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Recharacterization of Debt as Equity: Tribune Media Company v. Commissioner

By: Elliot Pisem and David E. Kahen

In 2009, Tribune Media Company and the Ricketts family closed a transaction to transfer almost all of Tribune Media's interest in the Chicago Cubs baseball team in what was intended to be a tax-advantaged manner to a partnership controlled by the Ricketts family. A key element of the plan, necessary to permit Tribune Media to defer taxation of the bulk of its gain, was for most of the funds invested by the Ricketts family to be characterized as "debt" for Federal income tax purposes. In *Tribune Media Co. v. Commissioner* (TC Memo 2021-122), a recent decision discussed below, the Tax Court determined that the Ricketts investment, although documented as subordinated debt, was properly characterized as "equity" for tax purposes, such that the deferral sought by Tribune Media was unavailable.

Facts in *Tribune Media*

Tribune Media Company, publisher of the Chicago Tribune newspaper, and its affiliates owned the Cubs baseball team. Beginning in 2007, Tribune Media began to explore the disposition of the Cubs as a non-core asset, a matter made more urgent by a leveraged buyout of Tribune Media (previously a public company) in 2007, financial pressures resulting from the buyout, and an economic downturn that resulted in a bankruptcy filing for the company.

Also potentially relevant to the structuring of the disposition, Tribune Media had elected to be taxed as an S corporation effective December 31, 2007. Although an S corporation is generally treated as a pass-through entity for Federal tax purposes, under Internal Revenue Code (IRC) section 1374 a tax at regular corporate rates is imposed on the corporation to the extent, generally, of net unrealized gain at the time of the S election that is recognized during the "recognition period" -- which, at the time Tribune Media's S corporation election was made, was a 10-year period commencing with the effective date of the election.

The Ricketts family (Ricketts), which emerged as the winning bidder for the team after three rounds of bidding, agreed at the insistence of Tribune Media to the following transaction structure. Ricketts would transfer to Chicago Baseball Holdings, LLC (CBH), a newly formed limited liability company, $150 million in cash, and Tribune Media would transfer the team and related assets valued (net of debt assumed) at approximately $735 million. Also on the date of closing of these transfers, CBH would make a cash distribution of $705 million to Tribune Media, with most of those funds being obtained by CBH through (i) loans aggregating $425 million from various banks and (ii) $249 million provided by an entity owned by members of the Ricketts family in the form of subordinated debt. Reflecting the relatively small remaining equity of Tribune Media after the cash distribution, the agreed-upon initial ownership percentages in CBH were 95% for Ricketts and 5% (collectively) for four Tribune Media entities.

If a partner transfers property to a partnership and there is a related distribution by the partnership to that partner, the contribution and distribution may be treated as a sale of property by the partner to the partnership, commonly referred to as a "disguised sale." It was undisputed that the transaction effected by Tribune Media, Ricketts, and CBH included such a disguised sale. However, in determining the consideration for that sale, funds borrowed by the partnership and then distributed to that partner are generally *not* taken into account to the extent the debt is allocable to the partner receiving the proceeds pursuant to regulations under IRC section 752.

Tribune Media provided guaranties (of ultimate collection of principal and interest, not of payment) with respect to both the bank debt and the subordinated debt. Those guaranties by Tribune Media would cause the debt to be allocable entirely to Tribune Media, and the distribution to CBH, to the extent attributable to the financing obtained by CBH, would not be treated as part of the disguised sale, so long as the cash infusions into CBH that had been documented as borrowings were treated as "debt," and not "equity," for tax purposes.

Following an audit, the IRS asserted tax deficiencies on various theories, and Tribune Media filed a petition for review by the Tax Court. A principal issue before the Tax Court in the decision referenced above was whether the subordinated debt was "debt" for tax purposes.

Discussion

The opinion discusses a familiar list of factors in determining how the subordinated debt should be characterized for tax purposes. One factor supporting characterization as debt was the label attached to the obligation as indebtedness. However, the opinion observes that this factor should be given relatively little weight in this case, taking into account that Ricketts controlled both the borrower and the lender and that those parties "did not negotiate at arm's length. They could label the advance as they desired."

Also found to support characterization as debt was the debt to equity ratio of CBH. The court found that ratio to be 4:1, even if the subordinated debt was classified as debt, and concluded, in part on the basis of expert testimony regarding typical capitalization of major league baseball teams, that CBH was sufficiently capitalized.

Other factors, however, favored characterization as equity. Although the stated term of the subordinated debt was 15 years, the government argued, and the court ultimately agreed, that the debt did not have a fixed maturity date for purposes of this analysis. The subordinated debt could not be repaid by its terms before the senior debt was paid off, and the senior lenders could effectively extend the maturity date of the subordinated debt indefinitely through extensions of the maturity of the senior debt, a right expressly reserved to the senior lenders for exercise "at any time."

Regarding the right of Ricketts to enforce payment, the court found that their enforcement rights were severely limited by the terms of the subordination agreement with the senior lenders. Also, other terms of the transaction documents provided for a cash waterfall under which the holder of the subordinated debt would be allocated payments only after payments on the senior debt, payments for specified capital contributions and in respect of other debt CBH might incur, and discretionary capital expenditures. Further, the loan documents did not provide a mechanism for Ricketts to enforce the obligation to pay interest against CBH if the above-described cash waterfall did not provide sufficient funds for the payment of interest.

It was also noted that the stated interest rate for the subordinated debt of 6.5% per annum was relatively low given the inherent riskiness of the debt, and that the debt included a feature permitting payment of roughly 60% "in kind," with only 40% of the interest being paid annually in cash. The government argued that the terms were not commercially reasonable, and the court appeared to agree with this view. Also undermining Tribune Media's argument for characterization as debt was the circumstance that the efforts made by Ricketts to find other investors who would be willing to participate in the subordinated debts were unsuccessful, providing further evidence that CBH could not have obtained funds from an unrelated party on substantially similar terms.

The opinion also observes that, although an identity of interest as between the creditors and the equity holders does not preclude debt treatment, it does lead to closer scrutiny; and that, in this case, the substantial identity between the Ricketts entity that was the member of CBH and the Ricketts entity that made the subordinated loan favored equity treatment. Finally, it was noted that the percentage ownership interests of Ricketts and Tribune Media in CBH of 95% and 5% respectively were almost exactly aligned with the members' proportionate capital contributions if the subordinated indebtedness was viewed as a form of capital, suggesting that the parties in their negotiations viewed the subordinated indebtedness as equity in substance.

Because the court ultimately concluded that the subordinated debt was not debt at all for tax purposes, it could not be allocated to Tribune Media for purposes of the disguised sale rules, and the amount funded as subordinated debt was viewed as a component of the consideration received by Tribune Media in the disguised sale.

A separate issue worthy of brief mention was the tax treatment of expenses of $2.5 million paid by Tribune Media to a competing bidder for the Cubs. Tribune Media deducted that payment on its return under IRC section 165(a) as an abandonment loss, on the ground that the payment related to an alternative transaction that was not consummated. In light, however, of evidence before the court that Tribune Media agreed to pay this amount "principally to push the Ricketts family to the closing table," rather than in pursuit of a separate and distinct transaction, the court concluded that the payment must instead be capitalized under IRC section 263 as part of the cost of the transaction ultimately completed with Ricketts.

Observations

Based on the evidence, the ultimate conclusion that the subordinated debt was equity for tax purposes does not seem surprising. *Tribune Media* represents yet another reminder of the enduring importance of close analysis of the underlying business deal and transaction documents in distinguishing equity from debt, even where (and perhaps especially where) commercial considerations pursued by senior lenders tend to undermine the rights of other providers of funds who are also seeking classification of their advances as debt for tax purposes.

Elliot Pisem and David E. Kahen are members of the law firm of Roberts & Holland LLP.