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# Proposed Regulations to Treat Debt as Stock

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Internal Revenue Code (Code) section 385(a) authorizes Treasury to prescribe regulations "to determine whether an interest in a corporation is to be treated for purposes of [title 26] as stock or indebtedness (or as in part stock and in part indebtedness)." Section 385(b) sets forth factors that may be included in regulations distinguishing creditors from shareholders, and section 385(c) generally requires the holders of an instrument issued by a corporation to treat that instrument consistently with the issuer's characterization of the instrument as stock or debt. Section 385 (apart from subsection (c)) has been a dead letter since its enactment in 1969; regulations issued in 1980 were withdrawn in 1983 (without coming into effect), and no further regulations were proposed until earlier this month.

On April 4, the Internal Revenue Service and Treasury issued a notice of proposed rulemaking (REG-108060-15) setting forth Proposed Regulations under section 385. The Proposed Regulations would characterize certain debt instruments issued by corporations (or certain related non-corporate entities) to related persons as stock for federal tax purposes. The Preamble suggests that the Proposed Regulations' underlying rationale is found in statements in IRS Notices 2014-52 and 2015-79 to the effect that Treasury and the IRS were considering "guidance to address strategies," such as corporate inversions, "that avoid U.S. tax on U.S. operations by shifting or 'stripping' U.S.-source earnings to lower-jurisdictions, including through intercompany debt." However, the Proposed Regulations are not limited to cross-border transactions, and they apply to many situations involving exclusively domestic parties.

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**Related v. Unrelated Parties**

The Proposed Regulations do not provide rules to distinguish between debt and equity where the debtor and creditor are unrelated. Rather, they focus on debt issued to a related party, and in particular on debt issued by one member of an "expanded group" to another member.

"Expanded group" is defined by reference to the term "affiliated group" as defined in the rules governing consolidated income tax returns, but members of an "expanded group" also include types of corporations which are generally not includible in affiliated groups filing consolidated returns, such as foreign corporations, tax-exempt corporations, REIT's and RIC's, and certain insurance companies. Further, a corporation is a member of an expanded group if 80% of the vote *or* value of its stock is owned by expanded group members, rather than 80% of vote *and* value as is generally required under the consolidated return rules; and a corporation may be included in an expanded group if a sufficiently large percentage of its stock is owned indirectly by other members through a controlled partnership. An instrument issued by one member of an expanded group and held by another member of the same group is an "expanded group instrument," or "EGI." For purposes of some of the rules, a broader construct, a "modified expanded group" defined generally by reference to 50%, rather than 80%, stock ownership, is used.

**Types of Potential Recharacterization**.

The Proposed Regulations characterize certain interests that are, in form, debt instruments as equity in specified contexts. They would also provide authority to the IRS to characterize a debt instrument as part-debt and part-equity. However, the Proposed Regulations cannot, by their terms, be used by an issuer or holder to justify a part-debt, part-equity treatment. They do not provide for recharacterization of any interest that is equity in form as debt for tax purposes. And they provide little guidance as to when a debt instrument will be determined by the IRS to be part-debt, part-equity, other than to state that the determination will be made under general tax principles. If, for example, IRS analysis supports a "reasonable expectation" that, as of the time of the issuance of an EGI, only a portion of the principal would be repaid, and if general tax principles supported a bifurcated analysis, the IRS could make a determination that the instrument should be treated as debt in part and stock in part. The part-debt, part-equity characterization may be made under these rules if the issuer and the holder of the instrument were members of the same modified expanded group.

**Documentation Requirements for Treatment of EGI as Debt**

Additional rules apply in respect of an EGI if any one of the following tests is met: (i) any member of the expanded group has stock traded on an established securities market; (ii) at the time the applicable instrument first becomes an EGI, total assets exceed $100,000,000 on any "applicable financial statement"; or (iii) at the time the applicable instrument first becomes an EGI, annual total revenue exceeds $50,000,000 on any applicable financial statement. An "applicable financial statement" includes a certified audited financial statement of any member of the expanded group that is used for credit purposes, reporting to shareholders, or any other substantial non-tax purpose, or any other financial statement (other than a tax return) of an expanded group member that is required to be provided to a government agency.

If one or more of these tests is met, an EGI will generally be treated as stock for tax purposes unless certain documentation is prepared contemporaneously with the making of the loan and maintained thereafter. The required documentation includes: documents to establish that the issuer has entered into an unconditional and legally binding obligation to pay a sum certain on demand or at one or more fixed dates;[1] and documents that must "establish that the holder has the rights of a creditor to enforce the obligation," with such creditor's rights described as including the rights to declare a default upon the non-payment of interest or principal when due, to accelerate the remaining indebtedness, and to sue the issuer to enforce payment.

There must also be documentation, such as cash flow projections, business forecasts, or asset appraisals, establishing that, at the time the instrument was issued, the issuer's financial position supported a reasonable expectation that the issuer would be able to meet its obligations under the instrument. If the issuer fails to timely pay interest or principal, there must be documentation that the holder reasonably exercised the diligence and judgment of a creditor in seeking to collect on the debt. The documentation must be prepared contemporaneously with the issuance of the debt or the event of default, and maintained until the period of limitations expires for any return with respect to which the treatment of the EGI is relevant.

Special rules apply where a debt instrument is issued by a disregarded entity, or issued or held by a controlled partnership, that is included within the expanded group.

The threshold requirements described above (and certain other rules noted below) do not apply where the holder and the issuer of an applicable instrument are members of a "consolidated group"—that is, a group filing a consolidated return. More specifically, for purposes of the Proposed Regulations, members of the consolidated group are treated as one corporation. An applicable instrument issued by one member of a consolidated group to another may have to be evaluated for potential treatment as equity under the Proposed Regulations, however, if the holder and issuing members cease to file a consolidated return but remain part of the same expanded group.

**Disregarded Entities and Partnerships**

Special rules apply if a disregarded entity (that is, a business entity that is disregarded as an entity separate from its owner for federal tax purposes) or controlled partnership (80% or more of the interests in the capital or profits of which are owned by members of an expanded group) is the issuer of an EGI. If the EGI is recharacterized as equity, it is treated as an equity interest in the disregarded entity (thereby creating a partnership, possibly) or controlled partnership.

**Additional Requirements**

Additional rules—a "general rule" and a "funding rule"—apply if the aggregate adjusted issue price of all debt instruments held by members of the expanded group, and that would otherwise potentially be subject to recharacterization under these rules, is more than $50,000,000.

Under the general rule, a debt instrument issued by a corporation to a member of the corporation's expanded group may be recharacterized as stock if it is received: (i) in a distribution; (ii) in exchange for stock of another member of the expanded group (including acquisitions of so-called "hook stock"), subject to certain exceptions applicable to certain transfers of property to a corporation in exchange for its stock, where the transferor has a greater than 50% interest in the transferee for a specified period; or (iii) in exchange for property in certain asset-type reorganizations. For example, if a corporation distributes its debt instrument to a shareholder that is a member of the corporation's expanded group, but not a member of its consolidated group, that note will be characterized as equity for tax purposes (overriding well-established case law referenced in the Preamble that respects such debt instruments as debt).

Under the "funding rule," a debt instrument will be characterized as equity to the extent it is issued by a corporation to another corporation in exchange for property, with "a principal purpose" of funding certain distributions or acquisitions of property within the expanded group. For example, if corporation X, wholly owned by parent corporation P, lends cash to corporation Y, also wholly owned by P; Y makes a cash distribution to P within a specified time interval; and the debt instrument for the loan by X to Y was issued within the 72-month period beginning 36 months before the distribution, that debt instrument will generally fail the principal purpose test and be recharacterized as equity absent the applicability of the consolidated group rule or one of the other exceptions referenced in the Proposed Regulations. The Proposed Regulations also include an anti-abuse rule to characterize a debt instrument issued with a principal purpose of avoiding these rules as stock.

For these purposes, a controlled partnership may be treated as an aggregate of its partners, such that each partner that is a member of the expanded group is treated as issuing its proportionate share of any debt instrument issued by the controlled partnership. The regulations also include complex rules to deal with circumstances where a debt instrument is transferred outside a consolidated group or becomes a consolidated debt instrument.

**Effective Dates**

The Proposed Regulations are proposed to apply, generally, to debt instruments issued after April 4, 2016; however, if a debt instrument is issued before final regulations are published, it will not be recharacterized as equity under the new rules until 90 days after final regulations are published. The documentation requirements will apply, generally, to debt instruments issued or deemed issued after final regulations are published. Of course, existing law may apply to recharacterize a debt instrument issued at any time.

**Observations**

The Preamble refers more than once to an intention to impose “discipline” on related parties that enter into lending transactions with each other, sometimes with a view to minimization of income tax obligations. The choice of words and overall tone of the Preamble suggests that such transactions are perceived as inherently suspect and potentially deserving of punishment. Regardless of the intent, it seems likely that the Proposed Regulations will discourage related party loans and may force related parties to contemplate (more expensive) borrowings from third parties as a possible means of avoiding the more onerous rules. The rules relating to documentation of loans seem to promise more work for attorneys and other professionals. Whether any of such results were contemplated by Congress in adding section 385 to the Code is far from clear.

[1] It seems unlikely that this requirement is intended to narrow the types of debt instruments that may be treated as debt for tax purposes so as to exclude, for example, debt instruments with payment dates that are determined by reference to future circumstances and therefore not fixed when the debt is issued. The wording of this requirement is, however, troubling.