor would have loaned funds to the corporation at the time of the advance, an inference arises that a reasonable shareholder would likewise not so act."

10 See also *National Carbide Corporation v. Commissioner of Internal Revenue,* 336 U.S. 422, 435 n.16, 69 S.Ct. 726, 93 L.Ed. 779 (1949).

11 *Curry v. United States,* 396 F.2d at 634.

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Exhibit 2. Debt Versus Equity in a Divorce Context

BVU subscribers have access to a massive library of articles, many of which are written by guest contributors. Doing a search of "debt vs. equity" at BVLibrary (www.bvlibrary.com) brings up a number of articles and court case digests, including a series of articles by Christine Baker, CPA/ABV/CFF, of Charter Capital Partners (Grand Rapids, Mich.) that examine debt versus equity in a divorce context.

Baker points out that the sum of the guidance for legal and valuation experts boils down to this: The resolution of a debt-versus-equity issue is like searching for a result along a continuum, which has at one end debt and at the other end equity. In the absence of a bright-line test, "economic reality" may prove to be the basis on which decision-makers consider what constitutes an equitable conclusion.

Practical idea. Baker suggests that, in some cases, a practical step for the valuation expert may be to present counsel with two valuation scenarios. One scenario could offer a valuation conclusion assuming the loan is not a bona fide debt of the company. The other scenario could offer a valuation conclusion assuming the loan is legitimate and is to be included (at its fair market value) in the overall determination of the parties' net worth. This approach may provide enough information for the parties and their respective counsel to negotiate an equitable settlement.

The three-part series of articles, titled "Shareholder Loans in Divorce," focuses on loans a shareholder makes to a business entity and options for dealing with such loans when doing a valuation in divorce. The articles also examine the factors that some courts have weighed when deciding whether an advance of funds from an owner should be treated as a bona fide debt or as contributed capital.

The extent to which the advance was used to acquire capital assets. The lower court examined whether there were existing sources for repayment of the loan, such as an income-producing asset. "Further, the court considers whether the funds are temporary advances to provide working capital that can be repaid in the near term or whether the funds are used to acquire capital assets (i.e., capital asset financing which is longer term)," the appellate court noted. "A determination needs to be made as to whether the funds were used for working capital or used for the acquisition of assets."

The failure of the corporation to repay on the due date. This factor and the previous factor supports the district court's characterization of the advance as a bona fide debt. "The advance was without question utilized to provide working capital for the day-to-day operations of the bank and was in no way connected to any acquisition of capital assets. Moreover, it is clear that the bank repaid the advance as soon as the conditions previously discussed were met."

Conclusion. Sometimes it is not obvious as to the appropriate classification of a "loan" on the balance sheet. The analysis from the *Mixon* case can be useful in making that determination. An analysis of each factor with supporting documents, where available, will assist in supporting the professional judgment exercised to provide an opinion as to the appropriate classification. The accompanying sample analysis in Exhibit 1 can help the analyst make an informed decision as to the classification of debt versus equity—and it can be used for all types of transactions where the issue arises. ◆

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