Testing for Thin Capitalization Under Section 163(j): A Flawed Safe Harbor

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ABSTRACT

This Article discusses why the current Code balance sheet safe harbor in section 163(j), which is based on the taxpayer's tax basis in its assets and not their fair market value, is conceptually incorrect. Section 163(j) limits the deduction for interest expense in certain cases with a major impact on many U.S. subsidiaries of foreign corporations. Section 163(j) does not however limit the interest expense deduction where the issuer's ratio of debt-to-equity does not exceed 1.5-to-1, which is why it is important that the statute be amended to measure assets at their fair market value. This Article also discusses, outside of the section 163(j) context, why fair market value, and not book or tax basis, is the proper measure for assets in testing as to whether the taxpayer should be thinly capitalized. Thin capitalization is one factor the courts look to in determining whether an instrument purporting to be debt will be respected as such.

I. Introduction

This Article comments on the debt-to-equity safe harbor included in section 163(j), which addresses earnings stripping, also commonly referred to as interest stripping. Under certain circumstances, as discussed below, section 163(j) limits the deduction for interest expense paid or accrued by the taxpayer. The provision, enacted in 1989,[1] contains a debt-to-equity safe harbor pursuant to which no interest expense is disallowed if, under regulations to be prescribed, the ratio of debt-to-equity does not exceed 1.5-to-1.[2] The statute uses adjusted tax basis of assets instead of fair market value in determining

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[1] *See* Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, § 7210, 103 Stat. 2106, 2339-46.

[2] I.R.C. § 163(j)(2)(A)(ii).

equity for purposes of calculating the 1.5-to-1 safe harbor.[3] The purpose of the statutory safe harbor is to exclude taxpayers who are adequately capitalized from the disallowance.[4] It seems incongruous that this safe harbor measures a taxpayer's assets using their tax basis rather than their fair market value.[5] In many instances, the use of tax basis or book value in measuring assets will provide a distorted picture of the borrowing ability of the taxpayer in question. As discussed below, outside the context of section 163(j), the vast majority of cases have held that, to determine thin capitalization for purposes of deciding whether an instrument should be treated as debt or equity, a taxpayer's assets should be measured at their fair market value.[6] The Tax Court's decision in *Laidlaw Transportation Inc. v. Commissioner* is a possible outlier.[7] *Laidlaw* should be limited to its facts and should not be interpreted as rejecting in most circumstances the use of fair market value in resolving the question of whether a taxpayer is thinly capitalized.

This Article includes some background on the purpose and scope of section 163(j), including the statutory 1.5-to-1 debt-to-equity safe harbor, case law dealing generally with the characterization of an instrument as debt or equity for federal income tax purposes, and where thin capitalization fits with respect to such a determination. Its main focus, however, is fairly simple. The principal focus of this Article is the 1.5-to-1 safe harbor established by section 163(j)(2)(A). This Article argues that for purposes of determining whether the safe harbor applies, the statute should have required use of the fair market value of the issuer's assets rather than the tax basis of such assets. This should also be the proper measurement for establishing whether the issuer is adequately capitalized outside of section 163(j).

II. Why Was Section 163(j) Enacted?

Congress enacted section 163(j) in order to "limit the deduction for interest that a taxable person pays or accrues to a tax-exempt entity whose economic interests coincide with those of payor. To allow an unlimited deduction for such interest permits a significant erosion of the tax base."[8] A primary, but

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[3] § 163(j)(2)(C)(i). Under the Proposed Regulations the debt-to-equity safe harbor treats an affiliated group as one taxpayer whether or not the group is also a consolidated group. *See* Prop. Reg. § 1.163(j)-5(a)(2), 56 Fed. Reg. 27,907, 27918 (1991).

[4] *See* H.R. Rep. No. 101-386, at 567 (1989) (Conf. Rep.).

[5] As discussed *infra*, the debt-to-equity safe harbor has also been criticized for failing to tailor the safe harbor to different industries with different asset mixes. *See, e.g.*, Office of Tax Policy, Dep't of the Treasury, Corporate Inversion Transactions: Tax Policy Implications 23 (2002); *NYSBA Comments on Proposals to Modify Earnings-Stripping Rules,* 2003 Tax Notes (TA) 178-49 (Sept. 15, 2003); *see also* John L. Carr, Jr. et al., *Earnings Stripping Provisions: A Historical Perspective and Critique*, 32 Tax Mgm't Int'l J. 3, 13 (2003).

[6] *See* Boris I. Bittker & James S. Eustice, Federal Income Taxation Of Corporations And Shareholders, ¶ 4.04[3] (7th ed. 2012).

[7] Laidlaw Transp., Inc. v. Commissioner, 75 T.C.M. (CCH) 2598, 1998 T.C.M. (RIA) ¶ 98,232.

[8] H.R. Rep. No. 101-247, at 1241 (1989).

not exclusive, focus of section 163(j) are U.S. subsidiaries of foreign parent corporations that seek to limit or eliminate entirely their U.S. tax liability by financing their operations mainly with debt from a related foreign entity or debt guaranteed by such an entity.

In describing why Congress thought section 163(j) was necessary, the Conference Committee Report noted that:

> Some have argued that under present law, foreign persons may be treated for some purposes more favorably than similarly situated U.S. persons. For example, the unrelated business income tax rules impose a tax on earnings stripping amounts (i.e. interest, annuities, royalties and rents) received by any tax-exempt organization that individually owns 80 percent or more of a U.S. subsidiary (sec. 512(b)(13)). No similar rule applies to foreign persons. As another example, it has been argued that some foreign persons can afford to pay more for U.S. companies than prospective U.S. buyers because a foreign person can borrow to acquire in its home country where interest deductions are beneficial, and may in some cases be able to use the capital in a tax haven finance subsidiary to generate interest income from a U.S. acquisition vehicle (deductible against income of the target) that is subject to little or no current tax.
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> The conferees believe that for these purposes related and unrelated lenders need not be treated as similarly situated. Allowance of unlimited deductions for related party interest permits an economic unit that consists of more than one legal entity to contract with itself at the expense of the government.[9]

The House Ways and Means Committee further observed that "the tax laws of several industrialized countries include limitations on the deduction of excessive amounts of interest expense paid to related foreign (i.e. tax-exempt) parties."[10] The Committee recognized "that the impact [of section 163(j)] may fall heavily on foreign-based multinational corporations."[11] The Committee justified this by stating that "[t]his limitation may affect foreign-owned U.S. businesses more than other taxpayers because current U.S. tax laws have already addressed certain aspects of this problem in the purely domestic context (see, e.g., sections 267, 4975, and 512(b)(13))."[12]

III. Section 163(j) – An Overview

Section 163(j) targets U.S. base erosion in situations where the taxpayer: (1) does not meet the statutory safe harbor, (2) pays what the statute refers to as "disqualified interest,"[13] and (3) has "excess interest expense"[14] for the year.

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[9] *See* H.R. Rep. No. 101-386, at 568 (1989) (footnote omitted).
[10] *See* H.R. Rep. No. 101-247, at 1241 (1989).
[11] *Id.* at 1249.
[12] *Id.*
[13] "Disqualified interest" is defined in Code section 163(j)(3).
[14] "Excess interest expense" is defined in Code section 163(j)(2)(B)(i).

If *any* of the three requirements are not met, section 163(j) does not apply to the taxpayer.

The operation of section 163(j) can be illustrated with the following example. U.K. parent corporation (UKPAR) finances its wholly owned U.S. subsidiary (USSUB) with sizeable intercompany debt. Assume that the ratio of debt-to-equity of USSUB exceeds 1.5-to-1 as of the close of the tax year. Pursuant to Article 11 of the U.S.-U.K. Income Tax Treaty, the interest paid by USSUB to UKPAR would generally not be subject to the normal 30% withholding tax imposed on domestic source interest.[15] The interest would thus be characterized as "disqualified interest."[16] Contrast this example with the following example. The foreign parent is Brazilian and similarly loans funds to its wholly owned U.S. subsidiary. Since there is no ratified income tax treaty between the United States and Brazil, interest paid by the U.S. subsidiary would generally be subject to a 30% withholding tax. If the U.S. withholding tax applied, the interest would not be "disqualified interest" and section 163(j) would be inapplicable, whether or not the U.S. subsidiary met the statutory safe harbor or had "excess interest expense."

"Disqualified interest" includes interest paid or accrued to: (1) a "related person" if no tax is imposed with respect to such interest,[17] (2) an unrelated person in certain instances in which a related person guarantees the debt and no gross basis tax is imposed with respect to such interest,[18] or (3) a taxable real estate investment trust (REIT) by a taxable REIT subsidiary of that trust.[19]

"Excess interest expense" means "the excess (if any) of – (I) the corporation's net interest expense, over (II) the sum of 50 percent of the adjusted taxable income of the corporation plus any excess limitation carryforward . . . ."[20]

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[15] *See* I.R.C. § 881(c); Double Taxation: Taxes on Income, Jul. 24, 2001, U.S.–U.K., art. 11(1), T.I.A.S No. 13161. Code section 881(a)(1) imposes a 30% withholding tax on interest income of foreign corporations not connected with United States business subject to several exceptions including "portfolio interest."

[16] Code section 163(j)(3)(A) defines "disqualified interest" to include "any interest paid or accrued by the taxpayer (directly or indirectly) to a related person if no tax is imposed by this subtitle with respect to such interest."

[17] I.R.C. § 163(j)(3)(A). Code section 163(j)(4) defines "related person", in general, to mean "any person who is related (within the meaning of section 267(b) or 707(b)(1)) to the taxpayer." With respect to the requirement that no tax be imposed in Code section 163(j)(3)(A) and (B), pursuant to Code section 163(j)(5)(B), interest that is subject to a reduced rate of tax under a treaty is treated as partially exempt and partially taxable based on the ratio of the treaty rate to the 30% statutory rate.

[18] § 163(j)(3)(B). Code section 163(j)(3)(B)(i) uses the term "disqualified guarantee" which is in turn is defined in Code section 163(j)(6)(D) and excludes, for example, guarantees where "the taxpayer owns a controlling interest in the guarantor." *See* I.R.C. § 163(j)(6)(D)(ii)(II). Congress also authorized regulations to exclude instances "where the interest on the indebtedness would have been subject to a net basis tax if the interest had been paid to the guarantor." *See* § 163(j)(6)(D)(ii)(I).

[19] § 163(j)(3)(C).

[20] § 163(j)(2)(B)(i).

"Adjusted taxable income" includes taxable income without regard to the deductions for "net interest expense,"[21] net operating losses, domestic production activities, depreciation, amortization and depletion.[22] "Excess limitation carryforward" means the amount by which (if any) 50% of "adjusted taxable income" exceeds "net interest expense" for the three prior years, to the extent not already used.[23]

Returning to the UKPAR and USSUB fact pattern, suppose that all of USSUB's interest expense was entirely from loans from UKPAR. Further suppose USSUB had no interest income and its interest expense exceeded 50% of its "adjusted taxable income."[24] Finally, suppose that there was no "excess limitation carryforward."[25] Section 163(j) would disallow a portion of USSUB's interest expense deduction in the current year because: (1) it did not meet the statutory safe harbor, (2) it had "excess interest expense," and (3) its interest expense consisted of "disqualified interest." USSUB would be able to have the disallowed interest expense carried forward indefinitely and used in a future year or years when 50% of adjusted taxable income exceeds net interest expense, including the carried forward interest expense.[26]

In June 1991, the Treasury Department released Proposed Regulations under section 163(j),[27] but they have never been finalized. The Proposed Regulations limit the application of section 163(j) to domestic C corporations and foreign corporations with income, gain, or loss that is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States.[28]

Congress has made several amendments to section 163(j). For example, section 163(j) was amended by the Revenue Reconciliation Act of 1993 to cover certain third party loans subject to a related party guarantee.[29] Section 163(j) was also amended to include, within the definition of "disqualified interest,"

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[21] "Net interest expense" is defined in Code section 163(j)(6)(B) to mean "the excess (if any) of— (i) the interest paid or accrued by the taxpayer during the taxable year, over (ii) the amount of interest includible in the gross income of such taxpayer for such taxable year."

[22] § 163(j)(6)(A). The Proposed Regulation provides some additions and subtractions in arriving at adjusted taxable income. *See* Prop. Reg. § 1.163(j)-2(f); 56 Fed. Reg. 27,907 (1991).

[23] § 163(j)(2)(B)(ii)-(iii).

[24] Code section 163(j)(6)(A) defines the term "adjusted taxable income" to mean "the taxable income of the taxpayer— (i) computed without regard to— (I) any deduction allowable under this chapter for the net interest expense, (II) the amount of any net operating loss deduction under section 172, (III) any deduction allowable under section 199, and (IV) any deduction allowable for depreciation, amortization, or depletion, and (ii) computed with such other adjustments as the Secretary may by regulations prescribe."

[25] *See* § 163(j)(2)(B)(ii)-(iii). If there had been excess limitation carryforward, it would have been added to 50% of adjusted taxable income and compared with taxpayer's net interest expense. To the extent the latter exceeds the sum of excess limitation carryforward and 50% of adjusted taxable income, taxpayer has "excess interest expense."

[26] *See* § 163(j)(1)(B).

[27] Prop. Reg. § 1.163(j)-1 to -10, 56 Fed. Reg. 27,907, 27,912-27 (1991).

[28] Prop. Reg. § 1.163(j)-1(a)(1), 56 Fed. Reg. 27,907, 27,912-13 (1991).

[29] Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13228, 107 Stat. 312.

interest paid by a taxable REIT subsidiary to a related REIT. This amendment was added by the Tax Relief Extension Act of 1999.[30] Furthermore, the Tax Increase Prevention and Reconciliation Act of 2005 modified the earnings stripping rules to cover corporate owners of partnership interests.[31]

Section 163(j) has been subject to attack even prior to its enactment. It has been criticized because, among other reasons, it was alleged to discriminate against our treaty partners in violation of such treaties.[32] Its overall fairness and effectiveness, including the use of a 1.5-to-1 one-size-fits-all safe harbor, has also been subject to criticism and proposed revision. The explanation accompanying the Bush Administration's Fiscal Year 2004 Revenue Proposals indicated with respect to section 163(j) that:

> Under current law, opportunities are available to reduce inappropriately the U.S. tax on income earned from U.S. operations through the use of foreign related-party debt. Tightening the rules of section 163(j) is necessary to eliminate these inappropriate income-reduction opportunities. Further, the current-law operation of section 163(j), which provides a safe harbor for corporations with a debt-to-equity ratio of greater than 1.5 to 1, applies inconsistently across taxpayers in different industries and with different leverage pictures. This safe harbor can be better tailored through the use of a debt-to-asset threshold that reflects the underlying mix of assets held by a corporation and the amount of leverage a company with that mix of assets typically can support. Without this tailoring, some businesses could be subject to the tightened limits under section 163(j) even though they may not

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[30] Tax Relief Extension Act of 1999, Pub. L. No. 106-70, § 544, 113 Stat. 1860.

[31] Tax Increase Prevention and Reconciliation Act of 2005, Pub L. No. 109-222, § 501, 120 Stat. 345 (2006).

[32] *See*, e.g., *NYSBA Tax Section Opposes Earnings Stripping Proposal*, 1989 Tax Notes Today 212-7(Oct. 17, 1989); Lee Sheppard, *Tax Officials Discuss Law's Ebb and Flow; Treasury Opposes Two Foreign Law Tax Changes; Trier Addresses Corporate Provisions*, 1989 Tax Notes Today 196-3 (Sept. 26, 1989). Congress disagreed with this criticism of Code section 163(j) being in violation of tax treaties stating that:

> The conferees believe that the conference agreement does not violate treaties. This belief is based on several factors. First, the conferees believe that because the provision treats similarly situated persons similarly, there is no discrimination under treaties. For this purpose the conferees believe that the determination of which persons are similarly situated is properly made by reference to the U.S. tax those persons do or do not bear on interest income from U.S. corporations. This is consistent with the view that payments leaving U.S. taxing jurisdiction may in appropriate circumstances, consistent with treaties, be subjected by the United States to tax that would not be imposed on a payment to a U.S. person . . . . [R]elated and unrelated lenders need not be treated as similarly situated. Allowance of unlimited deductions for related party interest permits an economic unit that consists of more than one legal entity to contract with itself at the expense of the government . . . . The conferees also believe that the provisions of the bill are generally consistent with the United States obligations under its treaties because the bill sets forth standards for determining thin capitalization in an arm's length fashion.

H.R. Rep. No. 101-386, at 568-69 (1989) (Conf. Rep.).

> be considered to be highly leveraged when compared to other businesses operating with a similar mix of assets. Use of a tailored debt-to-asset ratio as a safe harbor, instead of relying on a fixed debt-to-equity ratio across the board, would make an appropriate safe harbor available to the full range of companies, including those in industries and businesses with an asset mix that typically is more highly leveraged. For example, certain businesses can be highly leveraged because their assets are very liquid, such as financial securities. The revised safe harbor based on asset classes would serve to better focus the application of the section 163(j) limits so that the rules, after tightening, would apply only to companies with unusually high levels of indebtedness when compared with other companies that have a similar mix of assets.[33]

Besides proposing that the safe harbor be based on asset classes, the Bush Administration proposed lowering the adjusted taxable income threshold from 50% to 35%[34] and inserting a second alternative limitation:

> [A limitation] would be added to section 163(j) that would deny a deduction for disqualified interest to the extent that the U.S. members of a corporate group are more highly leveraged than the overall worldwide corporate group (the "worldwide limitation"). Under the worldwide limitation, the amount of excess indebtedness in the United States would be determined by comparing the ratio of indebtedness incurred by the U.S. members of the group to assets held by such members with the ratio of indebtedness incurred by all members of the worldwide group to assets held by the worldwide group. Disqualified interest would be disallowed to the extent attributable to such excess U.S. indebtedness. This worldwide limitation would apply separately to the subgroup consisting of all financial corporations in the corporate group. The amount of interest that would be disallowed under the worldwide test would be limited by the revised safe harbor based on asset classes. Specifically, the amount of excess U.S. indebtedness determined under the worldwide limitation would not exceed the amount by which the corporation's U.S. indebtedness exceeds its safe harbor amount.[35]

None of the proposed changes discussed above by the Bush Administration were enacted.

Another proposal to adjust section 163(j) was made by then Ways and Means Committee Chairman William M. Thomas in 2003. If it had been enacted, it would have increased the scope of section 163(j) considerably by, among other things, repealing the safe harbor entirely, reducing the adjusted taxable income test first to 35% and then to 25% for interest treated as "disqualified" other than by reason of a guarantee, reducing the unlimited carryforward of interest disallowed under section 163(j) to ten years, and elim-

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[33] U.S. Dep't of the Treasury, General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals 104 (2003).

[34] *Id.* at 106.

[35] *Id.* at 105-06.

inating the three year carryforward of "excess limitation".[36] The Bush Administration incorporated these provisions in its fiscal year (FY) 2005 through 2008 budget proposals and included a variation of it in its FY 2004 budget proposal.[37] These proposals were never enacted. Congress did, however, in 2004 direct the Treasury to study "the effectiveness of section 163(j) . . . in preventing the shifting of income outside the United States" and to develop "specific recommendations as to how to improve the provisions . . . ."[38] The Treasury Department issued its report in 2007.[39] The report stated that:

> The earnings-stripping study did not find conclusive evidence of earnings stripping from FCDCs (foreign-controlled domestic corporations) that had not inverted . . . .
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> The Treasury Department believes that additional information is needed to determine how the Administration's Budget proposal would affect FCDCs that have not inverted and whether modification to the proposal would be appropriate. In order to obtain this additional information and further the administration of section 163(j), a new tax form has been created, Form 8926, *Disqualified Corporate Interest Expense Disallowed Under Section 163(j) and Related Information*. Form 8926 solicits information relating to the determination and computation of a corporate taxpayer's section 163(j) limitation, including the determination of the taxpayer's debt-to-equity ratio, net interest expense, adjusted taxable income, excess interest expense, total disqualified interest for the tax year and the amount of interest deduction disallowed under section 163(j), as well as certain information with respect to the related persons receiving disqualified interest.[40]

IV. The Statutory Debt-to-Equity Safe Harbor

The original bill that passed the House did not contain a safe harbor (as discussed below, the safe harbor was added at the House-Senate conference). Even prior to enactment, the bill was criticized because it "would deny interest deductions in cases where net interest expense exceeds the interest threshold *not because the corporation is thinly capitalized* but because the year-to-year changes in profitability or in the amount of depreciation, amortization or depletion."[41] In order to address this concern several changes were made. One change was the inclusion of the debt-to-equity safe harbor. In this regard, the Conference Committee Report stated:

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[36] *See* American Jobs Creation Act of 2003, H.R. 2896, 108th Cong. § 2001 (2003) (introduced by Chairman Thomas on July 25, 2003). An earlier version of the legislation is in section 201 of the American Competitiveness and Corporate Responsibility Act. *See* H.R. 5095, 107th Cong. (2002).

[37] *See* U.S. Dep't of the Treasury, Report to Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties 28 (2007).

[38] American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 424, 118 Stat. 1418, 1519-20.

[39] *See* U.S. Dep't of the Treasury, *supra* note 37, at 9.

[40] *See* U.S. Dep't of the Treasury, *supra* note 37, at 31.

[41] *See* H.R. Rep. No. 101-386, at 567 (1989) (Conf. Rep.) (emphasis added).

> For example, the conferees expect that interest deductions of many corporations will not be affected by the provision because many corporations with what can fairly be called typical capital structures have debt-equity ratios below the safe-harbor ratio in the bill. The conferees understand that the median debt-equity ratio for U.S. corporations is generally measured as less than 1.5 to 1.[42]

Section 163(j)(2)(A)(ii) establishes a 1.5-to-1 "ratio of debt to equity" safe harbor set "as of the close of such taxable year (or on any other day during the taxable year as the Secretary may by regulations prescribe) . . . ." The Proposed Regulations kept the testing date as of the close of the taxable year.[43] In its preamble to the Proposed Regulations, the Treasury noted that "a more frequent determination was not adopted because many taxpayers might have difficulty in obtaining the required information prior to the close of their taxable years."[44] As noted, taxpayers meeting the 1.5-to-1 test are not subject to the section 163(j) interest expense disallowance regardless of any other circumstance. The "ratio of debt to equity" is defined in the statute to mean "the ratio which the total indebtedness of the corporation bears to the sum of its money and all other assets reduced (but not below zero) by such total indebtedness."[45] The statute further provides that:

> (i) the amount taken into account with respect to any asset shall be the adjusted basis thereof for purposes of determining gain,
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> (ii) the amount taken into account with respect to any indebtedness with original issue discount shall be its issue price plus the portion of the original issue discount previously accrued as determined under the rules of section 1272(determined without regard to subsections (a)(7) or (b)(4) thereof) . . . .[46]

The statute further provides for "such other adjustments as the Secretary may by regulations prescribe."[47]

Proposed Regulation section 1.163(j)-3 provides rules for the computation of the debt-to-equity ratio. Debt means the taxpayer's liabilities "determined according to generally applicable tax principles."[48] Accordingly, the Preamble notes that "in general, a contingent liability for financial accounting purposes that has not accrued for tax purposes will not be treated as a liability for purposes of section 163(j)."[49] The Proposed Regulations include a provision that for debt with original issue discount the amount taken into account is its "issue price plus the portion of the original issue discount previously accrued

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[42] *Id.*
[43] Prop. Reg. § 1.163(j)-1(b), 56 Fed. Reg. 27,907, 27,913 (1991).
[44] Prop. Reg. § 1.163(j), 56 Fed. Reg. 27,907, 27,908 (1991).
[45] I.R.C. § 163(j)(2)(C).
[46] § 163(j)(2)(C)(i),(ii).
[47] § 163(j)(2)(C)(iii).
[48] Prop. Reg. § 1.163(j)-3(b)(1), 56 Fed. Reg. 27,907, 27,916 (1991).
[49] *See* Prop. Reg. § 1.163(j), 56 Fed. Reg. 27,907, 27,909 (1991).

under Section 1272 . . . ."[50] The Proposed Regulations exclude from debt, for purposes of calculating the safe harbor, both "short-term liabilities" and "commercial financing liabilities."[51] "Short-term liabilities" are defined as "accrued operating expenses, accrued taxes payable and any accounts payable for the first 90 days of its existence provided that no interest is accrued . . . ."[52] "Commercial financing liabilities" are defined generally as "incurred by the obligor under a commercial financing agreement . . . to buy an item of inventory [that is] secured by" the inventory and "is due on or before sale of the item [of inventory] . . . ."[53] The Proposed Regulations provide that with respect to determining the debt of a corporate partner, the corporate partner is treated as incurring its pro-rata share of the partnership's liabilities.[54] There is a comparable provision for determining a corporate partner's treatment of partnership assets.[55] The Proposed Regulations contain an anti-abuse anti-rollover rule in determining debt pursuant to which "[d]ecreases in the corporation's aggregate debt during the last 90 days of its taxable year shall be disregarded to the extent that the corporation's aggregate debt is increased during the first 90 days of the succeeding year."[56]

"Equity" is defined in the Proposed Regulations as "the sum of money and the adjusted basis of all other assets of the corporation reduced (but not below zero) by the taxpayer's debt . . . ."[57] The Proposed Regulations provide for adjustments to be made to the basis of stock which is not an "includible corporation" (as defined in section 1504(b)).[58] Under the Proposed Regulations, assets are reduced by the amount of liabilities excluded from determining debt under Proposed Regulation section 1.163(j)-3(b)(2).[59] The Proposed Regulations contain both a general anti-avoidance rule and an anti-stuffing provision.[60] Pursuant to the former rule, "[a]n asset of the taxpayer shall be disregarded in computing the taxpayer's debt-equity ratio if the principal purpose for acquiring the asset was to reduce the taxpayer's debt-equity ratio."[61] The anti-stuffing provision is somewhat comparable to the anti-rollover provision for debt. Pursuant to Proposed Regulation section 1.163(j)-3(c)(5)(ii),

> [i]n determining a corporation's equity, any transfer of assets made by a related person to the corporation during the last 90 days of its taxable year shall be disregarded to the extent that there is a transfer of the same or similar assets

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[50] Prop. Reg. § 1.163(j)-3(b)(1), 56 Fed. Reg. 27,907, 27,916 (1991).
[51] Prop. Reg. § 1.163(j)-3(b)(2), 56 Fed. Reg. 27,907, 27,916 (1991).
[52] Prop. Reg. § 1.163(j)-3(b)(2)(i), 56 Fed. Reg. 27,907, 27,916 (1991).
[53] Prop. Reg. § 1.163(j)-3(b)(ii), 56 Fed. Reg. 27,907, 27,916 (1991).
[54] Prop. Reg. § 1.163(j)-3(b)(3), 56 Fed. Reg. 27,907, 27,916 (1991).
[55] *See* Prop. Reg. § 1.163(j)-3(c)(4), 56 Fed. Reg. 27,907, 27,916 (1991).
[56] Prop. Reg. § 1.163(j)-3(b)(4), 56 Fed. Reg. 27,907, 27,916 (1991).
[57] Prop. Reg. § 1.163(j)-3(c)(1), 56 Fed. Reg. 27,907, 27,916 (1991).
[58] Prop. Reg. § 1.163(j)-3(c)(2), 56 Fed. Reg. 27,907, 27,916 (1991).
[59] Prop. Reg. § 1.163(j)-3(c)(3), 56 Fed. Reg. 27,907, 27,916 (1991).
[60] Prop. Reg. § 1.163(j)-3(c)(5), 56 Fed. Reg. 27,907, 27,916 (1991).
[61] Prop. Reg. § 1.163(j)-3(c)(5)(i), 56 Fed. Reg. 27,907, 27,916 (1991).

> by the corporation to a related person during the first 90 days of the corporation's succeeding taxable year.

Finally, the Proposed Regulations provide that "the spot rate on the last day of the taxable year" is used to translate both assets and liabilities with respect to "a qualified business unit that has a functional currency other than the dollar . . . ."[62]

Returning to the UKPAR and USSUB fact-pattern, assume USSUB is in the pharmaceutical industry and incurs considerable expenditures in research and development (R&D). Further, assume that it has elected to deduct R&D expense pursuant to section 174 rather than to capitalize it. Furthermore, USSUB has not purchased any intangibles and has therefore no tax basis in its patents and know-how. Very recently, after years of research and testing, it has developed and patented a drug whose efficacy in fighting certain types of cancer with minimal adverse side effects is clear. The drug has just received approval from the Food and Drug Administration and USSUB plans to launch sales of the drug at the beginning of next year. Qualified experts in the field have put the fair market value of the drug at no lower than $5 billion. Because drug sales have not yet commenced, adjusted taxable income for the current year does not reflect any earnings from the patent. Assume further that the other assets and liabilities on the balance sheet are: (1) current assets, with a tax basis and fair market value of $200 million; (2) property plant and equipment, with a tax basis and fair market value of $500 million; (3) other intangibles, with a fair market value of $600 million, and a tax basis of $0; (4) current liabilities of $200 million; and (5) long term liabilities, consisting entirely of loans from UKPAR, of $2.5 billion.

USSUB has failed the statutory safe harbor because $5.6 billion worth of intangibles have been ignored because they possess no tax basis. In reality, however, the fair market value of the USSUB's assets greatly exceeds its liabilities, and would more than meet the 1.5-to-1 debt-to-equity safe harbor if it was based on the assets' fair market value and not tax basis. Furthermore, presumably given its valuable intangibles, USSUB could readily have issued third party debt in place of the loans from UKPAR without a parent company guarantee.

V. The Judicially Developed Rules for Determining Whether Related Party Debt Should Be Treated as Equity for Tax Purposes

The decision to ignore the nomenclature and reclassify for tax purposes a related party instrument purported to be debt, as equity, is based on a number of factors. The relative thinness of the capital is just one of many points the courts consider. While section 385 lists certain factors, including the ratio of debt-to-equity of the corporation, that may be included in regulations

[62] Prop. Reg. § 1.163(j)-3(d), 56 Fed. Reg. 27,907, 27,916 (1991).

to be issued by the Treasury,[63] because there are no regulations currently in effect,[64] the analysis is generally based on case law.[65]

As the Court of Appeals for the Sixth Circuit noted in *United States v. Title Guarantee & Trust Co.*:

> The essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it, so that he may enjoy the chances of profit. The creditor, on the other hand, does not intend to take such risks so far as they may be avoided, but merely to lend his capital to others who do intend to take them.[66]

One area where this issue comes up is in the context of loans made by a foreign parent to its wholly owned United States subsidiary, where the decision to treat parent company financing as debt instead of equity is often driven by the tax benefit of interest expense versus dividends. Under these circumstances, obviously, the shareholder and the purported creditor are one and the same, and the funds advanced are in proportion to the lender's ownership in the borrower.[67] As the Court of Appeals for the Third Circuit noted in *Fin Hay Realty Co. v. United States*:

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[63] Code section 385(b) provides in part that "[t]he factors so set forth in the regulations may include among other factors: (1) whether there is 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, (2) whether there is subordination to or preference over any indebtedness of the corporation, (3) the ratio of debt to equity of the corporation, (4) whether there is convertibility into the stock of the corporation, and (5) the relationship between holdings of stock in the corporation and holdings of the interest in question."

[64] Code section 385(a) authorizes the Secretary of the Treasury to "prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness)." Final regulations that had been issued under Code section 385 were withdrawn in 1983 and have not been reissued. *See* T.D. 7920, 1983-2 C.B. 69-70.

[65] Code section 385(c), however, is operative. Section 385(c)(1) provides that "[t]he characterization (as of the time of issuance) by the issuer as to whether an interest in a corporation is stock or indebtedness shall be binding on such issuer and on all holders of such interest (but shall not be binding on the Secretary)." Cummings points out that "[s]ection 385(c) has been interpreted to mean that the issuer's characterization of an instrument on its U.S. federal tax return is binding unless the holder states on his U.S. tax return that it is reporting differently." Jasper L. Cummings, Jr., Pepsico *and Debt Equity*, 138 TAX NOTES (TA) 111, 115 (Jan. 7, 2013).

[66] United States v. Title Guarantee & Trust Co., 133 F.2d 990, 993 (6th Cir. 1943).

[67] This should be contrasted to situations where there is a "sharply disproportionate ratio between a stockholder's percentage interest in stock and debt." *See* Estate of Mixon v. United States, 464 F.2d 394, 409 (5th Cir. 1972) (debt treatment determined where "funds advanced were not in proportion to" equity ownership); *see also* Adelson v. United States, 737 F.2d 1569, 1572 (Fed. Cir. 1984) (debt treatment sustained where lender had only "a minor equity interest in the" debtor corporation).

> In a corporation which has numerous shareholders with varying interests, the arm's-length relationship between the corporation and a shareholder who supplies funds to it inevitably results in a transaction whose form mirrors its substance. Where the corporation is closely held, however, and the same persons occupy both sides of the bargaining table, form does not necessarily correspond to the intrinsic economic nature of the transaction, for the parties may mold it at their will with no countervailing pull. This is particularly so where a shareholder can have the funds he advances to a corporation treated as corporate obligations instead of contributions to capital without affecting his proportionate equity interest. Labels, which are perhaps the best expression of the subjective intention of parties to a transaction, thus lose their meaningfulness.[68]

The distinction between debt and equity has been subject to considerable litigation with courts stressing similar but not uniform factors in deciding the matter. Furthermore, not all factors are necessarily relevant in deciding a particular case.[69] A recently decided Tax Court case, *NA General Partnership v. Commissioner,* involved what, for U.S. income purposes, was a foreign parent and U.S. subsidiary.[70] The court, holding for the taxpayer, treated an advance as a loan rather than as a capital contribution. The court noted that, because the decision was appealable to the Court of Appeals for the Ninth Circuit, the factors to be considered were:

> (1) the name given to the documents evidencing the indebtedness; (2) the presence of a fixed maturity date; (3) the source of the payments; (4) the right to enforce payments of principal and interest; (5) participation in management; (6) a status equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) payment of interest only out of "dividend" money; and (11) the corporation's ability to obtain loans from outside lending institutions.[71]

The court added that "[n]o one factor is decisive, and the weight given to each factor depends on the facts and circumstances."[72]

A recent Tax Court decision, *Pepsico Puerto Rico Inc. v. Commissioner,* involved a cross-border hybrid instrument designed to be treated as debt for Dutch income tax purposes, but as equity for U.S. income tax purposes.[73]

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[68] Fin Hay Realty Co. v. United States, 398 F.2d 694, 697 (3d Cir. 1968).

[69] *See, e.g.*, Dixie Dairies Corp. v. Commissioner, 74 T.C. 476, 493-94 (1980).

[70] NA General Partnership v. Commissioner, 103 T.C.M. (CCH) 1916, 2012 T.C.M. (RIA) ¶ 2012-172, at 1315.

[71] *Id.* at 1919, 2012 T.C.M. (RIA) ¶2012-172 at 1320 (citing Hardman v. United States, 827 F.2d 1409, 1412 (9th Cir. 1987)).

[72] *Id.*

[73] PepsiCo Puerto Rico Inc. v. Commissioner, 104 T.C.M. (CCH) 322, 324, 2012 T.C.M. (RIA) ¶ 2012-269, at 1852.

The taxpayer successfully argued for equity treatment.[74] With respect the factors to be considered in distinguishing debt from equity, the Tax Court stated:

> Various Courts of Appeals have identified and considered certain factors in resolving debt-versus-equity inquiries. See, e.g., United States v. Uneco, Inc. (In re Uneco, Inc.) 532 F.2d at 1208 (10 factors); Estate of Mixon v. United States, 464 F.2d 394, 402 (5th Cir. 1972) (13 factors); Fin Hay Realty Co. v. United States, 398 F.2d at 697 (16 factors). This Court has articulated a list of 13 factors germane to such an analysis: (1) names or labels given to the instruments; (2) presence or absence of a fixed maturity date; (3) source of payments; (4) right to enforce payments; (5) participation in management as a result of the advances; (6) status of the advances in relation to regular corporate creditors; (7) intent of the parties; (8) identity of interest between creditor and stockholder; (9) "thinness" of capital structure in relation to debt; (10) ability of the corporation to obtain credit from outside sources; (11) use to which advances were put; (12) failure of debtor to repay; and (13) risk involved in making advances.[75]

In *Estate of Mixon v. United States,* the Court of Appeals for the Sixth Circuit listed the following factors as relevant in distinguishing debt from equity: (1) the name given to the certificate evidencing the indebtedness; (2) "the presence or absence of a fixed maturity date"; (3) the source of payments, that is, whether the recipient of the funds can repay the advance with reasonably anticipated cash flow or liquid assets; (4) whether the provider of the funds has "the right to enforce payment"; (5) whether the provider of the advance gains an increased right to participate in management; (6) "the status of the contribution in relation to regular creditors"; (7) "the intent of the parties"; (8) whether the recipient of the advance is adequately capitalized; (9) whether there is an "identity of interest between the creditor and the shareholder"; (10) "source of interest payments," (*i.e.*, whether the recipient of the funds pays interest from earnings); (11) "the ability of the corporation to obtain loans from outside lending institutions"; (12) the extent to which the recipient used the advance to buy capital assets; and (13) whether the recipient repaid the funds on the due date.[76]

In response to the issuance of certain financial products, including monthly income preferred securities (MIPS), the Service issued Notice 94-47, provid-

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[74] The court noted in this regard "[i]n a typical debt-versus-equity case, the Commissioner argues for equity characterization whereas the taxpayers endeavor to secure debt characterization. In the present circumstances the roles are reversed." *Id.* at 335 n.48, 2012 T.C.M. (RIA) ¶ 2012-269 at 1868 n.48. Also in 2012 the Tax Court decided another case where a taxpayer sought equity treatment, Hewlett-Packard Co. v. Commissioner, 103 T.C.M. (CCH) 1736, 1747, 2012 T.C.M. (RIA) ¶ 2012-135, at 1070, but this time the Commissioner prevailed.

[75] *PepsiCo Puerto Rico Inc.*, 104 T.C.M. (CCH) at 335, 2012 T.C.M. (RIA) ¶ 2012-269 at 1868 (citing Dixie Dairies Corp. v. Commissioner, 74 T.C. 476, 493 (1980) (footnotes omitted)).

[76] Estate of Mixon v. United States, 464 F.2d. 394, 402 (5th Cir. 1972).

ing eight factors to be considered for distinguishing debt from equity in certain circumstances.[77] The Service indicated that these factors are:

> (a) whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future; (b) whether holders of the instruments possess the right to enforce the payment of principal and interest; (c) whether the rights of the holders of the instruments are subordinate to rights of general creditors; (d) whether the instruments give the holders the right to participate in the management of the issuer; (e) whether the issuer is thinly capitalized; (f) whether there is identity between holders of the instruments and stockholders of the issuer; (g) the label placed upon the instruments by the parties; and (h) whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes. No particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity. The weight given to any factor depends upon all the facts and circumstances and the overall effect of an instrument's debt and equity features must be taken into account.[78]

As can be seen, the tests are similar but not uniform and are not the paradigm of clarity. In his recent insightful article, "*Pepsico* and Debt Equity," Jasper Cummings notes:

> In practice the result of the debt-equity factors is not to provide a solution to the problem but rather to foster uncertainty. Flexibility of a rule always favors the IRS more than taxpayers because most taxpayers are scared by the lack of clear rules and because the IRS can argue different ways in different cases.[79]

In *Litton Business Systems, Inc. v. Commissioner,* the Tax Court suggests that the factors can be distilled to one, albeit conjunctive, determinative question: "[w]as 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?"[80] In *Scriptomatic, Inc. v. United States*, the Court of Appeals for the Third Circuit suggested the ultimate test "be expressed in terms of two lines of inquiry: assuming that the obligation is debt in form, (1) did the form result from an arm's-length relationship and/or (2) would an outside investor have advanced funds on terms similar to those agreed by the shareholder."[81] A variation of the foregoing was proposed

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[77] Notice 94-47, 1994-1 C.B. 357.

[78] *Id.* An excellent article on Notice 94-47 is David P. Hariton, *Distinguishing Between Equity and Debt in the New Financial Environment*, 49 TAX L. REV. 499 (Spring 1994).

[79] Cummings, *supra* note 65, at 121.

[80] Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367, 377 (1973).

[81] Scriptomatic, Inc. v. United States, 555 F.2d 364, 368 (3d Cir. 1977). *See also* Thomas D. Greenaway & Michelle L. Marion, *A Simpler Debt-Equity Test,* 66 TAX LAW. 73, 74, (2012) (suggesting that the distinction between debt and equity should be tested as follows: "[d]id the parties to the transaction reasonably expect the funds would be repaid in full?").

by Professor Wayne Gazur as follows: "if a third-party lender, acting at arm's length and with reasonable knowledge of all relevant facts at the time of the transaction would not make the loan in substantially the same manner in which it was structured then the presumptive classification is equity."[82]

VI. The Ratio of Debt-to-Equity in the Determination of Thin Capitalization

Now turn to the factor with which this Article concerns itself: the degree of thin capitalization of the issuer, and more relevantly, how the ratio of debt-to-equity should be determined for this purpose. With respect to what ratio to utilize in determining thin capitalization, Professors Bittker and Eustice observe:

> As to the ratio itself, the courts have not laid down any mathematical formula, recognizing that what is excessive in one industry may be normal in another and that corporations' financial requirements vary even within the same industry. It is usually assumed, however, that a ratio of debt to equity that does not exceed 3 to 1 will withstand attack. A less favorable ratio is likely to invite attention, but there is a general judicial tendency to regard even an excessive ratio as no more than a factor to be considered rather than as an independent test of the purported debt's validity; and there are a few cases in which it is regarded as virtually irrelevant.[83]

Carman and Bender explain the role of the thin capitalization test as follows:

> The debt-equity ratio indicates to what extent a corporation may suffer losses without impairment of the interests of the corporation's creditors. A high ratio lowers the protection afforded to the creditors against sudden business slumps. As a result, a high ratio of debt to equity indicates that the issuance of the instrument is evidence of a contribution to capital rather than a bona fide loan.[84]

In short, thin capitalization is evidence that an unrelated third party would not have loaned the money under these circumstances. Carman and Bender add that "even a finding that an issuer is thinly capitalized may not adversely affect debt classification if cash flows sufficient to service the debt can be demonstrated to be reasonably assured."[85] For example, in *Delta Plastics, Inc. v. Commissioner*, the Tax Court sustained debt treatment claimed by the taxpayer despite a 26-to-1 ratio of debt-to-equity at the inception of the company, where the business was likely to be successful and thus pay principal and interest because of the taxpayer's knowledgeable officers and directors (the court did point out that the debt-to-equity ratio dropped to 4-to-1 within

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[82] Wayne M. Gazur, *An Arm's Length Solution to the Shareholder Loan Tax Puzzle*, 40 Seton Hall L. Rev. 407, 419-20 (2010) (footnotes omitted).

[83] Bittker & Eustice, *supra* note 6, at ¶ 4.04[3] (footnote omitted).

[84] Paul Carman & Kelley Bender, *Debt, Equity or Other: Applying a Binary Analysis in a Multidimensional World*, 107 J. Tax'n 17, 20 (2007).

[85] *Id.* at 20.

three years).[86] Raby and Raby characterized the taxpayer in *Delta Plastics* "as having an unrecorded asset that might be termed 'goodwill' and, as subsequent events demonstrated, was probably worth several million dollars."[87] In other words, the ratio was not really 26-to-1 at the inception of the company if the company's intangibles, not recorded in the books, were counted.

We now turn to how thin capitalization should be determined: book value, tax basis, or fair market value of the assets. In his epic work, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*,[88] William Plumb, in describing the test for thin capitalization writes, "[a]ttention is not riveted on the book net worth, however, but on the fair market value of the net assets or, in default of proof of asset values, on the market value of the stock of the corporation."[89] He notes, "goodwill, going concern value and similar intangibles which inhere in the business are generally taken into account, if they reflect proven earning capacity rather than merely potential value."[90] Plumb does indicate that "such intangibles may be volatile and may have little realizable value to creditors in the event of default, so the proportion of debt which can be supported thereby may be less than in the case of tangible assets."[91] The prevalent, albeit not unanimous, view of courts that have considered the issue is that in determining whether an entity is thinly capitalized, assets should be measured by their fair market value rather than book or tax basis.[92]

Bittker and Eustice point out that in determining whether the ratio of debt-to-equity is excessive, "the use of market values for the assets (including goodwill), rather than their cost or book value, is well established . . . ."[93] In *Liflans Corp. v. United States*, the Court of Federal Claims indicated that "[t]he prevailing view seems to be that assets are to be taken at fair market value rather than at book value when valuing the equity interest in order to compute the ratio."[94] In the well cited decision of the Court of Appeals for the Second Circuit, *Kraft Foods Co. v. Commissioner,* the court pointed out that

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[86] Delta Plastics, Inc. v. Commissioner, 85 T.C.M. (CCH) 940, 943, 2003 T.C.M. (RIA) ¶ 2003-054, at 263-65 (2003).

[87] Burgess J.W. Raby & William L. Raby, *Debt vs. Equity Not Merely a Matter of Ratios*, 98 Tax Notes (TA) 1707, 1707 (Mar. 17, 2003).

[88] William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 Tax L. Rev. 369 (1971).

[89] *Id.* at 516-17 (footnotes omitted).

[90] *Id.* at 518 (footnotes omitted).

[91] *Id.*

[92] *See* Bittker & Eustice, *supra* note 6, at ¶ 4.04[3]; *see also infra* notes 97-103 and accompanying text.

[93] Bittker & Eustice*, supra* note 6, at ¶ 4.04[3].

[94] Liflans Corp. v. United States, 390 F.2d 965, 970 (Ct. Cl. 1968) (quoting William M. Goldstein, *Corporate Indebtedness to Shareholders: "Thin Capitalization" and Related Problems*, 16 Tax L. Rev. 1, 19 (1960) (footnote omitted)).

"[w]e think it obvious that in the determination of debt-equity ratios, real values rather than artificial par and book values should be applied."[95]

In *Georgia-Pacific Corp. v. Commissioner,* the Tax Court stated that "advances were not placed at the risk of the business, for the *fair market value of* [the issuer's] assets greatly exceeded its debts . . . ."[96]

In *Nye v. Commissioner*, the Tax Court specifically addressed the importance of considering the fair market value of intangible assets in sustaining the taxpayer's debt characterization of the instrument in question, stating:

> We perceive no reason why either the going-concern value or the goodwill of the established business should not be taken into account in testing the adequacy of the corporation's capitalization. While no evidence was offered to establish precisely the going-concern value of the business, the high level of income both before and after the transfer demonstrates substantial value . . . . Such going-concern value is not to be treated as merely incidental to the depreciable assets; it is, in itself, a nondepreciable intangible asset . . . . Respondent's mathematical computation of a debt-to-capital ratio ignores these factors. We believe that both the goodwill and going-concern value, which were placed at the risk of the business as capital contributions, were substantial.[97]

The importance of considering intangibles not on the books for determining whether a corporation was thinly capitalized was also stressed by the Court of Appeals for the Ninth Circuit in *Murphy Logging Co. v. United States.*[98] Similarly, in another decision by that court, *Miller v. Commissioner,* the court emphasized the significance of considering the fair market value of the assets in making the proper determination.[99]

The significance of counting intangible assets not on the books was also underscored by the Tax Court in *LaStaiti v. Commissioner*:

> We note that in arguing that Associates was thinly capitalized and had an excessive proportion of debt in relation to equity capital, the Government has relied solely on figures from Associates' books. However, the books would not necessarily reflect the full value of petitioner's investment in Associates. When petitioner formed the corporation in 1955, he contributed to it the assets of a business which had been operating successfully and expanding for over 20 years. This business undoubtedly possessed substantial goodwill, and it cannot be ignored in computing the value of petitioner's capital investment in the corporation.[100]

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[95] Kraft Foods Co. v. Commissioner, 232 F.2d 118, 127 (2d Cir. 1956).

[96] Georgia-Pacific Corp. v. Commissioner, 63 T.C. 790, 797 (1975) (emphasis added).

[97] Nye v. Commissioner, 50 T.C. 203, 215 (1968).

[98] *See* Murphy Logging Co. v. United States, 378 F.2d 222, 224 (9th Cir. 1967).

[99] *See* Miller v. Commissioner, 239 F.2d 729, 733 (9th Cir. 1956).

[100] LaStaiti v. Commissioner, 41 T.C.M. (CCH) 511, 524 n.8, T.C.M. (P-H) ¶ 80,547, at 2325 n.8 (1980).

While it is only a Tax Court Memorandum decision, *Laidlaw Transportation, Inc. v. Commissioner*[101] might be construed as an exception to the cases holding that use of fair market value of assets is the correct approach in testing whether the issuer is thinly capitalized. In *Laidlaw,* the taxpayer lost in its attempt to sustain debt characterization. In its review of the factors distinguishing debt from equity as set forth in *Estate of Mixon v. United States,*[102] the court analyzed the capitalization of the taxpayer and found that "[t]he debt to equity ratio was initially high . . . [and] the parties realized that it would likely go higher . . . ."[103] The Tax Court rejected the taxpayer's argument that the fair market value of the assets was the proper measurement noting that:

> The leverage ratios and coverage ratios in petitioner's loan agreements were based on book value. None of the loan documents stated that the leverage or coverage ratios were based on fair market values. Banks which made commercial loans to petitioners generally determined financial ratio requirements by referring to the book values of the Laidlaw borrowers and guarantors.[104]

The Tax Court in *Laidlaw* did note that that the issue was moot because "[e]ven if we considered fair market value debt to equity ratios, petitioners fare no better because their debt to equity ratios were worse than those of their competitors using either book or fair market values."[105]

Because of its unusual facts, courts should limit *Laidlaw* to situations where third party loans were predicated on use of financial statements reflecting book values. Perhaps for some issuers in industries where book value or tax basis somewhat replicates fair market value (where there are not significant intangible assets with little or no book value or tax basis) it is inconsequential that an issuer's debt-to-equity ratio is not based on the fair market value of its assets. *Laidlaw* may be an example of such a situation. This sort of situation clearly does not exist in the UKPAR and USSUB fact pattern posited with the U.S. borrower possessing valuable self-developed intangibles. Loans made by third party lenders would take such intangibles into consideration.[106] It would be absurd to ignore such assets in determining whether the issuer was thinly capitalized, whether or not such assets are reflected in its financial statements, or possess a tax basis.

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[101] Laidlaw Transp., Inc. v. Commissioner, 75 T.C.M. (CCH) 2598, 1998 T.C.M. (RIA) ¶ 98,232.

[102] Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972).

[103] *See Laidlaw Transp., Inc.*, 75 T.C.M. (CCH) at 2620, 1998 T.C.M. (RIA) ¶ 98,232 at 1366.

[104] *Id.* at 2620, 1998 T.C.M. (RIA) ¶ 98,232 at 1367.

[105] *Id.*

[106] As Plumb *supra* note 88 indicates, there may be some discount made by lenders because of lesser realizable value upon default, but they would not be ignored, especially in the fact pattern the author postulates where the drug's effectiveness with limited side effects is clear.

VII. Why the Debt-to-Equity Safe Harbor Measuring Assets at Their Tax Basis Is Flawed

As the example with UKPAR and USSUB illustrates, companies that have successfully engaged in R&D, such as pharmaceutical and computer software companies, and have, as a result, valuable patents and know-how will often not reflect these assets in a debt-to-equity ratio that measures the assets by their tax basis. Taxpayers in such situations would in most instances have elected to deduct such R&D expenditures and therefore have no tax basis in the fruits of the research. Similarly, a consumer products company that has self-developed valuable goodwill and other marketing-based intangibles by engaging in advertising, promotion, and similar activities will not have its true worth and borrowing ability determined correctly if assets are measured by tax basis since presumably such expenses that helped create these assets were deducted under section 162. In a letter to House Ways and Means Committee Chairman William Thomas, in conjunction with some legislative proposals addressing section 163(j), the New York State Bar Association Tax Section voiced similar concerns with the thin capitalization safe harbor:

> In commercial lending transactions, the borrower's tax basis in its assets is irrelevant. Lenders generally look to the capacity of the borrower's assets to generate cash to service debt. Even in asset-based financings (a subset of the commercial financing market), tax basis is not a pertinent consideration. Asset-based lenders concentrate on the value their collateral and its marketability, not on tax basis. Most taxpayers, for example, have a zero basis in self-created intangibles such as patents, trademarks, software code and know how. In the case of many companies, particularly in technology or service industries, these zero basis assets are their most valuable assets, with the capacity to generate billions of dollars of cash flow. Ascribing a zero value to such assets in the context of asset-based financing is not consistent with commercial reality. Conversely, ascribing a high value to certain assets with a high tax basis is also not consistent with commercial lending transactions. For example, publicly traded debt securities of issuers that are near insolvency cannot be leveraged at anything close to 90% of tax basis.[107]

VIII. Conclusion

There are sound policy reasons for limiting the deduction for interest paid to a related party where U.S. withholding tax has been reduced or eliminated by a tax treaty and the taxpayer is relatively thinly capitalized. Denying a taxpayer an interest expense deduction in circumstances where it is not overly leveraged is not however equitable. As noted above, in enacting section 163(j), Congress acknowledged concerns that the House version of the bill "would deny interest deductions in cases where net interest expense exceeds the income threshold not because the corporation is thinly capital-

[107] N.Y. State Bar Ass'n Tax Section, Report on Certain Legislative Proposals Relating to the Section 163(j) Earnings Stripping Rules 10-11 (2003).

ized . . . ."[108] The 1.5-to-1 safe harbor was incorporated into the provision to address this very concern. The current safe harbor, however, is not appropriate in dealing with the need to exclude adequately capitalized taxpayers from the reach of section 163(j). Revising the safe harbor to reflect assets' fair market value would undoubtedly reduce the reach of section 163(j). Congress could of course adjust the revenue loss by lowering the 1.5-to-1 ratio although this would be questionable in light of the acknowledged objective for the section not to apply when the issuer was not thinly capitalized.

In utilizing tax basis for measuring assets instead of fair market value in the 1.5-to-1 safe harbor, Congress was, perhaps, concerned about tax administration. If so, it would seem foolish to worry about auditing fair market value in this specific case. The Code and regulations contain countless other instances in which taxpayers employ fair market value in some aspect of their tax returns. For example, in determining the amount of gain or loss to be recognized, the Code provides "[t]he amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."[109] The fair market value is utilized with respect to property acquired from a decedent.[110] The amount of distributions of property made by a corporation to a shareholder is determined by its fair market value, as is the basis of the property received.[111] In apportioning interest expense for purposes of determining net foreign source income, taxpayers are permitted to elect to use fair market value instead of tax basis.[112] In short, the Service has successfully dealt with taxpayers using fair market values for many aspects of their tax returns and there is no reason why it should not be utilized here. Furthermore, tax basis itself is not trouble free to the Service in auditing tax returns. With the Code and regulations replete with complexity, there is no compelling argument that in this particular instance taxpayers should utilize a safe harbor based on assets' tax bases because it might be slightly simpler to administer.

Tax basis is the wrong economic measure, and its use and administration is far from effortless. There are pros and cons to having a more tailored safe harbor that might consider the industry in which the taxpayer operates, the makeup of its assets, or its degree of leverage in the U.S. versus the rest of the taxpayer's group offshore.

Assuming, however, that section 163(j) should continue to use a simple numeric debt-to-equity ratio safe harbor, then there is no justification for basing it on tax basis rather than the assets' fair market value. In both the safe harbor for section 163(j) and in the determination of whether an issu-

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108 H.R. Rep. No. 101-386, at 567 (1989) (Conf. Rep.).
109 I.R.C. § 1001(b).
110 *See* I.R.C. § 1014.
111 I.R.C. § 301(b)(1),(d).
112 Temp. Reg. § 1.861-9T(g)(1)(ii).

ance to a related party is treated as debt or equity, the measure of thin capitalization should reflect commercial reality, that is, the fair market value of the issuer's assets.