

## Section 385 Regulations on Related-Party Debt

Avoiding Reclassification of Debt to Equity, Structuring Intercompany Debt Instruments to Withstand IRS Challenges

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# Debt vs. Equity

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# Overview of Debt v. Equity

## Significance of the Differing Treatment

- Giving up ownership vs. obligation to repay
- Equity can generally be unlimited; there are usually covenants on how much debt a company can take on (other jurisdictions have thin-cap rules that proscribe debt: equity ratios)
- Discretion to declare dividends vs. Interest required to be paid
- Dividends paid are generally not deductible vs. interest paid is deductible subject to various limitations (163(j), 263A and others)

# Section 385

Congress enacted Section 385 in 1969 to provide the Treasury with authority to issue regulations to:

- “determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness”
- “or as in part stock and in part indebtedness”
- The “regulations...shall set forth factors...to be taken into account ... in a particular factual situation...The factors so set forth ... may include, among other factors:”
  - A written unconditional promise to pay a sum certain and fixed interest
  - Preferred or subordinated status.
  - Debt to equity ratio
  - Convertibility into stock of issuer
  - The relationship between holdings of stock in the corporation and the holdings of the instrument

# Case Law– Indicia of debt vs. equity

- Several court cases have developed checklists of factors to be considered when determining whether an advance should be treated as equity or debt
  - Estate of Mixon vs. US (1972)
  - Fin Hay Realty Co. vs. US (1968)
  - Dixie Dairies Corp. v. Commissioner (1980)
  - John M. Sensenig, et ux. v. Commr (2017)
- As many as 38 factors were analyzed in the above and other court cases that ruled on the matter
- No one factor is demonstrative of either debt or equity, rather, the courts identified specific factors in each circumstance and weighed them in deciding debt or equity

# Case Law– Indicia of debt vs. equity

Some of the main factors analyzed include the following:

- Names Given to the Certificates Evidencing the Indebtedness
- Presence or Absence of a Fixed Maturity Date
- Source of Payments
- Increased Participation in Management
- Right to Enforce Payment of Principal and Interest
- Intent of the Parties
- “Thin” or Inadequate Capitalization
- Identity of Interest Between Creditor and Stockholder
- Interest Payments
- Ability of the Corporation to Obtain Loans from Outside Lending Institutions
- Extent to Which the Loan Was Used to Acquire Capital Assets
- Failure of the Debtor to Repay on the Due Date or Seek a Postponement
- Voting Power of the Holder of the Instrument
- Contingency on the Obligation to Repay
- Provision for Redemption by the Corporation or Holder

# (Tortured) History of Section 385 Regulations

- Original regulations first proposed and finalized in 1980 and were supposed to become effective in 1981 but after heavy criticism were withdrawn
- Revised regulations were then proposed in 1982, but again, due to intense criticism, the proposed regulations were withdrawn in 1983
- In April 2016, Proposed Regulations were issued:
  - treat certain related-party interests in a corporation as indebtedness in part and stock in part for federal tax purposes (the Bifurcation Rule)
  - establish threshold documentation requirements that must be satisfied in order for certain related-party interests in a corporation to be treated as indebtedness for federal tax purposes (i.e., the Documentation Rules)
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# (Tortured) History of Section 385 Regulations

- In October 2016, Treasury finalized the -1, -2 and -3 regulations and issued 1.385-4T, treatment of consolidated groups, and 1.385-3T, which addressed qualified short-term debt instruments and the treatment of controlled partnerships under the Distribution Regulations, as temporary regulations
- In October 2019, three years after regulations 1.385-3T and 1.385-4T were issued in temporary form, they expired, leaving 1.385-1, 1.385-2, and the previously issued portion of 1.385-3 as final regulations. Additionally, the IRS announced in Notice 2019-58 (issued October 28, 2019) that taxpayers could rely on the 2016 Proposed Regulations, until further notice, if they consistently applied the 2016 Proposed Regulations in their entirety.
- In November 2019, the Documentation Regulations were removed but the Distribution Regulations were retained, however, Treasury indicated in an advance notice of proposed rule-making that more streamlined Distribution rules were forthcoming
- On May 13, 2020, Treasury issued final regulations adopting the 2016 Proposed Regulation with no substantive changes

# Proposed Section 385 Regulations

The preamble to the Proposed Regulations described several policy objectives:

- Debt issued between highly related parties under circumstances that do not increase the issuer's asset base is stated to be inherently more equity like than debt
- Related party debt is commonly used to engage in tax planning that was viewed as objectionable as a matter of tax policy

# Proposed Section 385 Regulations

- Contemporaneous Documentation Requirement - Prop. Treas. Reg. §1.385-2 required documentation of debt issued between members of an Extended Group (“EG”), i.e., Extended Group Instruments (“EGI”s). Documentation includes enforceable legal documentation with creditor’s remedies, as well as evidence of reasonable expectation of repayment and of behavior consistent with bona fide debtor-creditor relationship
- General Rule - Recharacterized as equity for all federal income tax purposes EGI’s issued in circumstances that may not increase the asset base of the issuer
- Funding Rule - Designed to prevent the circumvention of the General

# Proposed Section 385 Regulations

General Rule (discussed in more detail later)

An Expanded Group Instrument is treated as stock if it is issued in any of the following situations:

- In a distribution
- To acquire Expanded Group stock, other than to acquire stock of an acquiring corporation in an asset reorganization, or
- To acquire property in an asset reorganization, to the extent a shareholder that is a member of the issuer's expanded group immediately before the reorganization receives the debt instrument with respect to its stock in the transferor corporation

# Proposed Section 385 Regulations

Funding Rule (discussed in more detail later)

EGIs are also treated as stock if issued with a **principal purpose** of funding a distribution or acquisition described above

Therefore, an EGI issued to fund any of the following is equity:

- a distribution
- a purchase of equity in an affiliate, or
- Payment of boot in an asset reorganization

If the EGI is issued within 36 months of the transaction, the EGI was **irrebuttably presumed** to have been issued with a principal purpose of funding the transaction (the “**Per se Rule**”)

# Final and Temporary Section 385 Regulations

- The Distribution Rules set forth in the October 2016 Regulations aim to thwart the issuance of debt instruments that
  - Do not fund any new investment in the operations of the issuer and
  - potentially create significant U.S. federal income tax benefits absent meaningful non-tax economic effects
- Under the basic Distribution Rule, subject to certain exceptions, the issuance by a “covered member” of a “covered debt instrument” to a member of an “expanded group” in a distribution, in exchange for stock of an expanded group member (other than in an exempt exchange) or in exchange for property in certain asset reorganizations, could result in the treatment of such instrument as equity for federal tax purposes, thereby precluding a deduction by the issuer with respect to any purported interest payments thereon

# Final and Temporary Section 385 Regulations

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- The Funding Rules set forth in the October 2016 provide that a covered debt instrument issued to an expanded group member in exchange for cash or other property may be recast as equity if it is issued for a principal purpose of funding a distribution or acquisition of the types captured by the basic Distribution Rule
- This is determined based on all relevant facts and circumstances surrounding the issuance of the instrument
- However, under a per se rule, an instrument will be treated as funding a distribution or acquisition if it was issued during the period beginning 36 months before, and ending 36 months after, such distribution or acquisition and is outside the ordinary course of the issuer's trade or business

# Treas. Reg. 1.385-1: Definitions and Operating Rules

- The -1 Regs contain the general rule in Paragraph (b): “. . . whether an interest in a corporation is treated for purposes of the Internal Revenue Code as stock or indebtedness (or as in part stock and in part indebtedness) is determined based on common law, including the factors prescribed under such common law”
- Paragraph (c) contains definitions relevant throughout the regulations:
  - (1) Controlled Partnership – 80% rule
  - (2) Covered Member – a member of an “expanded group” that is a domestic corporation
  - (4) Expanded Group - one or more chains of corporations (other than S corporations) connected through stock ownership with a common parent corporation that is not an S corporation, RIC or REIT (such common parent corporation, an expanded group parent), but only if
    - The expanded group parent owns directly or indirectly stock meeting the requirements of section 1504(a)(2) (modified by substituting “or” for “and” in section 1504(a)(2)(A)) in at least one of the other corporations; and
    - Stock meeting the requirements of section 1504(a)(2) (modified by substituting “or” for “and” in section 1504(a)(2)(A) i.e. 80% vote OR value ) in each of the other corporations (except the expanded group parent) is owned directly or indirectly by one or more of the other corporations



## Transactions Potentially Subject to Recharacterization under Section 385 Regulations

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- **General Rule Transactions** *(discussed further in subsequent slides)*
  - The general rule transactions involve issuances of debt that are unaccompanied by transfers of cash
  - Three types
    - Note Distributions
    - Notes Issued for Stock of an Expanded Group Member
    - Note Issued as Boot in a Reorganization

## Transactions Potentially Subject to Recharacterization under Section 385 Regulations

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- Funding Rule Transactions
  - Rule is designed to prevent situations where the debt proceeds “fund” a transaction that would, if undertaken for a note, have been covered by the general rule
  - In other words, if you can’t do it directly, you can’t do it indirectly

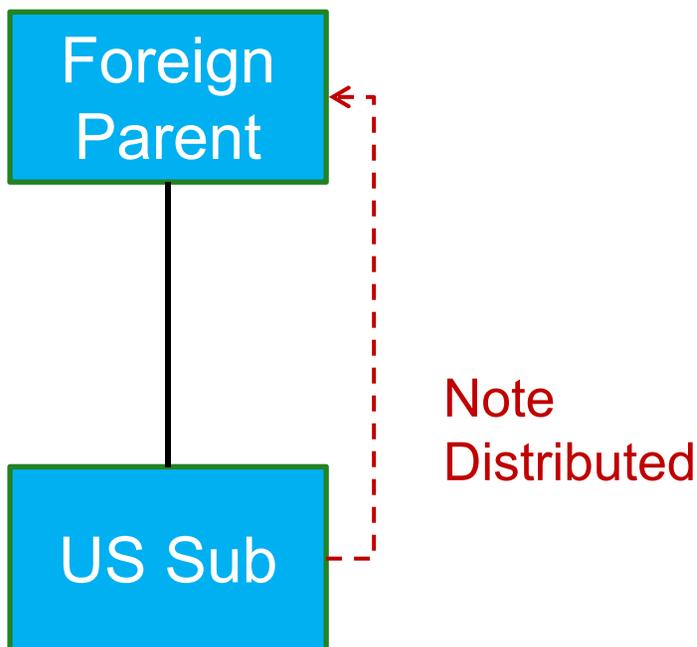
## Transactions Potentially Subject to Recharacterization under Section 385 Regulations

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- Funding Rule Transactions (Cont.)
  - *Per se* funding rule: 6-year window (3 on either side of transaction)
    - If there is a transaction in that window that de-funds the debt transaction, and that transaction would have been a general rule transaction if undertaken for a note, the debt can be recharacterized
    - Rule is *per se* because there is no intent element or tracing to borrowed funds.
  - Even if not within the *per se* window, IRS can recharacterize if principal purpose was de-funding

# Transactions Potentially Subject to Recharacterization under Section 385 Regulations

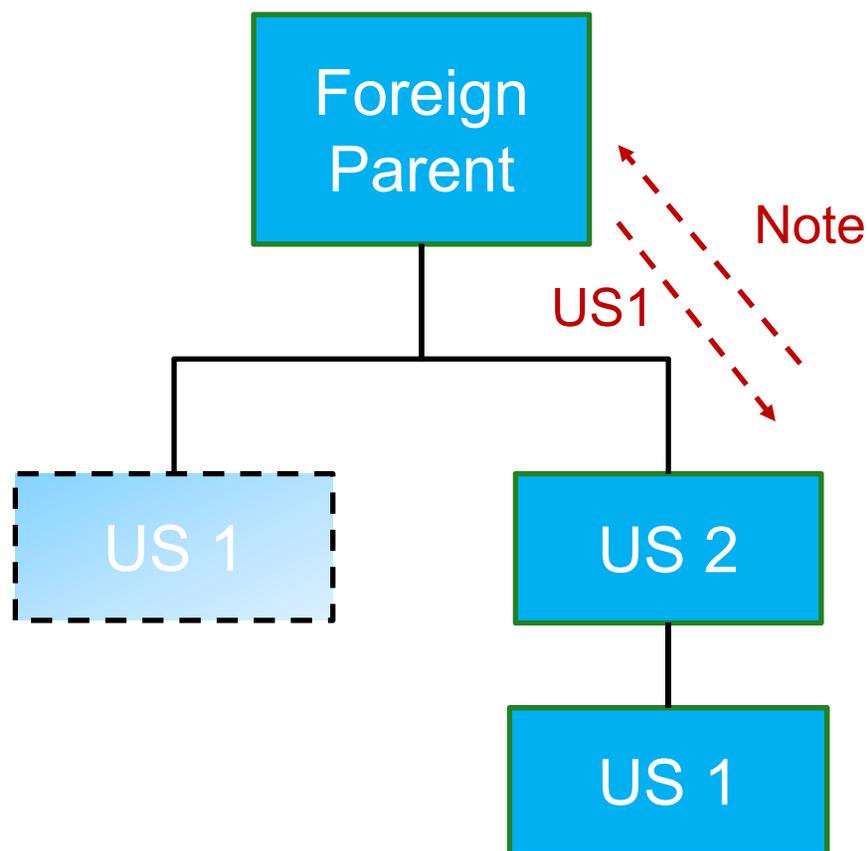
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- General Rule Transactions
  - Scenario 1: Note distribution
    - Scenario: US Company (“Sub”) owned by Foreign Parent (“Parent”)
    - Sub distributes note as a dividend to Parent
    - No cash is transferred

# Transactions Potentially Subject to Recharacterization under Section 385 Regulations

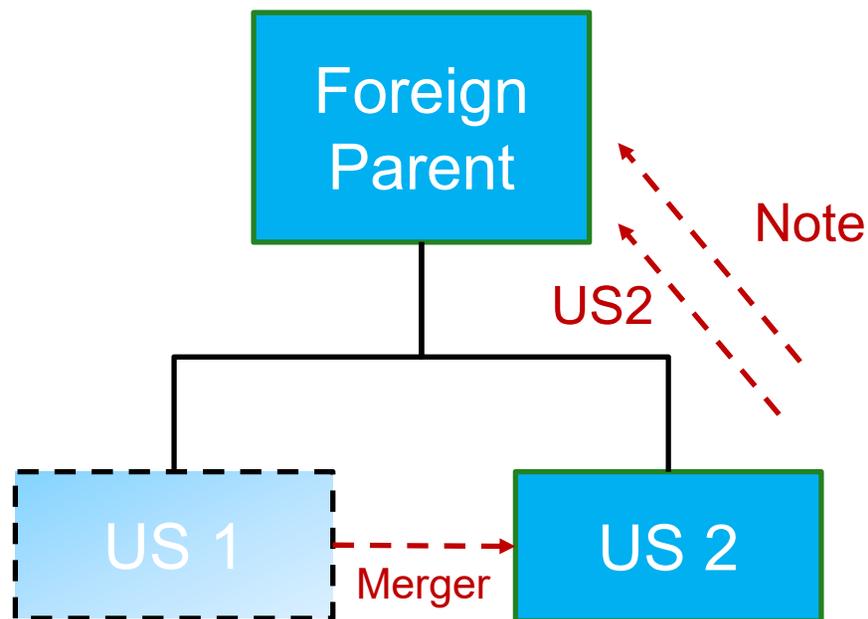
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- General Rule Transactions
  - Scenario 2: Debt issued for stock of an expanded group member
    - Scenario: Two US group members (“US 1” and “US 2”) with Foreign Parent (“Parent”)
    - Parent sells stock of US 1 to US 2 in a 304 transaction and takes back a note
    - No cash is transferred

# Transactions Potentially Subject to Recharacterization under Section 385 Regulations

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- General Rule Transactions
  - Scenario 3: Note issued as boot in a reorganization
    - The parent of two US groups, US 1 and US 2, are owned by Foreign Parent (“Parent”)
    - US 1 merges into US 2
    - Consideration is US 2 stock with a note as boot
    - No cash is transferred

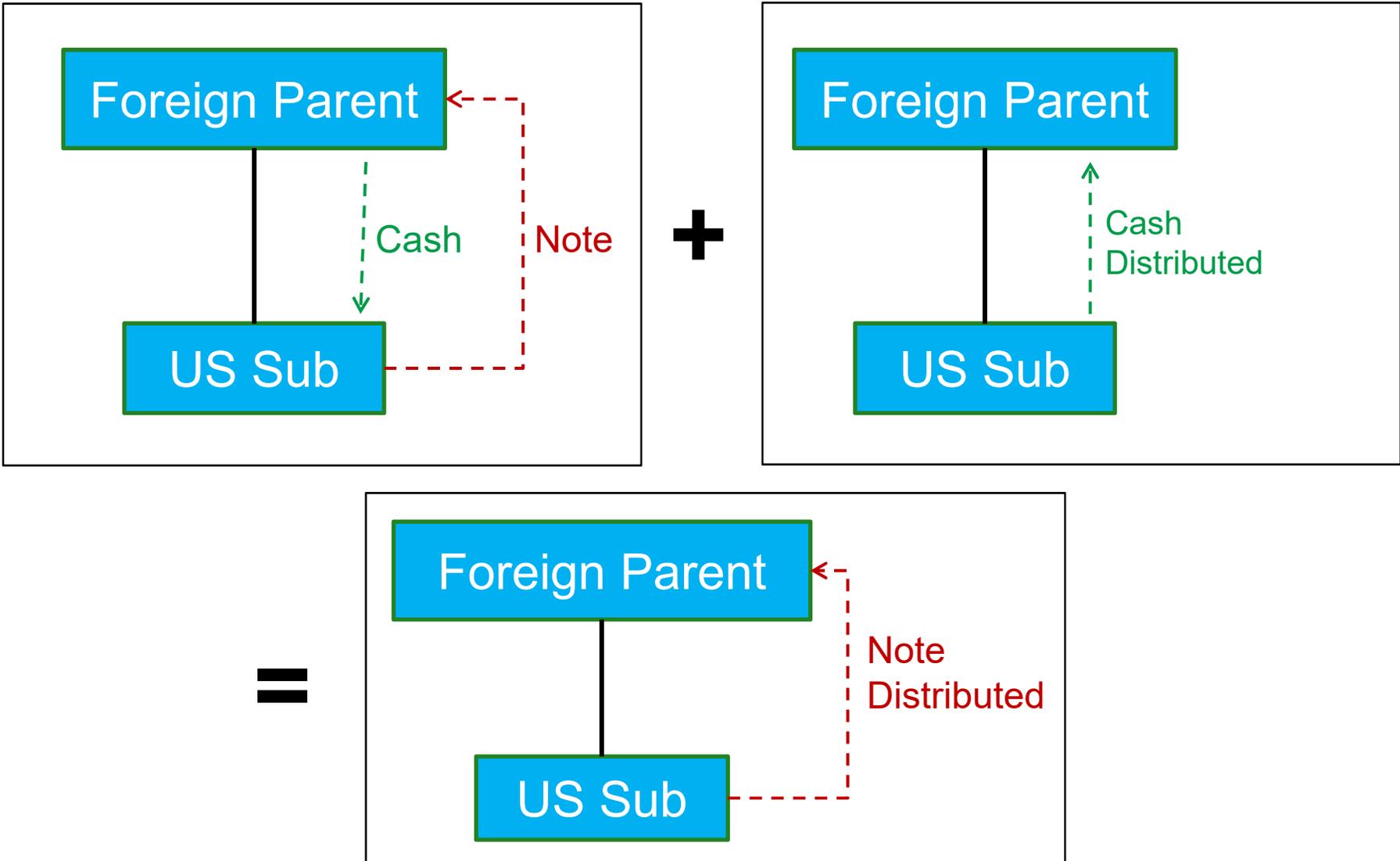
## Transactions Potentially Subject to Recharacterization under Section 385 Regulations

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- Funding Rule Scenario 1
  - Foreign parent (“Parent”) loans cash to US subsidiary (“U.S. Sub”)
  - Cash is actually transferred from Parent to Sub in exchange for the note
  - Within 3 years (before or after), Sub distributes cash to Parent
    - End result: In effect, Sub has simply distributed a note to Parent, as in General Rule Scenario 1
  - The same result would occur if another member of the expanded group, e.g., a brother-sister subsidiary to U.S. Sub loaned the money to U.S. Sub (even if U.S. Sub distributed the cash to Parent)

# ILLUSTRATION

## Funding Rule – Scenario 1



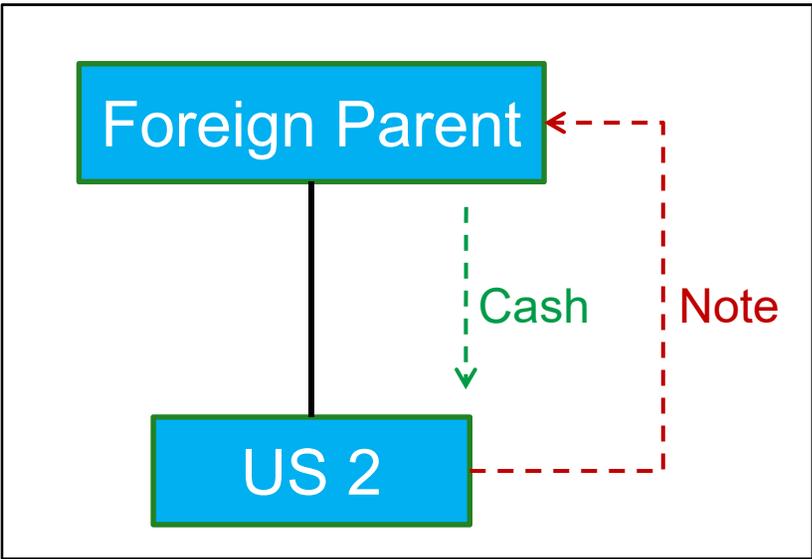
## Transactions Potentially Subject to Recharacterization under Section 385 Regulations

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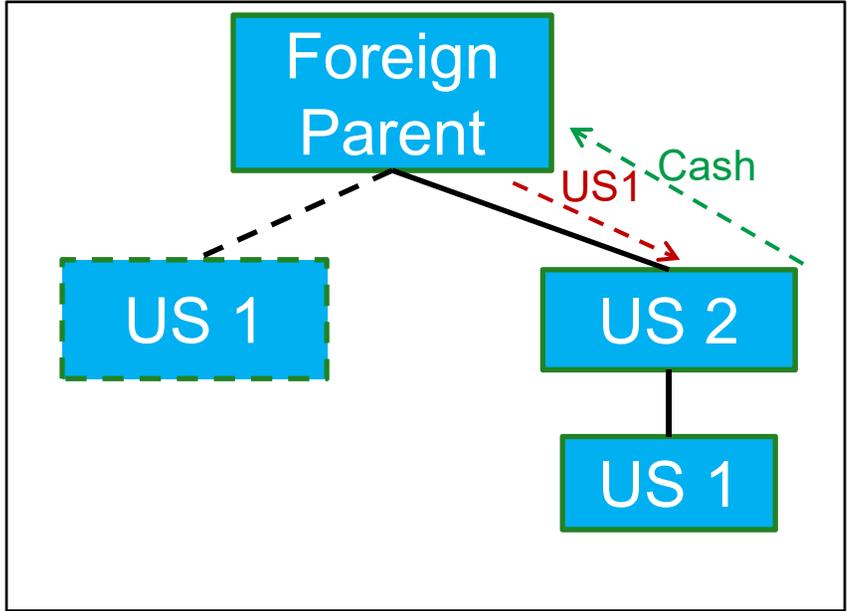
- Funding Rule Scenario 2
  - Foreign parent (“Parent”) owns group members “US1” and “US2”
  - Parent loans cash to US2 in exchange for a note from US2
  - Within 3 years (before or after), Parent sells US1 stock to US2 in exchange for that cash
    - End result: In effect, Parent has sold US1 stock to US2 in exchange for a note, as in General Rule Scenario 2

# ILLUSTRATION

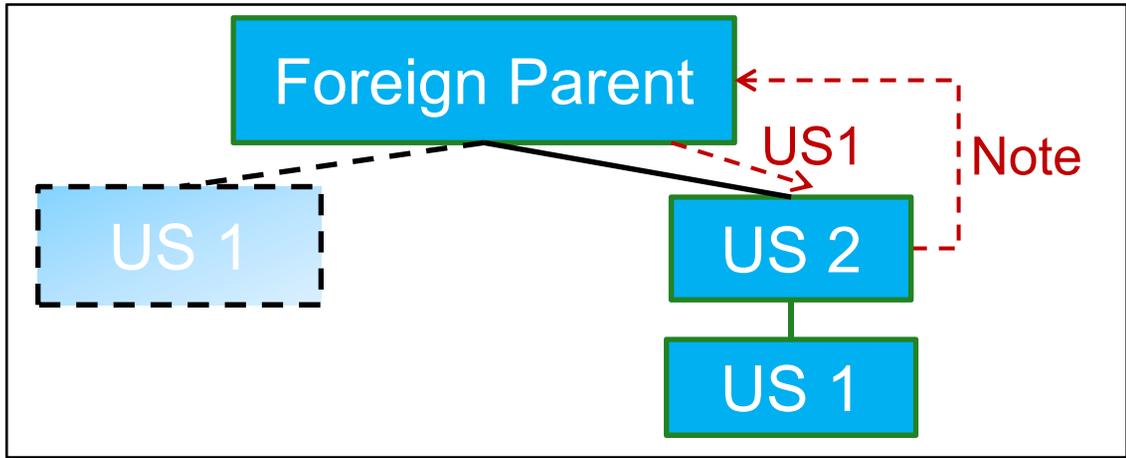
## Funding Rule – Scenario 2



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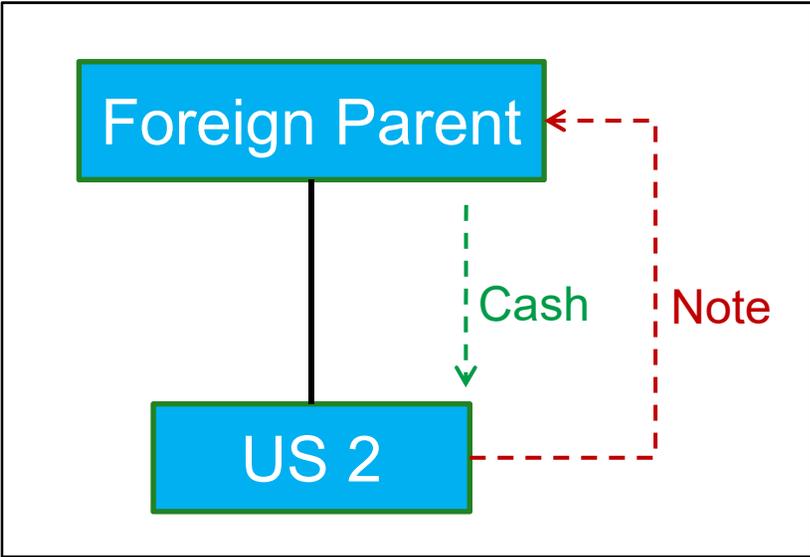
## Transactions Potentially Subject to Recharacterization under Section 385 Regulations

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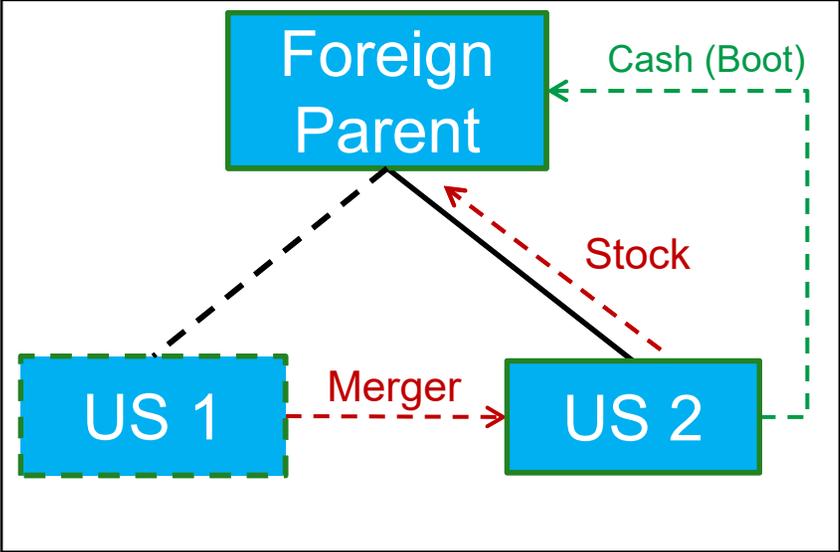
- Funding Rule Scenario 3
  - Foreign parent (“Parent”) owns US groups “US1” and “US2”
  - Parent loans cash to US2 in exchange for a note from US2
  - Within 3 years (before or after), US1 merges into US2, providing that cash as boot in the merger
    - End result: In effect, US1 has merged into US2 with the note as boot, as in General Rule Scenario 3

# ILLUSTRATION

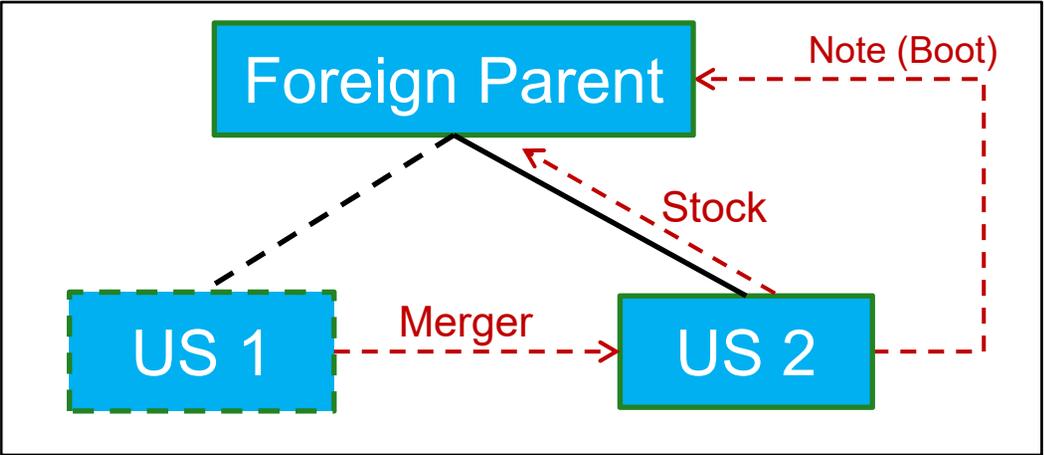
## Funding Rule – Scenario 3



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## Exceptions to the Recharacterization Rules

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- **Exceptions** *(discussed further in subsequent slides)*
  - Reduction for qualified group earnings
  - Reduction for qualified contribution
  - De minimis
  - Qualified short term debt
  - Certain acquisitions of subsidiary stock
  - Acquisitions of compensatory stock

## Exceptions to the Recharacterization Rules

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- Exception 1: Reduction for Qualified Group Earnings
  - In general: The amount of debt otherwise recharacterized under the general rule or funding rule with respect to a covered member is reduced by the expanded group earnings account (“Expanded Group Earnings”) of the covered member.
    - Expanded Group Earnings of a covered member are only those earnings that are accumulated while they were a member of the expanded group (but only after April 5, 2016).
  - Theory is that the E&P is being distributed, and the cash from the debt issuance remains with the borrower
  - Additional rules as to what earnings qualify

## Exceptions to the Recharacterization Rules

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- Exception 2: Reduction for Qualified Contribution
  - In general: The amount of debt otherwise recharacterized under the general rule or funding rule with respect to a covered member is reduced by the aggregate fair market value of the stock issued by the covered member in one or more qualified contributions.
  - Generally, a qualified contribution is property contributed to covered member by a member of the expanded group (except for excluded property) during the 6 year window described in the funding rule.
    - 6 year window does not include period that covered member was not in the expanded group
  - Theory again is that the debt proceeds (or cash fungible with such proceeds) remain with the borrower

## Exceptions to the Recharacterization Rules

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- Qualified Contributions Cont'd – Excluded Contributions
  - Qualified contributions do not include:
    - Upstream contributions from controlled subsidiaries
    - Contributions to a predecessor or successor corporation
    - Contributions that do not increase fair market value of the covered member's outstanding stock
    - Contributions that become excluded as a result of a subsequent transaction (i.e., if a transaction after the contribution would result in one of the above conditions being met)
    - Any contribution that has already been applied to reduce a recharacterization under these rules
    - Contributions of Excluded Property (*see next slide*)

## Exceptions to the Recharacterization Rules

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- Qualified Contributions Cont'd – Excluded Property
  - Excluded Property means:
    - Expanded group stock
    - Property acquired by the covered member in an asset reorganization from a member of the expanded group of which the covered member is a member
    - A covered debt instrument of any member of the same expanded group, including a covered debt instrument issued by the covered member
    - Property acquired by the covered member in exchange for a covered debt instrument issued by the covered member that would itself be subject to recharacterization under the Funding Rule
    - A debt instrument issued by a controlled partnership of the expanded group of which the covered member is a member (including the portion of such a debt instrument that is a deemed transferred or retained receivable)
    - Any other property acquired with principal purpose of avoiding the 385 rules, including an indirect transfer of property described in any of the above

## Exceptions to the Recharacterization Rules

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- Exception 3: De Minimis Exception
  - The first \$50 million of debt that would otherwise be recharacterized is not under a *de minimis* rule.
  - The de minimis exception is not a cliff effect. Thus, even if total that would be recharacterized is over \$50 million, the first \$50 million is not recharacterized.

## Exceptions to the Recharacterization Rules

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- Exception 4: Qualified Short Term Debt
  - Includes four categories:
    - Short-term funding arrangements
    - Ordinary course loans
    - Interest-free loans
    - Cash pool deposits



## Exceptions to the Recharacterization Rules

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- Exception 4: Qualified Short Term Debt
  - Short-term funding arrangements
    - (1) debt instruments with short-term interest rates, to extent of issuer's *specified current assets*
      - *Specified current assets* are assets reasonably expected to be realized in cash or sold (including by being incorporated into inventory that is sold) during the normal operating cycle of the issuer, other than cash, cash equivalents, and assets that are reflected on the books and records of a qualified cash pool header
    - or
    - (2) debt instruments with short-term interest rates if issuer is a net borrower from lender for less than 270 days during a taxable year

## Exceptions to the Recharacterization Rules

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- Exception 4: Qualified Short Term Debt
  - Ordinary course loans
    - Debt instruments issued for acquisition of property in ordinary course of issuer's trade or business that are reasonably expected to be repaid within 120 days

## Exceptions to the Recharacterization Rules

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- Exception 4: Qualified Short Term Debt
  - Interest-free loans
    - Debt instruments with no stated interest, OID, or imputed interest
      - Eliminates the potential interest rate arbitrage that is a major concern of the 385 regulations

## Exceptions to the Recharacterization Rules

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- Exception 4: Qualified Short Term Debt
  - Cash pool deposits
    - Demand deposits with a ‘qualified cash pool header’
      - Generally an expanded group member, controlled partnership, etc. with principal purpose of managing cash for participating expanded group members
  - In general, qualified short-term debt exceptions are intended to permit cash management techniques that lack any tax motive

## Exceptions to the Recharacterization Rules

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- Exception 5: Certain Acquisitions of Subsidiary Stock
  - Acquisitions of expanded group stock from a direct or indirect subsidiary are not considered to be defunding transactions, where:
    - Acquirer controls the member whose stock it acquires and does not relinquish control pursuant to a pre-existing plan (as of the date of acquisition)
      - Control means the direct or indirect ownership of more than 50 percent of the total combined voting power of all classes of stock of the corporation entitled to vote and more than 50 percent of the total value of the stock of the corporation.
      - For purposes of the preceding sentence, indirect ownership is determined by applying the principles of section 958(a) without regard to whether an intermediate entity is foreign or domestic.
    - Rebuttable presumption that there was a plan if control is relinquished within 36 months of acquisition

## Exceptions to the Recharacterization Rules

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- Exception 6: Acquisitions of Compensatory Stock
  - Acquisitions of stock to be used as equity compensation for individuals that are employees/directors, or independent contractors as consideration for the provision of services

## Exceptions to the Recharacterization Rules

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- Other Exceptions
  - Exclusion for distributions or acquisitions resulting from transfer pricing adjustments
  - Exclusion for acquisitions of expanded group stock by a dealer in securities
  - Exclusion for certain acquisitions of expanded group stock resulting from application of this section

## Transactions Potentially Subject to Recharacterization under Section 385 Regulations

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- Funding Rule Transactions
  - Rule is designed to prevent situations where the debt proceeds “fund” a transaction that would, if undertaken for a note, have been covered by the general rule
  - In other words, if you can’t do it directly, you can’t do it indirectly

# Debt vs. Equity

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# Rules Specific to Consolidated Groups

- The 2020 Final Regulations generally treat a single consolidated group as a single corporation for purposes of the Distribution Regulations
- A debt instrument issued by a member to a non-member is treated as issued by the consolidated group
- The “consolidated group debt” rule of Treas. Reg. 1.385-4(b)(1) provides that indebtedness between members of a consolidated group, as well as distributions and acquisitions that are wholly within a consolidated group, are disregarded

# Rules Specific to Consolidated Groups

- The funding rule can treat the debt instrument as funding a distribution and recharacterize the debt instrument if
  - 1) a corporation within a consolidated group issues a debt instrument to a corporation that is not a member of the consolidated group; and
  - 2) both corporations are members of the same expanded group; and
  - 3) a second member of the consolidated group makes a distribution to another expanded group member

# Rules Specific to Controlled Partnerships

- The 2020 Final Regulations generally treat a controlled partnership as an aggregate of its partners
- A controlled partnership is a partnership for which at least 80% of the interests in partnership capital or profits are held directly or indirectly by expanded group members
- A debt instrument issued by a controlled partnership is not recharacterized as stock; rather, the 2020 Final Regulations treat the holder of such instruments as exchanging the debt instrument for stock of the controlled group partners
- In other words, the actions of the partnership are deemed to be conducted by the partners, which could lead to triggering recharacterization

# Potential State Tax Considerations

- Almost every state having a corporate income tax begins the calculation of state taxable income with federal taxable income, either before or after federal net operating losses and special deductions
- The state will then apply various addition and subtraction modifications to such federal taxable income related to various items of federal income, gain, loss, and deductions
- States generally conform to the IRC as of a specific date or to part of the Code and adopt some Treasury Regulations provided they conform to state tax rules
- The manner of a state's conformity to the Internal Revenue Code will be an important consideration as a threshold matter when determining whether and how a state conforms to the Section 385 regulations

# Potential State Tax Considerations

- The key factor will be whether the specific state conforms to federal consolidated return rules
- Certain states require a company included in a consolidated return to calculate its federal taxable income as if it filed a separate federal return (a “pro-forma” return)
- If a state has the “as if” rule for state tax purposes and also conforms to the Section 385 regulations, the one corporation rule in the consolidated group rules may apply for federal tax purposes but not state income tax purposes resulting in potential complications