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Are Surplus Notes Disguised Equity?

If surplus notes look like debt, and act like debt, it's reasonable to assume the courts will treat them like debt for tax purposes.

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In connection with a settlement related to credit derivatives and other structured financings, Ambac Assurance Corp. (AAC) announced in March that it will transfer some $2 billion principal amount of "surplus notes" (along with $2.6 billion in cash) to certain counterparties. In an 8-K filing, Ambac Financial Group Inc., AAC's parent, warned that these surplus notes might be regarded by the Internal Revenue Service as equity capital.

Ambac Financial noted that if the recharacterized notes represent more than 20% of the total value of AAC's stock, the result will be the deconsolidation of AAC from the rest of Ambac Financial's consolidated group. In that event, AAC's net operating losses will no longer be available to reduce the taxable income, and hence the tax liabilities, of the consolidated group.

In addition, if the notes are regarded as equity, and they represent more than 50% of the total value of AAC's stock, AAC will experience an "ownership change" within the meaning of the Internal Revenue Code, specifically Section 382(g). As a result, for any taxable year ending after the change date, the amount of taxable income that may be offset by AAC's prechange NOLs will be severely limited. However, based on the sparse case law addressing the question of whether surplus notes constitute disguised equity, the odds of the IRS successfully asserting that AAC's surplus notes constitute equity capital appear to be rather slim.

In *Harlan* v. *United States*, 409 F.2d 904 (5th Cir. 1969), the taxpayer — W. Larry Harlan and his wife, Mary Jane Harlan — organized Union Bankers' Life Insurance Co. on March 9, 1961. The couple paid $25,000 in exchange for all of the capital stock of Union Bankers' Life. Then the taxpayers advanced an additional sum of $12,500, in return for which they were issued an interest-bearing surplus note, payable on demand. However, the note contained a clause that it shall mature and become payable *only at such time or times as the surplus funds of the corporation exceed $12,500 and only to the extent that such surplus funds are in excess of $12,500.*

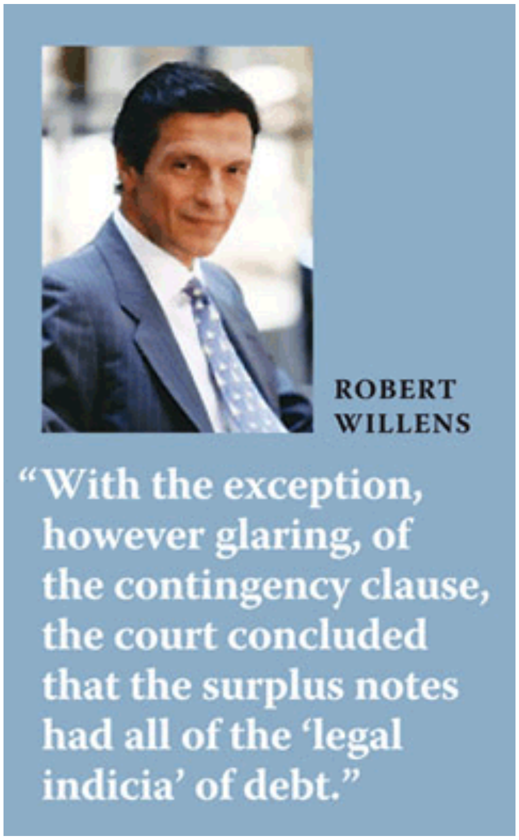
Therefore, the note did not embody an *unconditional* promise to pay a sum certain on demand or on a reasonably close maturity date. In fact, on April 8, 1963, Union Bankers' Life repaid the taxpayers the sum of $12,500 represented by the surplus note, plus interest.

The IRS contended that the surplus note simply represented a contribution to capital, and that the distribution to the Harlans was not a nontaxable repayment of loan principal; rather, it was "equivalent to a dividend." However, the U.S. District Court found that the surplus notes were, indeed, valid indebtedness. This holding was affirmed by the U.S. Court of Appeals for the Fifth Circuit.

A claim that is good "only against surplus" is, the IRS noted, *subordinated* to all liabilities of the issuer since surplus exists only to the extent that assets exceed liabilities. The court noted that, even if the notes had been *expressly* subordinated to other indebtedness, this factor alone, however incriminating, would not have been determinative.

Generally, the court observed, an inordinately postponed due date, or the absence of a fixed maturity date, "weighs in favor" of characterizing an advance as a capital contribution. But despite the fact that the payment of the notes was contingent upon the existence of surplus funds in excess of $12,500, the District Court found that this provision did not convert the notes from debt to capital. This finding, the Court of Appeals observed, "accords with reality," in view of the fact that the instrument was actually repaid two years after the advance of the funds: repayment in that relatively brief time frame is a clear indication that an early maturity date was contemplated.

Further, the court noted that "the restriction on payment of surplus notes to a time when surplus funds exceed a certain amount is required by state law." Moreover, the existence of "proportionality," although an "equity factor," was not dispositive. Proportionality, in this case, refers to the holders of the surplus notes owning the corporation's equity in the same proportions in which they held the notes.



With the exception, however glaring, of the contingency clause, the court concluded that the surplus notes had all of the "legal indicia" of debt. That is, they were in written form, for a certain sum, with fixed interest payments, confer no voting rights, and contain no provision for subordination to general creditors or restrictions against transferability. The court noted that the "reasonable interest provision" of 5% also lends credence to the taxpayer's intent to create a debt, as does the very low debt-to-capital ratio the corporation exhibited.

Accordingly, in the court's view, the transaction "lacked the aura of high-risk capital investments," and the surplus note, therefore, was properly classified as indebtedness for federal income-tax purposes. This case supports the notion that surplus notes that are imbued with the formal indicia of debt will be respected as such for tax purposes. That would be the case even though the instrument is subordinated, albeit not expressly, held by the same persons, and in the same proportions as the issuer's stock, and does not — due to its unusual terms — represent an unconditional promise to pay a sum certain on demand or on a reasonably proximate maturity date.[1]

Contributor Robert Willens, founder and principal of [Robert Willens LLC,](#) writes a weekly tax column for CFO.com.

Footnote

[1] See also *Jones* v. *United States*, 659 F.2d 618 (5th Cir. 1981); in 1954, the taxpayer and others organized an Alabama insurance company known as Associated Doctors Health and Life Insurance Co. AD. AD executed surplus capital notes. The court concluded that the notes represented valid indebtedness and not disguised equity capital. The court noted that the instrument was labeled "surplus capital notes," nomenclature common in the insurance business to refer to a debt executed in contemplation of applicable state surplus capitalization requirements. The notes were subordinated but the court played down this fact — subordination, the court observed, was superimposed by state laws that sought to protect the policyholders. We cannot, the court concluded, hold that subordination destroyed the debt aspects of the transaction. Moreover, here, the corporation was at all times adequately capitalized. The critical factor, the court concluded, *is that state regulations and laws are the reason the parties to this transaction structured it the way they did*. The fact that an insurer seeking to structure a debt transaction is "severely limited in his options," as well as the extent to which the transaction has paralleled the required form, led the court to conclude that the instruments, in the final analysis, represented bona fide indebtedness.