

**BEFORE THE MONTANA TAX APPEAL BOARD**

BILLINGS GENERATION, INC,  
OWEN H. ORNDORFF, ROBERT L.  
ROBERTS, & JEFFREY L. SMITH,

Appellants,

v.

STATE OF MONTANA,  
DEPARTMENT OF REVENUE,

Respondent.

CASE №: IT-2024-41, IT-2024-52, IT-  
2024-53, and IT-2024-54

**FINDINGS OF FACT,  
CONCLUSIONS OF LAW, ORDER,  
AND OPPORTUNITY FOR  
JUDICIAL REVIEW**

**STATEMENT OF THE CASE**

This is an appeal from a final decision by the Montana Department of Revenue (Department) denying a deduction for interest paid on shareholder promissory notes (Subject Transactions) issued by Billings Generation, Inc. (BGI). The Department issued a Response to Informal Review Letter (Final Audit Determination) in which it denied BGI and its shareholders (collectively, Taxpayers) a deduction for tax year 2020 totaling \$4,272,799, concluded that the Subject Transactions do not constitute bona fide debt, and that the transactions lack economic substance. The Department determined that the associated payments to the shareholders must be included on the shareholders' individual tax returns. The Taxpayers appealed the Final Audit Determination to the Department's Office of Dispute Resolution (ODR) on July 19, 2023. Taxpayers requested to bypass ODR, and the request was granted on April 5, 2024. Taxpayers timely appealed to the Montana Tax Appeal Board (MTAB) on April 26, 2024, and the four separate cases were consolidated for purposes of judicial efficiency. We affirm the Department's determination denying the Taxpayers' deduction and adjusting the individual shareholders' Montana tax returns.

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**ISSUES TO BE DECIDED**

The following issues have been presented before the Board:

- (1) whether the Department erred in denying the deduction for interest paid on shareholder promissory notes for tax year 2020;
- (2) whether the Department violated the Montana Taxpayer Bill of Rights as applied to the Taxpayers; and
- (3) whether the Department violated the Taxpayers' due process rights.

**EXHIBIT LIST**

The following evidence was submitted at the hearing:

Taxpayers' Exhibits:

1. 2020 Montana Pass Through Entity Tax Return;
2. 2020 Federal BGI Return;
3. Information Request Letter from DOR and BGI's Response;
4. Information Request Letter from DOR to BGI, dated October 13, 2021;
5. BGI Response Letter to DOR, dated November 11, 2021;
6. Letter from BGI to DOR with Ladenburg and BGI MOU, dated December 9, 2021;
7. Email from BGI to DOR with YELP Limited Partnership Agreement attached, dated December 9, 2021;
8. Email from BGI to DOR Regarding Ladenburg, dated December 9, 2021;
9. Withdrawn;
10. Letter from Crowley Fleck to DOR Regarding Position on Appeal, dated April 10, 2023;
11. Informal Review Determination by DOR, dated June 9, 2023;
12. Letter from Crowley Fleck to DOR with Additional Documents, Including Tabs 1-19, dated August 11, 2023;  
Tab 1 – YELP Investor Prospectus (Ex. 12-6 to 12-42);  
Tab 2 – Representative Shareholder Promissory Notes (Ex. 12-43 to 12-47);

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- Tab 3 – Shareholders’ 2020 Schedule E Supplemental Income and Losses (Ex. 12-48 to 12-55);
- Tab 4 – Crowley Fleck Letter to DOR with Grounds for Appeal (Ex. 12-56 to 12-60);
- Tab 5 – YELP Financial Statements from 1995, 2012 and 2013 (Ex. 12-61 to 12-416);
- Tab 6 – *Sletteland v. Roberts* (1999), including State Court and Montana Supreme Court Decisions from 2000 and 2002 (Ex. 12-417 to 12-453);
- Tab 7 – YELP Credit Agreement, dated July 1, 1993 (Ex. 12-454 to 12-631);
- Tab 8 – YELP Agreement of Limited Partnership (Ex. 12-632 to 12-758);
- Tab 9 – 1993 Revenue Deficiency Obligation Agreement (Ex. 12-759 to 12-774);
- Tab 10 – Intercreditor Agreement, dated July 1, 1993 (Ex. 12-775 to 12-878);
- Tab 11 – Guaranty Agreement (ZBD), dated July 1, 1993 (Ex. 12-879 to 12-892);
- Tab 12 – Guaranty Agreement (Tampella), dated July 1, 1993 (Ex. 12-893 to 12-908);
- Tab 13 – List of Shareholder Loans by Date, Amount, Principal, and Interest, with Copies of Representative Cancelled Checks and Summary of BGI Operating Expenses 1998-2013 (Ex. 12-909 to 12-1106);
- Tab 14 – 2013 BGI Federal Income Tax Return (Ex. 12-1107 to 12-1123);
- Tab 15 – Summary Chart of Shareholder Contributions 1997-2013 (Ex. 12-1124);
- Tab 16 – Chart of BGI’s Share of YELP Net Income 1995-2013 (Ex. 12-1125);
- Tab 17 – Chart of Funds Flow of YELP Distributions 2013-2021 (Ex. 12-1126);

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- Tab 18 – YELP Notes to Financial Statements 2010 and 2011 (Ex. 12-1127 to 12-1128);
- Tab 19 – 1993 Montana Board of Investments Bond Offering (Ex. 12-1129 to 12-1592);
13. Letter from Crowley Fleck to DOR with Follow-up Documentation, dated October 23, 2023;
  14. DOR Internal Email String Regarding BGI Shareholder Smith’s Response to Information Request, dated December 12, 2021;
  15. BGI Fax Response to November 29, 2021, Information Request Sent to BGI Shareholder Smith, dated December 6, 2021;
  16. Sletteland Amended Chapter 11 Plan of Reorganization, dated February 5, 2003;
  17. Withdrawn;
    - 17-1. Minutes of Special Meeting of BGI Directors (complete transcript), dated February 22, 1999;
  18. Excerpt from Minutes of BGI Directors’ Meeting, dated May 29, 2013;
  19. 2020 Smith Montana Tax Return and DOR Spreadsheets;
    - 19a. 2020 Smith Montana Tax Return and DOR Spreadsheets;
  20. 2020 Smith Amended Federal Tax Return;
  21. Agreed Methodology to Determine 2020 Montana Source Income for Part-time Resident with Taxable Income Exceeding \$18,700.00;
  22. Smith 2020 Montana Source Income Based on Agreed Formula;
  23. Withdrawn;
  24. Roberts Amended 2020 Federal Tax Return;
  25. Roberts 2020 Montana Tax Return;
  26. Information Request Letter to Roberts with Robert’s December 12, 2021, Response, dated November 29, 2021;
  27. Withdrawn;
  28. Orndorff Amended 2020 Federal Tax Return;
  29. Withdrawn;
  30. Reserved;

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31. DOR Responses to Taxpayers' First Discovery Requests, dated April 4, 2025;
32. *Hormel Foods Corporation v. Wisconsin Dep't of Revenue*;
33. *Skechers USA, Inc. v. Wisconsin Dep't of Revenue*;
34. 1976 General Counsel Memorandum 36702;
35. *Farley Realty Corporation v. Commissioner of Internal Revenue* (1960);
36. Mont. Code Ann. § 15-1-222, Taxpayer Bill of Rights;
37. Taleff Letter to DOR with Additional Follow-up Documentation, dated March 4, 2024;
38. Various Montana Statutes Regarding Law, Limited Common Law Application;
39. Google Search Results for David Merrien;
40. *State ex rel. Montana Wilderness Assn. v. Bd. Of Nat. Res. & Conservation of State of Montana* (1982);
41. DOR File Log;
42. Email from Wiley Barker to Kristina Warren, dated September 26, 2023;
43. MTC Tax Talks: Three Remedies for Income Shifts;
44. LB&I Concept Unit; Knowledge Base-S Corporations;
45. 1995 & 1996 YELP Financial Statements;
46. 1997 & 1998 YELP Financial Statements;
47. 1999 & 2000 YELP Financial Statements;
48. 2001 & 2002 YELP Financial Statements;
49. 2003 & 2004 YELP Financial Statements;
50. 2005 & 2006 YELP Financial Statements;
51. 2007 & 2008 YELP Financial Statements;
52. 2009 & 2010 YELP Financial Statements;
53. 2011 & 2012 YELP Financial Statements;
54. 2012 & 2013 YELP Financial Statements;
55. Note Purchase Agreement, dated April 24, 2013;
56. BGI Request for Informal Review, dated February 1, 2023;

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57. Smith Request for Informal Review, dated February 1, 2023;
58. Orndorff Request for Informal Review, dated February 1, 2023;
59. Roberts Request for Informal Review, dated February 1, 2023;
60. Dispute Resolution Extension Agreement, dated March 20, 2023;
61. Chart 1 of Loans from Shareholders Together with Copies of Promissory Notes and Cancelled Checks;
62. Copies of Promissory Notes and Cancelled Checks Representing Shareholder Loans (2001-2006);
63. Copies of Promissory Notes and Cancelled Checks Representing Shareholder Loans (1999-2001);
64. Summary of BGI Operating Expenses 1998-2013;
65. Summary of YELP and BGI Income, Capital, Loans/Guarantees, and Cash Flow;
66. Withdrawn;
67. Excel Spreadsheet with BGI's Categorized Expenses 1997-2020;
68. 2020 BGI Check Register Summary;
69. 2018-2020 Suspended Loss Carry Forward;
70. 2020 Shareholder Adjusted Basis Worksheet;
71. Withdrawn;
72. Withdrawn;
73. Promissory Notes and Checks 2003-2009;
74. Check Register 1998-2-22 and Promissory Notes 1999-2003;
75. Chart of Promissory Notes Regarding Legal and Professional Fees;
76. Promissory Notes and Record of Payments for Management Fee;
77. Withdrawn;
78. Bankruptcy Order Approving SSBB Fee Application;
79. 2018-2023 Distribution Summary;
80. Bloomberg Portfolio 702-1st;
81. IRS Field Service Guide;
82. YELP Operations & Maintenance Agreement;

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- 83. Letter from Jerry Bermensolo to Jennifer Kuehn at DOR, dated March 25, 2015;
- 84. Email String Between Jerry Bermensolo and Febe Gemlich, dated July 1, 2022;
- 85. Email String Between Jerry Bermensolo and Febe Gemlich, dated December 8, 2021-July 1, 2022;
- 86. Email from Jerry Bermensolo to Febe Gemlich, dated August 16, 2022;
- 87. Email String Between Jerry Bermensolo and Febe Gemlich, dated October 10, 2022-November 28, 2022;
- 88. Email from Jerry Bermensolo to Febe Gemlich, dated December 28, 2022;
- 89. Deposition Transcript of David Merrien; and
- 90. BGI Tax Return for 2018.

Department Exhibits:

- A. Response to Informal Review Letter, dated June 9, 2023;
- B. Promissory Notes from Shareholders;
- C. Meeting Minutes of Special Meeting of Directors of Billings Generation, Inc., dated February 8, 1999;
- D. Department's Pass-Through Unit Field Audit Manual;
- E. Department's Initial Determination Letters, dated December 20, 2022;
- F. Withdrawn;
- G. Withdrawn; and
- H. Withdrawn.

**PROCEDURAL HISTORY**

The Department denied a deduction on BGI's tax return for interest paid on shareholder promissory notes for tax year 2020. *MTAB Dkt. 3*. This resulted in additional tax assessments against the Taxpayers. *Id.* The Department audited BGI for tax years 2018-2020 but only revised the assessment for tax year 2020. *Id.* Taxpayers appealed this decision to ODR on July 19, 2023. *Id.* Taxpayers ultimately elected to bypass ODR, and on April 5, 2024, ODR granted the request and issued an Order of

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Dismissal. *Id.* The Taxpayers timely appealed to MTAB on April 26, 2024, per Mont. Code Ann. § 15-2-302, requesting reversal of the Department’s determination. *MTAB Dkt. 1.* The Department filed its Answer on May 23, 2024. *MTAB Dkt. 4.* Taxpayers filed a Petition for Interlocutory Adjudication in the Montana First Judicial District pursuant to Mont. Code Ann. § 15-2-305. *MTAB Dkt. 8.* On October 7, 2024, the First Judicial District Court determined that issues regarding the borrower’s intent and lender’s expectations were questions of fact that precluded consideration of the Petition. *MTAB Dkt. 10.* The court dismissed the case and remanded it to the Board for fact finding. *Id.*

Taxpayers filed a Motion for Summary Judgment and Brief in Support on August 29, 2025. *MTAB Dkt. 28, 29.* On the same day, Taxpayers filed Motions in Limine #1-3 and Brief in Support, seeking to limit the Department’s use of undisclosed expert opinions, federal common law, and any arguments outside the Department’s initial Notice of Determination. *MTAB Dkt. 30.* The Department filed its Responses to the Motion for Summary Judgment and Motions in Limine on September 12, 2025. *MTAB Dkt. 34, 35, 36.* Taxpayers filed their Reply Brief in Support of Motions in Limine #1-3 and Reply Brief in Support of Motion for Summary Judgment on September 19, 2025. *MTAB Dkt. 40, 41.* The Board denied the Motion for Summary Judgment on September 24, 2025, and denied the Motions in Limine on October 3, 2025. *MTAB Dkt. 46, 47.* The Department filed a Motion in Limine on December 3, 2025, seeking to preclude Taxpayers from introducing David Merrien’s deposition testimony into the record. *MTAB Dkt. 48.* On the same day, Taxpayers filed their Response to the Department’s Motion in Limine. *MTAB Dkt. 49.* The Board addressed the Department’s Motion in Limine at the beginning of the hearing and denied the motion. *MTAB Hr’g Tr. 11:21-12:2.*

The MTAB hearing was conducted in Helena on December 4 and 5, 2025, at which the following were present:

- a. Ward “Mick” Taleff, Taxpayers’ Counsel; Amanda Sowden, Taxpayers’ Counsel; Owen H. Orndorff, Shareholder; Jeremy Wonch, BGI’s Chief Financial Officer; Wiley Barker, Former Counsel; and Jerry Bermensolo, Certified Public Accountant (via Zoom).

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- b. Katherine Talley, Department Counsel; Kristina Warren, Department Counsel; Kandy Fleurisma, Paralegal; David Merrien, Tax Specialist; Thomas Fox, Unit Manager; and Febe Gemlich, Lead Auditor.

The record includes all materials submitted to ODR and MTAB in connection with the appeal, additional exhibits submitted by the parties prior to and at the MTAB hearing, post-hearing submissions, and the transcript of the MTAB hearing.

### FINDINGS OF FACT

1. To whatever extent the following findings of fact may be construed as conclusions of law, they are incorporated accordingly.
2. BGI is a Montana business corporation formed in 1989. *MTAB Dkt. 1*. BGI initially had five shareholders: Owen Orndorff, Robert Lee Roberts, Jeffrey Smith, James Sletteland, and Ronald Blendu. *Id.* Each shareholder was a nonresident of Montana and held a 20% ownership interest in BGI. *Id.* For tax purposes, BGI is an S corporation. *Id.*
3. BGI was formed to facilitate the construction and operation of a 54-megawatt cogeneration facility, or small power production facility. *Ex. 12-1; MTAB Hr'g Tr. 18:15-19:9*. The project was carried out through a limited partnership known as Yellowstone Energy Limited Partnership (YELP). *Ex. 12-1*. BGI is the general partner of YELP and holds a 35% ownership interest in YELP. *Ex. 12-1; MTAB Hr'g Tr. 29:1-4*. An Exxon subsidiary, Exxon Billings Cogeneration, Inc. (ECBI), is the limited partner and holds the remaining 65% ownership interest in YELP. *Ex. 12-1; MTAB Hr'g Tr. 29:1-4*.
4. BGI does not have employees or officers and is managed solely through its Board of Directors. *Ex. 12-1; MTAB Hr'g Tr. 22:4-17*. Management of the YELP project is performed by Rosebud Operating Services, Inc. pursuant to an operating and maintenance agreement. *Ex. 12-1; MTAB Hr'g Tr. 22:4-17*.

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5. The YELP facility qualifies under federal law to burn petroleum coke as a waste fuel and to scrub high-sulfur gas emissions from Exxon Mobil Corporation's Billings refinery. *Ex. 12-1; MTAB Hr'g Tr. 16:14-18:14.* YELP provides steam and distilled water to the refinery in exchange for agreed-upon compensation. *Ex. 12-1; MTAB Hr'g Tr. 18:17-19:9.*
6. BGI entered into additional contracts, such as Fuel Supply and Limestone Supply agreements, to further facilitate the project. *Ex. 12-8.*
7. BGI's various contracts, permits, and agreements were valued at \$6,000,000. *Ex. 12-8.* ECBI contributed \$8,000,000 to the project. *Id.* Under the YELP Limited Partnership Agreement, no further capital contributions could be required or permitted by either party without unanimous partner approval. *Ex. 12-8; MTAB Hr'g Tr. 75:8-76:16.* The Limited Partnership Agreement is specific to YELP and did not affect the permissibility of capital contributions to BGI. *Ex. 12-8.*
8. Financing for the YELP project primarily involved a Credit Agreement with Canadian Imperial Bank of Commerce. *Ex. 12-7.* The Montana Board of Investments guaranteed additional bonds totaling approximately \$120,000,000 which were underwritten by Morgan Stanley. *Ex. 12-19.*
9. YELP entered into an Intercreditor Agreement establishing how its available funds were to be applied to satisfy its obligations if those funds were insufficient to pay all debts. *Ex. 12-10; MTAB Hr'g Tr. 28:13-20.* This "waterfall of funds" arrangement established the priority of repayment among YELP's creditors. *Ex. 12-10; MTAB Hr'g Tr. 28:13-20.*
10. YELP contracted with Ladenburg, Thalmann & Co., Inc. (Ladenburg), an investment banking firm, to assist in obtaining the financing for the project. *Ex. 8, 12-8, 12-19.* YELP owed Ladenburg \$1,128,000 for its services in arranging

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the financing. *Ex. 12-8*. BGI separately owed Ladenburg an additional \$1,400,000 plus accrued interest for its services related to the project. *Ex. 12-8; MTAB Hr'g Tr. 89:12-15*.

11. The agreements executed as part of the development of the project included a Revenue Deficiency Obligation (RDO), by which, if facility operations generated insufficient revenue to meet operating expenses, BGI, through its shareholders, and ECBI would be required to provide funds to address any shortfall. *Ex. 12-9; MTAB Hr'g Tr. 20:24-21:17, 68:10-69:5*. As part of the RDO and standby financing for repairs to the plant, four of the five shareholders of BGI pledged their profits from the “Colstrip project” to support the venture. *Ex. 12-9; MTAB Hr'g Tr. 20:24-21:17, 68:10-69:5*. Under the YELP Limited Partnership Agreement, BGI and ECBI are obligated to meet revenue shortfalls. *Ex. 12-9*.
  
12. The YELP facility was expected to be financially viable from its inception. *MTAB Hr'g Tr. 24:2-25:2, 34:1-13*. However, problems arose with its construction and subsequent performance, including the general contractor attached to the project going bankrupt, complications with the fuel system feeding coke into the boiler, and problems with the air-cooled condenser, among other related issues. *MTAB Hr'g Tr. 24:2-25:2, 34:1-13*. Mr. Orndorff claimed that a lawsuit brought by Mr. Sletteland alleging improprieties on the part of Mr. Orndorff and Mr. Roberts further complicated efforts to obtain outside financing. *Ex. 12-6; MTAB Hr'g Tr. 27:18-25, 29:5-30:9*.
  
13. BGI required external funding to meet its overhead expenses because YELP was not generating profits that would flow through to BGI or paying BGI's monthly management fee. *Ex. 17; MTAB Hr'g Tr. 28:13-23, 29:5-23, 54:6-11, 89:9-11*.

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14. BGI's Board of Directors discussed potential ways to meet its financial needs, such as refinancing with a bank, to ensure that BGI did not default on its agreements and put YELP at risk. *Ex. 17*. The Board of Directors determined that BGI could not obtain outside financing and that the most suitable method for meeting its financial requirements was to obtain funds from the shareholders. *Id.* When asked whether he believed BGI could have obtained financing from a source other than the shareholders, Mr. Orndorff stated, "It, it's frankly laughable to think the bank will give somebody a loan with no income, no assets, and, uh, oh yeah, we'll loan you money for 17 years," and "I just cannot even imagine how you would get that loan." *MTAB Hr'g Tr. 34:23-35:11*.
  
15. BGI lacked sufficient funds to maintain operations and pay various creditors, so the Subject Transactions were made to prevent BGI from becoming insolvent. *MTAB Hr'g Tr. 36:1-7*. Mr. Orndorff, Mr. Roberts, and Mr. Smith each made advances to BGI amounting to \$100,798.92. *Ex. 61*. The total amount of funds advanced by the shareholders, including \$8,127.48 contributed by Mr. Blendu, was \$310,524.24. *Id.* No advances were made by the shareholders after 2013. *Ex. 61; MTAB Hr'g Tr. 43:24-25*.
  
16. The Subject Transactions were approved at the February 22, 1999, Special Meeting of Directors of BGI. *Ex. 17; MTAB Hr'g Tr. 32:5-17*. Each advance was documented by a written promissory note prepared by the counsel for the independent directors, and each transaction was treated as an unsecured note. *Ex. 17; MTAB Hr'g Tr. 44:6-9*.
  
17. The ownership percentages of BGI's five shareholders did not change as a result of the Subject Transactions. *MTAB Hr'g Tr. 44:1-5, 45:12-18*. Mr. Blendu advanced \$8,127.48 early in the project but eventually sold his ownership interest in BGI to Mr. Orndorff, Mr. Roberts, and Mr. Smith in a separate transaction in 1997. *MTAB Hr'g Tr. 26:12-18, 31:11-18, 44:1-5*. The

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- sale of Mr. Blendu's interests increased Mr. Orndorff, Mr. Roberts, and Mr. Smith's ownership percentage in BGI from 20% to 26.66%, while Mr. Sletteland remained at 20%. *MTAB Hr'g Tr. 26:12-18, 31:11-18, 44:1-5*. Mr. Sletteland did not participate in the purchase of Mr. Blendu's ownership interest or the Subject Transactions. *MTAB Hr'g Tr. 26:12-21*. The Subject Transactions were not made in proportion to the ownership interests of the lending shareholders. *MTAB Hr'g Tr. 31:11-32:4*.
18. BGI's sole source of income is derived from its partnership agreement with YELP, which consists of a 35% ownership interest in YELP and a monthly management fee. *MTAB Hr'g Tr. 28:15-23, 115:15-23*. However, Mr. Orndorff testified that no income flowed through to BGI for many years stating that "we had about 17 years of, uh, of limbo I would call it, of losing money and, and no, no cash flow to BGI..." *MTAB Hr'g Tr. 29:9-23*. BGI's Accountant, Jerry Bermensolo, testified that "the first return was filed in 1990 for [BGI], and through 2013 it was a losing company." *MTAB Hr'g Tr. 88:21-89:8*. BGI did not become profitable until 2014. *MTAB Hr'g Tr. 89:9-11*.
19. The terms of the Subject Transactions, including the interest rate and maturity date, were approved by independent outside directors of BGI. *Ex. 17; MTAB Hr'g Tr. 30:2-31:10, 33:15-25*.
20. The initial promissory notes had a stated maturity date of five years and provided that, upon maturity, the noteholders could pursue repayment at their discretion. *Ex. B*. The notes bore interest at a rate of 19%, compounded quarterly, and were "payable as funds are available as determined by the Board of Directors..." *Id.*
21. The shareholders understood that there was uncertainty regarding the timing of repayment and were willing to accept the risk that repayment could extend beyond the five-year maturity date due to the project's financial condition. *Ex.*

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- 17; *MTAB Hr'g Tr. 74:15-75:13*. When asked whether he expected repayment of the Subject Transaction, Mr. Orndorff stated, "I did not expect to be paid right away. I knew that would take time to, uh, to, uh fix the problems and that's why the five years was there, but there was other reasons, there wasn't one." *MTAB Hr'g Tr. 74:15-19*. When asked how the obligation to repay at the five-year maturity date was viewed internally, Mr. Orndorff stated, "[F]ive years was there because we didn't want to scare off, uh, the lenders. If you told them that if it worked out that seventeenth year, I'm not sure it would have a happy ending." *MTAB Hr'g Tr. 64:3-12*.
22. The funds advanced by the Subject Transactions were used exclusively for BGI's operational and administrative expenses. *MTAB Hr'g Tr. 29:5-23*. Mr. Orndorff testified that the Subject Transactions' funds were not used to purchase any intangible property or assets. *MTAB Hr'g Tr. 54:16-18*.
23. When asked why the shareholders did not enforce their right of repayment once the five-year maturity date had passed, Mr. Orndorff testified that "it would defeat the very purpose of what we were trying to do, the project would become insolvent..." *MTAB Hr'g Tr. 45:2-11*. Mr. Orndorff also stated, "It would have been counterproductive, uh, to, to bring a suit when you're trying to fix like I said the problems in the partnership and BGI, that why in the world would you, uh, try to collect a note when there's nothing to collect other than a bankruptcy of BGI and collapse of the whole thing." *MTAB Hr'g Tr. 63:13-18*.
24. In May of 2013, the promissory notes were refinanced into new notes bearing a lower interest rate of 12%, compounded annually rather than quarterly, to mirror the other deferred creditors and because it appeared reasonable at the time. *Ex. 12-2, 18; MTAB Hr'g Tr. 33:15-25*. Mr. Orndorff testified that the initial notes carried higher interest rates because, at the time they were issued, the perceived risk of nonrepayment was greater. *MTAB Hr'g Tr. 57:15-19*. Mr. Orndorff testified regarding the refinanced interest rates stating that "the

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- project was turning, uh, profitable, they lowered it to nine.” *MTAB Hr’g Tr. 33:15-25*. Mr. Orndorff also stated, “I believe the independent directors were sensitive to the cost of the loans and adjusted them as the situation improved.” *Id.* By the time the notes were refinanced, the performance of the facility had improved, reducing the perceived nonrepayment risk. *Ex. B; MTAB Hr’g Tr. 34:1-13*. BGI began repayment to Mr. Orndorff, Mr. Roberts, and Mr. Smith in 2019 after fulfilling other obligations to deferred creditors with contractually higher priority. *Ex. B; MTAB Hr’g Tr. 65:7-12*. The Subject Transactions were fully repaid between 2021 and 2022. *Ex. B; MTAB Hr’g Tr. 49:4-8*.
25. On September 13, 2021, the Department notified BGI that it had opened an audit for tax years 2018, 2019, and 2020. *Ex. 3; MTAB Hr’g Tr. 193:14-21*. Department Lead Auditor, Febe Gemlich, testified that, under Department procedure and policy, an audit may be initiated when an auditor identifies discrepancies or questions relating to a filed tax return. *MTAB Hr’g Tr. 193:3-13*. Ms. Gemlich stated that BGI was initially audited because of questions involving flow-through income versus apportionable income. *MTAB Hr’g Tr. 193:22-194:19*. During the audit process, Ms. Gemlich also identified a potential issue involving a deduction labeled as “Outside Services/Subcontractors” and requested additional information from BGI regarding the deduction. *Id.*
26. On December 20, 2022, Ms. Gemlich issued an initial audit determination letter to BGI. *Ex. E*. The Department made no adjustments to tax years 2018 or 2019 but denied a deduction on the 2020 return labeled as “Outside Services/Subcontractors” and disallowed prior year adjustments taken on the Schedule E. *Id.* The Department allowed similar deductions on BGI’s 2018 and 2019 returns for legal and professional expenses related to Ladenburg as a deferred creditor. *Ex. E; MTAB Hr’g Tr. 90:24-91:6, 113:17-114:3, 224:18-225:11*. Department Unit Manager, David Merrien, testified that he considers the deduction taken for Ladenburg’s services to be of a separate category than

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the Subject Transactions because it involved a third-party creditor rather than a shareholder and because the deduction was determined to be directly related to the production of income and could legitimately reduce Montana source income. *MTAB Hr'g Tr. 224:18-225:11.*

27. During the audit, Ms. Gemlich asked Mr. Merrien to provide her with documentation from the Bloomberg Tax database specifically regarding the deductibility of interest on shareholder loans. *MTAB Hr'g Tr. 154:6-155:3.* Mr. Merrien testified that this was necessary because Ms. Gemlich did not have a subscription to Bloomberg, while he did. *MTAB Hr'g Tr. 204:21-205:20.* Mr. Merrien explained that Bloomberg is a subscription service and, because the subscriptions are expensive, only a limited number of Department employees in each unit have access. *Id.* Ms. Gemlich stated that she ultimately arrived at her determination on her own. *MTAB Hr'g Tr. 154:6-17.* Mr. Merrien stated that he did not include any of his own notes on the documentation he provided to Ms. Gemlich. *MTAB Hr'g Tr. 221:3-10.*
28. Taxpayers timely requested an informal review of Ms. Gemlich's audit determination adjustments on January 31, 2023. *Ex. 56, 57, 58, 59.*
29. The informal review was assigned to Mr. Merrien, who had previously provided documentation to Ms. Gemlich relating to the initial audit determination. *Ex. 11; MTAB Hr'g Tr. 154:6-155:3.* On June 9, 2023, Mr. Merrien issued the Final Audit Determination. *Ex. 11.*
30. Mr. Bermensolo testified that he labeled the interest deductions as "Outside Services/Subcontractors" because they related to payments to deferred creditors. *MTAB Hr'g Tr. 98:17-25.* Mr. Bermensolo stated that if the Department had asked him to reclassify the deduction as an interest expense he would have done so because, "It comes out the same no matter what line they put it on, it's still an expense." *MTAB Hr'g Tr. 99:1-4.*

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31. BGI's Chief Financial Officer, Jeremy Wonch, testified that the timing of repayment of the Subject Transactions was governed by Mr. Sletteland's bankruptcy agreement and the YELP Partnership Agreement, which did not permit discretion regarding the timing of repayment. *MTAB Hr'g Tr. 138:13-24*. Mr. Wonch further testified that the repayment was not the result of discretionary decisions but followed the "waterfall concept" established by the agreements, under which payments were made as funds became available. *MTAB Hr'g Tr. 138:19-139:4, 145:6-18*. Mr. Wonch testified that "the cash to the creditors was a combination of cash flow from profits and from the refinance." *MTAB Hr'g Tr. 145:6-18*.
32. The Department asserted in its Final Audit Determination that the Subject Transactions constitute equity contributions rather than debt because they do not meet the requirements of the straight debt safe harbor rule, do not qualify as bona fide debt, and lack economic substance. *Ex. 11*. The Department relied on 26 U.S.C. § 1361(c)(5) and Treas. Reg. 26 C.F.R. 1.1361-1 for the position that the Subject Transactions did not qualify as "straight debt" under the safe harbor rule, arguing that the payments were entirely contingent on profits and the borrower's discretion. *Id.* Mr. Merrien testified that, in his view, the Subject Transactions do not qualify under the straight debt "safe harbor" provision because repayment of principal and interest was dependent on profitability as shown by the fact that repayment was postponed until profits began flowing from YELP to BGI. *MTAB Hr'g Tr. 209:16-210:3*. Mr. Merrien testified that in order for BGI to repay its debts, YELP needed to be profitable for several years to correct BGI's capital account. *MTAB Hr'g Tr. 209:19-210:3, 241:1-16*. Additionally, Mr. Merrien stated that "the borrowers and payors are the same people. So that in that, that's essentially the problem..." and "you are transacting with yourself... you have discretion on the terms of the notes." *MTAB Hr'g Tr. 242:8-16*.

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33. Mr. Merrien testified that one factor which contributed to his decision to deny the Taxpayers' deduction was that the shareholders were not in the business of lending money as described by the safe harbor rule. *Ex. A; MTAB Hr'g Tr. 243:4-21*. Mr. Merrien acknowledged that the language of the statute is disjunctive and permits the third element of the safe harbor rule to be met in ways other than being a person regularly engaged in the business of lending money. *MTAB Hr'g Tr. 243:4-21*.
34. Mr. Merrien also stated that he believes the Subject Transactions do not qualify as bona fide debt and are instead equity contributions made by the shareholders based on thirteen factors established by the Fifth Circuit to distinguish debt from equity. *Ex. A, F; MTAB Hr'g Tr. 206:17-20, 209:10-15, 210:11-211:24*. Mr. Merrien testified that BGI's inability to obtain credit from outside sources supported his view that any money advanced by the shareholders represented equity contributions by the shareholders. *MTAB Hr'g Tr. 210:21-211:7*. Mr. Merrien further testified that BGI's failure to repay the advances by the maturity date, and BGI's low level of capitalization, substantiate his conclusion that the shareholders' advances were equity rather than debt. *MTAB Hr'g Tr. 211:8-24*.
35. In the Final Audit Determination, the Department relied on 26 U.S.C. § 7701(o) for the position that no substantial business purpose exists for treating the shareholder advances as debt and that such treatment primarily served to generate significant interest deductions to avoid or substantially reduce the Taxpayers' Montana income tax liability. *Ex. 11, A; MTAB Hr'g Tr. 212:3-213:19*. The Department stated that treating the transactions as debt rather than equity did not meaningfully change the Taxpayers' economic position and the label had no substantial non-tax purpose apart from federal income tax effects. *Ex. 11, A; MTAB Hr'g Tr. 212:3-213:19*. Mr. Merrien explained that if the Subject Transactions were reported as equity there would be no difference to BGI's economic status except that BGI could not deduct roughly \$4,200,000 in

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losses which by the mechanics of the federal return reduces Montana source income by \$4,200,000. *MTAB Hr'g Tr. 212:20-214:23*. The Taxpayers argue that the Subject Transactions do have economic substance and a legitimate business purpose because they were necessary to keep BGI solvent and operational, involved actual transfers of money, and were approved by an independent board of directors. *MTAB Hr'g Tr. 29:5-23, 41:9-24*.

36. Mr. Merrien disagreed with one aspect of the initial audit determination which stated that prior year adjustments could not be applied to the shareholders' 2020 returns but agreed that the amount of suspended losses each shareholder could claim is undetermined. *Ex. 11; MTAB Hr'g Tr. 206:7-16, 213:6-215:12*. In the Final Audit Determination, the Department maintained the character of the distributive shares of income received by the shareholders and reversed the additional liability. *Ex. 11*. The Department asserts that treating the transactions as debt allowed the Taxpayers to suspend losses and control the timing of when those losses were used to offset income taxed at higher marginal tax rates, thereby increasing the tax benefit of the deductions. *Id.* Mr. Merrien testified that he relied on documentation provided by the Taxpayers during the initial audit when preparing the Department's Final Audit Determination. *MTAB Hr'g Tr. 205:21-206:6*.

37. Taxpayers timely requested review of the Department's Final Audit Determination with ODR on July 19, 2023. *Ex. G*. The Taxpayers elected to bypass ODR and proceed directly to MTAB on April 3, 2024. *Ex. H*. On April 5, 2024, ODR issued an Order of Dismissal. *Ex. H; MTAB Dkt. 3*.

38. The Taxpayers timely appealed to MTAB on April 26, 2024. *MTAB Dkt. 1*.

## JURISDICTION AND STANDARD OF REVIEW

39. The Montana Tax Appeal Board is an independent agency not affiliated with the Montana Department of Revenue. *Mont. Const., Art. VIII § 7; Mont. Code*

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- Ann. § 15-2-101*. The Taxpayer filed a timely appeal of the DOR's decision to the MTAB. Therefore, this Board maintains jurisdiction to hear and decide this matter. *Mont. Code Ann. § 15-2-302*.
40. This Board may hear appeals de novo. *Dept. of Revenue v. Burlington N.*, 169 Mont. 202, 213-14, 545 P.2d 1083 (1976). "A trial de novo means trying the matter anew, the same as if it had not been heard before and as if no decision had been previously rendered." *McDunn v. Arnold*, 2013 MT 138, ¶ 22, 370 Mont. 270, 275, 303 P.3d 1279, 1282.
41. The Board's order is final and binding upon all parties unless changed by judicial review. *Mont. Code Ann. § 15-2-302(6)*.

### CONCLUSIONS OF LAW

42. To whatever extent the following conclusions of law may be construed as findings of fact, they are incorporated accordingly.
43. The Taxpayer bears the burden of proving the error of DOR's decision. *Farmers Union Cent. Exch. v. Dep't of Revenue*, 272 Mont. 471, 476, 901 P.2d 561, 564 (1995); *Western Air Lines*, 149 Mont. at 353, 428 P.2d at 7.
44. When construing a statute, it is the Board's role to "determine what in terms or substance is contained in it, and not to insert what has been omitted or to omit what has been inserted." *State v. Minett*, 2014 MT 225, ¶ 12, 376 Mont. 260, 263, 332 P.3d 235, 238; *Mont. Code Ann. § 1-2-101*.
45. Statutory construction is a holistic endeavor and must be accounted for in the statute's text, language, structure, and object. *City of Missoula v. Pope*, 2021 MT 4, 402 Mont. 416, 478 P.3d 815.

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46. “In the construction of a statute, the intention of the legislature is to be pursued if possible. When a general and particular provision are inconsistent, the latter is paramount to the former, so a particular intent will control a general one that is inconsistent with it.” Mont. Code Ann. § 1-2-102.
47. Tax Law requires that creditorship have genuine existentiality. This is more than a declaration of intent to create an indebtedness and more than the existence of corporate paper encrusted with the appropriate nomenclature caption. *Estate of Mixon v. United States*, 464 F.2d 394, 407 (1972).
48. The determination of whether the funds advanced to a corporation are to be regarded as “capital contributions” or “loans” must be made in the light of all the facts of the particular case. *Gilbert v. Commissioner*, 262 F.2d 512, 513-14 (2nd Cir. 1957); *Hewlett-Packard Co. v. Comm’r*, 875 F.3d 494, 497-98 (9th Cir. 2017) (citing *A.R. Lantz Co v. United States*, 424 F.2d 1330, 34 (1970)); *Indmar Prods. Co. v. Comm’r*, 444 F.3d 771, 776, 778 (6th Cir. 2006).
49. “Whether a financial arrangement is best characterized as debt or equity ‘is considered by this court to be a question of fact...’” *Hewlett-Packard Co. v. Comm’r*, 875 F.3d 494, 497-98 (9th Cir. 2017) (citing *A.R. Lantz Co v. United States*, 424 F.2d 1330, 1334 (9th Cir, 1970)).
50. For an S corporation, the single stock requirements would be effectively repealed by judicial action if form were so allowed to control substance that what purports to be debt but according to objective criteria is equity cannot be treated as what it is. The Commissioner and the courts are not required to accept as conclusive the label of debt given by the corporation and those with whom it deals (often its own stockholders) to their own transactions. *Amory Cotton Oil Co. v. United States*, 468 F.2d 1046, 1050, (5th Cir.1972).

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51. Independent tribunal of experts' usefulness lies in their ability to examine relevant facts of business to determine whether or not they come under statutory language and experts are hardly needed to decide questions of dates or amounts or values or to calculate rates. *John Kelly Co. v. Commissioner*, 326 U.S. 521, 529, (1946); *Hewlett-Packard Co. v. Comm'r*, 875 F.3d 494, 497-98 (9th Cir. 2017) (citing *A.R. Lantz Co v. United States*, 424 F.2d 1330, 1334 (1970)).
52. Transactions which are shams, or without economic substance, should be disregarded for tax purposes even if the transaction technically complies with the Tax Code. *Santander Holdings USA, Inc. v. United States*, 844 F.3d 15 (1st Cir. 2016) (citing *Gregory v. Helvering*, 293 U.S. 465 (1935)).
53. The economic substance doctrine asks whether “there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-dependent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached...” *Frank Lyon Co. v. United States*, 435 U.S. 561, 584 (1978).
54. The Taxpayer has the right to a complete and accurate written description of the basis for any additional tax assessed by the department. Mont. Code Ann. § 15-1-222(6).
55. The taxpayer has the right to a review by management level employees of the department for any additional taxes assessed by the department. Mont. Code Ann. § 15-1-222(7).
56. The taxpayer is entitled to collect court costs and attorney fees from the department for frivolous or bad faith lawsuits as provided in Mont. Code Ann. § 25-10-711. Mont. Code Ann. § 15-1-222(9).

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57. “In addition to costs and attorney fees permitted under Mont. Code Ann. § 25-10-711, the board shall award costs and reasonable attorney fees as determined by the board from the department to a taxpayer that substantially prevails on the merits of an appeal of the value of class four residential property. Costs and attorney fees awarded by the board are limited to cases in which the department appeals a decision of the county tax appeal board.” Mont. Code Ann. § 15-2-306(2).
58. If a term is not defined in this chapter (15), the term has the same meaning as it does when used in a comparable context in the Internal Revenue Code. Mont. Code. Ann. § 15-30-2620(2).
59. Definition of small business corporation. (1) Except as provided in subsection (2), the term "small business corporation" is synonymous with "S. corporation" as defined in 15-30-2101 and means a corporation for which a valid election under section 1362 of the Internal Revenue Code (26 U.S.C. 1362) is in effect. Mont. Code Ann. § 15-30-3301.
60. Except as provided in subsection (g), a small business corporation may elect, in accordance with provisions of this section, to be an S corporation. 26 U.S.C. § 1362(a).
61. For the purposes of this title, the term “S corporation” means, with respect to any taxable year, a small business corporation for which an election under section 1362(a) is in effect for such year. 26 U.S.C. § 1361(a)(1).
62. For the purposes of 26 U.S.C. § 1361, the term “small business corporation” means a domestic corporation which is not an ineligible corporation, and which does not –
- A. Have more than 100 shares,

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- B. Have as a shareholder a person (other than an estate, a trust described in subsection (c)(2), or an organization described in subsection (c)(6)) who is not an individual,
- C. Have a nonresident alien as a shareholder, and
- D. Have more than 1 class of stock

26 U.S.C. § 1361(b)(1)(A)-(D).

63. In general. For purposes of subsection (b)(1)(D), straight debt shall not be treated as a second class of stock. 26 U.S.C. § 1361(c)(5)(A).

64. Straight debt defined.

For purposes of this paragraph, the term “straight debt” means any written unconditional promise to pay on demand or on a specified date a sum certain in money if -

- (i) the interest rate (and interest payment dates) are not contingent on profits, the borrower’s discretion, or similar factors,
- (ii) there is no convertibility (directly or indirectly) into stock, and
- (iii) the creditor is an individual (other than a nonresident alien), an estate, a trust described in paragraph (2), or a person which is actively and regularly engaged in the business of lending money. 26 U.S.C. § (c)(5)(B).

65. The Secretary shall prescribe such regulations as may be necessary or appropriate to provide for the proper treatment of straight debt under this subchapter and for the coordination of such treatment with other provisions of this title. 26 U.S.C. 1361(c)(5)(C).

66. The fact that an obligation is subordinated to other debt of the corporation does not prevent the obligation from qualifying as straight debt. 26 C.F.R. 1.1361-1(I)(5)(ii).

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67. An obligation that originally qualifies as straight debt ceases to so qualify if the obligation is materially modified so that it no longer satisfies the definition of straight debt. 26 C.F.R. 1.1361-1(I)(5)(iii).
68. In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—
- A. the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and
  - B. the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction. 26 U.S.C. § 7701(o)(1).
69. “[T]he characterization of an instrument for federal income tax purposes depends on the terms of the instrument and all surrounding facts and circumstances.” IRS Notice 94-47, 1994-1 C.B. 357.

**DISCUSSION**

The primary issue is whether the Department improperly denied a deduction for interest paid on promissory notes. This question hinges on whether the Subject Transactions represent debt or equity contributions. When an instrument is treated as debt, generally the corporation can deduct the interest payments made to the creditors, thereby reducing the corporation's taxable income. In contrast, payments that constitute capital contributions or equity injections are typically non-deductible. Taxpayers argue that the Subject Transactions were loans which constitute debt, whereas the Department argues that the transactions instead constitute equity contributions. BGI is registered as an S corporation. Under 26 U.S.C. § 1361(b)(1)(D), an S corporation cannot have more than one class of stock. However, the IRC provides a safe-harbor rule for instruments meeting the definition of “straight debt”.

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### I. Whether All Facts and Circumstances Should be Considered When Determining Debt Versus Equity

It is the majority's opinion that when 26 U.S.C. § 1361 was created, the drafters intended to create a definition of an S corporation and guidelines to determine, with respect to any taxable year, if a company meets the definition of a S corporation using all facts related to a particular case, not just the written instrument.

The Ninth Circuit Court of Appeals has routinely held that determining whether a financial arrangement is characterized as debt or equity is a question of fact. *Hewlett-Packard Co. v. Comm'r*, 875 F.3d 494, 497-98 (9th Cir. 2017) (citing *A.R. Lantz Co v. United States*, 424 F.2d 1330, 1334 (9th Cir. 1970)). In *Gilbert*, the court stated that the determination whether the funds advanced to a corporation are to be regarded as "capital contributions" or "loans" must be made in light of all the facts of the particular case. *Gilbert v. Commissioner*, 262 F.2d 512, 513-14 (2nd Cir. 1957); *Hewlett-Packard Co. v. Comm'r*, 875 F.3d 494, 497-98 (9th Cir. 2017) (citing *A.R. Lantz Co v. United States*, 424 F.2d 1330, 1334 (1970)); *Indmar Prods. Co. v. Comm'r*, 444 F.3d 771, 776, 778 (6th Cir. 2006). This point is further illustrated in *Amory Cotton Oil Co.*, which states that when deciding if small advances made to an S corporation occasionally by a segment of its stockholders violate the one stock rule relating to S corporation the single stock requirements would be:

"[E]ffectively repealed by judicial action if form were so allowed to control substance that what purports to be debt but according to objective criteria is equity cannot be treated as what it is. The Commissioner and the courts are not required to accept as conclusive the label of debt given by the corporation and those with whom it deals (often its own stockholders) to their own transactions." *Amory Cotton Oil Co. v. United States*, 468 F.2d 1046, 1050 (5th Cir. 1972).

Additionally, 26 U.S.C. § 1361(c)(5)(C) mandates the Secretary of the Treasury to prescribe regulations to provide for the proper treatment of straight debt. The Secretary created 26 C.F.R. § 1.1361-1(I)(5)(iii) to examine a debt obligation

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throughout its life. An obligation that originally qualifies as straight debt will cease to qualify if the obligation is materially modified so that it no longer satisfies the definition of straight debt. This rule is not concerned with debt creation via the instrument but is more concerned with how the debt is treated throughout the life of the obligation to determine if the obligation meets the definition of “straight debt.” The U.S. Internal Revenue Service (IRS) is the agency that is charged with the enforcement of the safe harbor rule. The IRS analysis and interpretation of 26 U.S.C. § 1361 and 26 C.F.R. §1.1361-1 in IRS private letter rulings require considering all surrounding facts and circumstances. IRS guidance specifically addresses this issue and states “the characterization of an instrument for federal income tax purposes depends on the terms of the instrument and all surrounding facts and circumstances.” IRS Notice 94-47, 1994-1 C.B. 357, 1994 IRB LEXIS 246.

Statutory construction is a holistic endeavor and must be accounted for in the statute’s text, language, structure, and object. This Board must effect the manifest intent of the statute in accordance with the clear language. Looking at the drafter’s intent in creating 26 U.S.C. § 1361(c)(5), and the statute itself, the purpose of subsection 1361(b)(1)(D) is to determine when “straight debt” shall not be treated as a second class of stock. In making the determination of whether the Subject Transactions meet the definition of debt or equity, the Supreme Court has stated that an independent tribunal of experts, such as this Board’s, usefulness lies in its ability “to examine relevant facts of business to determine whether or not they come under statutory language,” and that experts in tax are hardly needed “to decide questions of dates or amounts or values or to calculate rates.” *John Kelly Co. v. Commissioner*, 326 U.S. 521, 529, (1946); *Hewlett-Packard Co. v. Comm’r*, 875 F.3d 494, 497-98 (9th Cir. 2017) (citing *A.R. Lantz Co v. United States*, 424 F.2d 1330, 1334 (1970)). Therefore, while our findings are not binding, the Board will carry out its role to find facts related to the Subject Transactions and apply all relevant facts, along with the written promise to pay, in determining whether the Subject Transactions meet the statutory definition of “straight debt.” Additionally, 26 U.S.C. § 1361(c)(1)-(5) sets rules relating to S corporations in applying 26 U.S.C. § 1361(b). The rules under 26

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U.S.C. 1361(c)(1-5) are intended to be applied to the extrinsic facts and the context of the relationship between the shareholders and the S corporation, to determine if an S corporation fits the definition under 26 U.S.C. 1361(b) and can therefore make an S corporation election under 26 U.S.C. § 1362.

The Board reads 26 U.S.C. § 1361(c)(5) as a whole to ensure sections are consistent and not contradictory. While the statute does require a written unconditional promise to pay, all three factors of the statute allow for outside analysis to occur when determining safe harbor. In 26 U.S.C. § 1361(c)(5)(B)(i), similar factors may be used when determining contingencies, indicating that there are outside contingencies that are not included in subsection (i). Subsection (ii) allows for convertibility into stock (directly or indirectly) to be considered. The word “indirectly” implies that stock convertibility that is not straightforward or direct is considered by applying the context of the surrounding facts of the transaction to determine stock convertibility. Subsection (iii) allows outside inspection of the creditor to determine if they are an individual, an estate, or a trust which similarly indicates a reliance on examining external factors. Reading subsections (i) and (ii) narrowly and confining their inquiry to the writing, while allowing section (iii) to broadly consider all facts creates contradictory intent not only between the plain meaning of the words used but also the three subsections themselves. Additionally, there is no qualifying language in 26 U.S.C. § 1361(c)(5)(B) limiting subsection (i), (ii), or (iii) to an analysis of the writing. In its ordinary plain meaning, the statute reads “if” the interest rate is not contingent on profits; not in the contrary “if in the written promise to pay” interest rates are not contingent on profits, and the same reading applies to the other two factors.

Neither party argued, and there is nothing in the record indicating the Board is confined to the writing of the unconditional promise to pay. In *Mixon*, which was presented before this Board, the court stated, “Tax Law requires that creditorship have genuine existentiality. This is more than a declaration of intent to create an indebtedness and more than the existence of corporate paper encrusted with the appropriate nomenclature caption.” *Estate of Mixon v. United States*, 464 F.2d 394,

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407 (1972). For the Board to consider only the written unconditional promise to pay would ignore the reality of the transaction. The minority opinion would have the Board ignore facts and accept as conclusive the label of debt given by the corporation and its own shareholders who are acting as the lenders in this case and are closely related. Therefore, considering the relevant case law, principles of statute interpretation, and guidance from the agency charged with enforcement, the majority of the Board believes that whether a statutory definition or common law analysis is used, the debt versus equity question is a question of fact and must be made in the light of all the facts of the particular case. With this in mind, we address the three elements of the straight debt safe harbor rule below.

**a. The Interest Rate and Interest Payment Dates Must Not Be Contingent on Profits, the Borrower’s Discretion, or Similar Factors**

The first element of the straight debt safe harbor rule requires that the interest rate and interest payment dates not be contingent on profits, the borrower’s discretion, or similar factors. Taxpayers contend that neither the interest rate nor interest payment date were contingent on BGI’s profitability or the borrower’s discretion. The Department contends that repayment was effectively conditioned on profits, and subject to borrower discretion.

Here, the promissory notes imposed a stated interest rate and definite maturity dates. Nothing in the language of the notes contractually tied interest accrual or payment to BGI’s earnings, net income, or profitability. Nonetheless, considering the totality of the circumstances, the Board finds that repayment would not have occurred absent YELP, and by extension BGI’s return to profitability, thereby rendering repayment of principal and interest contingent on profits.

The promissory notes provided that the shareholders were to be repaid “as funds are available, as determined by the Board of Directors, but in any event not later than five (5) years from the date hereof...” The Taxpayers contend that the phrase “payable as funds are available, as determined” refers to administrative timing and BGI’s cash flow rather than being specifically tied to profits. Taxpayers further argue

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that the Department conflates profits and income. However, because BGI's only source of income was its partnership agreement with YELP, and BGI was unable to obtain additional financing, any funds used to repay the shareholders would necessarily have been derived from profits.

Although the promissory notes contained fixed five-year maturity dates, those maturity dates were not adhered to, and testimony in the record calls into question whether they were viewed as definite obligations or if the listed maturity dates were simply to avoid intimidating other lenders. This is further supported by the fact that, when the maturity dates were reached and the shareholders had not been repaid, the shareholders declined to enforce repayment. Mr. Orndorff testified that he chose not to enforce repayment because "the project would become insolvent..." Mr. Orndorff also stated, "It would have been counterproductive, uh, to, to bring a suit when you're trying to fix like I said the problems in the partnership and BGI, that why in the world would you, uh, try to collect a note when there's nothing to collect other than a bankruptcy of BGI and collapse of the whole thing." This testimony indicates that repayment was contingent on BGI's profitability, as the factor preventing enforcement of repayment was BGI's poor financial condition and the risk of corporate collapse. If BGI had been profitable, the shareholders would presumably have sought to force repayment, indicating a contingency.

While businesses can, and often do, postpone or alter repayment dates, that was not the case here. Upon reaching the five-year maturity dates, no action was taken by either party to address the failure to repay. Instead, the obligations were not revisited until 2013, when they were refinanced at a lower interest rate, compounded annually rather than quarterly. The timing of that refinancing also appears indicative of a contingency on profits as it coincided with YELP's renewed profitability. When asked about the decision to refinance the transactions, Mr. Orndorff testified, "Well, we got to the point where we were comfortable, and our profitability was and, and reliability looked like it was going to continue upward..." Based on this testimony, the timing of the refinancing, as well as the revised interest rate and repayment terms were tied to the renewed profitability.

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Lastly, the record shows that at the time the Subject Transactions were made, BGI was limited to only one source of income and was unable to obtain additional financing. Had the Subject Transactions not taken place, BGI would have been unable to pay its daily operating costs and would have gone bankrupt. The record reflects that BGI did not have access to any other source of funds to repay the loans except for the 35% interest in YELP, and the monthly management fee, which had not been paid due to YELP's poor financial performance. This is an important distinction because if the Subject Transactions had been guaranteed with additional capital or if BGI had an alternative means of repaying the loans, this analysis would perhaps be different. If the shareholders had been guaranteed repayment of the Subject Transactions, similar to how BGI's deferred creditors' loans were guaranteed with profits from the Colstrip project as stated in the RDO, that might have been sufficient to show that repayment was possible through an alternative income stream and not conditional on profit. Instead, the record shows that either BGI was highly likely to go bankrupt and default on the Subject Transactions thereby causing the shareholders to lose their principal and interest, or YELP was going to make the necessary repairs to generate profit which would allow BGI to repay the Subject Transactions. The Board is not concerned with the debt subordination or timing of payments under the waterfall agreement as they only affect the order of repayment, not the source. The Board is instead focused on the fact that BGI's only viable source of funds for interest payments came entirely from profits paid by YELP to BGI.

Ultimately, while the four corners of the promissory notes do not expressly make the interest rate or repayment dates contingent on profits, the practical reality shows that the five-year maturity date was not treated as a definite repayment obligation and that repayment depended on YELP, and by extension BGI, achieving profitability. Therefore, with the first element of the safe harbor rule having not been met, the Subject Transactions do not meet the definition of straight debt. However, we briefly address the remaining two elements below for the sake of clarity.

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**b. There Must Not Be Convertibility, Either Directly or Indirectly,  
Into Stock**

The second element of the straight debt safe harbor rule states that there can be no convertibility, either directly or indirectly, into stock. Taxpayers contend that the promissory notes contain no language that mentions or refers to convertibility into stock and that the promissory notes had no such effect. Additionally, neither BGI nor the shareholders made any claims that they attempted to create a second class of stock. The Department concedes that the promissory notes met this element.

The Board agrees that the plain language of the promissory notes and the circumstances of the transactions do not allow for convertibility, either directly or indirectly, into stock. Therefore, the second element of the safe harbor rule is met.

**c. The Creditor Must be Either an Individual, an Estate, a Trust, or a  
Person Actively and Regularly Engaged in the Business of Lending  
Money**

The third element of the straight debt safe harbor rule requires that the creditor be either an individual (other than a nonresident alien), an estate, a trust, or a person who is actively and regularly engaged in the business of lending money.

The Department stated in its Final Audit Determination that the shareholders not having been regularly engaged in the business of lending was a factor which was considered when making their decision. However, Taxpayers argued, and the Board agrees, that due to the presence of “or” in the statutory language, the criteria listed in the straight debt safe harbor rule are disjunctive rather than conjunctive. The inclusion of “or” before the final factor implies that only one of the criteria must be met, whereas “and” would require that all factors be met for the element to be satisfied. Therefore, it is sufficient for shareholders to satisfy any one of the listed criteria above to satisfy this element of the safe harbor rule.

The shareholders are individuals who are not nonresident aliens, facts which the Department does not dispute. The record reflects that the shareholders are U.S.

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citizens who reside in Boise, Idaho. Thus, the shareholders satisfy the third element of the safe harbor rule.

### II. Whether the Payments Qualify as Bona Fide Debt

The Department contends that even if the notes constitute straight debt under the safe harbor rule, they may still be considered equity according to general principles of federal tax law. However, as the majority of the Board concludes that the transactions do not meet the first element of the safe harbor rule, and do not constitute straight debt, the Department's bona fide debt argument need not be addressed.

### III. Whether the Taxpayers' Payments Have Economic Substance

The Department also contends that regardless of whether the payments are safeguarded by the safe harbor rule, the payments lack economic substance and that the deduction should therefore be denied. The Taxpayers argue that whether the payments have economic substance is immaterial because federal law should not apply in this instance, but even if this Board rules that federal law does apply, the payments do have economic substance.

Economic substance is an anti-abuse doctrine that codifies the common-law doctrine allowing a transaction to be disregarded as a sham for tax purposes if it does not have economic substance or lacks a business purpose. As "economic substance" is not a term defined in the MCA, the Department relies on the definition contained in 26 IRC § 7701(o). Section 15-30-2620(2) of the MCA allows the Department to adopt definitions contained in the IRC if the term is not defined in the chapter. The IRC definition states that a transaction shall be treated as having economic substance only if "(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction." In *Gregory*, the Supreme Court held that transactions which are shams, or without economic substance, should be disregarded for tax purposes even if the transaction technically complies with the Internal Revenue Code. *Santander Holdings USA, Inc. v. United States*, 844 F.3d 15 (1st Cir. 2016) (citing *Gregory v. Helvering*, 293 U.S. 465 (1935)).

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In *Frank Lyon Co.*, the Supreme Court framed the economic substance question as whether “there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-dependent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached...” *Frank Lyon Co. v. United States*, 435 U.S. 561, 584 (1978).

Here, the Taxpayers state that the business purpose behind the transactions was to ensure that BGI remained solvent. The record reflects that the Subject Transactions were issued as a direct result of the general contractor abandoning construction prior to its completion and filing for bankruptcy. As a result, YELP and BGI were left with insufficient funds to sustain their operations. The Department argues that the payments do not have economic substance because the shareholders’ \$310,524 in total contributions would have the same economic benefit of providing BGI the capital necessary for BGI to survive whether it was treated as debt or equity. The Department contends that the only difference is that treating the payments as debt allows for a deduction of approximately \$4.3 million in interest expense, while treating the payments as equity would allow no such deduction.

Considering all relevant facts and circumstances, the Board concludes that the payments did have economic substance and were not sham transactions. Addressing the second element of the IRC definition first, the Taxpayers’ stated purpose of providing BGI sufficient funds to allow for its continued operation is an adequate and substantial purpose for the transaction other than tax avoidance. The Taxpayers have provided ample evidence that when the Subject Transactions were made, BGI was in dire financial straits and required additional funding to pay administrative and operational expenses. The Department relies on the approximately \$4.3 million deduction as evidence that the transactions lack economic substance and claims that labeling the payments as debt rather than equity was done solely to allow for the deduction of interest expense. However, transactions may result in tax benefits while still having economic substance so long as tax benefits or tax avoidance are not the sole driving factor behind making the transaction. In this case, there were reasons other than the

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creation of tax benefits or tax avoidance, to treat the payments as debt rather than equity. Primarily, treating the payments as debt indicated that the shareholders eventually expected repayment. Had the parties instead considered the payments to be equity contributions, the shareholders would not have been entitled to repayment. Characterizing the payments as debt is not a meaningless label assigned solely for tax avoidance. Labeling and treating the payments as debt carries real significance and changes the nature of the transaction to be that of a debtor and creditor. The Board views the creation of any tax benefits as a natural result of the transaction, rather than the sole purpose of its existence.

Regarding the first element of the IRC definition, the transactions did meaningfully change the taxpayer's economic position. The transactions created an influx of funds and an obligation to repay on BGI's side and constituted an investment with the risk of nonrepayment on the shareholders' side. While the transactions certainly did result in tax benefits, the form of the transactions was such that the result could have also been nonrepayment to the shareholders and economic loss. The risk associated with the transactions is indicative that there is economic substance. If the transactions were indeed a sham, they would likely have been formatted in a way to guarantee that the shareholders received tax benefits through tax-avoidance features and the assignment of meaningless labels as described in *Frank Lyon Co.* In this case, the Board finds no evidence of tax-avoidance features in the terms of the promissory notes, or the assignment of meaningless labels in the Subject Transactions. For the reasons noted above, the Board considers the transactions to have economic substance.

Therefore, while the Board believes that the Subject Transactions do have economic substance, the majority nonetheless concludes that denial of the interest expense deduction was proper because the transactions fail to qualify as straight debt under the safe harbor rule.

#### **IV. Whether the Department Violated the Taxpayers' Due Process Rights by Failing to Provide a Complete and Accurate Description of the Basis for the Additional Tax Assessment**

The Taxpayers argue that the Department violated the Montana Taxpayer Bill of Rights by failing to provide a complete and accurate written description of the

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bases for its initial and final determinations. The Department maintains that the determinations provided thorough written analysis in support of their conclusion which fulfilled its obligation to fully explain the basis for the determinations.

The Montana Taxpayer Bill of Rights entitles taxpayers to a “complete and accurate written description of the basis for any additional tax assessed by the department.” Mont. Code Ann. § 15-1-222(6).

The Department described the contents of the Final Audit Determination as containing “the history of the facts and issues at play... a thorough written analysis, citing statutory, regulatory, and common law in support of its conclusions, including references to the specific authorities analyzed.” The Taxpayers primarily dispute that the determinations contained complete descriptions of the bases for the Department’s decisions and point to several instances in which they believe a complete analysis was not provided. For instance, Taxpayers argue that the Department’s statement “it appears BGI has forfeited its Federal S election,” which was included in the initial determination letter, failed to fully explain how the Department concluded that the notes were not loans. Similarly, Taxpayers contend that they did not receive complete explanations as to why the name or label assigned to the interest payments was relevant, or why it was improper to exclude the Subject Transactions from BGI’s Schedule L, among other examples.

While the Board acknowledges that not every statement in the Department’s determinations is accompanied by exhaustive analysis, the Board nonetheless concludes that the Department satisfied its obligation to provide a complete and accurate written description of the bases for its decisions. Any written determination is likely to prompt additional questions from the recipient. This is an unavoidable aspect of the review process that does not, by itself, establish a violation. Even substantially longer and more detailed determinations would be unlikely to address every potential question, and requiring such detail for every determination would be impractical. In this case, the Department provided a reasonable analysis of its decision which the Board believes constitutes a complete and accurate description. The determinations span several pages and include analysis supported by citations to multiple legal

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authorities. In the Board's view, the determinations sufficiently address the reasons for the additional tax assessments. Accordingly, the Taxpayers' claim is denied.

### **V. Whether the Department Violated Taxpayers' Due Process Rights by Allowing a Management-Level Employee to Review an Audit Determination in Which the Employee Previously Assisted**

The Taxpayers argue that the Department violated their due process rights by allowing a Department employee who assisted the lead auditor in conducting research for the initial determination to later decide the Taxpayers' appeal of that determination. The Department contends that the internal review was consistent with standard agency practice and that Taxpayers have not presented sufficient evidence showing actual bias or an unfair result at the administrative level.

The Montana Taxpayer Bill of Rights states that a "taxpayer has the right to a review by management level employees of the department for any additional taxes assessed by the department."

Taxpayers allege that their review was compromised when Mr. Merrien reviewed Ms. Gemlich's audit determination that relied on authorities previously provided to her by Mr. Merrien. Taxpayers argue that the appearance of impropriety in the review process negates the legitimacy of the review, regardless of whether there was actual impropriety. Taxpayers believe that the Department decision was biased, and the Department's conclusion is not supported by law. Taxpayers contend that the Department's bias is evidenced by its reliance on cases which, in some instances, were decided more than sixty years ago and involved questionably similar facts and circumstances. Specifically, Taxpayers contend that the Department relied on a case involving royalty payments in schemes that the Taxpayers believe were clearly improper and have no connection to the case at hand. Furthermore, Taxpayers claim that Mr. Merrien's prior involvement in the BGI audit was not disclosed until after Taxpayers appealed before this Board.

The Board heard testimony from Department witnesses that Mr. Merrien did provide documentation to Ms. Gemlich during the initial audit determination phase which consisted of expert portfolios, relevant authorities, and tax information pulled from Bloomberg Tax. However, Mr. Merrien stated that this was necessary because

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Ms. Gemlich did not have access to Bloomberg herself. Bloomberg is a subscription service which, due to its expensive license, was only provided to a limited number of Department employees in each unit, such as Mr. Merrien. Mr. Merrien testified that he supplied the documents as they were listed on Bloomberg and did not attach any of his own notes or directions on how to interpret the materials. The Board believes that Mr. Merrien did not influence Ms. Gemlich's initial audit determination, evidenced by the fact that Mr. Merrien eventually reversed one of Ms. Gemlich's conclusions related to prior year adjustments to the benefit of the Taxpayers. If Mr. Merrien had improperly influenced Ms. Gemlich's determination, it stands to reason that they would have reached the same conclusions. Instead, it appears that Ms. Gemlich used the materials she requested from Bloomberg to reach her own conclusions regarding BGI's audit, which were then adjusted based on further review by Mr. Merrien.

The Board is similarly unconvinced by Taxpayers' argument that the Department utilized outdated cases with dissimilar fact patterns to reach a conclusion it wanted, rather than a conclusion supported by law. The age of the opinions referenced is inconsequential if they address a pertinent aspect of the case at hand and accurately reflect the law. Moreover, it is this Board's obligation to determine the relevance of any case cited. This includes determining whether the facts of the cases are similar to those at hand, and how courts have treated the rulings in subsequent opinions. The Board finds that the Department's legal analysis was logical, and the cases referenced had enough bearing to the facts at hand to warrant their use. There was no evidence presented indicating that the Department purposely selected cases which led to a desired conclusion. The use of older cases, or cases which do not contain identical facts and circumstances, does not automatically establish bias.

Finally, Taxpayers claim that the review process was compromised by Mr. Merrien's prior involvement in the audit process being undisclosed until after Taxpayers appealed before this Board. However, as the testimony shows, Mr. Merrien's prior involvement in the audit process was limited to providing materials Ms. Gemlich requested due to her inability to access Bloomberg herself. This Board also heard testimony that Mr. Merrien did not advise Ms. Gemlich on how to interpret the material, or how to rule on the issues. Due to Mr. Merrien's minimal involvement

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in the initial audit determination, the Board finds it reasonable that his participation was not explicitly disclosed until required by the discovery process. The Department is not required to disclose every employee who may have assisted in some form in the review process. The Board agrees that, ideally, the management level employee assigned to review a taxpayer's assessment should not have any prior involvement in the review process, even minimally. However, the Department has sufficiently established that Mr. Merrien's involvement was strictly limited to providing documents for Ms. Gemlich which she was unable to retrieve herself. This alone does not violate Taxpayers' due process rights. Additionally, in instances where a taxpayer feels the decision rendered by the Department was influenced by bias, this Board serves as a neutral body able to address those concerns. Taxpayers have exercised their due process rights by appealing before this Board and have not provided sufficient evidence that the Department's decision was influenced by bias. For the above-mentioned reasons, Taxpayers' due process claim is denied.

### **VI. Whether Taxpayers are Entitled to Attorney Fees.**

Taxpayers have requested reasonable costs and attorney fees to be awarded as allowed by law. The Montana Taxpayer Bill of Rights affords taxpayers two potential pathways to collect attorney fees from an appeal before this Board. The first entitles taxpayers to "collect court costs and attorney fees from the department for frivolous or bad faith lawsuits as provided in 25-10-711..." and the second applies to "lawsuits pertaining to the appeal of the value of class four residential property in which the taxpayer substantially prevails as provided in 15-2-306." Mont. Code Ann. 15-1-222(9). Mont. Code Ann. § 25-10-711(1) states that "in any civil action brought by or against the state, a political subdivision, or an agency of the state or a political subdivision, the opposing party, whether plaintiff or defendant, is entitled to the costs enumerated in 25-10-201 and reasonable attorney fees as determined by the court if: (a) the opposing party prevails against the state, political subdivision, or agency; and (b) the court finds that the claim or defense of the state, political subdivision, or agency that brought or defended the action was frivolous or pursued in bad faith."

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Here, the case brought before this Board does not pertain to the value of class four residential property. Thus, Taxpayers may only collect attorney fees if the Department's claims are deemed frivolous or in bad faith. The Department has provided ample evidence and testimony in support of its decision to deny the tax deduction of interest paid on shareholder promissory notes. Based on the evidence and testimony presented before the Board, we do not believe that the Department's claims are frivolous or were made in bad faith. The Department's witnesses testified that the decision to deny the tax deductions was made because, in their opinion, the tax deductions do not fit under the safe harbor rule, are not considered bona fide debt, and do not have economic substance. The Department witnesses pointed to specific elements of the safe harbor rule which they did not think the Subject Transactions met and explained why they believe the transactions do not constitute bona fide debt and lack economic substance. These conclusions were based on the facts available to the Department at the time of the audit determinations and do not reflect any capriciousness. The Board considers this legal analysis adequate to overcome the assertion that the claims are frivolous or were pursued in bad faith. Taxpayers did not provide sufficient evidence supporting their conclusion that the Department's decision was frivolous or made in bad faith and did not prevail on their claims against the state. Therefore, Taxpayers' request for attorney fees is denied.

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**ORDER**

1. The Taxpayers' appeal is denied.
2. The Department's determination denying the Taxpayers' claimed interest deduction and adjusting the individual shareholders' Montana tax returns is affirmed.
3. The Department did not violate the Montana Taxpayer Bill of Rights.
4. The Department did not violate the Taxpayers' due process rights.

Dated this 22nd day of May 2026.



A handwritten signature in blue ink, appearing to read "Travis Brown", written over a horizontal line.

Travis Brown, Chairman

A handwritten signature in blue ink, appearing to read "Adam Millinoff", written over a horizontal line.

Adam Millinoff, Member

**Notice:** You are entitled to judicial review of this Order by filing a petition in district court within 60 days of the service of this Order. The Department of Revenue shall promptly notify this Board of any judicial review to facilitate the timely transmission of the record to the reviewing court. *Mont. Code Ann. §15-2-303(2)*.

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**DISSENT**

I respectfully dissent from the majority's conclusion that the shareholder promissory notes fail to qualify as "straight debt" under the safe harbor provision of 26 U.S.C. § 1361(c)(5). The notes satisfy each statutory requirement, including the critical first element that their interest rate and payment dates are not contingent on profits, the borrower's discretion, or similar factors as defined in 26 U.S.C. § 1361(c)(5)(B)(i). Because the majority's contrary holding rests on an interpretation that imports general debt-equity principles into a specific statutory framework and equates economic dependence with legal contingency, I must dissent.

Section 1361 establishes the requirements for S corporation status, including that a qualifying small business corporation may not "have more than 1 class of stock". This single-class-of-stock requirement has historically created uncertainty regarding whether debt instruments might be recharacterized as a second class of stock, thereby terminating S corporation status. Congress addressed this concern in 1982 by enacting the straight debt safe harbor in 26 U.S.C. § 1361(c)(5)(A), which provides that "straight debt shall not be treated as a second class of stock".

The statute defines "straight debt" through three specific, mandatory requirements set forth in 26 U.S.C. § 1361(c)(5)(B). The instrument must be: (i) a written unconditional promise to pay on demand or on a specified date a sum certain in money, with an interest rate and payment dates that "are not contingent on profits, the borrower's discretion, or similar factors"; (ii) not convertible into stock; and (iii) held by a qualifying creditor. Each requirement serves a distinct function, and each must be analyzed according to its terms.

This dissent concerns only the first requirement. The parties, and this Board, do not dispute that the notes satisfy the second and third requirements. The notes contain no conversion features, and the creditors are individuals who qualify under 26 U.S.C. § 1361(c)(5)(B)(iii). The sole question is whether the notes' interest rate and payment terms are contingent on profits, borrower's discretion, or similar factors within the meaning of 26 U.S.C. § 1361(c)(5)(B)(i).

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When Congress enacts specific statutory criteria, courts must apply those criteria as written rather than substituting broader policy considerations or general principles developed in different contexts. This fundamental principle of statutory interpretation takes on particular significance here, where Congress deliberately replaced an uncertain, fact-intensive inquiry with defined statutory elements.

Section 1361(c)(5)(B)(i) asks whether "the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors". This language directs attention to the terms of the obligation itself, specifically, whether those terms make the interest rate or payment dates dependent on specified contingencies. The inquiry is whether the instrument, by its terms, conditions payment on profits or discretion, not whether payment is practically or economically dependent on future profitability.

The statutory structure confirms this textual focus. Subsection (c)(5)(B)(iii) expressly requires examination of the creditor's identity, an inquiry that necessarily involves facts external to the instrument. Congress knew how to require consideration of external circumstances when it intended to do so. The absence of similar language in subsection (i) indicates that the statute directs primary attention to the instrument's terms.

Safe harbor provisions serve a critical function in tax law by providing clear, administrable rules that allow taxpayers to determine legal consequences based on identifiable characteristics. Section 1361(c)(5) was enacted against the backdrop of decades of uncertainty surrounding the debt-equity distinction, a notoriously fact-intensive inquiry that generated substantial litigation and unpredictability. By supplying defined criteria for "straight debt," Congress adopted a more predictable framework for determining when an instrument will not be treated as a second class of stock in the S corporation context.

This legislative choice reflects a judgment to constrain, rather than expand, open-ended inquiry. If eligibility depends on subsequent developments, subjective assessments of economic reality, or creditor forbearance practices, the statutory

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criteria cease to provide meaningful guidance. The approach adopted by the majority reintroduces the very uncertainty the safe harbor was designed to eliminate.

The majority opinion relies on authorities addressing the general debt-equity distinction, which involve multi-factor tests examining the economic substance of purported debt. Those authorities arise from a different analytical framework and do not displace the specific statutory criteria Congress enacted in 1982 to define straight debt in this particular context.

General debt-equity cases address whether an instrument should be characterized as debt or equity in the absence of defined statutory criteria. They involve open-ended inquiries into factors such as the debt-to-equity ratio, the presence of subordination, the likelihood of repayment, and the parties' intent. Here, however, Congress has provided a structured framework that governs the analysis. Section 1361(c)(5)(B) establishes specific elements that, when satisfied, conclusively determine that an instrument will not be treated as a second class of stock. Respecting that framework requires applying the statutory elements as written rather than substituting a general, open-ended inquiry. General substance-over-form principles apply in the absence of governing statutory criteria; where Congress has defined the governing standard, that standard governs.

The record also reflects substantial adherence to corporate formalities uncommon in cases where insider advances are recharacterized as equity. The advances were approved by independent outside directors, documented through written promissory notes prepared by counsel, assigned fixed interest rates and maturity dates, and later refinanced through formal corporate action. Ownership percentages did not change as a result of the advances, and the notes contained no conversion rights or participation features characteristic of equity instruments. These facts materially distinguish the Subject Transactions from the informal or undocumented insider advances frequently associated with disguised equity contributions.

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The critical interpretive question is what it means for interest rates or payment dates to be "contingent on profits, the borrower's discretion, or similar factors" under 26 U.S.C. § 1361(c)(5)(B)(i). Proper interpretation requires examining each component of this phrase and understanding how they relate to one another.

A payment term is "contingent on profits" when the obligation itself makes payment dependent upon the existence or level of earnings. This occurs when the instrument provides that interest will be paid only if profits are realized, or that the interest rate will vary based on profitability, or that the maturity date will be extended if earnings targets are not met. The defining characteristic is that the terms of the instrument tie payment to profitability.

The statute distinguishes between a contingency defined by the terms of the obligation and the economic reality that repayment may depend on future profitability. Only the former is relevant to the safe harbor analysis. An obligation may be economically dependent on profitability in the sense that repayment is unlikely without improved financial performance, but that circumstance does not, absent a contractual dependency on profits, render the payment terms contingent on profits within the meaning of the statute. An inability to pay absent profitability reflects financial risk, not contractual contingency. The distinction between economic dependence and contractual contingency is particularly important in the context of distressed-business financing. Closely held businesses experiencing financial difficulty often rely on insider financing precisely because outside credit is unavailable. In many such cases, repayment is realistically expected to occur only if the business eventually returns to profitability. If that practical dependence on future business success alone were sufficient to render repayment "contingent on profits," few insider loans to struggling S corporations could ever qualify as straight debt. Such an interpretation would substantially narrow the safe harbor Congress enacted to provide certainty in this area.

This distinction is not semantic; it reflects the fundamental difference between the legal characteristics of an instrument and the practical likelihood of payment. A fixed obligation remains fixed even when owed by a financially distressed borrower.

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The creditor's remedies may be limited by the debtor's financial condition, but the obligation itself does not become contingent merely because collection is uncertain.

"Borrower's discretion" refers to the ability of the obligor to determine unilaterally whether or when payment will be made without a binding legal obligation to pay. This occurs when the instrument gives the borrower the option to defer payment, to determine the amount of payment, or to decide whether interest will accrue. The key is whether the borrower has legal discretion to avoid or modify the payment obligation.

Like profit contingency, borrower discretion concerns the legal terms of the instrument, not the practical reality that a borrower may choose to default or that a creditor may choose not to enforce. Every debtor has the practical ability to refuse payment, and every creditor has the discretion to forbear from enforcement. Those realities do not convert fixed obligations into discretionary ones.

The phrase "similar factors" must be read in context with the specific terms that precede it. When general language follows specific terms, it is properly understood to refer to matters of the same kind. Here, "profits" and "borrower's discretion" identify contingencies tied either to earnings or to unilateral control over payment. "Similar factors" therefore refers to comparable contingencies in the terms of the obligation, such as contingency on revenue, sales, or other financial metrics, or discretion vested in third parties, not to every circumstance that may affect a debtor's financial condition or the likelihood of repayment.

The statutory structure reinforces this narrow reading. Section 1361(c)(5)(B) contains three separate requirements, each addressing a distinct concern. Subsection (i) addresses payment contingencies; subsection (ii) addresses conversion features; and subsection (iii) addresses creditor identity. If "similar factors" were read broadly to encompass any circumstance affecting the likelihood of repayment, it would effectively collapse the specific statutory criteria into an amorphous inquiry indistinguishable from general debt-equity analysis. Such a reading would render the

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specific limitations in subsections (i) and (ii) largely superfluous and would defeat Congress's purpose in establishing defined criteria.

Moreover, a broad reading of "similar factors" would create an unworkable standard. Virtually every debt instrument issued by an operating business is economically dependent on the business's future performance. If economic dependence on profitability constituted a "similar factor," the safe harbor would be unavailable to most closely held businesses, the very taxpayers for whom S corporation status is most important and for whom the safe harbor was designed. If economic dependence alone were sufficient, nearly all closely held business debt would fall outside the safe harbor, a result incompatible with the statute's design.

Applying these principles, the notes at issue satisfy the requirements of 26 U.S.C. § 1361(c)(5)(B)(i).

The notes provided for a fixed interest rate, initially 19 percent, later refinanced at 12 percent, without any reference to profitability. The interest rate did not fluctuate based on earnings. It did not become payable only upon the realization of income. It did not vary with any financial metric. The rate was stated in the instrument and remained constant unless modified by subsequent agreement, which occurred through the refinancing.

The majority does not contend that the stated interest rate itself was contingent on profits. Rather, the majority's concern is with the payment terms, specifically the "as funds are available" language. But § 1361(c)(5)(B)(i) distinguishes between interest rates and payment dates. Even if the payment terms raised questions, the interest rate component of the first requirement is clearly satisfied.

The notes contained defined maturity dates. Nothing in the terms of the instrument made those dates dependent on profitability. The notes did not provide that maturity would be extended if profits were insufficient. They did not condition payment on the achievement of earnings targets. They established fixed dates on which payment was due.

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The critical issue is the provision that payment would occur "as funds are available as determined by the Board of Directors." The majority treats this language as creating a contingency on profits or borrower discretion. I believe that interpretation is incorrect for several reasons.

First, this language addresses the manner and timing of payment in practical terms; it does not eliminate the underlying obligation or transform it into one that exists only upon profitability. The notes created enforceable legal obligations with fixed maturity dates. The "as funds are available" language did not make the obligation itself contingent; it addressed how payment would be made within the constraints of available resources.

The distinction between payment mechanics and payment contingencies is critical and must be preserved to give effect to the statutory text. Payment mechanics address how and when payment will be made within the constraints of available resources and contractual priorities. Payment contingencies condition the obligation itself on the realization of profits or vest discretion to avoid the obligation. Section 1361(c)(5)(B)(i) targets the latter, not the former.

Second, the record reflects that repayment followed an established priority structure governed by external agreements, under which payments were made according to defined ordering principles as funds became available. In that context, the BGI Board of Directors' role in determining fund availability was limited to applying those contractual priorities, not exercising unfettered discretion to condition payment on profitability. The Board of Directors did not have discretion to pay or not pay based on subjective judgments; it had a ministerial function of determining what funds were available after satisfying prior obligations and applying the contractual payment waterfall.

This framework reflects payment mechanics constrained by external agreements, not profit contingency or borrower discretion within the meaning of the statute. The Board's determination of fund availability was not a grant of discretion to

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the borrower to decide whether to pay; it was a recognition that payment would be made in accordance with a defined priority structure as resources permitted.

Third, treating routine cash flow management provisions as creating profit contingency would effectively eliminate the safe harbor for any debt owed by financially constrained borrowers. Many closely held businesses operate with limited liquidity and must manage cash flow carefully to meet multiple obligations. If acknowledging that reality in the payment terms of a note disqualifies it from the safe harbor, the safe harbor becomes unavailable precisely when it is most needed, when a business is using debt financing and must coordinate multiple obligations. Such a result is inconsistent with the statute's purpose. Congress enacted the safe harbor rule to provide certainty in the S corporation context, not to limit its availability to businesses with unlimited liquidity. A borrower's inability to pay at a given moment does not convert a fixed obligation into a contingent one, and language acknowledging that payment will be made as funds become available does not create a profit contingency.

Fourth, commercial lending frequently involves borrowers whose ability to repay depends on improved performance, and such loans routinely include provisions addressing payment timing and cash flow constraints. These provisions do not convert fixed obligations into contingent ones. A working capital loan to a seasonal business, a term loan to a startup, or a note issued by a company undergoing restructuring all involve economic dependence on future profitability, yet all can constitute fixed obligations with defined terms.

The majority's approach would treat any acknowledgment of financial constraints as creating a disqualifying contingency. That interpretation is difficult to reconcile with commercial practice or with the statute's purpose of providing a workable safe harbor.

The majority relies on subsequent conduct, including creditor forbearance when the notes matured and later refinancing at a reduced interest rate. Neither circumstance alters the statutory analysis.

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Creditor forbearance is a common feature of commercial relationships and reflects a choice not to enforce rights, not the absence of those rights. The notes created enforceable obligations with fixed maturity dates. That the shareholders chose not to enforce those obligations immediately when they matured reflects a creditor's business judgment to preserve the debtor's viability rather than force default, not the absence of a fixed obligation. A creditor's decision to delay enforcement does not transform a fixed obligation into one contingent on profits.

Similarly, refinancing reflects changed circumstances and does not retroactively alter the character of the original obligation. The adjustment of interest rates in response to improved financial conditions is consistent with ordinary commercial practice. Creditors frequently agree to modify terms when a borrower's financial condition improves or deteriorates. Such modifications do not indicate that the original terms were contingent on profitability; they reflect the parties' response to changed circumstances. Moreover, the notes were ultimately repaid in full. That fact strongly supports the conclusion that the parties treated the obligations as genuine debt rather than disguised equity. Unlike sham debt instruments that are never enforced, forgiven, or silently absorbed into capital accounts, these obligations remained on the books, were refinanced through formal corporate action, and were eventually satisfied. The actual repayment history therefore reinforces, rather than undermines, the conclusion that the parties understood the transactions to create enforceable debtor-creditor relationships.

The statute directs attention to whether the terms of the instrument create a contingency on profits or borrower discretion. It does not provide that subsequent financial performance, creditor forbearance, or negotiated modifications may retroactively redefine whether the terms were contingent at inception. The majority's reliance on subsequent conduct shifts the inquiry from the instrument's terms to the parties' later behavior.

The majority's interpretation, if adopted, would significantly undermine the safe harbor's utility and reintroduce the uncertainty Congress sought to eliminate.

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Under the majority's approach, whether an instrument qualifies as straight debt depends not solely on its terms but on subsequent events, creditor behavior, and judicial assessment of economic reality. This standard provides little guidance to taxpayers seeking to structure their affairs in compliance with the statute. A note that appears to satisfy the statutory criteria when issued might later be disqualified based on forbearance practices, refinancing, or the business's financial performance, factors that may not be known or controllable at the time the instrument is created.

Moreover, the majority's approach effectively requires courts to engage in the same multi-factor, fact-intensive inquiry that characterized debt-equity analysis before the safe harbor was enacted. If the safe harbor is available only when repayment is not economically dependent on profitability, and if creditor forbearance or refinancing can disqualify an instrument, then the safe harbor provides little practical benefit beyond what would be available under general debt-equity principles.

This result is inconsistent with Congress's purpose in enacting § 1361(c)(5). The safe harbor was designed to provide certainty and administrability. It accomplishes that purpose only if eligibility is determined by objective criteria ascertainable from the instrument's terms, not by subsequent conduct or economic outcomes.

The notes at issue establish a written, unconditional obligation to pay a sum certain with a fixed interest rate and defined maturity dates. The interest rate is not contingent on profits, borrower's discretion, or similar factors within the meaning of 26 U.S.C. § 1361(c)(5)(B)(i). The "as funds are available" language addresses payment mechanics within a defined priority structure, not profit contingency or unfettered borrower discretion. Subsequent forbearance and refinancing reflect creditor choices and changed circumstances, not the absence of fixed obligations at inception.

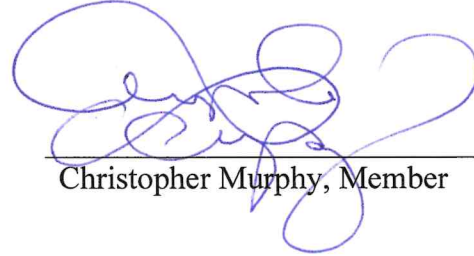
Because the notes satisfy each requirement of the straight debt safe harbor, they should not be treated as equity, and the corporation's S corporation election should remain valid. The majority's contrary holding rests on an interpretation that treats

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economic dependence as equivalent to legal contingency, imports general debt-equity principles into a specific statutory framework, and undermines the certainty the safe harbor was designed to provide.

For these reasons, I respectfully dissent.



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Christopher Murphy, Member

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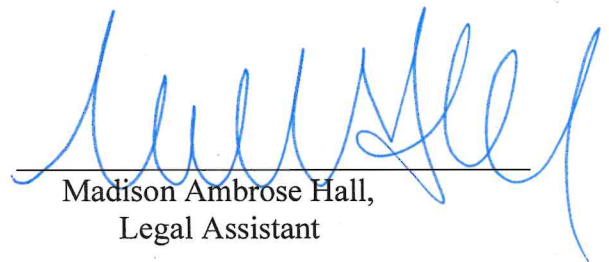
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**Certificate of Service**

I certify that I caused a true and correct copy of the foregoing *Findings of Fact, Conclusions of Law, Order, and Opportunity for Judicial Review* to be sent by email and United States Mail via Print & Mail Services Bureau of the State of Montana on May 22, 2026, to:

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