JUST BECAUSE YOU SAY IT'S DEBT DOESN'T MEAN IT IS: SUBSTANCE OVER FORM IN ACTION

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Tax law focuses on substance, not form, so the labels applied to a transaction don't control its tax treatment. Among the most common examples of this principle are cases in which debt is treated as an equity investment for tax purposes. Courts generally look at a variety of factors to determine whether what purports to be debt should be treated as an equity investment, and some of the cases are close calls. Others are not, as in *Rutter v. Commissioner,* No. 15840-14, 2017 U.S. Tax Ct. Memo LEXIS 174 (Sept. 7, 2017), which the Tax Court decided last week.

Rutter involved a prominent scientist who had a history of success in the biotechnology field. The case involved his relationship with a telehealth company, iMetrikus ("IM"), which developed technology permitting doctors to monitor the health of patients remotely. 2017 U.S. Tax Ct. Memo LEXIS 174 at **3. The taxpayer did not own any common stock in IM; instead, the company's common stock was held by key employees of IM and by certain members of his family. *Id.* at **4. Dr. Rutter was actively involved in IM's business, and he made a series of cash advances to it that were central to the Tax Court case.

Initially, the advances were made in a relatively formal way, with Dr. Rutter receiving a promissory note that could be converted into either common or preferred stock if certain contingencies occurred. *Id.* Between September 2000 and February 2002, the taxpayer received 39 convertible promissory notes in return for $10.6 million in cash advances. *Id.* The notes were essentially identical, and they provided for IM to pay 7% interest, which IM duly paid. *Id.* at **4-**5. The formalities began to lapse, however, after February 2002, as Dr. Rutter advanced another $22 million to IM between February 2002 and May 2005 with only $3.4 million of the advances supported by formal promissory notes. *Id.* at **5. The remaining advances were simply recorded on IM's books as debt, and they accrued interest at 7%, which was the rate used in the most recent note. *Id.* In addition, IM stopped paying interest on a current basis. *Id.*

In May 2005, the taxpayer converted all of his outstanding advances, which totaled $43.4 million, into preferred stock. *Id.* After converting his outstanding advances, Dr. Rutter continued to make additional cash advances to IM, lending it $43.04 million between May 2005 and December 2009; these funds were the company's sole source of cash during that time period. *Id.* The advances were made periodically to permit IM to meet its operational budget; the taxpayer received no promissory notes, and the loans were not supported by any collateral. *Id.* at **6. The advances were simply recorded on IM's books as loans and accrued interest at 7%; they totaled $47.5 million by the end of 2009. *Id.*

IM incurred substantial losses throughout the relevant time frame, with revenues falling well short of its internal projections. *Id.* at **8. The taxpayer began to develop concerns whether the advances he had made to the company were collectible; he discussed IM's financial condition with Laurence Bardoff, who worked at Synergenics, an entity that Dr. Rutter controlled. *Id.* at **9. After learning that IM's situation was precarious, the taxpayer began to discuss the possibility of claiming a bad debt deduction for his advances with Bardoff and with his accountant. *Id.*

Ultimately, the taxpayer decided to claim a bad debt deduction for $8.55 million in advances; as part of the process, his attorney prepared a note to document the remaining advances that were not to be written off. *Id.* at **10. In March of 2010, IM and Dr. Rutter executed a debt restructuring agreement; Dr. Rutter gave IM a certificate of debt forgiveness for $8.55 of the open advances, and he received a promissory note for the remaining $34.5 million. The documents were dated as of the end of 2009. *Id.* The taxpayer then claimed the $8.55 million as a bad debt loss on his 2009 return, and the IRS disallowed the deduction, giving rise to the Tax Court case.

The Tax Court commenced its analysis by examining whether the debt that was the subject of the deduction was bona fide debt, focusing on whether an outside lender would have advanced funds to IM on the terms offered by the taxpayer. *Id.* at **16. To guide its analysis, the court relied upon a multiple factor analysis articulated by the Ninth Circuit in *Hardman v. United States*, 827 F. 2d 1490 (9th Cir. 1987). The first two factors, the "Labels on the Documents" reflecting the debt and the presence of a fixed maturity date, were quickly resolved in favor of the government given the absence of any formal promissory note. 2017 U.S. Tax Ct. Memo LEXIS 174 at **18-**19. The court explicitly indicated that the promissory note created when the taxpayer wrote off a portion of his advances had "no probative value." *Id.* at **19.

Next, the Tax Court examined the source of funds that IM would have to repay Dr. Rutter's advances. This factor did not weigh in favor of the taxpayer for two reasons:

- First, IM had incurred substantial losses and had been kept afloat by the taxpayer's funds.
- Second, Dr. Rutter testified that he anticipated that repayment would be derived through either a sale of IM or an outside equity investment.

Id. at **20-**21. In the court's view, the taxpayer's expectation that payment would be the product of a corporate buyout "strongly supports characterization of his advances as equity." *Id.* at **21.

Dr. Rutter's rights to enforce payment, or more accurately his lack of rights also weighed in favor of treating his advances as an equity investment. Since there was no note evidencing the debt, he lacked the ability to demand payment at a specific time. *Id.* at **21-**22. The court also emphasized the lack of any collateral, as well as the practical inability of IM to repay the advances. *Id.* at **22.

The next relevant factor was the extent to which Dr. Rutter received additional rights to participate in management as a result of his advances. The taxpayer argued that none of the advances gave him either increased voting rights or a larger share in the equity of IM. While acknowledging that this was literally true, the Tax Court concluded that he already had complete control. *Id.* at **22-**23. In the court's view, this factor also supported a determination that the advances were equity investments. *Id.* at **23.

The Tax Court then considered the taxpayer's position as contrasted with other creditors. Since there were no other creditors, this factor was problematic. The Tax Court resolved that problem by considering the lack of formalities associated with the advances, including the absence of a promissory note, of a maturity date, of collateral, and of interest payments; the court then commented that "[n]o 'regular creditor' would have lent funds to a loss-ridden company like IM on such terms." *Id.*

Turning to the question of intent, the Tax Court concluded that the taxpayer's actions "strongly suggest that he intended the advances to be equity." *Id.* at **24. The absence of promissory notes and the taxpayer's failure to enforce interest payments were among the factors cited by the court. The Tax Court also cited Dr. Rutter's control over the company, and his expectation that he would be paid through a sale or a third party investment. *Id.* This factor also weighed in favor of equity treatment.

The Tax Court then addressed IM's capitalization, as "thin" capitalization suggests a high risk of non-payment that is inconsistent with bona fide debt. *Id.* at **25. The court noted that the amount of the taxpayer's advances between May of 2005 and December 2009 were roughly equal to the face value of IM's preferred stock. While the presence of significant equity invested was relevant, its impact was limited because the bulk of that equity was the taxpayer's own funds. *Id.* at **26. The court concluded that this factor was either neutral or slightly in Dr. Rutter's favor.

The ninth factor addressed was whether the advances were made by a sole shareholder. The court acknowledged that Dr. Rutter was not the sole shareholder, but commented that he controlled the company and owned between 78% and 92% of its capital. *Id.* The court concluded that this capital structure favored equity treatment slightly or was neutral. *Id.* at **27.

The final two factors addressed by the Tax Court were the payment of interest and IM's ability to obtain alternative financing. The fact that IM made no interest payments to Dr. Rutter between February 2002 and December 2009 was obviously problematic, and the court concluded that this factor weighed heavily in favor of treating his advances as equity investments. *Id.* Similarly, the court readily determined that IM could not have obtained financing from another source, particularly in the absence of customary terms such as a promissory note, interest payments, collateral, and a personal guaranty. *Id.* at **28. The court also noted that Rutter had continued to advance funds to IM after making the decision to write off a portion of his advances. *Id.* at **29.

With the vast bulk of the factors weighing in favor of the equity determination, the Tax Court disallowed the deduction for bad debt due to the lack of bona fide debt.

Two aspects of the Tax Court's opinion in *Rutter* are noteworthy. First, the court periodically indicates that Dr. Rutter had "control" over IM. That is frankly debatable, as he held no common stock and apparently had no voting rights. While he appeared to have significant operational control, the record suggests that technical legal control over IM still rested with its common stockholders. While they had been permitting Rutter to run IM, there was no assurance that they would continue to do so.

Second, the complete lack of any formalities made this a very difficult case for the taxpayer. Perhaps the outcome would have been the same, but if promissory notes had been used and interest had been paid, Dr. Rutter's counsel would have had a better hand to play and that might have yielded a settlement. The lesson is simple: Related party transaction are subject to heavy scrutiny; while formalities may not preserve the desired tax treatment, a lack of formalities will make it very difficult for the taxpayer to prevail.

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