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In this article, Pauls and Schoen analyze proposed regulations intended to address Treasury and IRS concerns about indebtedness between related entities within a larger corporate group and that apply regardless of whether the parties are domestic or foreign.

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Treasury and the IRS released proposed regulations on April 4 that aim to change dramatically the landscape for an age-old question: Does an instrument issued by a corporation to a related corporation (whether a parent company or a sister company) constitute bona fide indebtedness for federal tax purposes? The proposed regulations, which were promulgated under section 385,1 are intended to combat perceived concerns associated with indebtedness between related entities within a larger corporate group and generally apply to indebtedness between related entities without regard to whether the parties are domestic or foreign.

We review these aspects of the proposed regulations, along with several others, in greater detail below.

New Documentation Requirements

The proposed regulations prescribe the nature of the documentation and information that generally must be prepared and maintained for a debt instrument issued by a corporation to a related party to be treated as bona fide indebtedness for federal tax purposes. The proposed regulations, which were promulgated under section 385,1 are intended to combat perceived concerns associated with indebtedness between related entities within a larger corporate group and generally apply to indebtedness between related entities without regard to whether the parties are domestic or foreign. In brief, the proposed regulations would:

- provide an exception for indebtedness between members of a U.S. consolidated group;
- address whether the IRS may treat a debt instrument issued by a corporation as stock in part and debt in part for federal tax purposes; and
- generally be limited in application to large multinational corporate groups.

The proposed regulations would apply to debt instruments issued on or after the date that the rules are published in final form; however, the proposed rules on the tax characterization of debt instruments distributed to affiliates, issued in specific acquisition transactions involving affiliates, or issued to fund transactions to, or acquisition transactions involving affiliates would apply to debt instruments issued on or after April 4, 2016, that remain outstanding 90 days after the date that the regulations are published in final form.


2See prop. reg. section 1.385-2(a) and (b).
4. an ongoing relationship during the life of the debt instrument consistent with arm’s-length relationships between unrelated debtors and creditors.3

Although these factors reflect principles derived from the debt-equity analyses of the relevant case law,4 several cases have held that a related-party creditor need not be as “hard-nosed as a banker,” and therefore did not require such a creditor to employ the same corporate formalities or enforce its creditor rights as aggressively as an unrelated creditor.5 But the proposed regulations appear to reject that view and instead require a related-party creditor to maintain a relationship with a related-party debtor that is consistent with a relationship between unrelated parties. That approach would include enforcing creditor rights in the case of default by the related-party debtor.

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.”6 Further, the proposed regulations provide that although the preparation and maintenance of that documentation and information would be required to establish that a debt instrument is bona fide indebtedness for federal tax purposes, the presence of such documents and information is not determinative of that status.7 Rather, the multi-factor analysis in the relevant case law still applies to determine the true nature of the debt instrument.

Importantly, the proposed rules concerning the preparation and maintenance of relevant documentation and information are “intended to apply only to large taxpayer groups.”8 Accordingly, a debt instrument would not be subject to the rules unless:

• the stock of any member of the expanded group9 is publicly traded;

• all or any portion of the expanded group’s financial results are reported on financial statements with total assets exceeding $100 million; or

• the expanded group’s financial results are reported on financial statements that reflect annual total revenue exceeding $50 million.10

Effective/applicability date: These rules have been proposed to be effective for debt instruments issued on or after the date that the regulations are published in final form.11

Characterization Rules

Treasury and the IRS identified three types of transactions between affiliates that raise “significant” policy concerns. In this regard, the proposed regulations generally would characterize debt instruments issued in the following situations as stock for federal tax purposes:

• debt instruments distributed by a corporation to a related corporate shareholder;

• debt instruments issued in exchange for affiliate stock (including “hook stock” issued by a related corporate shareholder); and

• debt instruments issued by an acquiring corporation as consideration in an exchange pursuant to an internal asset reorganization (that is, a reorganization within the meaning of section 368(a)(1)(A), (C), (D), (F), or (G)).12

In the view of Treasury and the IRS, similar policy concerns arise when a related-party debt instrument is issued in a separate transaction with “a principal purpose” to “fund” (i) a distribution of cash or other property to a related corporate shareholder; (ii) an acquisition of affiliate stock from an affiliate; or (iii) acquisitions of property from an affiliate pursuant to an internal asset reorganization.14 Thus, pursuant to this so-called funding rule, the proposed regulations characterize “principal purpose debt instruments” as stock for federal tax purposes, subject to the exceptions outlined below.15 As a further layer of complexity, the proposed regulations provide that for purposes of applying

Specifically, (i) an expanded group includes foreign and tax-exempt corporations, life insurance companies, and corporations held through partnerships; (ii) the attribution rules of section 304(c)(3) would apply for purposes of determining relatedness; and (iii) the proposed regulations would treat a corporation as a member of an expanded group if 80 percent of the vote or value of its stock (rather than vote and value) is owned by expanded group members.

Footnote continued in next column.

5 See prop. reg. section 1.385-2(b).
6 See, e.g., Fin Hay Realty Co. v. United States, 398 F.2d 694 (3d Cir. 1968) (identifying 16 factors relevant for distinguishing between indebtedness and stock for U.S. federal tax purposes); see also Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972) (identifying 13 factors that are similar to, but not the same as, those used in Fin Hay to distinguish between indebtedness and stock for U.S. federal tax purposes).
8 Preamble at 19.
9 See prop. reg. section 1.385-2(a)(1) and (b)(1)(i).
10 Preamble at 38.
11 The term “expanded group” is defined by reference to the term “affiliated group” (as defined in section 1504(a)), with several key modifications. See prop. reg. section 1.385-1(b)(3).
13 See prop. reg. section 1.385-2(b).
14 See prop. reg. section 1.385-3(b)(2).
15 See preamble at 20-21.
16 See prop. reg. section 1.385-3(b)(3).
the funding rule, references to the so-called funded member include references to any “predecessor” or “successor” of that entity, with those terms defined generally, subject to their own special rules. 

Whether a debt instrument is issued with a principal purpose of funding a distribution or an acquisition is based on all the facts and circumstances. However, the proposed regulations would establish a non-rebuttable presumption that a debt instrument is issued with such a principal purpose if it is issued by the funded member during the period beginning 36 months before that entity makes a distribution or acquisition and ending 36 months after the distribution or acquisition. In the preamble, Treasury and the IRS justify this per se rule on the grounds that (i) money is fungible, and (ii) it is difficult for the IRS to discern the principal purposes of internal transactions.

The proposed regulations offer three exceptions from the application of the foregoing rules, specifically:

- a related-party debt instrument would not be characterized as stock if, as of the time that the debt instrument is issued, the aggregate adjusted issue price of all other related-party debt instruments that would be characterized as stock under these rules does not exceed $50 million;
- distributions or acquisitions described in the general rule or the funding rule that do not exceed the current earnings and profits of the issuing corporation would not be treated as distributions or acquisitions for purposes of those rules;
- an acquisition of affiliate stock would not be treated as an acquisition described in the second prong of the funding rule if (i) the acquisition results from a transfer of property by a funded member (that is, the transferor) to an issuer in exchange for stock of the issuer, and (ii) for the 36-month period following the issuance, the transferor holds, directly or indirectly, more than 50 percent (by vote and value) of the stock of the issuer.

**Effective/applicability date:** Those rules have been proposed to apply to any debt instrument issued on or after April 4, 2016. However, when the rules otherwise would characterize a debt instrument as stock before the date that the regulations are finalized, a transition rule provides that the debt instrument would be treated as indebtedness until the date that is 90 days after the date that they are published as final, at which time that debt instrument would be deemed to be exchanged for an equity interest. Moreover, for purposes of determining whether a debt instrument is a principal purpose debt instrument to which the funding rule would apply, a distribution or acquisition that occurs before April 4, 2016, is not taken into account.

**Consolidated Group Exception**

As noted above, the proposed regulations do not apply to obligations between members of a consolidated group, although general tax principles continue to apply. The proposed regulations achieve that result by treating a consolidated group as one corporation. That being said, the proposed regulations provide several rules affecting consolidated groups (for example, in an instance where an intercompany obligation becomes an obligation that is not an intercompany obligation). Overall, this exception guides the general application of the proposed regulations to debt instruments between domestic corporations and their foreign affiliates.

As a result of treating all members of a consolidated group as one corporation, the proposed regulations provide that a debt instrument issued to or by one member of a consolidated group generally is treated as issued to or by all members of the same consolidated group. Accordingly, a debt instrument issued by one consolidated group member to a member of its expanded group that is not a member of its consolidated group may be characterized under the funding rule as funding a distribution or acquisition by another member of that consolidated group, even though that other consolidated group member was not the issuer and thus was not funded directly. Similarly, a debt instrument issued by one consolidated group member to another consolidated group member would be characterized as stock under the general rule when the debt instrument is distributed by the holder to a

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16See prop. reg. section 1.385-3(b)(3)(iv); see e.g., prop. reg. section 1.385-3(g)(3), examples 9, 10, and 12.
17See prop. reg. section 1.385-3(f)(9) and (11).
19See prop. reg. section 1.385-3(b)(3)(iv)(B).
20See Preamble at 51-52.
21See prop. reg. section 1.385-3(c)(1).
22See prop. reg. section 1.385-3(c)(2); see, e.g., prop. reg. section 1.385-3(g)(3), Example 17.
23See prop. reg. section 1.385-3(c)(3).
member of the expanded group that is not a member of the same consolidated group. These rules necessarily direct that consideration be given to the potential deconsolidation of a consolidated group member on account issuing debt instruments to a member of the expanded group that is not also a member of the consolidated group.

**Broad Antiabuse Rule**

The proposed regulations contain an open-ended antiabuse rule that would apply if a debt instrument is issued with a principal purpose of avoiding the application of the characterization rules or the consolidated group rules noted above. To that end, they include a non-exhaustive list of examples in which the antiabuse rule might apply. Those examples involve the issuance of a debt instrument to a third party to avoid the application of the characterization rules or the consolidated group rules when, for example, the debt instrument is later acquired by a member of the expanded group (or the third party itself is acquired by the expanded group). The antiabuse rule also provides that notional principal contracts and other instruments may be characterized as stock if they are issued in lieu of a debt instrument with the intent of avoiding the application of the characterization rules or the consolidated group rules.

Instruments Treated as Stock in Part, Debt in Part

Finally, the proposed regulations permit the IRS to treat a debt instrument between related parties as stock in part and debt in part for federal tax purposes. That rule:

- would apply to debt instruments between parties that meet a 50 percent threshold for relatedness rather than the threshold applicable to other rules contained in the proposed regulations (which generally require satisfaction of an 80 percent vote or value threshold);
- would permit the IRS to treat a debt instrument between the parties as stock in part and debt in part consistent with its substance;
- would not affect the authority of the IRS to disregard a debt instrument as indebtedness or stock, to treat a debt instrument as indebtedness or equity of another entity, or otherwise to treat a debt instrument in accordance with its substance;
- would not permit issuers and related holders to treat the instrument in a manner inconsistent with the issuer’s initial characterization, and
- would not apply to debt instruments between unrelated parties or related-party instruments that are denominated as other than indebtedness.

**Effective/applicability date:** In general, this rule has been proposed to be effective to debt instruments issued on or after the date that the regulations are published in final form.

**Unclear Consequences of Equity Characterization**

A related-party debt instrument that is treated as equity under the proposed regulations would be treated as equity for all federal tax purposes, including, for example, sections 302, 304, and 305. The proposed regulations do not, however, provide any specific guidance on whether those instruments should be treated as common stock or preferred stock. Rather, the preamble simply states that this determination should be based on the terms of the instrument. Further, the collateral consequences of this treatment are not addressed in the proposed rules, and may require consideration of a number of other tax provisions, including the “fast pay” rules of reg. section 1.7701(1)-3 and the affiliated group rules of section 1504(a).

**Comments Requested**

Treasury and the IRS have requested comments on all aspects of the proposed regulations, including comments on their clarity and how they can be made more administrable. They have specifically requested comments on:

- whether other instruments should be subject to the proposed regulations, including other types of instruments that are not indebtedness in form but that should be subject to the documentation requirements described above;

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32 See prop. reg. section 1.385-3(b)(4); see, e.g., prop. reg. section 1.385-3(g)(3), Example 18.
33 See prop. reg. section 1.385-3(b)(4).
34 See id.
35 See id.
36 See prop. reg. section 1.385-1(d)(1).
37 Compare prop. reg. section 1.385-1(b)(5) (defining “modified expanded group”), with prop. reg. section 1.385-1(b)(3) (defining “expanded group”).
38 See, e.g., Plantation Patterns Inc. v. Commissioner, 462 F.2d 712 (5th Cir. 1972); cf. prop. reg. section 1.385-2(a)(1), (3).
40 See Preamble at 14-15.
41 See prop. reg. section 1.385-1(f).
42 See prop. reg. section 1.385-1(d), -2(a)(1), and -3(b)(1).
43 See Preamble at 33, 36, 45-46. If a related-party debt instrument were treated as preferred stock, most short-term and medium-term instruments presumably would constitute non-qualified preferred stock, which could represent a particularly adverse combination of stock and debt treatment for a taxpayer.
44 See id. at 75-78.
• whether special rules are warranted for cash pools, cash sweeps, and similar arrangements for managing cash of an expanded group;
• the application of the rules to any entity for a year in which the entity is not a U.S. person (defined in section 7701(a)(30)), is not required to file a U.S. tax return, and is not a controlled foreign corporation or a controlled foreign partnership, but in a later year becomes either; and
• whether indebtedness commonly used by investment partnerships, including indebtedness issued by certain “blocker” entities, implicate similar policy concerns as those motivating the proposed regulations, so that the scope of the proposed regulations should be broadened.

Written or electronic comments and requests for a public hearing must be received by the IRS by July 7, 2016.

Conclusion

The proposed regulations are broad, and their application to specific factual situations is complex, particularly with respect to any available exceptions. Although the proposed regulations leave open many unanswered questions, they afford taxpayers a glimpse into the government’s thinking concerning critical aspects of debt-equity issues. Thus, at a minimum, it would be wise for taxpayers, even today, to consider the proposed regulations when documenting and analyzing related-party loans because they suggest the factors that the IRS will scrutinize in applying the multi-factor debt-equity analysis that has developed under the common law for purposes of determining the tax character of those debt instruments.

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