THE LOANING SHAREHOLDER: PAYBACK PITFALLS

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I. INTRODUCTION

This article addresses how to structure an advance of capital from an individual to a corporation where the individual expects to receive both stock and a return. There are numerous vehicles for this type of transaction. This article focuses on a potential pitfall for the unwary and alternative structures to consider.

II. HYPOTHETICAL SCENARIO

Betty and Melissa are the sole officers and directors of XYZ, Inc. (the "Corporation"), a closely held C-corporation. Although they are highly skilled in the Corporation's trade, Betty and Melissa need additional capital and another individual with operational know-how. Betty and Melissa are introduced to Emily, an experienced, well-seasoned, and wealthy individual. Emily determines that the Corporation is well worth her time and decides to enter an agreement with the Corporation to become an officer, receive preferred shares of the Corporation, and advance $1,000,000.00 of capital (the "Advance").

As Emily begins to negotiate the Advance with Betty and Melissa, Emily decides that she would like to have the entire Advance returned to her over the course of 10 years. Emily expects to receive her Advance amount back from the Corporation tax free and anticipates that the Advance will be less burdensome than other credit available to the Corporation. The issue is how the transaction should be structured to reflect the parties' intentions and provide the most favorable tax treatment.

III. STRUCTURING THE RETURN OF THE ADVANCE

For Emily to receive the return of her Advance over 10 years, tax-free, a potential pitfall must be avoided. Since Emily received stock in the Corporation as part of the transaction, she runs the risk that any distributions made to her by the Corporation will be deemed to be *with* *respect to its stock*.[1] Distributions by a corporation with respect to a shareholder's stock trigger Internal Revenue Code ("Code") Section 301.[2] However, "[t]ransfers . . . such as debt repayment, even if the recipient is a shareholder, are not covered by [Code Section] 301 because they are not made '*with respect to the paying corporation's stock*.'"[3]

The United States Tax Court provided guidance in *Hewlett-Packard Co.* as to "whether an advance to a corporation gives rise to a bona fide debt as opposed to an equity investment."[4] The following factors are to be considered:

> (1) the labels on the documents evidencing the alleged indebtedness; (2) the presence or absence of a maturity date; (3) the source of payments; (4) the right of the alleged lender to enforce payment; (5) participation in management; (6) a status equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) the adequacy of the (supposed) borrower's capitalization; (9) whether stockholders' advances to the corporation are in the same proportion as their equity ownership in the corporation; (10) the payment of interest out of only "dividend money"; and (11) the borrower's ability to obtain loans from outside lenders.[5]

These factors underscore the importance of correctly documenting a loan made by a shareholder to a corporation.

A. The Pitfall: Distributions with Respect to the Corporation's Stock

When a corporation makes a distribution with respect to its stock, Code Section 301 will apply to the distribution.[6] Under Code Section 301(a), "a distribution of *property* made by a corporation with respect to its

1 I.R.C. § 301 (2018).
2 *See id.*
3 RICHARD L. DOERNBERG ET AL., FEDERAL INCOME TAXATION OF CORPORATIONS AND PARTNERSHIPS 105 (Vicki Been et al. eds., 5th ed. 2014) (quoting I.R.C. § 301(a)).
4 Hewlett-Packard Co. v. Comm'r, 103 T.C.M. (CCH) 1736, 1747 (T.C. 2012), *aff'd sub nom.* Hewlett-Packard Co. v. Comm'r, 875 F.3d 494 (9th Cir. 2017).
5 *Id.* (citing A.R. Lantz Co. v. U.S., 424 F.2d 1330, 1333 (9th Cir. 1970)). The list is not exclusive, and no factor is determinative.
6 § 301.

stock shall be treated in the manner provided . . ." under Code Section 301(c).[7] The definition of "property" in Code Section 317(a) includes cash distributed—the property being distributed in our hypothetical.[8]

Under Code Section 301(c), a distribution of cash with respect to the corporation's stock will be treated in the following manner: (1) under Code Section 301(c)(1), to the extent that the corporation has earnings and profits (E&P), the distribution will be deemed a taxable dividend under Code Section 61(a)(7);[9] (2) under Code Section 301(c)(2), the portion of the distribution that exceeds the E&P of the corporation shall be applied against and reduce the adjusted basis in the shareholder's stock;[10] and (3) the portion of the distribution that exceeds the adjusted basis of the shareholder's stock will be treated as capital gain.[11] In our case, Emily made the Advance intending to receive her funds back over the course of 10 years. When she made the Advance, Emily hoped that the Corporation would be successful, resulting in an appreciation in her stock value and a healthy salary as an officer. In other words, she will have anticipated that the Corporation will have E&P.

This is where the potential pitfall arises. If the Advance repayment is deemed to be made *with respect to* the Corporation's stock held by Emily, she will be deemed to have received a taxable dividend from the Corporation. To the extent that the Corporation has E&P, it may not earmark or delineate the return of the Advance payments as a return of capital to Emily. Because the Corporation cannot bypass dividend treatment and earmark distributions as a return of capital under Code Section 301(c)(2),[12] and Emily will not want to be taxed by receiving the payments as dividends, the Corporation should not apply the Advance amount to the adjusted cost basis of Emily's shares on its books or document the transaction as an investment.[13]

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[7] § 301(a) (emphasis added).

[8] *See* § 317(a).

[9] *See* §§ 61(a)(7), 301(c)(1).

[10] § 301(c)(2) (This is referred to as a return of capital; a practitioner must not confuse a return of capital, which is subject to Code Section 301, with the return of an advance of funds in the form of a tax-free event).

[11] § 301(c)(3)(A).

[12] *See* § 301(c)(2).

[13] For example, in a transaction such as this, it would be a mistake to plan the distributions by paying back the Advance in a shareholder agreement. One such provision, for example, is the following:
"Shareholder shall receive the following distributions:

B. *TRANSFER WITH RESPECT TO DEBT REPAYMENT*

Instead, the parties should structure the transaction as a loan from the Shareholder with repayment of the loan by the Corporation evidenced by a promissory note.[14] This form of repayment should be explicitly provided for, and any notion that the repayment is being made with respect to the shareholder's stock should be disclaimed.

The documentation should indicate the indebtedness, the a maturity date indicating a fixed obligation to repay, and the intent of the parties to create a debt obligation.[15]

In our case, Emily should document her loan to the Corporation, and the Corporation should agree to pay back the loan over 10 years in the form of a promissory note. This arrangement will result in Emily being taxed only on any interest income she will receive on the promissory note from the Corporation and not on the return of her principal amount loaned.

IV. ALTERNATIVE STRUCTURES AND MINORITY SHAREHOLDER OPPRESSION

The most simplistic form to return the Advance and avoid dividend treatment was detailed above. In this section, I will discuss alternative structures for returning Emily's Advance in our hypothetical.

Year 1: $100,000
Year 2: $100,000 . . . "

Given that these hypothetical distributions were provided for in a shareholder agreement, with no mention of the intention of the transaction, there is a risk that the distributions will be deemed to be made with respect to the shareholder's stock. The transaction will look akin to an investment instead of a repayment of a loan.

[14] *See* Hewlett-Packard Co. v. Comm'r, 103 T.C.M. (CCH) 1736, 1750 (2012) ("The issuance of a stock certificate indicates an equity contribution, whereas the issuance of a bond, debenture, or note indicates a bona fide indebtedness."), *aff'd sub nom.* Hewlett-Packard Co. v. Comm'r, 875 F.3d 494 (9th Cir. 2017).

[15] *Id.* (indicating that the shareholder should also charge interest on the loan). *Compare* Ill. Tool Works, Inc. v. Comm'r, 116 T.C.M. (CCH) 124 (2018) (holding that notes requiring the payment of interest were a factor considered in finding an advance of capital as a loan), *with* ACM Envtl. Servs., Inc. v. Comm'r, 104 T.C.M. (CCH) 709 (2012) (holding that the corporation receiving capital from a shareholder, interest free, was deemed to be a factor in finding that the capital was an investment rather than a loan).

In addition, I will discuss concerns with minority shareholder oppression in a closely-held corporation.

A. Redemptions of Stock

The transaction could also be structured as a redemption of stock. "[I]if a corporation redeems its stock . . . such redemption shall be treated as a distribution in part or full exchange for the stock."[16] Under Code Section 317(b), "stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property,[17] whether or not the stock so acquired is canceled, retired, or held as treasury stock."[18] This means that any money distributed to the shareholder by the corporation will be offset by the shareholder's adjusted basis in the shares exchanged in the redemption.[19] Conversely, if the distribution does not qualify as a redemption, it will be deemed a dividend, which does not benefit from basis recovery.[20]

Code section 302(b) also treats certain transactions, which were meant to be redemptions, as exchanges.[21] Code Section 302(b)(2) provides that a redemption will be treated as an exchange if the distribution is substantially disproportionate with respect to the shareholder.[22] "If a redemption does not qualify as substantially disproportionate under Internal Revenue Code Section . . . 302(b)(2) and is not in complete termination of the shareholder's interest, then the only possibility for redemption treatment is for the redemption to be 'not essentially

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[16] § 302(a) (2018).

[17] § 317(a) (defining property to include money).

[18] § 317(b).

[19] The shareholder's adjusted basis in the shares exchanged reflects the amount invested to acquire the shares, *i.e.*, the "cost" of such property. *See* § 1012. For example, if the shareholder purchased 10 shares for $1,000, the cost basis of each share would be $100. If all 10 shares are redeemed for $1,000, there would be no taxable gain to the shareholder because the $1,000 distribution from the corporation would be offset by the adjusted basis (cost basis) of the shares.

[20] *See generally* Robert W. Wood, *When Redemptions are Treated as Dividends: Whithier Basis?*, M&A TAX REP., Jan. 2003, at 3 (explaining how distributions can be treated as dividends).

[21] § 302(b).

[22] § 302(b)(2).

equivalent to a dividend.'"[23] Whether a distribution in redemption is not essentially equivalent to a dividend is a facts and circumstances intensive analysis and is beyond the scope of this article. Regarding the "substantially disproportionate" test:

> This test has as its primary advantage a mathematical certainty of result. It operates as a safe harbor to assure sale or exchange treatment. It was designed to provide a purely mechanical test for determining disproportionality. A pro rata distribution in redemption to shareholders looks like a dividend, and therefore is so treated.
>
> In contrast, a redemption resulting in a complete termination of a shareholder's interest ought to be treated as a sale or exchange. The substantially disproportionate redemption, where some shareholders have a significant portion (but not all) of their shares redeemed, falls somewhere in between these extremes. Since the substantially disproportionate test is applied shareholder by shareholder, it may apply to some shareholders, but not to others.[24]

Under Code Section 302(b)(2)(B), for a redemption to be substantially disproportionate, the shareholder must own less than fifty percent of the total combined voting power immediately after the redemption.[25] Also, a redemption is substantially disproportionate with respect to the shareholder if, "immediately after the redemption, the ratio of the redeemed shareholder's voting stock in the corporation in relation to the corporation's total voting stock has decreased by more than [twenty percent]."[26] Code Section 302(b)(2)(D) also extends exchange treatment to a series of redemptions made pursuant to a plan that, in the aggregate, reduces the shareholder's interest by more than twenty percent.[27]

In our case, this structure would not be favorable because Emily would be giving up ownership in the Corporation – ownership which she

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[23] Robert W. Wood, *Redemptions Not Essentially Equivalent to Dividends*, M&A TAX REP., July 2011, at 4–5 (quoting §302(b)(1)).
[24] Wood, *supra* note 20, at 5.
[25] § 302(b)(2)(B).
[26] Wood, *supra* note 20, at 5; *see* §302(b)(2)(C).
[27] *See* § 302(b)(2)(D).

hopes will become lucrative when her shares are redeemed. Also, as detailed above, the rules regarding redemptions must be closely followed and do not lend themselves to a simplistic approach.

B. CONVERTIBLE NOTES

A convertible note is a short-term debt agreement that may convert into equity at a future date.[28] "Convertible bonds are, customarily, fixed-rate bonds issued by a company, the terms of which allow the holders of the bonds to convert them into ordinary shares of the company at a prescribed conversion price and during a prescribed conversion period."[29] Given the complicated process of investing in start-ups, investors and corporations have embraced convertible bonds.[30] The convertible note reduces risk to the investor because the start-up is contractually obligated to pay the money back in the event it is not converted to equity.[31] This makes the convertible note inherently less risky than an equity investment, while still allowing for a conversion of debt to equity if the venture proves successful.[32]

It is important to determine the tax consequences of utilizing convertible debt. Generally, a convertible note is considered purely a debt instrument until it is converted to equity.[33] Thus, even though the instrument has an option that has value (*i.e.*, the potential equity conversion), the option feature is ignored for income tax purposes.[34] If the convertible note has regularly scheduled payments of interest (*e.g.*,

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[28] *See generally* Dominick Severance, *Debt or Equity: Convertible Bonds, Nine Factors, and the Difficulty of Investing in Startups*, KING HALL INTELL. PROP. L. ASS'N (Apr. 27, 2013), https://students.law.ucdavis.edu/ip/ip_news/posts/debt_or_equity_convertible_bonds.html (explaining that a convertible note holder can convert the debt into shares from the issuer).

[29] JAMES TAYLOR & ROBERT FLANIGAN, CONVERTIBLE BONDS: AN ISSUER'S GUIDE 1 (Mayer Brown Int'l LLP, U.K. 2013).

[30] Severance, *supra* note 28 (Start-ups do not always have a proven plan for monetization, it is difficult to balance investors' interests with the founder's interest, and start-ups have problems with valuation).

[31] *Id.*

[32] *Id.*

[33] Dan Wright, *Convertible Debt: An introduction to the Federal Income Tax Issues Associated with Conversion Features*, JDSUPRA (June 4, 2012), https://www.jdsupra.com/legalnews/convertible-debt-an-introduction-to-the-05778/.

[34] *Id.*

monthly or yearly), then the convertible note holder will recognize the interest as income when the interest is paid.[35] Further, if the convertible note is not converted to equity, the cost basis of the note will prevent any gain from being recognized by the note holder when the principal amount is returned.[36]

If the note is converted to equity, the IRS has issued a ruling indicating that no gain is recognized when the note is converted into stock.[37] When the note is converted to equity, the basis in the stock acquired is equal to the note holder's basis in the note immediately before the conversion.[38]

When Emily makes the Advance, a convertible note would be advantageous. Emily would receive a convertible note obligating the Corporation to repay to her the principal amount, including interest, until the time of maturity. She will also have the benefit of converting the note to equity in the Corporation if she decides that the Corporation's value has exceeded the repayment value on the note. This gives Emily the benefit of a wait-and-see approach. However, this approach burdens the Corporation for two reasons. First, if the Corporation is struggling when the note matures, Emily will likely ask for the note to be repaid, and the Corporation will have to come up with the cash. Second, if the value of the Corporation has grown tremendously, the value of the equity conversion could well outweigh the amount of repayment on the note.[39] In our example, Betty and Melissa could be required to give over equity valued beyond what would have likely been contemplated at the time the convertible note was made.

C. MINORITY SHAREHOLDER OPPRESSION

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[35] *Id.*
[36] *See* I.R.C. § 1001(a)–(b).
[37] Wright, *supra* note 33; *see also* I.R.S. Notice 2002-36, 2002-22 I.R.B. 1029 (June 3, 2002) ("Rev. Rul. 2002-31, 2002-22 I.R.B., dated June 3, 2002, provides guidance on the tax treatment of a debt instrument that is convertible into stock of the issuer and that also provides for one or more contingent cash payments (contingent convertible debt instruments). The revenue ruling holds that, in the described circumstances, the noncontingent bond method described in [Section] 1.1275-4(b) of the Income Tax Regulations applies to these debt instruments.").
[38] Wright, *supra* note 33.
[39] In this structure, Emily will not receive her principal Advance back in the form of cash; she will have analyzed the value of equity in the Corporation and abandoned her initial plan to receive her investment back.

Closely-held corporations have a limited amount of stock that is not publicly traded and have a small number of shareholders who are familiar with each other, live in the area, are active in the business itself, and may even be involved in the management and operations of the corporation.[40] Because of the nature of the closely-held corporation, majority shareholders in a closely-held corporation can use oppressive tactics to "freeze out" a minority shareholder.[41] "Freeze-out actions are those which deprive the minority shareholder of an opportunity to participate in the business and deny her a fair return on her investment."[42]

For example, if Emily invests in the Corporation and has a shareholder interest less than Betty and Melissa combined, Betty and Melissa could effectively freeze out Emily.[43] This practitioner has seen oppressive conduct that includes majority shareholders offering very little for the minority shareholder's shares, inhibiting the minority shareholder from performing officer duties, and taking away the minority shareholder's salary as an officer. When representing a party who may become a minority shareholder, the above should be considered, and alternative investment structures reviewed.

First, suppose the Advance in our hypothetical is structured as a transfer with respect to debt repayment. In that case, Emily will be protected from minority shareholder oppression to the extent of her Advance. However, the preferred shares she also receives may be at risk of becoming unmarketable. Second, the redemption of stock structure does not combat minority shareholder oppression. The majority shareholders have too much power over the redemption price.

Last, the convertible note has excellent features for combatting minority shareholder oppression. For example, if Emily makes the Advance in return for a convertible note, she can work as an officer and

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[40] Cochran v. L.V.R. & R.C., Inc., No. M2004-01382-COA-R3-CV, 2005 WL 2217067, at *3 (Tenn. Ct. App. Sept. 12, 2005).

[41] *Id.* at *4.

[42] *Id.*

[43] However, there are common law protections in place against oppressive actions. Hall v. Tenn. Dressed Beef Co., 957 S.W.2d 536, 541 (Tenn. 1997) ("[S]hareholders of a close corporation share a fiduciary relationship which imposes upon all shareholders the duty to act in good faith and fairness with regard to their respective interests as shareholders."). Because of "the similarities between the relationship of shareholders in a close corporation and partners in a partnership, courts have held that the fiduciary duties of shareholders in a close corporation are akin to the fiduciary duties of good faith and loyalty charged to partners." Cochran v. L.V.R. & R.C., Inc., 2005 WL 2217067, at *4.

use the benefit of the wait-and-see approach detailed above. Allowing a vetting period for Emily may be beneficial. She may find that she does not trust working with the other shareholders and choose to take the repayment at the maturity of the note rather than become a minority shareholder. It also gives Emily time to determine whether there may be a market for the shares of the Corporation before receiving the equity.

With proper planning, ideally, a client should not have to rely on common law protections.[44] A proactive approach should be taken to avoid the risk of costly litigation over the value of shares in the future.

VI. CONCLUSION

First, an individual expecting a return of an advance to a corporation should be careful to avoid the repayment being classified as a distribution *with respect to* the corporation's shares. A shareholder should document the transaction as a loan with the transfers from the corporation made as debt repayment. The loan transaction should be conducted carefully with proper documentation and adherence to the factors laid down in *Hewlett-Packard Co.*

Second, although structuring the transaction in our hypothetical as debt repayment lends itself as the most simplistic approach, there are alternative structures. As detailed above, the shareholder could have her advance returned through a stock redemption. However, the Internal Revenue Code's provisions must be closely followed, and there are pitfalls to be avoided due to minority shareholder oppression. The transaction could also be completed by using a convertible note. A convertible note provides the investor with greater protection while shifting investment risk to the corporation. The convertible note is the strongest structure for combating minority shareholder oppression because it allows the investor to either demand repayment of the note at maturity or convert the note to equity if in the investor's best interest.

Making an advance of funds to a corporation and receiving stock, while expecting the advance to be returned in the future, presents a pitfall for the unwary. This article should provide the reader with a simplistic approach to avoid dividend treatment of distributions to an investor, such as Emily, and give alternative approaches to structure the investment. As

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[44] Hall v. Tenn. Dressed Beef Co., 957 S.W.2d at 541 (exemplifying the difficulties in litigating based claims of breach of fiduciary duty by other shareholders in a closely-held corporation).

with all transactions, the facts and circumstances will determine the shape and form chosen.