RELATED-PARTY DEBT: PROPOSED CODE §385 REGULATIONS RAISE MAJOR NEW HURDLES

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INTRODUCTION

On April 4, the Treasury Department issued proposed regulations under Code §385[1] that will have a major impact on *any* tax planning involving related-party debt by potentially recharacterizing such debt as equity under three new rules.[2]

- First, a debt recharacterization rule provides that debt instruments are treated as stock if issued in certain disfavored transactions (such as when debt is distributed as a dividend to a shareholder).[3]
- Second, documentation requirements are imposed as a condition to retain the treatment of related-party debt as true debt (and not equity) for tax purposes.[4]
- Third, a bifurcation rule allows the I.R.S. to recharacterize certain related-party debt as part debt and part equity.[5]

While these proposals were accompanied by adoption of new inversion rules under Code §7874,[6] these new Code §385 rules are not limited to debt issued in an inversion. Rather, the Code §385 regulations apply to *any* debt issued between related parties, whether in an international or purely domestic context.

These sweeping changes demand a review of proposed debt arrangements to determine the modifications that are needed to minimize possible adverse impact and alternative action that may be needed if current planning comes within the crosshairs of the new rules.

If finalized, the new debt recharacterization rule would generally apply to any debt instrument issued on or after April 4, 2016.[7] By contrast, the new documentation rules and the bifurcation rule will generally apply to debt issued on or after publication of final regulations under Code §385.[8]

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1 References to a section are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

2 Prop. Treas. Reg. §§1.385-1, 2, 3, & 4.

3 Prop. Treas. Reg. §1,385-3.

4 Prop. Treas. Reg. §1,385-2.

5 Prop. Treas. Reg. §1.385-1(d).

6 T.D. 9761 (April 4, 2016). See also Philip Hirschfeld, "Inversions Under Siege: New Treasury Regulations Issued," *Insights* 3, no. 4 (2016).

7 Prop. Treas. Reg. §1.385-3(h).

8 Prop. Treas. Reg. §§1.385-1(f), 2(f).

At the May 2016 meeting of the American Bar Association's Section of Taxation (the "A.B.A. Meeting"),[9] the International Tax Counsel for the Department of the Treasury, Danielle Rolfes, indicated that these proposed regulations are a high priority item for the government. While she indicated that the Treasury is open to some modifications based on comments it receives, the primary goal is to finalize the regulations, especially the debt recharacterization rule, later this year. Rushing to finalize controversial regulations during the last months of an Administration's second term in office is not a new event, and can sometimes lead to less than optimum results.

BACKGROUND

In an attempt to thwart inversions, the Treasury previously issued Notice 2014-52[10] on September 22, 2014 and Notice 2015-79[11] on November 19, 2015. These notices indicated that the Treasury would issue regulations to limit the benefits of certain post-inversion tax avoidance transactions. Among other things, the notices also indicated that the Treasury considered guidance to restrict strategies that avoid U.S. tax on U.S. operations by shifting or "stripping" U.S.-source earnings to lower-tax jurisdictions through the use of intercompany debt. Such transactions are commonly done after an inversion transaction. Although these earlier notices focused solely on inversions, the actions taken on April 4 were not limited to debt issued in an inversion. Affected debt may include debt owed by any U.S. subsidiary to its foreign parent or debt issued by any U.S. corporation, including a real estate investment trust ("R.E.I.T."), to a related U.S. person.

The Treasury's decision to use Code §385 as the means to attack earnings stripping was a surprise. While Code §385 directly addresses debt-equity classification issues, this section was dormant for almost 40 years with no regulations having been issued, apart from a set of regulations that were withdrawn in 1983.[12] At the A.B.A. meeting, some practitioners expressed concern that the Treasury may have acted beyond its powers in adopting the debt recharacterization rule. The International Tax Counsel responded that the Treasury had broad regulatory power under Code §385 that justified its actions. In response to other questions, the International Tax Counsel stated unequivocally that the regulations do not violate the non-discrimination provisions of U.S. tax treaties or otherwise conflict with any treaty.

Code §385(a), as originally enacted,[13] authorizes the Treasury to issue regulations that are necessary to determine whether an interest in a corporation is treated as stock or indebtedness for purposes of the Code. Code §385(b) provides that the regulations shall set forth factors that are to be taken into account in making such determination. These factors may include (i) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of

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9 References to the A.B.A. Meeting refer to the "Current Developments Panel" at the Foreign Activities of U.S. Taxpayers, Transfer Pricing and U.S. Activities of Foreigners & Tax Treaties Luncheon held on May 6, 2016, at which the author was present.

10 2014-42 IRB 712.

11 2015-49 IRB 775.

12 T.D. 7920, 1983-2 C.B. 69.

13 Tax Reform Act of 1969 (Pub. L. No. 91-172, 83 Stat. 487).

interest; (ii) whether there is subordination to or preference over any indebtedness of the corporation; (iii) the ratio of debt to equity in the corporation; (iv) whether there is convertibility into the stock of the corporation; and (v) the relationship between holdings of stock in the corporation and holdings of the interest in question.

In 1989, Congress amended Code §385(a) to expressly authorize the Treasury to issue regulations under which an interest in a corporation is to be treated as in part stock and in part indebtedness.[14] In 1992, Congress added Code §385(c),[15] which provides that the issuer's characterization (as of the time of issuance) as to whether an interest in a corporation is stock or indebtedness is binding on the issuer and on all holders of such interest (but shall not be binding on the I.R.S.).[16]

TAX BENEFITS OF DEBT

When an investor is asked to infuse capital into a company, it often is valuable for part of that capital to be treated as a loan, rather than an equity investment.[17] As described below, capitalizing a company with debt as well as equity can produce major tax benefits for all parties involved.

Consider a situation where a U.S. subsidiary of a foreign parent company needs more money from its parent company. If the money is advanced for added stock or as a capital contribution, repayment of the amount contributed typically will be made by cash distributions to the shareholder that are subject to the characterization rules of Code §301. These distributions are treated first as dividends to the extent of the company's current or accumulated earnings and profits ("E&P").[18] Dividends distributed to a foreign shareholder are subject to a 30% U.S. withholding tax,[19] which may be reduced or eliminated by an applicable tax treaty.[20] Redemptions may be subject to comparable treatment if the redemption is not treated as a sale or exchange.[21] The company is not allowed a deduction for dividends paid, which results in double taxation of corporate profits.

By contrast, if the shareholder lends the money to the company, three major tax benefits may be derived:

- First, in comparison to a payment of a dividend or a redemption of stock that is treated as a dividend, repayment of the loan principal to a foreign lender is not subject to a 30% U.S. withholding tax.[22] If the lender is a U.S. person, principal payments are not considered to be taxable income.

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14 Omnibus Budget Reconciliation Act of 1989 (Pub. L. No. 101-239, 103 Stat. 2106).

15 Energy Policy Act of 1992 (Pub. L. No. 102-486, 106 Stat. 2776).

16 Code §385(c)(1).

17 Apart from tax concerns, if the company should face financial difficulty, it is sometimes easier to repay a loan to a shareholder rather than a dividend.

18 Code §301(c)(1).

19 Code §§871(a)(1), 881(a)(1), 1441(a), 1442(a).

20 Code §894.

21 Code §302.

22 See *Philadelphia Nat. Bank v. Rothensies*, 43 F. Supp. 923 (E.D. Penn. 1942).

- Second, while interest payments are subject to a 30% U.S. withholding tax that is subject to reduction or elimination by the terms of an applicable income tax treaty, interest payments are generally treated more favorably than dividend payments to portfolio investors. Treaties usually exempt interest from the 30% tax, whereas dividends are taxed at a reduced withholding rate – usually 5% when the dividend is paid to a foreign corporation that owns 10% or more of the stock of the U.S. company, but exempt under specified conditions in recent treaties.[23]

  There is also a portfolio interest exemption under U.S. domestic law. It eliminates U.S. withholding tax on certain payments of interest.[24] The exemption does not apply, *inter alia*, to debt paid to a related person. However, a shareholder of a corporation is only related if he or she owns 10% or more of the voting stock of the company.[25] Ownership includes direct ownership and ownership by attribution.[26] A shareholder may own most of the equity of a corporation and still not be related, if he or she owns only non-voting stock.

- Third, a corporation can claim an interest expense deduction to reduce or eliminate its taxable income.[27] This can serve to eliminate double taxation on corporate profits that occurs when a U.S. corporation is used to conduct business.

  As discussed in the next two sections of this article, there are two primary ways this interest deduction may not be allowed:

  ○ First, interest deductions may be deferred under the earnings stripping rules of Code §163(j).

  ○ Second, the I.R.S. may assert that the purported debt instrument should be recharacterized as equity under common law tax principles.

  However, the I.R.S. may be hesitant to challenge the classification under the common law, as it is highly subjective and therefore difficult to prove in most cases. Nonetheless, to avoid a common law challenge, practitioners will often limit lending to maintain a reasonable debt-to-equity ratio for the company.

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[23] *E.g.*, under Article 10(2)(a) of the U.S.-German Income Tax Treaty, a 5% withholding rate applies to dividends paid by a U.S. company to a German company that owns at least 10% of the voting stock of the U.S. company – assuming the German company is a German tax resident that satisfies the limitation on benefits ("L.O.B.") provision of the treaty. Alternatively, if the German company owns 80% or more of the voting power of a U.S. company and certain conditions of the L.O.B. provision of the treaty are met, the withholding tax is eliminated. If neither of these conditions is met, a 15% withholding rate applies, under Article 10(2)(b), to dividends paid to a German resident that meets the L.O.B. requirements. Article 11(1) of the treaty eliminates the withholding tax on interest paid by a U.S. company to a German tax resident (assuming the L.O.B. requirements are met).

[24] Code §§871(h), 881(c).

[25] Code §§871(h)(3), 881(c)(3).

[26] Code §871(h)(3)(C), 881(c)(3)(B).

[27] Code §163.

EXISTING EARNING STRIPPING LIMITATIONS

"Earnings stripping" is a practice of reducing the taxable income of a corporation by paying interest to related third parties. Code §163(a) allows a deduction for all interest paid or accrued within the tax year on indebtedness. Code §163(j), enacted in 1989,[28] placed substantial restrictions on the amount of certain related-party interest expense deductions that a foreign-owned U.S. corporation may claim when computing its income tax.

The earnings stripping rules under Code §163(j)(2)(A)(ii) generally apply to a U.S. corporation that has a debt-to-equity ratio in excess of 1.5:1 and pays[29] interest to a related foreign person that is not subject to the full 30% U.S. withholding tax.[30] A related person[31] includes a foreign person who owns more than 50% of the value of the stock of the U.S. corporation.[32] If applicable, this provision denies a *current* deduction for the related-party interest expense equal to the *lesser of* (i) the related-party interest expense or (ii) the total interest expense of the corporation that exceeds 50% of the company's adjusted taxable income for the year (the "50% income limitation").[33] The 50% income limitation applies to the corporation's adjusted taxable income, which is the corporation's regular taxable income subject to certain modifications.[34] For example, depreciation deductions are not included in adjusted taxable income, which increases this amount and therefore limits the impact of this rule.[35] Adjusted taxable income is similar in function to the accounting concept of E.B.I.T.D.A. (earnings before interest, tax, depreciation, and amortization).

"Earnings stripping is a practice of reducing the taxable income of a corporation by paying interest to related third parties."

The disallowed interest is *deferred* until the following year[36] when it is then treated as an interest deduction subject to application of the earning stripping rules in that next year. In practice, deductions affected by these rules may be deferred for several years, but they are often allowed in a later year when the U.S. company has significant income (such as from a sale of its assets). This may eventually ameliorate the harsh treatment of the 50% income limitation by allowing the deduction.

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28 Enacted by the Revenue Reconciliation Act of 1989, these rules were a response to the perceived erosion of the U.S. tax base through excessive interest expense deductions.

29 Comparable treatment is provided for interest paid to an unrelated person that is not subject to full 30% withholding tax when a related person provides a credit enhancer that supports the loan. This disallowance applies to interest paid to both foreign creditors that benefit from an income tax treaty and domestic creditors that are subject to full U.S. domestic tax, but not to 30% withholding tax.

30 If the 30% withholding tax is reduced, but not eliminated, then these limitations only apply to a portion of the interest based on the amount of interest that is not subject to withholding tax.

31 Code §163(j)(4).

32 Code §§267(b)(2), (3), (f).

33 Code §§163(j)(1)(A), (2)(B).

34 Code §163(j)(6)(A).

35 Code §163(j)(6)(A)(i)(IV).

36 Code §163(j)(1)(B).

COMMON LAW ON RECHARACTERIZING DEBT AS EQUITY[37]

Recharacterization of a debt as equity involves a determination of whether a debt actually exists for tax purposes. This determination is decided on the basis of the facts presented.[38]

The exposure to recharacterization can be minimized by structuring the cash infusion in accordance with certain basic criteria reviewed by the courts.[39] Courts review these factors on a case-by-case basis and no single factor is dispositive. In making this determination, the courts have mentioned the following important factors that should be considered:

- Presence or absence of a written instrument evidencing the loan
- Names given to the certificates evidencing the indebtedness
- Presence or absence of a fixed maturity date
- Source of the payments
- Right to enforce payments
- Participation in management as a result of the advances
- Status of the advances in relation to regular corporate creditors
- Intent of the parties
- Identity of interest between creditor and stockholder
- "Thinness" of capital structure in relation to debt
- Ability of the corporation to obtain credit from outside sources
- Use to which the advances were put
- Failure of the debtor to repay
- Risk involved in making advances
- Provision of a fixed rate of interest
- Whether or not the indebtedness was secured.

A key factor indicative of a loan is the issuance of a bond, debenture, or note or the existence of a lien. The presence of a fixed maturity date, fixed interest rate, and

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37 For detailed examinations of the common law factors that distinguish debt from equity, see Galia Antebi and Nina Krauthamer, "Debt vs. Equity: Comparing HP Appeal Arguments to the Pepsico Case," *Insights* 3, (2015) pp.9-16, and Galia Antebi and Nina Krauthamer, "Tax 101: Financing a U.S. Subsidiary – Debt vs. Equity." *Insights* 3, (2014) pp. 27-32.

38 *E.g.*, *Berkowitz v. United States*, 411 F.2d 818 (5th Cir. 1969).

39 *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476, 493 (1980), acq., 1982-2 C.B. 1; *Estate of Mixon v. U.S.*, 464 F2d 394 (5th Cir. 1972).

fixed schedule for payments are also characteristic of a debt obligation, as opposed to equity. Additionally, repayment of the obligation should not be dependent upon the success of the business and the existence of corporate earnings, but rather, it should be made from cash flow.

The ratio of debt to equity, sometimes referred to as the "thin capitalization" issue, is an important factor.[40] Inadequate capitalization of the company is strong evidence of equity status and supports recharacterization of the debt as equity. The determination of undercapitalization is highly factual and may vary substantially by industry and company.

NEW DEBT RECHARACTERIZATION RULE

Background

The Treasury identified three types of transactions between related persons that raised significant policy concerns, which needed to be addressed in the Code §385 regulations. The three transactions are:

- distributions of debt instruments by corporations to their related corporate shareholders;
- issuances of debt instruments by corporations in exchange for stock of an affiliate (including "hook stock" issued by related corporate shareholders); and
- certain issuances of debt instruments as consideration in an exchange pursuant to an internal asset reorganization.[41]

In *Kraft Foods Co. v. Commissioner*,[42] the Second Circuit held that a debt instrument distributed by a U.S. corporation to its shareholder as a dividend was true debt for tax purposes. By contrast, in *Talbot Mills v. Commissioner*,[43] the First Circuit held that notes distributed to a shareholder in exchange for stock should be treated as equity for tax purposes. The Treasury noted that:

> In many contexts, a distribution of a debt instrument similar to the one at issue in *Kraft*, lacks meaningful non-tax significance, such that respecting the distributed instrument as indebtedness for federal tax purposes produces inappropriate results. For example, inverted groups and other foreign-parented groups use these types of transactions to create interest deductions that reduce U.S. source income without investing any new capital in the U.S. operations. In light of these policy concerns, the proposed regulations treat such a debt instrument as equity issued in fact patterns similar to that in *Kraft* as stock.[44]

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40 *Schnitzer v. Commissioner*, 13 T.C. 43 (1949), aff'd, 183 F.2d 70 (9th Cir. 1950), cert. denied, 340 U.S. 911 (1951).

41 REG 108060-15, Background, VI(C)(1) (April 4, 2016).

42 232 F.2d 118 (2nd Cir. 1956).

43 146 F.2d 809 (1st Cir. 1944), aff'd sub nom, *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946).

44 *Id.*

Code §304 prevents taxpayers from acquiring affiliate stock to convert what otherwise would be a taxable dividend into a sale or exchange transaction. In a similar manner, the Treasury determined that "the issuance of a related-party debt instrument to acquire stock of a related person is similar in many respects to a distribution of a debt instrument and implicates similar policy considerations."[45]

The proposed regulations also address certain debt instruments issued by an acquiring corporation as consideration in an exchange pursuant to an internal asset reorganization.

> Internal asset reorganizations can operate in a similar manner to Code §304 transactions as a device to convert what otherwise would be a taxable dividend into a sale or exchange transaction without having any meaningful non-tax effect.[46]

Apart from the "general rule" to address these three types of transactions, the Treasury noted that:

> Similar policy concerns arise when a related-party debt instrument is issued in a separate transaction to fund (1) a distribution of cash or other property to a related corporate shareholder; (2) an acquisition of affiliate stock from an affiliate; or (3) certain acquisitions of property from an affiliate pursuant to an internal asset reorganization.

As a result, the regulations adopt an added test, called the "funding rule," to address these attempts to circumvent their new general rule.[47]

Debt Subject to New Rules

To address these concerns, Prop. Treas. Reg. §1.385-3 contains the new debt recharacterization rule. This rule applies to debt issued between members of an expanded group ("E.G."). An E.G. is an affiliated group of corporations within the meaning of Code §1504 (which generally requires 80% ownership) with some significant modifications.[48]

An E.G. expands the statutory definition of affiliated group – which is limited generally to domestic corporations -- by including foreign and tax-exempt corporations. For example, an E.G. will exist if a foreign corporation owns 80% or more of a U.S. corporation.[49] While the Code §1504 definition refers to ownership of 80% or more of stock having both value *and* vote, the E.G. definition covers ownership of 80% or more of either vote *or* value.[50] Also, the proposed regulations adopt the constructive ownership rules of Code §304(c)(3).[51] However, debt between members of a U.S.

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45 REG 108060-15, Background, VI(C)(3) (April 4, 2016).

46 REG 108060-15, Background, VI(C)(4) (April 4, 2016).

47 REG 108060-15, Background, VI(C)(1) (April 4, 2016).

48 Prop. Treas. Reg. §1.385-3(f)(6), §1.385-1(b)(3). An affiliated group of corporations generally files a consolidated federal income tax return.

49 Prop. Treas. Reg. §1.385-1(b)(3)(i)(A).

50 Prop. Treas. Reg. §1.385-1(b)(3)(i)(C).

51 Prop. Treas. Reg. §1.385-1(b)(3)(ii).

consolidated corporate group is not subject to these rules since all the members of that group are treated as one corporation.[52]

General Rule for Debt Recharacterization

Under the general rule, debt between members of an E.G. is subject to reclassification as equity if it is issued in any of the following three situations ("Targeted Transactions"):

- A *distribution* by an E.G. member to a shareholder who is part of that E.G. (*e.g.*, a dividend or return of capital distribution in the form of notes)
- A *transfer* in exchange for *stock* of another E.G. member (*e.g.*, a member of an E.G. acquires stock of another member in exchange for issuing a note to the selling member), other than in an "exempt exchange"
- A *transfer* in exchange for *property* of another E.G. member in the context of certain tax-free asset reorganizations, *but* only to the extent that, pursuant to a plan, a shareholder that is a member of the E.G. before the reorganization receives the debt instrument[53]

For purposes of the second Targeted Transaction listed above, an exempt exchange is an acquisition of E.G. stock where the transferor and transferee of the stock are parties to a reorganization that is an asset reorganization and one of the following conditions is met. Either (i) Code §§361(a) or (b) applies to the transferor of the E.G. stock and the stock is not transferred by issuance, or (ii) Code §1032 or Treas. Reg. §1.1032-2 applies to the transferor of the E.G. stock and the stock is distributed by the transferee pursuant to a plan of reorganization.[54] This limitation has the effect of causing exchanges of E.G. stock that are part of an asset reorganization to be covered only by the third Targeted Transaction, which, as noted above, also imposes limitations on its application.

A debt instrument treated as stock under this rule is treated as stock from the time the debt instrument is issued.[55]

Funding Rule for Debt Recharacterization

Under the funding rule, debt is subject to recharacterization as equity if it is a "principal purpose debt instrument."[56] This funding rule adds a great deal of complexity to the regulations. However, the Treasury felt that the additional rule was necessary.

> Without these funding provisions, taxpayers that otherwise would have issued a debt instrument in a one-step [Targeted Transaction] . . . would be able to use multi-step transactions to avoid the application of these proposed regulations while achieving economically similar outcomes. For example, a wholly-owned subsidiary that otherwise would have distributed a debt instrument to its parent

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52 Prop. Treas. Reg. §1.385-1(e).

53 Prop. Treas. Reg. §1.385-3(b)(2).

54 Prop. Treas. Reg. §1.385-3(f)(5).

55 Prop. Treas. Reg. §1.385-3(d)(1)(i).

56 Prop. Treas. Reg. §1.385-3(b)(3)(i).

corporation in a distribution could, absent these rules, borrow cash from its parent and later distribute that cash to its parent in a transaction that is purported to be independent from the borrowing.[57]

A principal purpose debt instrument is a debt instrument issued with a principal purpose of funding one of the following distributions or acquisitions ("Targeted Funding Transactions"):

- A *distribution* of cash or property by the funded member to another E.G. member
- An *acquisition* of *stock* of another E.G. member for cash or property, other than in an exempt exchange (as defined above)
- An *acquisition* of *assets* of another E.G. member for cash or property in an asset reorganization, *but* only to the extent that, pursuant to the plan, a shareholder that is a member of the E.G. immediately before the reorganization receives cash or other property within the meaning of Code §356 with respect to its stock in the E.G. member who transferred assets to the funded member.[58]

"Under the funding rule, debt is subject to recharacterization as equity if it is a principal purpose debt instrument."

For example, if a foreign parent corporation lends $1,000 of cash to its wholly owned U.S. corporate subsidiary and one week later the U.S. subsidiary distributes the $1,000 cash back to the foreign parent as part of a pre-arranged plan, the funding rule applies and the debt instrument would be recharacterized as equity.

The principal purpose of the debt issuance is determined based on facts and circumstances.[59] However, the funding rule contains an irrebuttable presumption that an instrument is a principal purpose debt instrument if the debt is issued at any time during the 72-month period beginning 36 months before and ending 36 months after the issuing member makes a distribution or acquisition that is considered a Targeted Funding Transaction.[60] For example, if a foreign parent corporation lends $1,000 cash to its wholly owned U.S. corporate subsidiary and 30 months later, the U.S. subsidiary distributes $1,000 cash back to the foreign parent but *not* as part of a pre-arranged plan, then this 72-month *per se* funding rule would apply and the debt instrument is recharacterized as equity.

At the A.B.A. Meeting, the International Tax Counsel indicated that adoption of this 72-month *per se* rule provides for ease of administration and allows for implementation of the funding rule without the difficult task of determining the principal purpose based on facts and circumstances. However, this same rule may catch transactions that were not structured with any purpose of avoiding the debt recharacterization rules. In these cases, taxpayers must rely on the limited exceptions and exclusions to these rules provided in the regulations that are discussed below.

There is an exception from this 72-month *per se* rule for debt instruments arising in the ordinary course of the issuing member's trade or business in connection with the purchase of property or receipt of services (*e.g.*, accounts payable). This ordinary

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57 REG 108060-15, Background, VI(C)(5) (April 4, 2016).

58 Prop. Treas. Reg. §1.385-3(b)(3)(ii).

59 Prop. Treas. Reg. §1.385-3(b)(3)(iv)(A).

60 Prop. Treas. Reg. §1.385-3(b)(3)(iv)(B)(1).

course exception only applies if (i) the debt instrument reflects an amount that is currently deductible under Code §162 or it is currently included in the issuer's cost of goods sold or inventory; and (ii) the amount of the debt obligation does not exceed an amount that would be ordinary and necessary if it were owed to an unrelated person.[61] If this exception applies in lieu of the 72-month *per se* rule, this ordinary course debt instrument can still be challenged under the general principal purpose test.

A debt instrument, treated as stock under the funding rule, is treated as stock in the year when the debt instrument is issued, but only if it is issued in the same year as the Targeted Funding Transaction, or in a subsequent year.[62] However, if the debt instrument is issued in a taxable year prior to that of the Targeted Funding Transaction, the debt instrument is respected as debt until the date of the Targeted Funding Transaction.[63]

Exclusions

Three major types of borrowings are excluded from the general rule and the funding rule.

First, an exception exists if a threshold amount of debt does not exist. Under this exception, debt is not recharacterized if, immediately after the debt is issued, the aggregate adjusted issue price of all such E.G. debt held by members of the E.G. group does not exceed $50 million.[64]

Second, debt issued by an E.G. member that may be recharacterized as equity under the general rule is *reduced* by the member's current year E&P.[65] To illustrate, if a U.S. subsidiary distributes a $1,000 note to its foreign parent and the U.S. subsidiary has $1,000 of current E&P for that year, the note continues to be characterized as a debt instrument for U.S. tax purposes, and accordingly, the issuance of the note continues to be treated as a distribution of $1,000 that is taxable as a dividend. However, if the U.S. subsidiary has $700 of current E&P, only the portion of the debt instrument in excess of such current E&P (*i.e.*, $300) is recharacterized as equity of the issuer of the subsidiary. The exception applies to $700 of the $1,000 face amount of the note. Note that the exception is not extended to accumulated E&P, which cannot be used to fit within the exception.

Because the funding rule is subject to the E&P exception,[66] a foreign parent corporation that lends $1,000 cash to its wholly-owned U.S. corporate subsidiary is not deemed to receive stock of the subsidiary if the latter distributes $1,000 to the parent corporation within the following 36 months and in the year of the distribution, the U.S. subsidiary has $1,000 of current E&P.

Complications exist in applying the current E&P exception where more than one distribution or acquisition occurs in a single taxable year. The proposed regulations

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61 Prop. Treas. Reg. §1.385-3(b)(3)(iv)(B)(2).

62 Prop. Treas. Reg. §1.385-3(d)(1)(i).

63 Prop. Treas. Reg. §1.385-3(d)(1)(ii).

64 Prop. Treas. Reg. §1,385-3(c)(2).

65 Prop. Treas. Reg. §1,385-3(c)(1).

66 Prop. Treas. Reg. §1.385-3(g)(3), Ex. 17(ii), Analysis (C).

contain an ordering rule under which the current year E&P exception is applied to the various transactions in the order in which each occurred.[67] Consider the case of a U.S. subsidiary that makes a distribution of $30,000 to its foreign parent on March 1 and a distribution of a $19,000 note to its foreign parent on July 1. The U.S. subsidiary has $35,000 of current E&P for that year. Under the ordering rule, the $30,000 cash distribution comes from $30,000 of current E&P leaving only $5,000 of current E&P to cover the $19,000 note. The remaining $14,000 of the note is caught by the general rule and characterized as equity.[68]

At the A.B.A. Meeting, practitioners expressed concern about the narrowness of this exception, which would not apply to distributions made shortly after year-end that are attributable to the prior year's E&P, as well as concern about how this exception will be applied. In response to these concerns, the International Tax Counsel indicated that the current E&P exception may need some modifications to better protect taxpayer actions not principally motivated by avoidance of these rules.

"At the A.B.A. Meeting, practitioners expressed concern about the narrowness of the current year E&P exception, which would not apply to distributions made shortly after year-end that are attributable to the prior year's E&P."

Third, the proposed regulations contain a more limited exception for funded acquisitions of subsidiary stock.[69] This exception applies where the acquisition results from a transfer of property by a funded member (the transferor) to an E.G. member (the issuer) in exchange for stock of the issuer. The exception applies only where the transferor holds, directly or indirectly, more than 50% of the total combined voting power of all classes of stock of the issuer entitled to vote and more than 50% of the total value of the stock of the issuer for the 36-month period immediately following the issuance of the shares.

Cash Pooling and Treasury Centers

When issuing these proposed regulations, the Treasury requested comments regarding the need for special rules that would be applicable for cash pools, cash sweeps, and similar arrangements that are used to manage cash of an E.G.[70] Cash pooling is a cash management system that allows a group of related corporations to combine the credit and debit positions of various member into one account to reduce costs and enhance flexibility in managing group liquidity.[71]

At the A.B.A. Meeting, a practitioner requested that the Treasury not apply the debt recharacterization rules to cash pooling arrangements or treasury centers used by corporate groups. The International Tax Counsel indicated support for an exclusion covering cash pooling and cash sweeps, but not to treasury centers. Treasury centers should be viewed differently because they deal with longer-term needs.

Anti-abuse Rule

An anti-abuse rule is also included in the proposed regulations.[72] It provides that a debt instrument will be treated as stock if it is issued with a principal purpose of avoiding the application of the proposed regulations. In addition, other interests that

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67 Prop. Treas. Reg. §1,385-3(c)(1).

68 Prop. Treas. Reg. §1.385-3(g)(3), Ex. 17(ii), Analysis (C).

69 Prop. Treas. Reg. §1,385-3(c)(3).

70 REG 108060-15, Comments & Public Hearing (April 4, 2016).

71 "What Is Cash Pooling? Definition and Meaning," InvestorWords.

72 Prop. Treas. Reg. §1.385-3(b)(4).

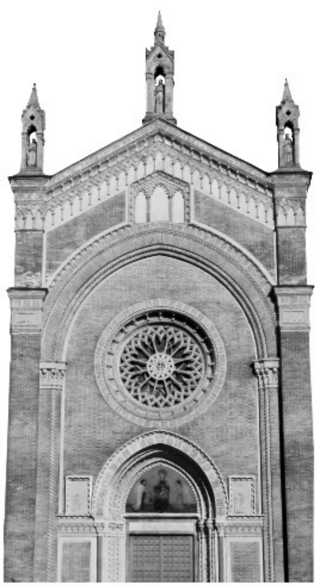
are not debt instruments for purposes of these rules (*e.g.*, contracts to which Code §483 applies or non-periodic swap payments) will be treated as stock if issued with the principal purpose of avoiding the application of these rules. A non-exhaustive list of illustrative examples is provided in the proposed regulations.[73]

Partnerships

To prevent avoidance of these rules through the use of partnerships, the new rules do not treat a controlled partnership as an entity, but rather they take an aggregate approach to controlled partnerships.[74] For example, when an E.G. member becomes a partner in a controlled partnership, the member is treated as acquiring its proportionate share of the controlled partnership's assets. A partnership is a controlled partnership if one or more members of an E.G. own 80% or more of the interests in the capital or profits of the partnership, either directly or indirectly.

Disregarded Entity

A debt instrument issued by a disregarded entity ("D.R.E."), that is treated as stock under these rules, is treated as stock of the sole member of the D.R.E. rather than as an equity interest in the D.R.E.[75] At the A.B.A. Meeting, one practitioner observed that this result is different than the treatment of a D.R.E. debt instrument subject to the documentation rules that is recharacterized as an equity interest in the D.R.E.[76] Responding to this observation, a senior counsel for the Office of International Tax Counsel, said that the Treasury was attempting to provide a more taxpayer-friendly result under the debt recharacterization rules. By taking such action, the regulations avoid creating an added entity, but only for purposes of the debt recharacterization rule.



Debt Instruments that Leave the E.G.

When (i) a debt instrument, that is treated as stock under these rules, is transferred to a person that is not an E.G. member or (ii) the obligor with respect to such debt instrument ceases to be an E.G. member, the interest ceases to be treated as stock.[77]

Effective Date

If finalized, the new rules regarding classification of certain debt as equity generally would apply to any debt instrument issued on or after April 4, 2016.[78]

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73 Prop. Treas. Reg. §1.385-3(b)(4). *E.g.*, the anti-abuse rule may apply if a debt instrument is issued to, and later acquired from, a person that is not a member of the issuer's E.G., and it is issued with the principal purpose of avoiding the application of the proposed regulations.

74 Prop. Treas. Reg. §1.385-3(d)(5).

75 Prop. Treas. Reg. §1.385-3(d)(6).

76 Prop. Treas. Reg. §1.385-2(c)(5).

77 Prop. Treas. Reg. §1.385-3(d)(2).

78 Prop. Treas. Reg. §1.385-3(h). This new rule will also apply to any debt instrument treated as or deemed to be issued before April 4, 2016, as a result of a "check-the-box" entity classification election that is made or filed on or after April 4, 2016.

DOCUMENTATION REQUIREMENTS

Background

Prop. Treas. Reg. §1.385-2 addresses the documentation and information requirements for a debt instrument issued between related parties to be treated as true debt for tax purposes. The Treasury is exercising its regulatory authority granted under Code §385(a) to treat the timely preparation and maintenance of this documentation as a necessary factor to be taken into account in determining if the interest is characterized as stock or indebtedness.

Compliance with these rules is not, however, a guarantee that the I.R.S. will treat the related-party debt as true debt for tax purposes. The common law Federal income tax principles discussed earlier still remain, and the documentation requirements under the rules are not determinative as to true debt characterization.

Debt Instruments Subject to These Documentation Rules

The documentation rules only apply to expanded group interests ("E.G.I.'s"), which are applicable instruments that are issued and held by members of an E.G.[79] There is no requirement that they be issued in connection with an inversion or any other specific transaction, so this rule has widespread impact. The aforementioned definition of an E.G. generally applies in this context as well. Thus, debt held by a controlled partnership will be subject to these rules.[80]

An E.G.I. only applies to applicable instruments that are interests issued in the form of debt instruments.[81] These rules are designed for traditional debt instruments. The proposed regulations reserved issuing guidance on the treatment of instruments that may be treated as debt for tax purposes but are not issued in the form of debt.[82] Comments are requested on how to address these other instruments.

These rules only apply to large taxpayer groups. An E.G.I. is subject to these rules only if (i) the stock of any member in the E.G. is publicly traded; (ii) all or any portion of the E.G.'s financial results are reported on financial statements with total assets exceeding $100 million; or (iii) the E.G.'s financial results are reported on financial statements that reflect annual total revenue that exceeds $50 million.[83] Only applicable financial statements, prepared within three years of the E.G.I. becoming subject to these rules, are relevant for determining whether an E.G.I. is subject to these rules.[84]

In response to practitioner comments at the A.B.A. Meeting, Marjorie Rollinson, Associate Chief Counsel (International) for the I.R.S., indicated that adoption of the documentation rule was reasonable and within the Treasury's power

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79 Prop. Treas. Reg. §1.385-2(a)(4)(ii).

80 See text accompanying note 70 *supra*.

81 Prop. Treas. Reg. §1.385-2(a)(4)(i).

82 Prop. Treas. Reg. §1.385-2(a)(4)(i)(B). Neither the Proposed Regulation nor the accompanying Treasury explanation gave examples of these unique debt instruments.

83 Prop. Treas. Reg. §1.385-2(a)(2).

84 Prop. Treas. Reg. §1.385-2(a)(4)(iv).

under Code §385. It was recognized, however, that application of the documentation rules to loans between two foreign entities that are members of an E.G. may impose a harsh burden and that the Treasury would consider comments that these rules not apply in this particular situation.

Proposed Documentation Requirements

The documentation rules are organized into four requirements, discussed below. The documentation must be maintained for all taxable years that the E.G.I. is outstanding, and it must be retained until the period of limitations expires on all returns to which the Federal tax treatment of the E.G.I. is relevant. While these four requirements represent fundamental case law principles for determining if an instrument is genuine tax indebtedness, they are now a mandatory component of true debt tax treatment, rather than relevant factors for making this determination.

The first requirement is there must be a binding obligation to repay the funds advanced. The rules require evidence in the form of a timely prepared written document executed by the parties.[85]

"The documentation rules only apply to E.G.I.'s. . . . There is no requirement that they be issued in connection with an inversion or any other specific transaction, so this rule has widespread impact."

The second requirement is for the loan agreement (or other written document) to delineate the creditor's rights to enforce the terms concerning the issuer's obligation to repay.[86] The creditor will need to have the legal rights to enforce the terms of the E.G.I. Typical creditor rights include the right to trigger a default, the right to accelerate payments, and the superior right over shareholders to share in the assets of the issuer in the event that the issuer is dissolved or liquidated. The impact of this requirement is that a one-page note evidencing the loan will likely no longer serve as adequate documentation.

The third requirement is a reasonable expectation of repayment by the issuer of the loan.[87] The proposed regulations indicate documentation requirements such as cash flow projections, financial statements, business forecasts, asset appraisals, determination of debt to-equity and other relevant financial ratios of the issuer. This documentation may not have been prepared in the past. Special rules are provided to address disregarded entities that issue an E.G.I. and whether the assets of the sole member of such entity can be considered in determining whether repayment is expected.

The final requirement is there must be evidence of a genuine debtor-creditor relationship.[88] The taxpayer asserting debt treatment must prepare and maintain timely evidence of an ongoing debtor-creditor relationship. This documentation can take two forms. In the case of an issuer that complied with the terms of the E.G.I., the documentation must include timely prepared documentation of any payments on which the taxpayer relies to establish such treatment under general Federal tax principles. If the issuer failed to comply with the terms of the E.G.I., either by failing to make required payments or by otherwise suffering an event of default under the terms of the E.G.I., the documentation must include evidence of the holder's reasonable exercise of the diligence and judgment of a creditor. The proposed regulations indicate acceptable forms of documentation, including evidence of the

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[85] Prop. Treas. Reg. §1.385-2(b)(2)(i).

[86] Prop. Treas. Reg. §1.385-2(b)(2)(ii).

[87] Prop. Treas. Reg. §1.385-2(b)(2)(iii).

[88] Prop. Treas. Reg. §1.385-2(b)(2)(iv).

holder's efforts to enforce the terms of the E.G.I., as well as evidence of any efforts to renegotiate the E.G.I.

Timing of Preparation of Documentation

The documentation generally must be prepared no later than 30 calendar days after the later of (i) the date that the instrument becomes an E.G.I. or (ii) the date that the E.G. member becomes an issuer with respect to an E.G.I. The preparation of the documentation of the debtor-creditor relationship can be prepared up to 120 calendar days after the payment or relevant event occurred, which gives more time to comply.[89]

Revolving Credit Agreements and Cash Pooling

The documentation requirements provide special rules for determining the timeliness of documentation preparation in the case of certain revolving credit agreements and similar arrangements, as well as cash pooling arrangements. The rules generally look to the documents pursuant to which the arrangements were established.[90]

Reasonable Cause Exception

If a taxpayer can show that failure to satisfy these rules is due to reasonable cause then appropriate modifications may be made to the requirements of this section in determining whether the requirements of this section have been met.[91] While the reasonable cause exception may benefit taxpayers in the event of an audit, it is not useful for planning purposes.

Effective Date

This documentation rule will apply to any debt instrument issued on or after publication of final regulations under Code §385.[92]

BIFURCATION RULE

Prop. Treas. Reg. §1.385-1(d) gives the I.R.S. the ability to recast only a portion of a debt instrument as equity and treat the remaining portion as debt (the "bifurcation rule"), instead of taking an "all-or-nothing" approach, as under current law. According to the Treasury and I.R.S., the existing all-or-nothing approach frequently does not reflect the economic substance of related-party debt.[93]

This bifurcation rule applies to a modified expanded group ("M.E.G."),[94]

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89 Prop. Treas. Reg. §1.385-2(a)(3)(i).

90 Prop. Treas. Reg. §1.385-2(b)(3)(iii).

91 Prop. Treas. Reg. §1.385-2(c)(1). The regulation adds that "[t]he principles of §301.6724-1 of this chapter apply in interpreting whether reasonable cause exists in any particular case."

92 Prop. Treas. Reg. §1.385-2(f). This new rule will also apply to any debt instrument treated as debt issued or deemed issued before April 4, 2016, as a result of a check-the-box entity classification election that is made or filed on or after April 4, 2016.

93 REG 108060-15, Background, VI(A) April 4, 2016).

94 Prop. Treas. Reg. §1.385-1(d)(2).

which covers a broader range of taxpayers than those affected by the other Code §385 rules. An M.E.G. means an E.G. where the threshold for determining relatedness is 50% ownership, not 80% as otherwise stipulated in the new rules.[95] Notably, the Treasury declined to apply this bifurcation rule to debt between unrelated persons since that "could result in uncertainty in the capital markets."[96]

Unlike the inversion guidance, which contained many illustrative examples, the new bifurcation rule does not provide much explanation as to when bifurcation may be appropriate. The only guidance is the following:

> For example, if the Commissioner's analysis supports a reasonable expectation that, as of the issuance of the E.G.I., only a portion of the principal amount of an E.G.I. will be repaid and the Commissioner determines that the E.G.I. should be treated as indebtedness in part and stock in part, the E.G.I. may be treated as indebtedness in part and stock in part in accordance with such determination, provided the requirements of §1.385-2, if applicable, are otherwise satisfied and the application of federal tax principles supports this treatment.[97]

Effective Date

This bifurcation rule will apply to any debt instrument issued on or after publication of final regulations under Code §385.[98]

CONSOLIDATED GROUPS

As noted earlier,[99] these new rules do not apply to debt issued between members of a U.S. consolidated group (a "consolidated group debt instrument"), since all the members are treated as a single corporation.[100] Prop. Treas. Reg. §1.385-4 was adopted to address situations where a debt instrument becomes or ceases to be a consolidated group debt instrument.

If a consolidated group debt instrument was not initially treated as stock solely due to the rule treating all members of a consolidated group as a single corporation, then the debt instrument is referred to as an "exempt consolidated group debt instrument." If either the creditor or debtor of an exempt consolidated group debt instrument leaves the consolidated group then the debt instrument is deemed to be exchanged for stock immediately after the departing member leaves the group.[101] By contrast, if a consolidated group debt instrument would not have been treated as equity under these rules in any event ("nonexempt consolidated group debt instrument") then such debt instrument retains its character as debt when either the

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95 Prop. Treas. Reg. §1.385-1(b)(5).

96 REG 108060-15, Background, VI(A) April 4, 2016).

97 Prop. Treas. Reg. §1.385-1(d)(1).

98 Prop. Treas. Reg. §1.385-1(f). This new rule will also apply to any debt instrument treated as debt issued or deemed issued before April 4, 2016, as a result of a check-the-box entity classification election that is made or filed on or after April 4, 2016.

99 See text accompanying note 48 *supra*.

100 Prop. Treas. Reg. §1.385-1(e).

101 Prop. Treas. Reg. §1.385-4(b)(1)(i).

debtor or creditor leaves the group. However, a nonexempt consolidated group debt instrument can be treated as equity under the funding rule[102] discussed earlier as a result of a later distribution or acquisition.[103]

When a member of a consolidated group transfers a consolidated group debt instrument to a member of the E.G. that is not part of the consolidated group, the debt instrument is treated as newly issued by the debtor or issuer that is held by the transferee E.G. member. The deemed date of issuance is the date of transfer.[104] That new issuance must then be tested under these rules to determine if debt status should be retained for tax purposes. Detailed examples are included in the regulations to assist in this determination.[105]

"These proposed Code §385 regulations cast a wide net and various related-party debt is affected. These rules go far beyond what was previously thought sufficient for related-party debt instruments to be respected as true debt."

When a debt instrument that was treated as stock under the debt recharacterization rule of Prop. Treas. Reg. §1.385-3 becomes a consolidated group debt instrument, the issuer is treated as issuing a new debt instrument to the holder in exchange for the debt instrument that was treated as stock under Treas. Reg. §1.385-3.[106]

Effective Date

These consolidation rules generally apply to any debt instrument issued on or after April 4, 2016,[107] which mirrors the effective date of the debt recharacterization rule of Prop. Treas. Reg. §1.385-3.

CONCLUSION

These proposed Code §385 regulations cast a wide net and various related-party debt is affected. These rules go far beyond what was previously thought sufficient for related-party debt instruments to be respected as true debt for tax purposes. While previously proposed Code §385 regulations were withdrawn in 1983,[108] it is likely that these regulations will be finalized in whole or in part before year-end. Given the effective dates of these new rules, and the need to accommodate their many new requirements, planning should begin immediately and be completed before year-end to ensure that related-party debt retains its tax character and usefulness.

As stated at the beginning of the article, the International Tax Counsel emphasized the current view of the Treasury Department as to the importance of issuing final regulations this year. A broader question that was not asked is the length of time such final regulations will remain in existence depending on the outcome of the Presidential election. Are these rules an anomaly or do they preview the future of U.S. tax policy?

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[102] Prop. Treas. Reg. §1.385-3(b)(3)(ii)

[103] Prop. Treas. Reg. §1.385-4(b)(1)(ii).

[104] Prop. Treas. Reg. §1.385-4(b)(2).

[105] Prop. Treas. Reg. §1.385-4(d), Ex. 1 and 2.

[106] Prop. Treas. Reg. §1.385-4(c).

[107] Prop. Treas. Reg. §1.385-4(e). This new rule will also apply to any debt instrument treated as debt issued or deemed issued before April 4, 2016, as a result of a check-the-box entity classification election that is made or filed on or after April 4, 2016.

[108] T.D. 7920, 1983-2 C.B. 69.