# UPROAR OVER PROPOSED §385 REGULATIONS: WILL TREASURY DELAY ADOPTION?

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**Tags**
Code §163(j)
Code §385
Code §482
Code §7874
Earnings Stripping
Interest Deductions
Related-Party Debt

## OVERVIEW

On April 4, the U.S. Treasury Department issued comprehensive and detailed proposed regulations under Code §385 that address whether a debt instrument will be treated as true debt for U.S. income tax purposes or re-characterized, in whole or in part, as equity.[1] While the initial motivation for the Treasury action was an attempt to deter inversions by American companies, the proposed regulations have a far greater impact. They affect companies with no intent to create an inversion and U.S. companies having shareholders that are all U.S.-based and operated. This was discussed in an earlier article in *Insights*.[2]

As noted in *Insights*, senior Treasury Department officials have indicated that these proposed regulations are a high priority item for the government. While these officials have indicated that they are open to some modifications based on comments they have received, their primary goal is to finalize all or a major part of the regulations later this year. On July 14, about 15 business representatives lined up to speak at an I.R.S. hearing on the proposed regulations. While the speakers advanced a number of compelling arguments in favor of modifying the tax regulations, I.R.S. and Treasury officials remained mostly silent regarding their plans for the regulations.[3]

In an unprecedented reaction outside the public hearing, the proposed regulations have received widespread criticism from members of Congress, the business community, bar and accounting groups, and practitioners. The comments generally fall into two groups. One raises technical issues and the other raises policy issues. Comments in the former group focus on the unintended impact of the regulations on routine business transactions. These commentators call for more time to revise the regulations in order to address the technical problems in a more detailed manner, which cannot be completed by the end of the year. Comments in the latter group focus on the potential harm that could be inflicted on the business community under the proposals as currently drafted. Several commentators, including the leaders of the two tax-writing committees in Congress, asked for a complete withdrawal of the regulations and a more comprehensive review of all pertinent issues. These commentators also call for additional study, but do so with the goal of defining the boundaries of the proposed regulations.

The Treasury has been listening, and indicated in some public forums that they are considering changes. The rules regarding cash pooling arrangements within a

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

2 Philip Hirschfeld, "Related-Party Debt: Proposed Code §385 Regulations Raise Major New Hurdles," *Insights*, Vol. 3, No. 5 (May 2016).

3 S. Olchyk and A. Norman, "Business Reps Urge Overhaul of US Debt/Equity Proposed Regulations at Hearing," *MNE Tax* (July 15, 2016)..

multinational group, foreign-to-foreign loans within a group, and the so-called "current year's earnings" rule are likely to be reworked. In addition, changes are under consideration for the documentation requirements of the proposals. However, the Treasury has not retreated from its initial goal of having a significant portion of the regulations finalized this year. The Treasury has not yet announced that it would delay adoption, but also has not indicated a specific target date for final adoption.

## EXECUTIVE SUMMARY OF THE PROPOSED REGULATIONS

The proposed regulations under Code §385[4] will have a major impact on *any* tax planning involving related-party debt by potentially re-characterizing such debt as equity under three new rules:[5]

- First, a debt re-characterization 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).[6]
- Second, contemporaneous documentation requirements are imposed as a condition to retain the treatment of related-party debt as true debt (and not equity) for tax purposes.[7]
- Third, a bifurcation rule allows the I.R.S. to re-characterize certain related-party debt as part debt and part equity.[8]

### Debt Re-characterization Rule

The debt re-characterization rule will reclassify as equity debt issued between members of a related party group called an expanded group ("E.G.") if issued in any of the following three fact patterns ("Targeted Transactions"):

- A debt instrument is distributed 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 debt instrument is transferred 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 debt instrument is transferred 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.

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

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

6 Prop. Treas. Reg. §1.385-3.

7 Prop. Treas. Reg. §1,385-2. In general, the documentation must be prepared no later than 30 calendar days after the date that the instrument becomes a related-party debt instrument.

8 Prop. Treas. Reg. §1.385-1(d).

before the reorganization receives the debt instrument.[9]

The regulations adopt an anti-abuse rule called the "funding rule" in order to combat cases where companies may engage in two transactions that together have the same impact as a one-step direct issuance of debt in a Targeted Transaction. For example, a company may want to issue a debt instrument as a dividend to its sole shareholder, but that type of transaction is a Targeted Transaction. The company and its sole shareholder may attempt to circumvent the Targeted Transaction by having the shareholder lend funds to the company after which the company distributes a dividend to the shareholder in the same amount in a pre-arranged transaction. Before the loan, the shareholder held cash and after the dividend, the shareholder held the same amount of cash and a note of the subsidiary. If the roundtrip of the cash is ignored, the only transaction left is the creation of a note distributed to the shareholder. When integrated, this two-step transaction produces the same result as a simple distribution of a note.

The funding rule in the proposed regulations addresses two-step transactions by re-characterizing the debt as equity. Under the funding rule, debt is subject to re-characterization as equity if it is a "principal purpose debt instrument."[10] A principal purpose debt instrument is a debt instrument issued by "the funded member" 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 by the funded member of stock of another E.G. member for cash or property, other than in an exempt exchange (as defined above)
- An acquisition by the funded member of assets of another E.G. member in an asset reorganization, but only to the extent that, pursuant to the plan, a shareholder in the funded member that is, itself, a member of the E.G., receives cash or "other property"[11] with respect to its stock in the transferor corporation.[12] To illustrate, the common parent of acquirer and transferor lends funds to acquirer that is used as part of the consideration to acquire the assets of transferor in a reorganization involving stock and boot. The integrated transaction concludes with a distribution of the stock and boot to the common parent.

The principal purpose of the debt issuance is determined based on facts and circumstances.[13] However, the funding rule contains a "non-rebuttable" 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

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[9] Prop. Treas. Reg. §1.385-3(b)(2). As discussed in the prior article in *Insights*, there are certain limitations or exceptions to this rule.

[10] Prop. Treas. Reg. §1.385-3(b)(3)(i). As discussed in the prior article in *Insights*, there are certain limitations or exceptions to this rule.

[11] In other words, "boot" within the meaning of Code §356.

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

[13] Prop. Treas. Reg. §1.385-3(b)(3)(iv)(A).

after the issuing member makes a distribution or acquisition that is considered a Targeted Funding Transaction.[14] For example, if a foreign parent corporation lends $1,000 to its wholly-owned subsidiary in the U.S., 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, the non-rebuttable presumption applies and the debt instrument is characterized as equity.

Interestingly, the I.R.S. justifies the non-rebuttable presumption because it has encountered difficulty in proving loans and dividend distributions are connected. To that end, the preamble to the regulations provides the following justification:

> The Treasury Department and the IRS have determined that this non-rebuttable presumption is appropriate because money is fungible and because it is difficult for the IRS to establish the principal purposes of internal transactions. In the absence of a *per se* rule, taxpayers could assert that free cash flow generated from operations funded any distributions and acquisitions, while any debt instrument was incurred to finance the capital needs of those operations. Because taxpayers would be able to document the purposes of funding transactions accordingly, it would be difficult for the IRS to establish that any particular debt instrument was incurred with a principal purpose of funding a distribution or acquisition.[15]

The non-rebuttable presumption has been identified as one of the biggest problems of the debt characterization rule because of the length of the period and the inability of taxpayers to demonstrate the absence of tax avoidance.

## Documentation Rules

There are four parts to the documentation rules that impose a new set of requirements in order to support true debt status for U.S. tax purposes.

The first requirement is there must be a binding obligation to repay the funds advanced. This rule requires evidence in the form of a timely-prepared written document executed by the parties.[16] The preamble explains the reason for this requirement:

> The proposed regulations are intended to impose discipline on related parties by requiring timely documentation and financial analysis that is similar to the documentation and analysis created when indebtedness is issued to third parties. This requirement also serves to help demonstrate whether there was intent to create a true debtor-creditor relationship that results in *bona fide* indebtedness and also to help ensure that the documentation necessary to perform an analysis of a purported debt instrument is prepared and maintained. This approach is consistent with the long-standing view held by courts that the taxpayer has the burden of substantiating its

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[14] Prop. Treas. Reg. §1.385-3(b)(3)(iv)(B)(1).

[15] Preamble to Prop Regs. 04/08/2016. Fed. Reg. Vol. 81, No. 68, p. 20911, [REG-108060-15] ("Preamble") Explanation §IV.B.2.b.i.

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

treatment of an arrangement as indebtedness for federal tax purposes. *Hollenbeck v. Commissioner*, 422 F.2d 2, 4 (9th Cir. 1970).[17]

The second requirement is for the loan documentation to delineate the creditor's rights to enforce the debtor's obligation to repay.[18] 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.

***"There are four parts to the documentation rules that impose a new set of requirements in order to support true debt status for U.S. tax purposes."***

The third requirement is a reasonable expectation of repayment by the issuer of the loan.[19] This rule requires that the taxpayer prepare and maintain supporting documentation such as cash flow projections, financial statements, business forecasts, asset appraisals, and the determination of debt to-equity and other relevant financial ratios of the issuer. For those advising multinational groups on the documentation required to support an intercompany debt as true debt, this is not a new requirement. The I.R.S. has routinely examined the credit-worthiness of U.S. borrowers in determining whether interest expense is deductible. Credit-worthiness is determined under an objective standard. When a disregarded entity having limited liability, such as a wholly-owned U.S. L.L.C., is the borrower, credit-worthiness is based on the assets of the disregarded entity.

The final requirement is evidence of a genuine debtor-creditor relationship.[20] This means that payment of interest and principal is made when and as provided in the loan documentation and such payment must be demonstrated. Examples of proof of payment include wire transfer records and account statements.

### Bifurcation Rule

The proposed regulations give the I.R.S. the power to split a single debt instrument into part equity and part debt. A major problem with this new rule is there are few guidelines as to when it may apply. Again, advisers to multinational groups that have paid attention to the credit-worthiness issue of a U.S. borrower from a foreign parent have often split lending transactions into two documents with different maturity dates so that a challenge to the status of debt could be limited to one of the lending transactions.

## CONGRESSIONAL REACTION

The regulations have been criticized by members of the tax-writing committees of Congress. All Federal tax legislation must originate in the House of Representatives and the House Ways and Means Committee has jurisdiction. In the summer, Ways and Means Committee Chairman Kevin Brady (R.-T.X.) released a statement after meeting with the Treasury Department to discuss the proposed regulations.[21] Congressman Brady expressed strong opposition to the adoption of the regulations

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[17] Preamble Background §VI.B.2.

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

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

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

[21] "Ways & Means GOP to Treasury: Proposed Regulations Threaten Jobs & Economic Growth." U.S. House of Representatives Ways and Means Committee. June 28, 2016.

in their current form, and called on the Treasury Department to reconsider the approach.

> Ways and Means Republicans…have serious concerns about the economic impact of Treasury's proposed section 385 regulations. Instead of preventing corporate inversion transactions, these regulations will actually discourage U.S. and international companies from investing in America and our workers.
>
> Today we had an opportunity to have a frank discussion with Treasury about the negative consequences of the proposed regulations and about the Administration's response to the American people's extensive comments and concerns about this proposal. The proposed regulations as currently drafted would be a damaging disruption in well-settled law with far-reaching implications for common business financing practices. During our discussion, I made it clear that this is neither the time nor the place for such unilateral action from the Administration.
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> In the days and months ahead, there must be a robust conversation among the Administration, the tax-writing committees, and affected stakeholders about the next steps in this process. We intend to continue to work with Treasury and the business community to protect American workers and their jobs. Ways and Means Members will consider all legislative options going forward.[22]

The Senate Finance Committee has jurisdiction for tax legislation in the Senate. In the summer, Senate Finance Committee Chairman Orrin Hatch (R-U.T.) wrote to the Treasury department, citing concerns over the policy and regulatory process of the Treasury Department. He called on Treasury Secretary Jack Lew to re-issue the regulations in proposed form.[23]

> I ask you to re-propose the regulations not because I wish for there to not be any section 385 regulations. Rather, I am seeking to ensure that, should the Treasury Department issue regulations under IRC section 385, the Department does so in a thoughtful, prudent, and legal manner.

Senator Hatch commented that the regulations in their current form could lead to unintended consequences for American businesses given the Administration's expedited timeline for issuance in final form. He questioned the regulatory transparency of the proposals, contending that statutory and executive order requirements may not have been followed properly.

> Your consideration of these concerns needs to be done in a thoughtful and deliberate manner. Moving swiftly to finalize the proposed regulations would not be consistent with such an approach. * * * The only prudent way to move forward -- given the complexity of the

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[22] "Brady Statement after Discussion with Administration Officials Regarding Section 385 Regulations." U.S. House of Representatives Ways and Means Committee. July 06, 2016.

[23] "Hatch Calls on Treasury to Re-Propose Debt-Equity Rules." U.S. Senate Committee on Finance. August 22, 2016.

> subject matter, given the many significant substantive concerns that have been pointed out, and given the procedural irregularities -- is to issue the regulations in re-proposed form.

U.S. Senators Dean Heller (R.-N.V.), Mike Crapo (R.-I.D.), Pat Roberts (R.-K.S.), John Cornyn (R.-T.X.), John Thune (R.-S.D.), Johnny Isakson (R.-G.A.), and Tim Scott (R.-S.C.) sent letters to Jacob Lew, Secretary of the Treasury, regarding the regulations. The letters requested an extension of the public comment period and asked the Treasury to ensure that ordinary business transactions, such as cash pooling, are not caught by the rules or subject to burdensome compliance requirements.[24]

## BUSINESS COMMUNITY REACTION

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than three million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.[25] The Chamber sent a letter to Treasury Secretary Lew expressing its opposition to the adoption of the regulations in their current form.[26] The Chamber asked that the regulations be withdrawn or, alternatively, suggested numerous changes.

> The Chamber continues to believe that additional time is needed to analyze and review the impact of these rules on both ordinary business operations as well as more extraordinary transactions. The breadth, scope, and consequences of these regulations for Chamber members are vastly greater than ever suggested in prior notices and other guidance. Rather than address base erosion concerns in the context of inversions as suggested in the earlier notices, these regulations impact the use of intercompany debt among all multinational groups, both domestic and foreign, except where those instruments are issued between U.S. consolidated group members. In certain instances, even wholly domestic groups are impacted.[27]

The Business Roundtable is an association of chief executives who lead companies that operate in every sector of the U.S. economy.[28] In a letter dated July 8, 2016 to Secretary Lew,[29] the Roundtable expressed very serious concerns about adoption of the regulations:

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24 "Heller Leads Letter to Treasury Secretary Lew Expressing Concerns Over Proposed 385 Rules." United States Senator Dean Heller. July 5, 2016.; "Letter to the Secretary of the Treasury." Dean Heller, Mike Crapo, Pat Roberts, John Cornyn, John Thune, Johnny Isakson, and Tim Scott to Jacob Lew. August 24, 2016.

25 See U.S. Chamber of Commerce webpage, https://www.uschamber.com/.

26 "Letter on Proposed Treasury Regulations under Section 385." U.S. Chamber of Commerce. May 6, 2016.

27 "Proposed Regulations Under §385 (REG-108060-15)." Caroline L. Harris to Internal Revenue Service. July 6, 2016. In U.S. Chamber of Commerce.

28 See Business Roundtable webpage, http://businessroundtable.org/.

29 "Report: Treasury's Rules Will Cause Serious Economic Harm." Business Roundtable. July 8, 2016.

> Business Roundtable * * * has very serious concerns about the business disruption and consequent harmful impact on the economy that would result from the Proposed Regulations. As drafted, the Proposed Regulations have an extremely broad impact, create significant uncertainty, have adverse consequences completely unrelated and disproportionate to the Treasury Department's stated concerns regarding 'inversion transactions' and 'earnings stripping.' * * * Business Roundtable believes the approach taken in the Proposed Regulations exceeds the regulatory authority granted to Treasury by Congress under Section 385. Further, the Proposed Regulations are inconsistent with fundamental principles of U.S. tax law, prior regulatory guidance, case law precedents, and Congressional intent.

## BAR GROUP AND PRACTITIONER REACTION

The American Bar Association Section of Taxation issued a detailed 153-page report on the proposed regulations that raised a multitude of issues, especially in regards to the timetable for adoption of final regulations.[30]

> The Proposed Regulations represent a stark departure from a century of federal income tax law on the treatment of such instruments, and, as a result, we are concerned with the abbreviated comment period being afforded with respect to such sweeping changes. * * * [W]e strongly urge Treasury and the Service to take the time necessary to evaluate and develop these rules, even if that means that the final version of the Proposed Regulations ("Final Regulations") cannot be issued as swiftly as the Treasury would have desired, and even if all or parts of the rules must be reproposed. We note that the April 4, 2016, effective date of Proposed Regulation section 1.385-3 has the effect of deterring targeted transactions pending the adoption of final rules, allowing Treasury and the Service time to study and develop responses to all of the comments that are received.

The New York State Bar Association Section of Taxation issued a detailed 172-page report on the proposed regulations that raised a multitude of issues that need to be addressed.[31] Again, the timetable for adoption was criticized:

> The Proposed Regulations represent a substantial change from settled law, with far-reaching implications, the full breadth of which may not be grasped by taxpayers, or the government, for some time to come. For well-advised taxpayers, the Proposed Regulations in their current form would have significant and disruptive effects on

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[30] "Comments on Proposed Regulations under Section 385." George C. Howell, III to John Koskinen, William J. Wilkins, and Mark Mazur. July 13, 2016. In American Bar Association, Section of Taxation.

[31] See "Report No. 1351 on Proposed Regulations under Section 385." Stephen B. Land to Mark J. Mazur, John Koskinen, and William J. Wilkins. June 29, 2016. In New York State Bar Association, Tax Section.; see also *Report on Proposed Regulations under Section 385*. Report no. 1351. Tax Section, New York State Bar Association. June 29, 2016.

> ordinary commercial activities and on other transactions that may not implicate tax policy concerns. For other taxpayers, the Proposed Regulations— and, in particular, Prop. Treas. Reg. § 1.385-3—will often operate as a trap for the unwary, in which taxpayers may learn only after the fact that an intercompany loan with customary debt terms can cause adverse tax consequences, even if the loan would (absent the Proposed Regulations) clearly constitute debt for U.S. federal income tax purposes. The fact that the Proposed Regulations raise these issues may to some extent be unavoidable, since Section 385 appears designed to distinguish between debt and equity based on a variety of factors germane to that analysis, rather than drawing the debt-equity distinction in a manner designed to achieve other tax policy goals.
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> We recognize the importance of the government's policy objectives in issuing the Proposed Regulations. However, we are concerned that Prop. Treas. Regs. §§ 1.385-1 and 1.385-2 both need to be substantially revised in order to operate properly. In addition, we strongly recommend that Prop. Treas. Reg. § 1.385-3 not be issued as a final regulation, due to the deep problems inherent in the proposed rule. We urge that the government instead put forward alternative guidance for taxpayers' and practitioners' review and comment.

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Other bar and professional groups have spoken out in opposition to the proposed regulations, including the District of Columbia Bar Association[32] and the American Institute of Certified Public Accountants.[33]

## CONCLUSION

While Code §385 directly addresses debt-equity classification issues, this section was dormant for almost 40 years, with only one set of regulations that were issued and immediately withdrawn in 1983.[34] The Treasury decision to resurrect Code §385 as a tool to combat inversions was expected, but the Treasury's decision to expand the scope of the attack to all forms of related-party debt caught nearly everyone by surprise. Major issues and problems have been raised by commentators. However, the most immediate problem is the announced timetable for the adoption of the regulations in final form.

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[32] "Comments Regarding the Proposed Regulations on Related-Party Debt Instruments, Prop. Treas. Reg. Sections 1.385-1, -2, -3 and -4." Letter to Mark J. Mazur, John Koskinen, and William J. Wilkins. June 30, 2016.

[33] "Proposed Regulations Regarding the Treatment of Certain Interests in Corporations as Stock or Indebtedness (REG-108060-15)." Troy K. Lewis to Jacob Lew, John Koskinen, Mark Mazur, and William Wilkins. July 7, 2016. In American Institute of CPAs.

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

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