§385 REGULATIONS ADOPTED WITH HELPFUL CHANGES, BUT SIGNIFICANT IMPACT REMAINS

Author
Philip R. Hirschfeld

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

OVERVIEW

On April 4, 2016, the U.S. Treasury Department surprised the tax community by issuing 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 recharacterized, in whole or in part, as equity.[1] As discussed in an earlier article in *Insights*,[2] these regulations contained: (i) new documentation requirements that must be met to support debt tax treatment, (ii) a debt recharacterization rule that will treat debt as equity when issued in a certain manner (such as when the debt constitutes property that is issued as a dividend to a shareholder) or when caught by an anti-abuse rule applicable to dividends funded by a borrowing of cash from the shareholder or a related party and certain other situations, and (iii) a bifurcation rule giving the I.R.S. authority to split a debt instrument into part equity and part debt as of the date of issuance.

In an unprecedented reaction, the proposed regulations received widespread criticism from members of Congress, the business community, bar and accounting groups, and practitioners. As discussed in an earlier follow-up article in *Insights*,[3] the comments raised policy and technical issues. Some commentators and members of Congress called for a complete withdrawal of the regulations. Other commentators called for major revisions to narrow the impact on transactions that are primarily motivated by business or acceptable Treasury procedures rather than tax savings.

On October 13, 2016, the Treasury Department released final and temporary regulations under Code §385 relating to the tax classification of debt.[4] The final and temporary regulations make several helpful changes to the proposed regulations including the following:

- Elimination of the bifurcation rule[5]

---

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* 5 (2016).

3 Philip Hirschfeld, "Uproar Over Proposed §385 Regulations: Will Treasury Delay Adoption?," *Insights* 8 (2016).

4 T.D. 9790 adopting Treas. Reg. §§1.385-1, 2, 3, and 4, and Treas. Reg. §§1.385-3T and 4T.

5 The bifurcation rule was found in Prop. Treas. Reg. §1.385-1(d). The proposed regulations contained few guiding principles on how such a bifurcation would be determined. While the final regulations omitted the bifurcation rule, the "Treasury and the IRS continue to study the comments received [on the bifurcation rule]" (T.D. 9790, Background III(D)). Thus, the bifurcation rule may resurface in the future.

- Adoption of a provision narrowing the scope of the regulations so that they will not impact non-U.S. issuers of debt,[6] S Corporations, non-controlled real estate investment trusts ("R.E.I.T.'s"), or regulated investment companies ("R.I.C.'s")[7]
- Adoption of a grandfathering rule preventing the application of the documentation rules for debt issued before January 1, 2018
- Adoption of expanded exceptions to the debt recharacterization rule for distributions of earnings and profits ("E&P"), equity contributions, and certain other transactions
- Adoption of an exception that removes from coverage short-term cash pooling arrangements and debt instruments issued by regulated financial groups and insurance companies
- Expansion of the $50 million threshold (so that it covers all corporations) and a limitation that prevents recharacterization on a cascading basis
- Revision of the effective date and transition rules

However, the basic structure of the regulations remains unchanged, including documentation rules – albeit with relaxed due dates – and the anti-abuse funding rule previously mentioned.[8]

In final form, these regulations will have a major impact on the way debt is structured to ensure classification as true debt for tax purposes. Challenges to the validity of these regulations are anticipated.

SUMMARY OF THE REGULATIONS

The final and temporary regulations under Code §385[9] may cause related-party debt to be recharacterized as equity in two instances:[10]

- First, debt instruments may be treated as stock if issued in certain disfavored transactions, such as when a debt instrument issued by the taxpayer is distributed to its shareholder as a dividend.[11]
- Second, timely compliance with documentation requirements is required for related-party debt to be treated as true debt for tax purposes.[12]

---

6 A covered member included a foreign corporation under the Prop. Treas. Reg. §1.385-1(c)(2)(ii). The final regulations reserved on treating a foreign corporation as a covered member (Treas. Reg. §1.385-1(c)(2)(ii)).

7 Treas. Reg. §1.385-1(c)(4).

8 Treas. Reg. §§1.385-2(b)(1) and 3(b)(1). The debt recharacterization regulations, however, provide a sole exception so that for purposes of the consolidated return rules, recharacterization will not apply (Treas. Reg. §1.385-3(d)(7)).

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

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

11 Treas. Reg. §1.385-3.

12 Treas. Reg. §1.385-2.

Debt Subject to New Rules

These rules apply 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 significant modification:[13]

- The E.G. includes 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.[14]
- The E.G. definition is satisfied by ownership of stock representing 80% or more of either vote *or* value, rather than vote *and* value.[15] The final regulations rely on the constructive ownership rules of Code §318(a) when determining whether the ownership test is met.[16]
- Debt between members of a U.S. consolidated corporate group is not subject to these rules since all the members of that group are treated as one corporation.[17]

In response to comments made to the proposed regulations, the final regulations exempt S Corporations, R.I.C.'s, and R.E.I.T.'s from being members of an E.G. This exemption does not apply when the R.I.C. or R.E.I.T. is controlled by members of the E.G.[18] The Treasury Department rejected requests to exempt tax-exempt entities and insurance companies from membership in an E.G.[19]

While a foreign corporation can be a part of an E.G., the final regulations exempt a foreign corporation from being a "covered member" of the E.G.[20] Consequently, debt issued by the foreign corporation is not subject to the documentation and recharacterization rules.

Debt Recharacterization Rule

The debt recharacterization rule reclassifies debt issued between members of an E.G. if issued in any of the following three fact patterns ("Targeted Transactions"):

- A debt instrument issued by an E.G. member is distributed to a shareholder who is part of that E.G. It does not matter whether the instrument is treated as a dividend because there is sufficient E&P or a return of capital.
- An E.G. member acquires stock of another member in exchange for the

---

13 Treas. Reg. §1.385-1(c)(4)(i). An affiliated group of corporations generally files a consolidated Federal income tax return.

14 *Id.*

15 Treas. Reg. §1.385-1(c)(4)(i)(A).

16 Treas. Reg. §1.385-1(c)(4)(iii). While the proposed regulations modified the indirect ownership test of Code §1504(a)(1)(B)(i) by adding a "directly or indirectly" test, the final regulations retained and expanded that concept by adding the directly or indirectly test to the application of Code §1504(a)(1)(B)(i) (Treas. Reg. §1.385-1(c)(4)(i)).

17 Treas. Reg. §1.385-4T(b).

18 Treas. Reg. §1.385-1(c)(4).

19 T.D. 9790, Summary of Comments and Explanation of Revisions, III(B)(2)(a).

20 Treas. Reg. §1.385-1(c)(2)(ii).

issuance of 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 when and to the extent that
    - a shareholder that is a member of the E.G. before the reorganization receives the debt instrument,
    - the receipt of the debt instrument is part of the plan of reorganization.[21]

The Treasury Department rejected most requests to modify the second and third prong of the definition of Targeted Transactions. However, it expanded an exception for an acquisition of *newly issued* stock from a majority-owned subsidiary to apply to acquisitions of *existing* stock from a majority-owned subsidiary.[22]

"The final regulations adopt an anti-abuse rule called the 'funding rule' to combat cases where companies engage in two transactions that together have the same effect as a direct issuance of debt in a Targeted Transaction."

The final regulations adopt an anti-abuse rule called the "funding rule" to combat cases where companies engage in two transactions that together have the same effect as a direct issuance of debt in a Targeted Transaction. To illustrate, the shareholder lends funds to a subsidiary that is an E.G. member, and the E.G. member distributes a dividend to the shareholder in the same amount. 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 regulations addresses two-step transactions by recharacterizing the debt as equity. Under the funding rule, debt is subject to recharacterization if the debt instrument is considered to be a "principal purpose debt instrument."[23] 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 of assets of one E.G. member by another, if the E.G. lends funds to the acquirer that are used as part of the consideration to acquire the assets of the transferor in a reorganization involving stock and boot[24] when the integrated transaction concludes with a distribution of the stock and boot to the common parent[25]

The principal purpose of the debt issuance is determined based on facts and

---

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

22 *Id.*; T.D. 9790, Background V(C)(3)(c).

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

24 In other words, "boot" within the meaning of Code §356.

25 Treas. Reg. §1.385-3(b)(3)(ii).

circumstances.[26] However, the funding rule contains a "nonrebuttable" 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 (the "72-Month Testing Period").[27] 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 nonrebuttable presumption applies and the debt instrument is characterized as equity.

The nonrebuttable presumption has been retained in the final regulations in much the same manner as it existed under the proposed regulations but with broadened exceptions discussed below.

Documentation Rules

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

- The first requirement relates to the need for there to 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.[28]
- The second requirement is for the loan documentation to delineate the creditor's rights to enforce the debtor's obligation to repay.[29] 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 if the issuer is dissolved or liquidated.
- The third requirement is a reasonable expectation of repayment by the issuer of the loan.[30] 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. 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.[31] 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.

The final regulations retained these four requirements, which were set forth in the proposed regulations, but added some changes discussed below to ease compliance

---

26 Treas. Reg. §1.385-3(b)(3)(iv)(A).

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

28 Treas. Reg. §1.385-2(b)(2)(i).

29 Treas. Reg. §1.385-2(b)(2)(ii).

30 Treas. Reg. §1.385-2(b)(2)(iii).

31 Treas. Reg. §1.385-2(b)(2)(iv).

and exempt certain debt instruments from their application.

BENEFICIAL CHANGES TO THE DEBT RECHARACTERIZATION RULE

While retaining the debt recharacterization rule largely in its proposed form, the final and temporary regulations made a few helpful changes to address comments that were received.

Expanded E&P Exception

As noted above, the funding rule is triggered if there is (i) an issuance of a debt instrument and (ii) a Targeted Funding Transaction (*e.g.*, a distribution made by the issuing company), made during the 72-Month Testing Period. The proposed regulations contained an exception where the Targeted Funding Transaction was a distribution of *current* E&P,[32] meaning the earnings generated during the year in which the loan is made. The proposed regulations reduced the amount of tainted distribution made by the amount of the current E&P. This reduced or eliminated the Targeted Funding Transaction.

The Treasury Department received comments that the E&P exception should apply to both *current* and *accumulated* E&P.[33] The final regulations adopted this recommendation but with a limitation. Under the final regulations, *current* E&P and *accumulated* E&P are to be considered if the accumulated E&P was accumulated in taxable years ending after April 4, 2016.[34] Thus, the Treasury Department decided to limit E&P to "the period of a corporation's membership in a particular expanded group."[35]

Expanded Access to $50 Million Threshold Exception

The proposed regulations contained a $50 million threshold exception so that the debt recharacterization rule would not apply if a taxpayer's related-party debt does not exceed $50 million. Commentators highlighted the cliff effect of the provision. If a taxpayer issued $1 of debt in excess of the $50 million threshold, the benefit of

---

32 Prop. Treas. Reg. §1.385-3(c)(1). The technical approach taken in the regulations is to reduce the amount of distributions made by the amount of the current E&P. To illustrate how the proposed regulations worked, a U.S. company borrows $100 million from its foreign parent and issues its note to the foreign parent for $100 million. The following year, the U.S. company makes a $10 million cash distribution to its foreign parent. The $10 million distribution is treated like a taxable dividend since the U.S. company has $4 million of current E&P and $5 million of accumulated E&P. Since $4 million of the distribution is from current E&P, only the remaining distribution of $6 million is a Targeted Funding Transaction triggering the funding rule and recharacterization of $6 million of the debt as equity.

33 T.D. 9790, Summary of Comments and Explanation of Revisions, V(E)(3)(a).

34 Treas. Reg. §1.385-3(c)(3)(i). Thus, for the prior example, the full amount of the $10 million distribution would be excluded assuming that the accumulated E&P was attributable to taxable years ending after April 4, 2016. If the accumulated E&P is partially for prior years, the prior year accumulated E&P cannot be used for this exclusion to apply.

35 T.D. 9790, Summary of Comments and Explanation of Revisions, V(E)(3)(a).

this rule would be lost, entirely.[36] The final regulations eliminate this cliff effect[37] so that all taxpayers can exclude the first $50 million of debt that would otherwise be recharacterized.[38]

Exclusion of Qualified Short-Term Debt Instruments

The proposed regulations contained an exception that excluded debt issued in the ordinary course of the issuer's business. The Treasury Department received comments that the ordinary course exception was very narrow and the regulations should be revised so that these rules should not apply to non-tax motivated cash management techniques, such as cash pooling or revolving credit arrangements, nor to ordinary course short-term lending outside a formal cash management arrangement.[39]

In response to these comments, the final regulations include an exception for qualified short-term debt instruments.[40] The definition of a qualified short-term debt instrument is set forth in the temporary regulations[41] and is subject to further change.

"The final regulations include an exception for qualified short-term debt instruments."

The definition of a qualified short-term debt instrument is long and complex and likely best understood by those involved in the treasury function of the E.G. A debt instrument is a qualified short-term debt instrument if the debt instrument is (i) a short-term funding arrangement that meets one of two alternative tests (the specified current assets test or the 270-day test),[42] (ii) an ordinary course loan,[43] (iii) an interest-free loan,[44] or (iv) a deposit with a qualified cash pool header.[45]

To satisfy the specified current assets test, two requirements must be satisfied:

> First, the rate of interest charged with respect to the debt instrument is less than or equal to an arm's length interest rate, as determined under section 482 and the regulations thereunder, that would be charged with respect to a comparable debt instrument with a term that does not exceed the longer of 90 days and the issuer's normal operating cycle.[46]
>
> Second, . . . immediately after the covered debt instrument is issued, the issuer's outstanding balance under covered debt instruments issued to members of the issuer's expanded group that satisfy any of (i) the interest rate requirement of the specified current assets test, (ii) the 270-day test . . . , (iii) the ordinary course loan exception, or

---

36 Prop. Treas. Reg. §1.385-3(c)(4).

37 T.D. 9790, Summary of Comments and Explanation of Revisions, V(E)(4).

38 Treas. Reg. §1.385-3(c)(4).

39 T.D. 9790, Summary of Comments and Explanation of Revisions, V(D)(8)(c).

40 Treas. Reg. §1.385-3(b)(3)(i).

41 Treas. Reg. §1.385-3T(b)(3)(vii).

42 *Id.*, (A).

43 *Id.*, (B).

44 *Id.*, (C).

45 *Id.*, (D).

46 *Id.*, (A)(1)(ii).

(iv) the interest-free loan exception, does not exceed the amount expected to be necessary to finance short-term financing needs during the issuer's normal operating cycle.[47]

For a debt instrument to satisfy the 270-day test, three conditions must be met:[48]

- First, the debt instrument must (i) have a term of 270 days or less, or be an advance under a revolving credit agreement or similar arrangement, and (ii) bear a rate of interest that is less than or equal to an arm's length interest rate, as determined under Code §482, that would be charged with respect to a comparable debt instrument with a term that does not exceed 270 days.
- Second, the issuer must be a net borrower from the lender for not more than 270 days during the taxable year of the issuer, and in the case of a covered debt instrument outstanding during consecutive taxable years, the issuer may be a net borrower from the lender for not more than 270 consecutive days.
- Third, a debt instrument will satisfy the 270-day test only if the issuer is a net borrower under all covered debt instruments issued to any lender that is a member of the issuer's E.G. that otherwise would satisfy the 270-day test, other than ordinary course loans and interest-free loans, for 270 or fewer days during a taxable year.

The temporary regulations generally broaden the ordinary course exception in the proposed regulations to provide that a debt instrument constitutes a qualified short-term debt instrument if issued as consideration for the acquisition of property other than money, in the ordinary course of the issuer's trade or business. In contrast to the proposed regulations, the temporary regulations provide that, to constitute an ordinary course loan, an obligation must be reasonably expected to be repaid within 120 days of issuance.[49]

Exclusion of Debt Instruments Issued by Regulated Financial Groups and Insurance Entities

The final regulations add an exception to the debt recharacterization rule so that a covered debt instrument does not include a debt instrument issued by either a regulated financial company or a regulated insurance company.[50] The rationale for this exclusion is that abuse is not viewed as being likely since these entities are subject to a specified degree of regulatory oversight regarding their capital structures.[51]

Limiting Certain Cascading Recharacterization

Several comments requested that the final and temporary regulations should include rules to address cascading recharacterizations. These are situations in which the recharacterization of one covered debt instrument could lead to deemed transactions that result in the recharacterization of one or more other covered debt instruments

---

47 *Id.*, (A)(1)(iii).

48 *Id.*, (A)(2).

49 *Id.*, (B).

50 Treas. Reg. §1.385-3(g)(3)(i).

51 T.D. 9790, Summary of Comments and Explanation of Revisions, V(G)(1), (2).

in the same E.G.[52] The final regulations narrow the application of the funding rule by preventing the cascading consequences of recharacterizing a debt instrument as stock in certain circumstances. The final regulations provide that once a covered debt instrument is recharacterized as stock under the funding rule, the distribution or acquisition that caused that recharacterization cannot cause a recharacterization of another covered debt instrument after the first instrument is repaid.[53]

Credit for Certain Capital Contributions

Numerous comments requested that capital contributions to a member should be netted against distributions or acquisitions by the member for purposes of applying the debt recharacterization and funding rules. The commentators reasoned that, to the extent of capital contributions, a distribution does not reduce a member's net equity.[54]

The Treasury Department agreed that it is appropriate to treat distributions or acquisitions as funded by new equity before related-party borrowings.[55] The final and temporary regulations provide that a distribution or acquisition that may trigger application of this rule is reduced by the aggregate fair market value of the stock issued by the covered member in one or more qualified contributions (the "Qualified Contribution" reduction).[56] A Qualified Contribution is a contribution of property (other than excluded property) to the covered member by any member of the covered member's E.G. in exchange for stock of the covered member during the qualified period. The qualified period generally means the period beginning 36 months before the date of the distribution or acquisition, and ending 36 months after the date of the distribution or acquisition.

Exception for Equity Compensation

Some comments requested an exception to the extent that the acquiring entity makes an actual payment for the stock of the issuing corporation that is conveyed to a person as consideration for services.[57] The final regulations adopt this approach by adding an exception for the acquisition of stock delivered to employees, directors, and independent contractors as consideration for services rendered.[58]

Expansion of the 90-Day Transition Rule for Recharacterization

The proposed regulations provided for a 90-day delay in implementation for debt instruments issued on or after April 4, 2016, but prior to publication of the final regulations in the Federal Register.[59] The final regulations expand this delayed implementation to any debt instrument issued on or after the date that is 90 days after publication of the final regulations in the Federal Register. This 90-day delayed

---

52 *Id.*, V(B)(4).

53 Treas. Reg. §1.385-3(b)(6).

54 T.D. 9790, Summary of Comments and Explanation of Revisions, V(E)(3)(b).

55 *Id.*

56 Treas. Reg. §1.385-3(c)(3)(ii).

57 T.D. 9790, Summary of Comments and Explanation of Revisions, V(E)(2)(b).

58 Treas. Reg. §1,385-3(c)(2)(ii).

59 Prop. Treas. Reg. §1.385-3(j).

date is January 11, 2017.[60]

BENEFICIAL CHANGES TO THE DOCUMENTATION RULES

While retaining the documentation rule largely in its proposed form, the final and temporary regulations make a few helpful changes.

Delayed Implementation

Under the final regulations, the documentation rules only apply to debt instruments issued on or after January 1, 2018.[61] This change will allow taxpayers more time to properly implement procedures to comply with the new documentation rules.

Extension of Period Required for Compliance

The proposed regulations generally required documentation to be prepared not later than 30 calendar days after the date the instrument becomes a related-party debt instrument.

The final regulations eliminate the 30-day timely preparation requirement and instead treat documentation and financial analysis as having been timely prepared if it is in existence at the time the issuer's Federal income tax return is filed (taking into account all applicable extensions).[62] At a minimum, a taxpayer will have until the filing date of the tax return of the taxable year that includes January 1, 2018, to complete the documentation requirements.

Limited Rebuttable Presumption

The proposed regulations provided that compliance with the documentation rules is required for true debt status. If any debt instrument is not timely documented, it would be treated as equity regardless of any argument in support of debt treatment.[63]

The final regulations add a rebuttable presumption, rather than a mandatory recharacterization. However, the rebuttable presumption applies only if an E.G. is highly compliant with the documentation rules.[64] Consequently, the relaxed standard applies in a narrow class of situations.

To demonstrate that a high degree of compliance exists, a taxpayer must meet one of two tests:

- Under the first test,[65] a taxpayer must demonstrate that covered instruments representing at least 90% of the aggregate issue price of all covered instruments within an E.G. are in compliance with the documentation rules.

---

60 Treas. Reg. §1.385-3(j).

61 Treas. Reg. §1.385-2(d)(2)(iii).

62 Treas. Reg. §1.385-2(c)(4).

63 Prop. Treas. Reg. §1.385-2(b).

64 Treas. Reg. §1.385-2(b)(2)(i).

65 *Id.*, (B)(1).

- Under the second test,[66] a taxpayer must demonstrate either that
  - no covered instrument with an issue price of more than $100 million and less than 5% of the covered instruments outstanding failed to comply with the documentation rules, or
  - no covered instrument with an issue price of more than $25 million and less than 10% of the covered instruments outstanding failed to comply with the documentation rules.

"The rebuttable presumption applies only if an E.G. is highly compliant with the documentation rules. Consequently, the relaxed standard applies in a narrow class of situations."

An anti-stuffing rule applies to these requirements so that a debt instrument will not be counted in applying these requirements if it was entered into with a principal purpose of satisfying these rules.[67]

If a taxpayer is eligible for rebuttable presumption treatment, then the debt will continue to be treated as debt for tax purposes if the taxpayer clearly establishes that there are sufficient common law factors present to treat the instrument as indebtedness, including that the issuer intended to create indebtedness when the instrument was issued.[68]

Master Agreements Allowed for Revolving Credit Agreements, Cash Pooling, and Similar Arrangements

The Treasury Department received comments requesting relief in the case of revolving credit agreements or cash pooling and similar arrangements. The concern expressed was that a technical application of these rules could lead to a burdensome need to prepare documentation for each advance under the lending arrangement.

In response, a special rule is added to cover

- a revolving credit agreement,
- a cash pool agreement,
- an omnibus or umbrella agreement that governs open account obligations or any other identified set of payables or receivables, or
- a master agreement that sets forth general terms of an instrument with an associated schedule or ticket that sets forth the specific terms of an instrument.[69]

The documentation requirements regarding a separate note or written obligation to repay the loan and documentation of creditor's rights in each written agreement are deemed satisfied if the material documentation associated with the instrument, including all relevant documents, is prepared and maintained in accordance with the requirements of the regulations.[70] A single master agreement can satisfy the two requirements.

---

66 *Id.*, (B)(2).

67 Treas. Reg. §1.385-2(b)(2)(i)(B)(4).

68 Treas. Reg. §1.385-2(b)(2)(i)(A).

69 Treas. Reg. §1.385-2(c)(3)(i)(A).

70 *Id.*, (2).

With respect to the requirement of a reasonable expectation of repayment, the written documentation need only be prepared once every year for all advances in the year, rather than multiple times, once each for all advances. This documentation should demonstrate that the issuer's financial conditions support a reasonable expectation that the issuer would be able to pay interest and principal in respect of the maximum principal amount outstanding under the terms of the revolving agreement.[71]

Partnership Debt Exclusion

The Treasury Department decided that the documentation rules should not apply to partnership debt.[72] However, the Treasury Department indicated that it remains concerned about partnership debt so that an anti-abuse rule can bring partnership debt into coverage under the documentation rules if the partnership is used with a principal purpose of avoiding the application of the documentation rules for corporations.[73]

Treatment of Disregarded Entities

The final regulations provide that if debt issued by a disregarded entity does not satisfy the documentation rules, the debt is recharacterized as equity of the corporation that is the sole member.[74] This approach reflects comments that the debt recharacterization rules should not cause a disregarded entity to be treated as a partnership.[75] Consequently, if equity treatment is mandated, the equity is in the sole member, not its disregarded subsidiary.

CONCLUSION

Despite numerous comments made to the Treasury Department for major modification or deferral of adoption of these rules, the final and temporary regulations under Code §385 retain the basic approach of the proposed regulations, with some modifications to restrict the impact of the rules to large corporations. The Treasury Department cautions that the final regulations provide an additional level of tests that must be met in addition to the tests under case law.[76] They supplement the rules under existing law rather than replace those rules. As a result, the common-law concerns about what debt-to-equity ratio is acceptable, as well as the reasonableness of other terms of the debt (such as fixed maturity date and interest rate), remain.

---

71 Treas. Reg. §1.385-2(c)(3)(i)(A)(3).

72 T.D. 9790, Summary of Comments and Explanation of Revisions, IV(B)(1)(a).

73 Treas. Reg. §1.385-2(f).

74 Treas. Reg. §1.385-2(e)(4).

75 T.D. 9790, Background IV(A)(4).

76 Treas. Reg. §1.385-1(b). For a discussion of these common-law principles, see Hirschfeld, "Related-Party Debt: Proposed Code §385 Regulations Raise Major New Hurdles."