Slim Ventures, LLC

The Law of Taxation on Loans
Overview

Under federal tax law, the proceeds of a loan are not taxable to a taxpayer. However, as with any transaction, the substance of the transaction must be considered. Following is a brief overview of the standards courts have used in determining that a true loan existed, and therefore was not taxable.

"Debt for Federal income tax purposes connotes an existing, unconditional, and legally enforceable obligation to repay." *Hubert Enter., Inc. Subsidiaries v. Comm'r*, 125 T.C. 72, 91, 2005 WL 2293526 (2005). Accordingly, to meet the fundamental requirement of a loan: "a genuine intention on the part of the parties to create a debt," must exist which is done by looking at the facts and circumstances surrounding the purported debtor-creditor relationship.

A capital contribution or a gift is not a debt. *See* 26 C.F.R. § 1.166-1(c). Courts, in reviewing a monetary transaction to determine whether it constitutes a *bona fide* debt, must review closely the "objective facts" of the transaction, *Roth Steel Tube Co. v. Comm'r*, 800 F.2d 625, 630 (6th Cir.1986), rather than whatever characterization that the taxpayer subsequently chooses to ascribe to it.

Courts have held that "taxpayers are liable for the tax consequences of the transaction they actually execute." *Selfe v. United States*, 778 F.2d 769, 773 (11th Cir.1985). That is, taxpayers "are bound by the `form' of their transaction and may not argue that the `substance' of their transaction triggers different tax consequences." *Id.*

The burden of showing that a monetary transfer is a *bona fide* debt is on the taxpayer.*Hubert*, 125 T.C. at 91 (citing *Roth Steel*, 800 F.2d at 630). This burden is "a difficult one to meet," when the "transaction is cast in sufficiently ambiguous terms to permit an argument either way depending on which is subsequently advantageous from a tax point of view." *Estate of Leavitt v. Comm'r*, 875 F.2d 420, 424 (4th Cir.1989).

In *Lane v. United States*, 742 F.2d 1311, 1314-15 (11th Cir.1984), a court established a multi-factor test to aid courts in determining whether transfers to a corporation constitute debt or equity. 742 F.2d at 1314. Although *Lane* involved the question of whether a transfer constituted a debt for purposes of the bad debt deduction under 26 U.S.C. § 166, the *Lane* test has been applied subsequently in a number of cases to determine whether a particular monetary transfer constituted a debt. *See, e.g., Selfe*, 778 F.2d at 773; *In re Hillsborough Holdings Corp.*, 176 B.R. 223, 248 (Bankr.M.D.Fla.1994).

The thirteen *Lane* factors that should be considered in determining whether a transfer is a *bona fide* debt are:

(1) the names given to the certificates evidencing the indebtedness;
(2) the presence or absence of a fixed maturity date;
(3) the source of payments;
(4) the right to enforce payment of principal and interest;
(5) participation in management flowing as a result;
(6) the status of the contribution in relation to regular corporate creditors;
(7) the intent of the parties;
(8) "thin" or adequate capitalization;
(9) identity of interest between creditor and stockholder;
(10) source of interest payments;
(11) the ability of the corporation to obtain loans from outside lending institutions;
(12) the extent to which the advance was used to acquire capital assets; and
(13) the failure of the debtor to repay on the due date or to seek a postponement.

742 F. 2d at 1314-15. The courts have made clear that these factors are not rigid rules but are rather helpful guidelines to be considered and weighed by the court. *Id.* at 1315. Additionally, a court is not bound to consider all thirteen of the *Lane* factors; it needs to weight only those factors that are relevant to the particular transaction. *Id.*