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The Final §385 Debt Equity Regulations: Who Got a Pass and Who Should Worry

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> *Your committee believes that any attempt to write into the statute precise definitions which will classify for tax purposes the many types of corporate stocks and securities will be frustrated by the numerous characteristics of an interchangeable nature which can be given to these instruments*[1]

Drafting rules to distinguish stock from debt must not be easy. Congress couldn't do it. Treasury has tried — not once, but now twice. Under §385, enacted in 1969 as part of the Tax Reform Act of 1969,[2] the IRS was granted regulatory authority "to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for the purposes of this title as stock or indebtedness (or as in part stock or in part indebtedness)."[3] Eleven years later, proposed regulations were issued in March 1980, finalized in December 1980 with a delayed effective date which was extended multiple times, and finally withdrawn in 1983.[4] They were not well received.

In the spring of 2016, Treasury again attempted comprehensive regulations under §385.[5] The proposed regulations were changed significantly with issuance of final and temporary regulations effective October 21, 2016.[6] In the interim, the 2016 regulations were caught in the net of Executive Order 13789, which instructed the Treasury Secretary to review all significant tax regulations issued on or after January 1, 2016 to identify regulations imposing undo financial burdens, undo complexity, or exceeding the IRS's statutory authority. Temporary regulations issued in 2016 expired in 2019 with limited applicability to taxable years ending before May 14, 2020.

Final regulations were issued in May of this year.[7] The most significant change made to the regulations in the process of their evolution was to delete entirely Reg. §1.385-2, which contained onerous documentation requirements for an issue to be treated as debt.[8] What is left is a set of rules with limited applicability as to whom they apply, but broad applicability as to when they apply.

TAXPAYERS NOT SUBJECT TO THE FINAL REGULATIONS

Several types of taxpayers are expressly excluded from application of the final regulations.

- S corporations,[9]
- excepted regulated financial companies (bank holding companies, savings and loan holding

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[1] S. Rep. No. 1622, 83d Cong., 2d Sess. 42 (1954), *quoted in* Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (7th ed.), ¶4.02[8][a].

[2] Pub. L. No. 91-172, §415(a).

[3] §385(a). All section references are to the Internal Revenue Code, as amended, or the Treasury regulations thereunder, unless otherwise specified.

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

[5] REG-108060-15, 81 Fed. Reg. 20,912.

[6] *See* T.D. 9790, 81 Fed. Reg. 72,858.

[7] T.D. 9897, 85 Fed. Reg. 28,870 (May 14, 2020).

[8] *See generally* Ward, *Down-Market Implications of the Proposed §385 Regulation*, 45 Tax Mgmt. Int'l J. 436 (July 8, 2016).

[9] Reg. §1.385-1(c)(4)(i).

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companies, national banks, federal reserve banks, and similar financial services companies identified in Reg. §1.385-3(g)(3)(iv)(A)),

- regulated insurance companies described in Reg. §1.385-3(g)(3)(v)
- domestic issuers that are not corporations,[10]
- foreign issuers,[11] and
- unrelated issuers and borrowers (that is entities that are not members of the same expanded group).[12]

DEBT INSTRUMENTS NOT SUBJECT TO THE FINAL REGULATIONS

Not only will the final regulations not apply to certain taxpayers, but many debt instruments issued by taxpayers to whom the regulations do not apply are also excluded from application of the final regulations. These debt instruments include

- qualified dealer debt instruments described in Reg. & sect;1.385-3(g)(3)(ii),
- excluded statutory or regulatory debt instruments described in Reg. §1.385-3(g)(3)(iii),
- the first $50 million of covered debt instruments issued by the issuer's expanded group (based on the aggregate adjusted issue price) that would be recharacterized as stock under the rules of the regulations, and
- qualified short-term debt instruments:
  - ordinary course loans as defined in Reg. §1.385-3(b)(3)(vii)(B),
  - interest-free loans,
  - demand deposits received by a qualified cash pool header as described in Reg. §1.385-3(b)(3)(vii)(D), and
  - short-term funding arrangements.[13]

Whether a debt instrument qualifies as a short-term funding arrangement is determined by one of two alternative tests: the specified current assets test or the 270-day test.[14] Either test may be used, and different tests may be used from year to year. However, the same test must be used for all covered debt instruments issued in the same taxable year. The specified current asset test looks to the total amount of outstanding debt instruments issued as short-term funding arrangements to members of the issuer's expanded group. This amount is compared with the amount of current assets ''reasonably expected'' to be realized in cash or sold during the normal operating cycle of the issuer as reflected on the issuer's balance sheet during the 90-day period following issuance or the issuer's normal operating cycle, if longer. Realization is determined using U.S. Generally Accepted Accounting Practices. Cash, cash equivalents, and assets reflected on the books and records of a qualified cash pool header do not count. Similarly, amounts owed by the issuer will be reduced by the issuer's deposits with a qualified cash pool lender if the deposits satisfy the tests for qualification as a short-term funding arrangement.

The 270-day test for qualification as a short-term funding arrangement is met if the covered debt instrument has a maturity of 270 days or less or is an advance under a revolving credit agreement or similar arrangement. The 270-day test is subject to an overall indebtedness limit that requires the issuer to be a net borrower under 270-day debt instruments issued to the members of the issuer's expanded group for no more than 270 days during the taxable year of the issuer.[15]

To qualify as a short-term funding arrangement by satisfying either the specified current asset test or 270-day test, the interest rate on the debt instrument cannot exceed an arm's-length interest rate as determined under §482 principles that would be charged with respect to a comparable debt instrument with a term that does not exceed 90 days or the issuer's normal operating cycle (whichever is longer).[16]

TRANSACTIONS NOT SUBJECT TO THE FINAL REGULATIONS

Not only are certain taxpayers and debt instruments not subject to the final §385 regulations, but debt instruments issued by taxpayers who are subject to the regulations will nonetheless escape risk of recharacterization if issued in transactions which are outside the scope of the §385 regulations. These include transactions which

- are between unrelated parties;
- result in new investments in the issuer;[17]
- are distributions of stock in non-recognition transactions under §354(a)(1) or §355(a)(1) or transactions in which gain is recognized under

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[10] *See* Reg. §1.385-1(c)(2).
[11] *Id.*
[12] *See* Reg. §1.385-3(b)(2).
[13] Reg. §1.385-3(b)(3)(vii).
[14] Reg. §1.385-3(b)(3)(vii)(A).
[15] Reg. §1.385-3(b)(3)(vii)(A)(ii)(4).
[16] Reg. §1.385-3(b)(3)(vii)(A)(i)(2), §1.385-3(b)(3)(vii)(A)(ii)(2).
[17] Reg. §1.385-3(a).

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§354 or §355, but the stock is not treated as boot under §356;[18]

- are distributions of property in complete liquidation under §336(a) and §337(a);[19]
- are exchanges in which expanded group stock is acquired from a transferor in an asset reorganization to which the transferor and transferee are parties, and
  - §361(a) or §361(b) applies to the transferor and the stock is not transferred by issuance, or
  - §1032 or Reg. §1.1032-2 applies to the transferor and the stock is distributed by the transferee pursuant to the plan of reorganization;[20]
- are exchanges in which expanded group stock is acquired from a shareholder that receives property in a complete liquidation to which §331 or §332 applies;[21] or
- are exchanges in which expanded group stock is acquired from a transferor that is an acquiring entity that is deemed to issue the stock in exchange for cash from an issuing corporation in a transaction described in Reg. & sect;1.1032-3(b).[22]

WHAT IS LEFT?

The §385 regulations will apply to recharacterize debt as stock only where the debt is

- a covered debt instrument,
- issued by a covered member,
- issued to a member of the covered member's expanded group, and
- issued in a transaction that is either
  - a distribution,
  - an acquisition for expanded group stock, or
  - an exchange for property in an asset reorganization.

Debt instrument. The term ''debt instrument'' is broadly defined by reference to §1275(a) and the regulations thereunder to refer to any bond, indenture, note, certificate, or other evidence of indebtedness.[23]

Covered debt instrument. ''Covered debt instrument'' is defined by exclusion to refer to any debt instrument issued after April 4, 2016 which is not a

- qualified dealer debt instrument (that is, a debt instrument issued or acquired by an expanded group member that is a dealer in securities in the ordinary course of its business of dealing in securities) or
- an excluded statutory or regulatory debt instrument (as defined in Reg. §1.385-3(g)(3)(iii)).

As noted above, the debt instruments issued by a regulated financial company or regulated insurance company cannot be covered debt instruments.[24] A debt instrument will be regarded as a covered debt instrument if it was issued to fund a distribution of property to an expanded group member, an acquisition of expanded group stock from an expanded group member, or an acquisition of property in an asset reorganization in which a shareholder in the corporation which transferred the property receives other property or money (boot) with respect to its stock in the transferor corporation.

Covered member. Covered members are limited to domestic corporations.[25]

Expanded group. To be at risk of the recharacterization, the covered debt instrument must be issued to a covered member of the issuing covered member's expanded group. An expanded group is a group of corporations connected through stock ownership to a parent corporation that is not an S corporation, regulated investment company, or real estate investment trust.[26] The common parent must be the direct or indirect owner of at least 80% of the stock of one other expanded group member determined by vote or value. In addition, stock of other corporations in the expanded group must each be owned at least 80% (measured by vote or value) by at least one other expanded group member. To determine indirect ownership, the attribution rules of §318(a)(2)(C) and §318(a)(4) are applied, but not the family attribution rules of §318(a)(1) or the downward attribution rules of §318(a)(3). The option attribution rule of §318(a)(4) applies only to options which are reasonably certain to be exercised within the meaning of Reg. §1.1504-4(g). Stock ownership is determined immediately before the event giving rise to application of the regulations: for example, issuance of the debt instrument or the distribution or acquisition of stock or property.

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[18] Reg. §1.385-3(g)(10)(i).
[19] Reg. §1.385-3(g)(10)(ii).
[20] Reg. §1.385-3(g)(11)(i).
[21] Reg. §1.385-3(g)(11)(ii).
[22] Reg. §1.385-3(g)(11)(iii).
[23] Reg. §1.385-3(g)(4).
[24] Reg. §1.385-3(g)(3)(i)
[25] Reg. §1.385-1(c)(2).
[26] Reg. §1.385-1(c)(4)(i).

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Distribution. The term ''distribution'' is defined as any distribution made by a corporation with respect to its stock,[27] other than exempt distributions noted above,[28] and distributions occurring before April 5, 2016.[29] Also excluded are distributions resulting from transfer pricing adjustments which are deemed to occur under Reg. §1.482-1(g) and distributions of stock to individuals as consideration for services rendered to a member of the expanded group.[30]

Exchange or acquisition of expanded group stock. The covered debt instrument is subject to recharacterization if issued in exchange for expanded group stock or if the expanded group stock is acquired in exchange for property other than expanded group stock under a special funding rule.[31] The acquisition of expanded group stock in exchange for property is conclusively deemed to have occurred if the covered debt instrument is issued by a covered group member and funds a distribution or acquisition of property.

Acquisition transaction. No special definition is provided by the regulations for the term ''acquisition.''

Asset reorganization. The regulations define the term ''asset reorganization'' as an A, C, D, F, or G reorganization under §368(a)(1).[32]

Funding Rule

To facilitate the determination that the debt instrument was issued in exchange for property, a *per se* funding rule applies such that the debt instrument is treated as funding the distribution or acquisition if issued within 36 months before or after the date of the distribution or acquisition.[33]

The *per se* funding rule has received significant adverse commentary, and its amendment or elimination was anticipated in response to an advance notice of proposed rulemaking issued on October 31, 2019.[34] However, no such amendment or elimination has occurred in the iterations of Reg. §1.385-3 to date.

$50 Million Safe Harbor

As noted above, in order for debt to be subject to recharacterization as stock under the regulations, the aggregate adjusted issue price of the covered debt instruments held by members of the issuer's expanded group must exceed $50 million. This is a most interesting safe harbor in that debt instruments otherwise deemed abusive under the regulations are sheltered from recharacterization as long as the abusive debt issued by the expanded group does not exceed $50 million.[35]

Controlled Partnerships

Although expanded group members are limited to corporations, debt issued by disregarded entities or controlled partnerships owned by the corporations which are expanded group members may also be subject to recharacterization.[36] In order to be included in the expanded group, 80% or more of the interest in the partnership's capital or profits must be owned directly or indirectly by members of the expanded group.

Consolidated Groups

Generally, members of a consolidated group are treated as members of one corporation. Application of the covered debt instrument provisions of Reg. §1.385-3 to members of a consolidated group (including corporations which enter or leave the group) is addressed in Reg. §1.385-4.

CONCLUSION

Relative to the regulations that were proposed in the spring of 2016, the final §385 regulations are more similar than dissimilar in their principles but considerably diminished in the issuers to which they apply. The rules are clearly more likely to apply to public companies than private companies. However, the expansive notion of an expanded group and the requirement that all debt other than debt expressly excepted by the regulations be taken into account will concern more corporate debt issuers than might first appear to be the case. Those taxpayers who have gotten a pass because they are not the kind of taxpayers to which the regulations apply, or do not issue debt instruments or engage in transactions to which they apply, will suffer or thrive with the lack of a clear line dividing debt from equity.

One might say that this is one of those areas of the tax law where the virtues of vagueness exceed its vices. . . .[37]

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[27] Reg. §1.385-3(g)(9).

[28] *See* text at nn. 20-22.

[29] Reg. §1.385-3(b)(3)(viii).

[30] Reg. §1.385-3(c)(2)(ii)(iii).

[31] *See* Reg. §1.385-3(b)(3)(i)(B).

[32] Reg. §1.385-3(g)(1).

[33] Reg. §1.385-3(b)(3)(iii) [REG-123112-19].

[34] REG-123112-19, 84 Fed. Reg. 59,318.

[35] Reg. §1.385-3(g)(4)

[36] *See* Reg. §1.385-3(h)(3)(xiii) *Ex.* 13.

[37] Lyon, *Federal Income Taxation*, Surv. Am. L. 123, 142 annot. (1957), *quoted in* Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (7th ed.), ¶4.02[8][a].

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