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THE RESURRECTION OF CODE §385:

TREASURY DEPARTMENT REVISES REGULATIONS ON RELATED-PARTY DEBT

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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 cross-hairs 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).

"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. . . . Capitalizing a company with debt as well as equity can produce major tax benefits for all parties involved."

- 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).

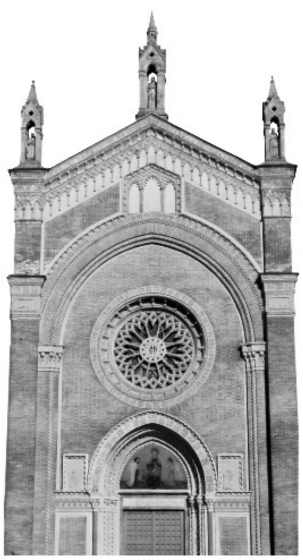
are not debt instruments for purposes of these rules (*e.g.*, contracts to which Code §483 applies or non-periodic swap payments) will be treated as stock if issued with the principal purpose of avoiding the application of these rules. A non-exhaustive list of illustrative examples is provided in the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

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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).

instrument") then such debt instrument retains its character as debt when either the 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.

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

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Tags
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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

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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)..

are considering changes. The rules regarding cash pooling arrangements within a 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

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).

the extent that, pursuant to a plan, a shareholder that is a member of the E.G. 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

[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

[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]

> ***"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 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.

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]

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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.

Congressman Brady expressed strong opposition to the adoption of the regulations 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.
>
> 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

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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.

> only prudent way to move forward – given the complexity of the 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

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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.

of the regulations:

> 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

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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.

> “The A.B.A. 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.”

> to come. For well-advised taxpayers, the Proposed Regulations in their current form would have significant and disruptive effects on 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.
>
> 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.

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.

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

Author
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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]

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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* 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]

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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

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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

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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 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]

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

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

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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

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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.

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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).

> *"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."*

- 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.

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.

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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.

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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."

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