TAX AND BUSINESS OPPORTUNITIES (AND PITFALLS) IN MAKING LOANS AND CAPITAL CONTRIBUTIONS TO YOUR CLOSELY HELD BUSINESS

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INTRODUCTION

Today's discussion will focus on some of the more interesting or important tax and asset protection issues that arise when our clients need to infuse funds into their closely held business.

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PART ONE

BAD DEBT DEDUCTION RULES FOR SHAREHOLDER LOANS/ADVANCES AND CAPITAL CONTRIBUTIONS

I. Background.

We often have many clients who have had to infuse their businesses with operating capital. Oftentimes, a taxpayer will make advances to a closely-held corporation. In many cases, a desperate taxpayer continues to loan money to an entity that is not credit worthy. The tax question at issue is often whether or not the capital infusion is truly a loan or instead a capital contribution.

Oftentimes, however, shareholder-creditors fail to carefully document whether these transfers are **(i) bona fide loans or (ii) capital contributions**. In these cases, the following problems may arise:

(1) Subsequent repayment of these "advances", or payment of “interest”, may be treated as C Corporation **dividends** to the C Corporation shareholder creditor;

(2) In the S Corporation context, the S Corporation repayment of advances or interest may be treated as a **bonus** which is subject to payroll taxes;

(3) In the S corporation context, where the shareholder has no basis in the S corporation's note to the shareholder (because the S shareholder used its basis in the note to absorb S corporation operating losses), any repayment of the debt by the S corporation will be **taxable income** to the S Corporation shareholder. The **character of taxable income** will depend upon whether or not the debt is evidenced by a promissory note. Generally, the debt repayment will be treated as capital gain to the S corporation shareholder-creditor, as long as the debt is evidenced by a note. Rev. Rul. 64-162. However, if the debt is not evidenced by a note (for example, where there is “open account” debt), there is no sale or exchange when the debt is repaid, and therefore the S corporation shareholder-creditor recognizes ordinary income to the extent of the amount paid over the shareholder-creditor's basis in the debt. Rev. Rul. 68-537;

(4) Loans by a family member to the corporation (owned by family members) may be recharacterized as gifts to the shareholder-children; and

(5) The tax treatment to the shareholder upon the subsequent insolvency or dissolution of the company will differ depending upon whether the cash infusion is treated as a loan or as a capital contribution.

(6) Second Class of Stock issues may arise for S corporations.

II. Review of Section 165 Capital Loss Rules and Section 166 Bad Debt Deduction Rules.

A. **Advance Treated As a Capital Contribution**. If the corporation fails to repay an advance that is properly characterized as a capital contribution rather than as a loan, the Shareholder will not be able to claim a Section **166(a) business bad debt deduction** or a Section **166(b) non-business bad debt deduction** for the worthless debt. Instead, there will be no allowable deduction at all - if the advance is treated as a capital contribution to the corporation - until the underlying stock becomes worthless. (See Section 165 and Section 1244 for worthless stock rules). Generally, Section 165 ensures that any such worthless stock loss will be treated as a capital loss, rather than as an ordinary loss, unless the stock qualifies as Section 1244 stock.

B. **Advance Treated As a Loan**. If the corporation fails to repay an advance that is properly characterized as a loan rather than as a capital contribution, the lending Shareholder will be able to claim a Section **166(a) business bad debt deduction** or a Section **166(b) non-business bad debt deduction** for the worthless debt. "Business" bad debt losses are treated as ordinary loses, but "non-business" bad debt losses are treated as capital losses, and, to claim a business bad debt loss, one must show that the loan was made in connection with the taxpayer's trade or business.

1. **Business Bad Debts: Debts Incurred to Protect Shareholder's Employment**. Section 166 defines a business bad debt as a debt incurred in connection with the taxpayer's trade or business. The "trade or business" test can include the shareholder's trade or business of being an employee. Thus, an employee's loan to the corporation will be deemed to have been made in connection with the employee's "trade or business" of being an employee if the advance to the employer corporation was necessary to insure the employee's continued employment. Trent v. Commissioner, 291 F.2d 660 (2d Cir. 1961).

2. **Nonbusiness Bad Debts: Debts Incurred to Protect Shareholder's Investment Rather Than Employment**. If the loss loan was not made in connection with the taxpayer's trade or business (such as where the shareholder was not employed by the corporation), the loss is deemed to be a Section 166(b) nonbusiness bad debt which is only deductible as a capital loss. Section 165(c) and Section 165(d).

3. **Summary Comparison of Tax Results of Section 165 Capital Loss versus Section 166(d) Bad Debt Loss Treatment**. Since bad debt deductions attributable to one's services as an employee are miscellaneous itemized deductions under Section 63(d) and 62(a)(1), you may be better off claiming a non-business bad debt capital loss rather than a business bad debt attributable to the provision of services as an employee, since unreimbursed employee business expenses are no longer deductible for tax purposes.

4. **Section 1244 Stock Loss Rules**. Also, under IRC § 1244(a), an individual may claim an ordinary loss deduction of up to $50,000 ($100,000 for joint returns) for worthless §1244 stock. Section 1244 stock is defined as original issue stock of $1,000,000 or less. Ordinary losses, however, will not arise where the taxpayer makes subsequent additional capital contributions, even if the taxpayer's stock is already 1244 stock. Reg. 1.1244(c)-1(b). **Thus, the**

additional §1244 capital infusions would have to be structured as new purchases of newly issued stock.

C. <u>**Note**</u>: In the past, courts have held that a taxpayer's investment in a corporation does not constitute a "trade or business". Section 166(d); <u>*Whipple v. Commissioner*</u>, 373 US 193 (1963). On the other hand, being an employee is a trade or business. <u>Trent vs. Commissioner</u>, 291 F.2d 6609 (1961).

D. <u>**Factors Indicating Funding Was to Protect Employment Status Rather Than to Preserve Investment**</u>**.**

1. Employee's after-tax compensation was larger than investment in the corporation.

2. Shareholder/employee did not have other sources of income, so he/she was dependent on salary income.

3. Shareholder/employee spent substantial time as an employee of the corporation.

4. The value of the shareholder/employee's investment was insignificant.

E. <u>**Loans vs. Capital Contributions**</u>**.** In the past, courts have set forth a 13 point test or a 16 point test to determine whether a capital infusion is a loan versus a contribution to capital. The <u>Tedford</u> case, TC Summary Opinion 2004-132, and the <u>Warning</u> case, 2001-2 U.S.T.C. 50,729 (2001), provide excellent restatements of the 13 point and 16 point tests. Also see <u>Indmar</u>, 444 F3d 771 (2006).

F. <u>**Are cash Infusions Loans or Capital Contributions**</u>**?**

<u>**Tedford,**</u> **TC Summary Opinion 2004-132 (September 4, 2004)**

<u>**And**</u>

<u>**Warning**</u>**, 88 AFTR 2nd 2001-6476 (September 14, 2001)**

1. Names Given to the Transaction Documents:
   - Notes
   - Contemporaneous minutes
   - Loan Agreements
   - Designation of "loans" on checks
   - Contemporaneous journal entries

2. Fixed Maturity Date?

3. Repayment Schedule – fixed or contingent upon future profits?

4. Expectation that Lender would enforce repayments?

5. Expectation that borrower would make repayments?

6. Adequate interest and adequate security for loans?

7. Status equal to or subordinate to other creditors.

8. Thin or inadequate capitalization.

9. Relationship between Creditor and Borrower.

10. Could the borrower/corporation obtain funds from a third party?

11. Use of Funds by borrower/corporation.

12. Were any loan repayments actually made?

For an excellent and in-depth discussion of capital verses loan distinction, see B.N.A. Tax Management Portfolio 702, "Capitalizing a business Entity: Debt vs. Equity".

III. No "Business Bad Debt" Deduction Allowed For Shareholder/Employee Who Made Loans To Protect His Investment Rather Than To Protect His Salary; *Haury v. Commissioner*.

In *Haury v. Commissioner*, 113 AFTR 2d 2014-2074 (May 12, 2014), the 8th Circuit Court of Appeals upheld the earlier decision of the Tax Court (TC Memo 2012-215 (July 30, 2012)) that Mr. Haury's worthless loans to his corporation should be treated as non-business bad debts rather than as business bad debts.

Mr. Haury was a software engineer who designed computer software used by two corporations that employed Mr. Haury. Mr. Haury owned less than 50% of the stock of both corporations.

In 2005 and 2006, one corporation paid Mr. Haury just over $147,000 in compensation, but the other corporation paid him no compensation for either tax years.

In 2007, the two corporations employing Mr. Haury entered into a software license agreement with the Department of Homeland Security. To perform the contracts, the corporations needed additional funds and Mr. Haury allowed his IRA to loan funds to the corporations in 2007.

Mr. Haury used his IRA to loan funds to his corporations. The loans were bona fide loans, that were documented by valid and enforceable notes, and Mr. Haury expected the loans would be paid in full. The court ruled that, even though the loans became worthless during the tax year at issue, the bad debts were non-business bad debts since the dominant motivation of Mr. Haury for making the loans was to protect his investment interests in the companies rather than to protect his salary as an employee of the corporations.

By the end of 2007, Mr. Haury's loans to the corporations had become worthless. Mr. Haury filed his 2007 return and claimed a business bad debt deduction on his Schedule C, taking the position that he had incurred a "business bad debt" for his worthless loans.

The Tax Court agreed with the IRS that Mr. Haury had made a loan to his corporations in order to protect his investment as a stockholder -- rather than to protect his status as an employee of the two corporations. The Tax Court noted that Mr. Haury had only received modest compensation from the corporations in 2005 and 2006. In addition, Mr. Haury had substantial investments in both corporations, both in terms of his actual stock ownership as well as in terms of his personal time in developing the computer software used by the corporations.

The Tax Court noted that, in past cases, in determining whether a worthless loan is deductible as a "business bad debt" versus a "non-business bad debt," the key issue is the taxpayer's "dominant motive" in making the loan to the corporation. That is, was the dominant motive in making the loan to protect the taxpayer's investment or to protect the taxpayer's salary? For example, in *Dagres v. Commissioner*, 136 TC 263 (2011), the Tax Court held that a loss is a non-business bad-debt where the taxpayer's "dominant motive" is to protect his investment in the corporation even if the taxpayer was also an employee of the corporation.

Here, in light of Mr. Haury's modest salary from the corporations in 2005 and 2006, and in light of the fact that he was paid no employee compensation in 2007 and thereafter, and in light of his substantial investment in his corporations through his stock ownership, Mr. Haury's dominant motive in making the loans must have been to protect his investment as a shareholder and not as an employee.

The Eight Circuit Court of Appeals agreed with the Tax Court that Mr. Haury was unable to prove that he provided an active role in the day-to-day operations of the businesses. Moreover, the fact that Mr. Haury subordinated his own loans, to persuade a third party to invest in the companies, showed that his primary role was that of an owner-investor rather than that as an employee.

According to the Court, it was clear that Mr. Haury's primary and dominant motivation in making the loans was to protect his status as an investor based upon his large ownership interest in the two corporations and based upon his interest in enhancing the return on these investments. Furthermore, Mr. Haury's interests and motivation as an employee were less clear. Mr. Haury received a modest salary from his two corporations, and he could not show that he was heavily involved in the day-to-day operations of those businesses. The fact that Mr. Haury allowed his loans to be subordinated to persuade a third party to make an investment in the companies indicated that his role in 2007 looked more like an owner/investor rather than an employee.

The court acknowledged that there was no doubt that Mr. Haury made loans to protect the **substantial salaries** he received in 2006 and 2007. However, since Mr. Haury failed to prove that he played a role in the day-to-day operations of the business in 2007, the tax court was entitled to view the **substantial** 2007 salary as a form of return on his investment that did not prove that Mr. Haury's dominant motivation in making the loans was to protect his business interest as an employee of the two companies.

PART TWO

SPECIAL LOAN/CAPITAL CONTRIBUTION ISSUES FOR S CORPORATIONS

I. Review of Stock and Loan Basis Limitations on Deducting S Corporation Losses.

A. Background and Introduction. An S Corporation shareholder may deduct his/her pro rata share of any losses sustained by the S Corporation, but these loss deductions will be limited to the sum of (1) the shareholder's adjusted tax basis in the stock **plus** (2) any corporate indebtedness actually owed to the shareholder. IRC Section 1366(d)(1). As many past Court cases have held, a loan made to an S Corporation by an outside lender will not increase the S Corporation shareholder's basis in the stock, even if the shareholder guarantees the bank loan or pledges personally-owned assets to secure the loan. In order to obtain tax basis, the S Corporation shareholder must make an "economic outlay" to the S Corporation.

B. The "Economic Outlay" Requirement. Hafiz v. Commissioner, TC Memo 1998-104 (March 16, 1998). In the case of Hafiz, Mr. Hafiz secured a loan from the bank to the S Corporation. The bank proceeds were used to purchase real property in the name of the S Corporation. The shareholder pledged all of his personally owned assets to secure the bank loan. The shareholder also was a co-maker of the S Corporation's note issued back to the bank.

After the loan, the S Corporation suffered financial reversals and recognized significant operating losses. The taxpayer sought to deduct these losses on his personal income tax return on the basis that his tax basis in his S Corporation stock should increase as a result of the S Corporation indebtedness to the bank. The Tax Court, however, held that there was no "economic outlay" on the part of the shareholder, since he did not directly incur the bank indebtedness.

According to the Tax Court, no form of "indirect borrowing" will save the transaction, regardless of whether the shareholder is a guarantor or co-maker and regardless of whether or not the shareholder pledges individually owned assets to secure the indebtedness. According to the Tax Court, the shareholder must make actual disbursements in the form of loans directly to the S Corporation.

II. Court of Appeals Upholds Tax Court Decision That No Tax Basis Increase for Loan Guarantees, Even After A Loan Is Called in Full; Phillips vs. Commissioner, 121 AFTR 2d. 2018–1776 (11th Circuit Court of Appeals May 17, 2018).

In Phillips v. U.S., TC Memo 2017-621 (April 10, 2017), Mrs. Phillips was a 50% owner of an S corporation. The S corporation developed and sold real estate. In 2007, after the S

Corporation defaulted on significant real estate loans, the company's creditors sued Mrs. Phillips and were awarded judgments in excess of $100 Million. Mrs. Phillips took the position that once the loan obligations were reduced to judgments against Ms. Phillips, then she should be entitled to increase her tax basis in her S corporation stock by the guaranteed debt.

The Tax Court, however, ruled that, under the "economic outlay requirement," Mrs. Phillips would not be entitled to any tax basis increase for her loan guaranties until she actually made payment to the corporation's lenders.

III. How to Restructure Corporate Bank Debt in Order to Get Shareholder Basis.

A. S Corporation Basis Increase Is Allowed Where S Corporation Shareholder Replaces Corporation Notes for Shareholder Notes. In the case of Miller v. Commissioner, TC Memo 2006-125 (June 25, 2006), the S Corporation owed Notes to the Bank. In this case, Mr. Miller was a shareholder of the S Corporation which had borrowed money from the Bank to finance the S Corporation's operations. All loans were guaranteed by the shareholders, including Mr. Miller. Unfortunately, the Corporation's losses soon exceeded the shareholders' direct investment.

At the end of 1998, the S Corporation had substantial losses and the shareholders believed that the S Corporation would lose additional money in 1999. At that point, Mr. Miller restructured the bank debt by refinancing the bank debt and becoming the primary obligor of the obligations to the Bank, with the S Corporation becoming a guarantor of the Bank debts.

Mr. Miller had the S Corporation's Notes payable to the Bank cancelled and Mr. Miller substituted his own notes to the Bank followed by a Note from the S Corporation to Mr. Miller. Therefore, Mr. Miller became the primary obligor of the bank loans to him personally. Since the Bank's loan to Mr. Miller was fully recourse, and since the Bank could assert collection obligations against Mr. Miller, this strategy allowed Mr. Miller to increase his basis in his S Corporation by the amount of the substituted notes.

According to the Tax Court, this restructure arrangement met the "economic outlay" test under the Hafiz case. It is important to note that, in this case, the Bank's debt to Mr. Miller was fully recourse and therefore the Bank could pursue collection directly against Mr. Miller.

B. Form Over Substance Supports Tax Basis Increase Where S Corporation Shareholder Borrows Funds From a Bank and then Re-loans the Funds to His S Corporation. Gleason v. Commissioner, TC Memo 2006-191 (September 11, 2006). In this case, an S Corporation shareholder borrowed loans from a bank and then re-lent these funds to the S Corporation. The "borrower" on the loan documents was the shareholder himself rather than the S Corporation. Although the S Corporation guaranteed repayment of the loans to the Bank, and even though the S Corporation shareholder pledged his S corporation stock to the Bank to secure these loans, the Tax Court held that the form of the transaction overrode the substance of the transaction and therefore allowed Mr. Gleason to increase his basis in his S Corporation stock by the amount of the loans.

PART THREE

I. Structing Smart Cash Infusions for the Struggling Business Entity

a. Consultation with Existing Loan Documents is Key. Prior to making any significant equity injection or related-party loan, principals should consult what restrictions may be contained in the existing loan documents.

- **i.** Existing loan documents may require lender consent before obtaining **any** additional indebtedness. If such a provision is included, a shareholder loan may trigger an event of default.
- **ii.** Even where existing loan documents permit additional indebtedness, they may include covenants that limit the shareholder's right to repayment.
  - **1.** Some loan documents require subordination of all repayment to any payment of the primary lender's debt;
  - **2.** Some loan documents include cash flow and/or repayment covenants that restrict repayment such that it is only permitted in certain circumstances; and
  - **3.** Other loan documents prohibit repayment of any other indebtedness.
- **iii.** Existing loan documents may also contain covenants regarding ownership. If a loan agreement provides a shareholder must maintain a minimum percentage of ownership, consideration should be given as to whether an equity injection from a shareholder will cause a violation of such a covenant.

b. Preparing to Deal with Judgment Creditors. Equity owners of struggling companies need to be prepared to deal with the fallout of what happens if things go south despite their efforts to inject new cash into a struggling business venture.

- **i.** If there are potential judgment creditors looming, judgment collection efforts may interfere with recovery of equity injections OR repayment of unsecured indebtedness.

- **ii.** If insiders can collateralize their loans to the company, they may be able to make the company more judgment resilient.

c. Resource Allocation is all about PRIORITY. Struggling companies have a finite number of assets. Prior to equity holders making loans or capital contributions, it is likely that all real estate is already encumbered by a first-priority deed of trust. Personal property may be encumbered as collateral for a revolving line of credit.

- **i.** The loan documents for the company's term loan and line of credit (if any) may provide that such liens must be the *only* encumbrances permitted on the company's assets.

ii. If the loan documents do not restrict further encumbrances, collateralizing the loans described above (i) helps legitimize documentation of the transaction and (ii) provides protection from judgment creditors.

1. If permitted, in documenting a loan from a business insider, upon making the loan, the company should sign a security agreement authorizing the filing of a financing statement and should grant a deed of trust on any real property of the company.

2. This will allow the insider-creditor to step in line behind only the primary secured lenders should there ever be a threatened liquidation.

3. **IMPORTANT NOTE**: deeds of trust should be recorded. Financing statements should be indexed with the Secretary of State. Without taking this step, the insider-creditor will not receive any benefit as to third parties.

iii. If the loan documents of the primary secured creditor restrict secondary permitted liens, the aforementioned filings may trigger an event of default. Prior to recording any such deed of trust or indexing any such financing statement, consult existing loan documents.

II. Insider Transactions Upon the Occurrence of a Bankruptcy Event

a. Debt vs. Equity matters in Bankruptcy.

i. In a Chapter 7 Case, a debtor liquidates all of its assets.

1. Virtually all Chapter 7 debtors are balance sheet insolvent, and, upon liquidation will pay unsecured creditors a *pro rata* share of their claims and return no value to equity.

a. **Thus, equity injections will receive no return in bankruptcy. Unsecured loans may receive pennies on the dollar.**

2. In Chapter 7, a trustee is vested with the right to avoid certain historical transactions as well.

a. **Fraudulent transfers –** any transfer made within two years of the date of the bankruptcy petition that is for less than reasonably equivalent value and was made while insolvent is avoidable.

i. This means dividend disbursements in the 24 months preceding bankruptcy will be scrutinized and potentially reversed.

b. **Preferential transfers** – Any payment made to an insider in the 12 months leading up to bankruptcy may also be avoided as an avoidable preference.

i. Any payment of antecedent debt that isn't in the ordinary course of business may also be avoided.

1. If the insider loans money to the company, and the company repays the debt during the preference period, then such payment may be avoidable, unless the payment is pursuant to a documented repayment schedule or is in the borrower's ordinary course.

c. These avoidance powers still exist in Chapter 11 cases, but the Company, as debtor in possession, retains control over the right to bring such actions. It may be possible to confirm a plan and complete a reorganization without bringing avoidance actions.

3. In a traditional Chapter 11 case, the analysis is more complicated, but debt vs. equity is still a key question.

a. In Chapter 11, a priority system applies:

i. Administrative claims (the costs of the bankruptcy proceeding and post-petition claims) get paid first;

ii. Priority claims next get paid (claims determined by Congress as warranting preferential treatment—certain tax claims, for instance);

iii. Secured claims are to be paid from their collateral;

iv. Unsecured claims come next; and

v. Equity receives a return last.

b. In order to get a bankruptcy plan confirmed, a debtor either needs creditor consent, or may <u>cram down</u> a Plan despite creditor objection in certain circumstances.

i. If a cram-down occurs, the absolute priority rule applies. The absolute priority rule states that no class of creditors (or equity stakeholders) may receive repayment until all preceding classes are paid in full.

ii. As an example, if a Debtor owes $100,000 in administrative claims, $1,000,000 in secured claims, and $500,000 in general unsecured claims, unless (a) it has the consent of a class of creditors that isn't being repaid at 100% , each of those claims must be repaid in full before equity can retain its interest in the property.

iii. However, the New Value Exception to the Absolute Priority Rule provides that equity holders may inject new cash, or cash equivalent at a dollar for dollar value, into the company in order to preserve equity interests.

1. Simply providing that (a) the equity holder has significant expertise to lead the company is ***not*** new value.

c. Thus, the question of whether new cash to the company from an owner-operator can be the difference between receiving a return in bankruptcy and receiving nothing unless the owner-operator provides new value.

d. Bankruptcy courts apply a similar multi-factor analysis as tax courts in the Fourth Circuit to determine whether cash provided by an insider is loaned or invested. In *Fairchild Dornier GMBH v. Official Comm. of Unsecured Creditors (In re Official Committee of Unsecured Creditors for Dornier Aviation (North America), Inc.)*, 453 F.3d 225 (4th Cir. 2006), the Fourth Circuit held that **bankruptcy courts have the authority to look past form to review substance and may recharacterize debt as equity after evaluating the following factors:**

(1) the names given to the instruments, if any, evidencing the indebtedness (is there an instrument called a note, loan agreement, etc?);

(2) the presence or absence of a fixed maturity date and schedule of payments;

(3) the presence or absence of a fixed rate of interest and interest payments;

(4) the source of repayments;

(5) the adequacy or inadequacy of capitalization;

(6) the identity of interest between the creditor and the stockholder;

(7) the security, if any, for the advances;

(8) the corporation's ability to obtain financing from outside lending institutions;

(9) the extent to which the advances were subordinated to the claims of outside creditors;

(10) the extent to which the advances were used to acquire capital assets; and

(11) the presence or absence of a sinking fund to provide repayments.

b. The New Sub-Chapter V of Chapter 11 May Complicate the Analysis

- **i.** Small Business Reorganization Act of 2019 ("SBRA") went into effect on Feb. 19, 2020.
  - **1.** It added a new subchapter V to chapter 11 designed to make bankruptcy easier for small businesses, which are "defined as entities with less than about $2.7 million in debts that also meet other criteria."
  - **2.** The act "imposes shorter deadlines for completing the bankruptcy process, allows for greater flexibility in negotiating restructuring plans with creditors, and provides for a private trustee who will work with the small business debtor and its creditors to facilitate the development of a consensual plan of reorganization." (U.S. Department of Justice. "U.S. Trustee Program Ready to Implement the Small Business Reorganization Act of 2019.").
    - **a.** A key goal of Sub-Chapter V is to provide accelerated, affordable reorganization for Small Business Debtors.

ii. Eligibility for Sub-Chapter V is subject to a number of factors:

1. Aggregate non-contingent liquidated debts of up to $2,725,625 has been raised to $7.5; and

a. THIS DEBT LIMIT EXCLUDES LOANS TO (A) AFFILIATES AND (B) INSIDERS;

2. the debtor's primary activity must be in business, other than business of owning/operating single-asset real estate.

iii. Sub-Chapter V offers considerable benefits for small-business debtors vs. conventional Chapter 11 filings:

1. eliminates the official committee of unsecured creditors;

2. eliminates a debtor's obligation to pay quarterly U.S. Trustee fees;

3. provides a reduced period (90 days) for the debtor (but no other party) to file a Chapter 11 plan;

4. permits a debtor to spread the payment of administrative expenses (including its attorneys' fees and that of the Subchapter V trustee) over the life of its plan—which can stretch up to five years following plan confirmation—as opposed to having all administrative expenses due at confirmation; and

5. relaxes the "absolute priority rule," which allows a debtor's equity holders to retain their ownership interests in the debtor without an infusion of new capital or the payment of all creditors in full.

iv. **The end result is that Sub-Chapter V cases are cheaper and faster for small businesses, while allowing equity holders to retain control of their business. As a result, bankruptcy under a Sub-Chapter V proceeding may make sense, when another Chapter 11 proceeding doesn't.**

1. Given that, prior to making an equity injection or a loan, a small business owner should contemplate how Subchapter V or bankruptcy laws generally may impact their contribution or loan.

a. An insider may even want to pay down traditional debt, either through equity or insider debt, in order to preserve Subchapter V eligibility given the debt limit.