THE NEW SECTION 385 DEBT-EQUITY REGULATIONS—WHO'S IMPACTED AND WHAT DOES IT MEAN FOR THE REST OF US?

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On October 21, 2016, Treasury and the IRS published an extensive package (518 pages!) of final, temporary and proposed regulations under Section[1] 385 addressing debt issued among highly related parties (the "new regulations").[2] The tax practitioner community was, or at least should have been, largely relieved as these rules omitted or pared back many of the more controversial aspects of the proposed regulations on which they were based.[3] The new regulations, in important part, limited the reach of these rules to apply only to relatively large multinational enterprises and to debt issuers that are domestic entities. Thus, these new regulations should now directly impact a much narrower group of taxpayers and their tax advisors.

Of course, the release of the new regulations preceded the 2016 general election. With the new Trump administration and Republicans controlling both the Senate and the House, the future of the new regulations in their current form is uncertain. House Ways & Means Chairman Brady has repeatedly stated that one of his primary objectives is to have the new regulations removed if tax reform does not replace the existing regime for taxing capital investments. President Trump has also ordered the Treasury secretary to review all "significant" tax regulations issued on or after January 1, 2016, to determine which, if any: (1) impose an undue burden on U.S. taxpayers; (2) add undue complexity to the tax laws; or (3) exceed the statutory authority of the IRS. Executive Order 13789 § 2(a) (2017). Treasury has recently identified the new regulations (among others) as significant for this purpose, and is currently soliciting comments to inform its final report recommending specific actions to mitigate the burden imposed by the identified regulations to be submitted to the President by September 18, 2017. Notice 2017-38, 2017 WL 2899737 (July 8, 2017). The administration may respond to the Treasury secretary's recommendations by delaying, modifying or revoking regulations.

This article, however, does not seek to read the political tea leaves to divine what portion of the new regulations will survive, if any. Nor does it seek to provide a comprehensive description of all aspects of the new regulations.[4] Rather, it provides a high-level review of the new regulations to focus on the impact that they have on the existing judicially-developed tests for distinguishing debt from equity for tax purposes. In this way, this article also assesses the potential implications for debt instruments not explicitly subject to the new regulations under their current form based on the government's concerns that prompted these new rules.

U.S. TAX INCENTIVES FOR DEBT CAPITAL

Before delving into the new regulations and the preexisting rules for distinguishing debt from equity for tax purposes, it is useful to review how the tax law treats these different forms of capital investment. Debt financing is generally considered the tax-favored form of financing. Subject to certain limitations and exceptions,[5] the issuer (debtor) deducts interest payments or accruals on debt and the investor (lender) recognizes interest income that is taxed as ordinary income. Generally, neither the lender nor debtor is subject to tax on payments treated as repayments of principal for tax purposes. For an equity financing, in contrast, the issuer (stock issuer) may not deduct payments to the investor (stockholder) in respect of the stock and the stockholder generally recognizes income from the distribution under the Section 301/302 dividend and redemption tax regime.

The preference for debt financing may be particularly acute for foreign parented multinational enterprises.[6] For example, debt issued by a U.S. subsidiary to its foreign parent has the potential to reduce the

effective worldwide tax rate imposed on U.S. earnings. The interest paid by the U.S. subsidiary would create a deduction offsetting its U.S. taxable income. This interest payment would not be subject to a significant rate of U.S. withholding tax (assuming the foreign parent resides in a U.S. treaty jurisdiction) and the foreign parent would presumably be subject to a lower rate of taxation in its jurisdiction upon receipt. Moreover, repayment of principal is not subject to U.S. withholding tax. This sort of practice is referred to as "earnings stripping" because U.S. earnings are effectively removed or "stripped" out of the relatively high corporate tax rate U.S. jurisdiction to a lower tax rate foreign jurisdiction. This debt financing earnings stripping benefit is not available for an equity financing—the payment to a shareholder on capital stock does not produce a deduction for the paying corporation and the payment may be subject to U.S. withholding tax on dividends, which is generally imposed at a higher rate under U.S. tax treaties than on interest payments.[7]

International affiliates have employed various methods to establish these types of debt financing structures to facilitate outbound earnings stripping. One of these methods has involved a U.S. subsidiary distributing its promissory note to its foreign parent in respect of its stock. The distribution of the note may not be subject to significant taxes, either by operation of the U.S. tax laws[8] or under reduced treaty withholding rates. Subsequent payments of interest under the notes would have the earnings stripping effect as detailed above. Thus, this type of note distribution and economically similar transactions have the potential to create an earnings stripping arrangement merely through documentation and tax and accounting reporting and without an economic infusion of capital into the U.S.

SECTION 385 AND COMMON LAW DEBT-EQUITY FACTORS

Given the importance of the distinction in tax treatment between debt and equity, it is hardly surprising that debt-equity characterization issues have often been the subject of disputes between taxpayers and the IRS, particularly in the related party context. Courts have accordingly long wrestled with problems inherent in these disputes: classifying a broad variety of financial instruments in a binary fashion (that is, as "debt" or "equity"). As explained by one notable commentator,

> The crux of the classification problem is that "debt" and "equity" are labels for the two edges of a spectrum, between which lie an infinite number of investment instruments, each differing from its nearest neighbors in barely perceptible ways. At one end of the spectrum is what is sometimes called straight or classic debt—"an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or the lack thereof." At the other end of the spectrum is "equity," which has not generated a similarly classic definition, but which connotes an unlimited claim to the residual benefits of ownership and an equally unlimited subjection to the burdens thereof. It has been said that "[t]he stockholder's intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it, so that he may enjoy the chances of profit."
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> Moving toward the center of the spectrum, away from both the classic definition of "debt" and the more vague concept of equity, there exist, in the corporate context, such financial phenomena as (1) debentures that are entitled to a share of the issuing corporation's profits and are subordinated to the claims of general creditors, (2) preferred stock that is entitled to receive a fixed return if earned and is to be redeemed at a specific price, and (3) a host of other instruments with similarly blended characteristics.[9]

Prompted by "the uncertainties and difficulties which the distinction between debt and equity has produced in numerous situations,"[10] Congress enacted Section 385 under the Tax Reform Act of 1969 to authorize Treasury to prescribe regulations to determine whether an interest in a corporation is treated as stock or indebtedness for tax purposes. Congress, in Section 385(b), also mandated that these regulations would set forth factors to be taken into account for making a debt-equity determination, which could include the following five judicially derived factors (among others): (1) 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 interest; (2) whether there is subordination or preference over any indebtedness of the corporation; (3) the ratio of debt-to-equity of the corporation; (4) whether

there is convertibility into stock of the corporation; and (5) the relationship between holding of stock in the corporation and holding of the financial interest at issue. Treasury promulgated such regulations in 1982 expanding the list of debt-equity characterization factors, but those regulations were withdrawn in 1983 due to criticism from both taxpayers and practitioners.

As a result, the factors to be considered in determining whether a financial instrument should be classified as debt or equity for tax purposes has continued to be determined by case law. Different courts have articulated various factor-based tests for conducting a debt-equity classification facts and circumstances analysis.[11] These tests generally incorporate variations on the factors set forth in Section 385(b), and often include different formulations of the following factors: (1) the presence or absence of a reasonable fixed maturity date; (2) the source of payments; (3) whether the holder of the instrument has a traditional creditor's ability to enforce payment of principal and interest; (4) whether the corporate recipient is "thinly" or inadequately capitalized; (5) the intent of the parties and labels used in the documents evidencing the instrument; (6) whether payments on the instrument are subordinate to the claims of regular creditors of the corporate recipient; (7) whether the instrument is held by shareholders and, if so, whether such holdings are proportionate to share ownership; (8) whether there is increased participation in management of the corporate recipient as a result of the advance; and (9) whether outside investors would have made similar advances. The weight to be accorded to each factor depends on each unique situation and no one factor is determinative.[12] However, certain courts have expressed the factors as inherently focused on whether the parties' arrangement reflects an objective intent to create an indebtedness relationship, particularly as it relates to a reasonable expectation of repayment regardless of the success of the issuer's business.[13]

Congress revisited Section 385 when it amended Section 385(a) and added Section 385(c) pursuant to the Omnibus Budget Reconciliation Act of 1989. In doing so, Congress clarified in Section 385(a) that the regulations to be issued under Section 385 could specify that an interest in a corporation could be characterized as "in part stock and in part indebtedness" in addition to a stock *or* debt characterization. Section 385(c) provides that the issuer's initial characterization of an instrument upon issuance as stock or debt is binding on the issuer and on the instrument's holders, but not on the government. Section 385(c) also authorizes Treasury to require such information as it determines is necessary to carry out the provision.

Both Congress and successive administrations remained silent on Section 385, again leaving the judiciary to make distinctions in the area of debt versus equity determinations until Treasury and the IRS released the proposed regulations under Section 385 discussed below.

THE PROPOSED REGULATIONS

On April 4, 2016, Treasury and the IRS released proposed regulations under Section 385 on the same day they released separate temporary regulations under Sections 7874 and 367 attempting to curtail and limit the benefit of certain inversion transactions[14] and post-inversion earnings stripping practices. It was therefore initially assumed that the Section 385 proposed regulations would specifically target earnings stripping structures associated with debt issued by U.S. issuers to foreign lenders, similar to the existing Section 163(j) interest deduction suspension rules.[15] However, a deeper dive into the proposed regulations reflected a paradigm shift in the government's approach to related party debt.

The proposed regulations uniformly would have applied to U.S. and foreign debt issuers so that they could have affected cross-border, U.S.-to-U.S. and even to foreign-to-foreign issued debt. The proposed regulations were organized into three main provisions – the bifurcation rule set forth in 1.385-1(d), the "Documentation Rules" set forth in 1.385-2 and the "Transaction Rules" set forth in 1.385-3. Under each of these provisions, purported debt issued among related parties could be recharacterized as equity, often under an automatic, *per se* determination. The Documentation and Transaction Rules, the current versions of which are discussed in greater detail below, generally would have applied only to relatively large, highly-related issuers and holders of purported debt instruments based on an 80% affiliation threshold. In contrast, the bifurcation rule, which would have explicitly permitted the IRS to treat purported debt as in part indebtedness and in part stock to the extent supported by a debt-equity analysis as of the issuance date, required only 50% affiliation between the issuer and holder and could have applied to all persons regardless of size, including individuals.

Overall, the proposed regulations reflected the government's frustration with the development of the debt-equity common law, especially after a number of high profile losses litigating the issue.[16] The bifurcation rule expressed dissatisfaction with the courts' general all-or-nothing approach for characterizing a financial instrument as either debt or equity. The Documentation Rules introduced a mechanism to address the factual complexity often involved in related party debt-equity issues by requiring taxpayers to fully develop and produce written evidence of their arrangement. And, through the Transaction Rules, the government effectively tried to shut down certain related party debt structuring practices it viewed as abusive.

THE NEW REGULATIONS

After receiving an avalanche of industry and practitioner comments and withstanding attacks on the issue from Capitol Hill, Treasury and the IRS published the new regulations on October 21, 2016 that significantly narrowed the scope of the proposed regulations. Importantly, the new regulations now do not address debt instruments issued by foreign persons (by reserving on the issue)—only U.S. entity-issued debt instruments are subject to the rules. Therefore, the new regulations more narrowly align with the anti-earnings stripping objectives assumed at the time the proposed regulations were originally released. The new regulations also remove the bifurcation rule (by reserving on the issue) and generally no longer apply to S corporations, RICs and REITs.[17]

Consequently, and since the new regulations (like the proposed regulations) do not apply to debt issued among U.S. consolidated group members, the new regulations generally target debt issued by larger U.S. taxpayers to their foreign affiliates. In the parlance of the new regulations, these new rules may apply to debt issued by a "covered member," a domestic corporation, to a member of its "expanded group" or "EG." EG membership is determined under an 80% vote or value ownership affiliation test, incorporating indirect and constructive ownership attribution rules.

For subject debt instruments, the new regulations establish two sets of rules that can result in the automatic recharacterization of the debt as equity (stock): (1) the Documentation Rules and (2) the Transaction Rules.[18] These rules, however, do not provide a safe harbor for debt tax treatment. Purported debt instruments not characterized as equity under the Documentation Rules or the Transaction Rules must still pass muster under the existing factor-based judicial analysis to qualify as debt for tax purposes.

The Documentation Rules

The Documentation Rules set forth in 1.385-2 reflect a set of document preparation and maintenance requirements for certain debt instruments issued by a covered member of an EG to another member of the EG (an "expanded group interest" or "EGI") to be respected as indebtedness for tax purposes. The stated intent of the Documentation Rules in the preambles to the proposed and new regulations is "to impose discipline on the legal documentation and economic analysis supporting the characterization of an interest as indebtedness for federal tax purposes" consistent with third-party debt. The government concedes, however, that the Documentation Rules are also intended to require a contemporaneously created record for related party debt that may be reviewed on audit or by a court in the course of litigation.

Initially, it is important to define the boundaries of taxpayers and debt potentially subject to the Documentation Rules. Only relatively large affiliated EGs may be subject to the rules based on whether the stock of any EG member is publicly traded, or whether one or more applicable financial statements for an EG member or multiple EG members report total assets in excess of $100 million or annual total revenue in excess of $50 million. Unlike under the proposed regulations, debt issued by a partnership is generally excluded from the Documentation Rules.[19] The Documentation Rules apply to a broad set of indebtedness arrangements, including revolving credit facilities, cash pool agreements and open account obligations, whether documented as debt in a ledger, accounting system, open account intercompany debt ledger, trade payable or journal entry. Debt issued among consolidated group members is disregarded for purposes of the Documentation Rules while it retains such intra-group status.

For subject EGIs, the Documentation Rules require the parties to prepare and maintain documentation satisfying four categories derived from the Section 385(b) and judicial debt-equity factors. First, documentation must show an unconditional and legally binding obligation for the issuer to pay a fixed or determinable sum certain on demand or at one or more fixed

dates. Second, the documentation must reflect sufficient creditor's rights to enforce this obligation. For this purpose, typical creditor's rights include (but are not limited to) the right to trigger an event of default or acceleration of the EGI for failure to make timely required payments and the right to sue the issuer to enforce payment. The documented creditor's rights must include a superior right to capital stock holders to share in the assets of the issuer upon its dissolution. Creditor's rights provided by local law are taken into account so long as the written documentation refers to the relevant applicable jurisdiction.

The third factor is that the documentation must establish that, as of the issuance date, the issuer's financial position supported a reasonable expectation that the issuer intended to, and would be able to, meet its obligations pursuant to the terms of the EGI. The new regulations generally require documentation of diligence consistent with a third-party lending arrangement. The regulations mention that this documentation may include cash flow projections, financial statements, business forecasts, asset appraisals, determination of debt-to-equity and other relevant financial ratios of the issuer in relation to industry averages, and other information regarding the sources of funds enabling the issuer to meet its obligations pursuant to the terms of the debt. Documented credit support analysis for nonrecourse debt must include information on any cash or other property securing the debt. The new regulations relax the documentation requirement (as compared to the proposed regulations) for multiple debt instruments issued under a "master" credit agreement, such as a revolving credit facility or cash pooling agreement, by obligating the parties to prepare a single documented credit analysis for all debts issued under the agreement on or after the date of the analysis through the end of the taxable year.

Finally, parties to an EGI must document actions evidencing a debtor-creditor relationship, such as payment of interest or principal (including through the netting of payables or receivables on EGI centralized cash management system journal entries) or the reasonable exercise or non-enforcement of creditor's rights in the event of an issuer default. The issuer default-related documentation must reflect that the EGI holder is continuing to act in the capacity as a creditor. Most notably, if the holder does not enforce its creditor rights, there must be documentation that supports the holder's decision as being consistent with the reasonable exercise of the diligence and judgment of a creditor.

The new regulations relax the document timely preparation requirement by replacing the proposed regulations' general 30-day after issuance deadline with one that documentation must be prepared by the filing of the issuer's tax return (including extensions).[20] The new regulations also remove the *per se* equity recharacterization for debt instruments not complying with the documentation requirements in favor of a rebuttable presumption of equity treatment for EGs that are otherwise considered "highly compliant" with the documentation requirements, although this high compliance standard may be difficult to satisfy in practice other than for documentation deficiencies for only a small portion of an EG's intercompany debt issuances. There is also a reasonable cause exception for failure to comply with the Documentation Rules based on the information reporting noncompliance reasonable cause exception, which in pertinent part requires documentation to be prepared within a reasonable time of the parties learning of such failure.

The Documentation Rules apply to debt issued on or after January 1, 2018, delaying the effective date from the publishing of the final regulations date set forth in the proposed regulations.

The Transaction Rules

The "Transaction Rules" set forth in 1.385-3 and 1.385-3T automatically treat debt issued between EG members, called "covered debt instruments" or "CDIs," as part of certain enumerated transactions as stock for all federal income tax purposes other than in determining whether a covered member is a member of a Section 1504 affiliated group. The government intends the Transaction Rules to address certain types of intercompany debt arrangements it finds objectionable because of one overriding feature—the purported debt is not supported by the infusion of capital. As mentioned in the preambles to the proposed and new regulations, the Transaction Rules are devised to attack "extraordinary transactions that have the effect of introducing related party debt without financing new investment in the operations of the issuer."

The particular arrangements subject to the Transaction Rules consist of three "general rule" transactions and three "funding rule" transactions. The three general rule transactions pertain to debt instruments

issued by an EG member to another EG member as part of the following transactions: (1) a distribution; (2) an exchange for EG member stock, other than in an "exempt exchange"[21]; and (3) an exchange for property in an asset reorganization ("A", "C", "D", "F", and "G" reorganizations) to the extent that, pursuant to the plan of reorganization, a shareholder in the transferor corporation that is a member of the issuer's EG immediately before the reorganization receives the debt instrument with respect to its stock in the transferor corporation.

The "funding rule" transactions involve an issuance of a debt instrument by a "funding member" of an EG to a "funded member" of the EG in exchange for property with a principal purpose of funding a transaction described in the general rule. More precisely, the funding rule may apply to the extent a CDI issued for property is considered to fund the following transactions: (1) a distribution of property by the funded member to another member of its EG, other than in an "exempt distribution"[22]; (2) an acquisition of EG member stock, other than an "exempt exchange," by the funded EG member from a member of the same EG in exchange for property other than EG member stock; and (3) an acquisition of property by the funded EG member in an asset reorganization to the extent that, pursuant to the plan of reorganization, a shareholder in the transferor EG member corporation receives Section 356 "boot" with respect to its stock in the transferor corporation.

As described in the preambles to the proposed and new regulations, the government intends these six transactions to address variations of the first general rule transaction, a distribution of a debt instrument by one EG member to another EG member with no capital infusion being made back to the issuer. This simplest iteration of the six Transaction Rule transactions, the government notes, may be used as a tool for inverted and other foreign owned U.S. groups to establish a related party earnings-stripping arrangement without introducing any new capital (in the manner described above). The preambles describe the additional two general rule transactions as variations of and economically similar to a debt distribution—they do not change the ultimate ownership of the EG parties involved and introduce no new operating capital. The preambles indicate that the funding rule is intended to address "transactions that, when viewed together, present similar policy concerns as the transactions that are subject to the general rule." In plain language, the funding rule is a backstop to the general rule prohibiting parties from engaging in a multi-step transaction that has the same economic impact as a general rule transaction.

For purposes of determining whether the funding rule applies (that is, whether a "principal purpose" of the debt was to fund an enumerated transaction), the new regulations retain one of the more controversial aspects of the proposed regulations, the 72-month "*per se* funding rule." This rule automatically treats a debt instrument as funding one of the three funding rule transactions if it is issued during the period beginning 36 months before and ending 36 months after the date of the relevant transaction. The preambles indicate that the government views this *per se* funding rule as appropriate because of the fungible nature of money and the administrative difficulties associated with implementing an alternative approach, such as a tracing rule. A CDI issued as part of a series of transactions not falling within the 72-month *per se* funding rule period may nonetheless be treated as a "principal purpose" funding rule debt instrument based on the underlying facts and circumstances.

The new regulations, however, have lessened the potentially draconian impact of the 72-month *per se* funding rule by providing a list of exceptions applying to "qualified short-term debt instruments." The preamble to the new regulations explains that these exceptions are intended to except from the funding rule certain short-term, cash management and other ordinary course of business related party financings not intended to be caught by the funding rule. The first of these "qualified short-term debt instrument" exceptions applies to a "short-term funding arrangement" satisfying one of two alternative tests, the 270-day test or the specified current assets test (only one of which may be claimed by the issuer in the same taxable year). In order to satisfy the 270-day test, the debt instrument, among other requirements, must have a term of 270 days or less or be an advance under a revolving credit facility or similar arrangement and must bear an arm's length interest rate (based on Section 482 principles). The alternative specified current assets test may be satisfied if the debt instrument, among other requirements, bears an arm's length interest rate (based on Section 482 principles) charged for comparable debt instruments with a term not exceeding the longer of 90 days and the issuer's normal operating cycle.

The second qualified short-term debt instrument category is for "ordinary course loans," which applies to debt instruments issued in the ordinary course of the issuer's trade or business to acquire property other than money that are reasonably expected to be repaid within 120 days of issuance. "Interest-free loans" are the third type of qualified short-term debt instrument and consist of zero interest coupon instruments for which interest is not imputed under the various tax rules, including under the OID regime (Section 127-1275), Section 483, Section 7872 or Section 482. The fourth, and generally most well received when introduced under the new regulations, category of qualified short-term debt instruments is for certain deposits with a qualified cash pool header. This exception applies to deposits with an EG member principally engaged in a cash-management arrangement for other EG members that maintains any surplus balance in the cash pool as either cash or investments in obligations of unrelated persons.

The new regulations include an additional set of exceptions to both the general and funding rules that expands on their versions in the proposed regulations. The first exception that will likely be of principal importance as an initial matter to most taxpayers is the $50 million threshold exception. This provides that a debt instrument will not be treated as stock under the Transaction Rules to the extent that the aggregate amount of the CDIs held by the issuer's EG members that would otherwise be recharacterized as stock under the Transaction Rules (but for this exception) does not exceed $50 million.[23] Another important exception provides that the amount of a covered member's transactions otherwise subject to the general and funding rules is reduced by the issuer's "expanded group earnings account," which are the earnings of the issuer accumulated in taxable years ending after April 4, 2016 while it was a member of the EG with the same EG parent (expanded from the proposed regulations' current year earnings and profits exception).

Unlike under the Documentation Rules, a debt instrument issued by a partnership controlled by EG members (based on 80% interest in profits or capital) may be subject to the Transaction Rules, generally based on treating a partnership as an aggregate of its EG corporate partners. Members of a consolidated group are treated as a single corporation for purposes of the Transaction Rules, thereby excluding intra-group debt from potential Transaction Rule recharacterization unless such debt ceases to be among consolidated group members.

The Transaction Rules apply to taxable years ending on or after January 19, 2017. However, the new regulations retain a controversial feature of the proposed regulations that they may apply to debt instruments issued after the date of the proposed regulations, April 4, 2016.[24]

GENERAL IMPACT ON TAXPAYERS SUBJECT TO THE NEW REGULATIONS

In light of the above, the changes to the proposed regulations reflected in the new regulations mean that these recharacterization rules generally only apply to large multinational enterprises. But, for taxpayers fitting this profile, the new regulations will undoubtedly increase tax compliance costs to mitigate risk to their intercompany debt financing structures.

For these larger multinational enterprises, the Transaction Rules initially shut down the three general rule transactions as a viable means of implementing a U.S.-to-foreign entity intercompany debt financing structure. Beyond this, the greatest impact will be experienced by foreign parented affiliated groups rather than U.S. parented ones. This is because the Section 956 anti-deferral rules for investments by controlled foreign corporations in U.S. property already provides a disincentive for U.S. parent-to-foreign subsidiary outbound debt issuances.[25] More specifically, while it is common practice for foreign affiliates to lend to a U.S. parent on a short-term basis, these loans are typically closed out within 60 days to avoid being included in a Section 956 U.S. property computation.[26] In these situations, the U.S. parent issuer may be able to rely on one of the "qualified short-term debt instrument" exceptions to the funding rule to avoid possible equity recharacterization.

In contrast, foreign parented groups may be particularly impacted by the new regulations. These taxpayers will have to monitor potential funding rule issues associated with any intercompany debt issued by a U.S. affiliate to the foreign parent for property. This may require significant additional diligence and operational controls on the part of large multinational enterprises and their legal and accounting advisors, including to monitor risk of running afoul of the 72-month per se funding rule and maintaining complex running

calculations of the post-April 4, 2016 EG earnings and profits for computing the "expanded group earnings account."

For both of the foreign parented and U.S. parented situations, the parties must comply with the Documentation Rules beginning in 2018. The first two Documentation Rule factors (promise to pay and creditor's rights) may have minimal impact as the large taxpayers subject to these rules will likely already be documenting intercompany payables and receivables in a manner largely satisfying these factors. The second two documentation factors (credit analysis and evidence of payment or non-payment) will most certainly require additional diligence and documentation beyond what related parties are currently producing and maintaining.

BROADER IMPLICATIONS OF THE NEW REGULATIONS

So, what do the new regulations mean for taxpayers not subject to the rules, most notably, by virtue of their more limited size? Does this change the legal analysis for testing their debt? Explicitly no, but it is conceivable that the IRS or a court could reference standards in the new regulations in performing a debt-equity analysis for instruments not subject to the rules. It is worth noting that Treasury and the IRS have expended considerable resources in drafting, publishing and defending a regulation package impacting (by their accounts as stated in the preamble to the new regulations) only 6,300 of the roughly 1.6 million C corporations in the United States (0.4 percent). While the government was justifiably concerned about larger dollar debt-equity disputes given its recent litigation over the issue, it is not unlikely that the government would also prefer other taxpayers not subject to the new rules to similarly follow them. At the very least, the government in the new regulations has staked its position on factors it views as particularly important in conducting a debt-equity analysis for certain types of debt. These "superfactors" are discussed below to determine how the new regulations place additional importance on these factors as compared to how they have been applied by the courts.

Relatedness

The initial, most important superfactor in the new regulations is the relatedness between debtor and creditor. The new regulations generally apply an 80% relatedness threshold test while the prior proposed regulations used a 50% relatedness test for the bifurcation rule to have applied. The preamble to the new regulations notes the government's particular concern for related party debt:

> Related parties do not have the same commercial incentives as unrelated parties to properly document their interests in one another, making it difficult to determine whether there exists an actual debtor-creditor relationship. In addition, because debt, in contrast to equity, gives rise to deductible interest payments, there are often significant tax incentives to characterize interests in a corporation as debt, which may be far more important than the practical commercial consequences of such characterization.

As support for selecting relatedness as a superfactor, the preamble to the proposed regulations quotes PepsiCo Puerto Rico[27] for the proposition that "courts have [consistently] recognized that transactional forms between related parties are susceptible of manipulation and, accordingly, warrant a more thorough and discerning examination for tax characterization purposes."[28] While the Tax Court did address a related party financial instrument (purported equity) in PepsiCo Puerto Rico, this quoted language appears in the sham transaction portion of the opinion rather than the debt-equity analysis portion. This approach by the Tax Court in PepsiCo Puerto Rico largely mirrors how courts have dealt with debt-equity issues for related party financial instruments—they often first analyze whether the purported arrangement should be disregarded as a sham.[29] It is only once the courts clear this hurdle that they arrive at the factor-based debt-equity analysis.

The factor actually applied by the courts in a debt-equity analysis is generally different from a pure relatedness test. Instead, the courts test if a purported loan is advanced to an entity by an equityholder in proportion to its relative equity ownership interest in the borrower; this proportionate funding suggests that the advance is a contribution to capital and not a loan in cases where there is not a 100% parent-subsidiary relationship.[30] Additionally, agreements to maintain purported loans by equityholders in amounts corresponding to their relative equity interests are indicative of equity treatment.[31] The rationale underpinning this factor is the reality "that [equityholders] will usually subordinate or extend their debt-based claims rather

than insist on payment if that action would trigger a bankruptcy proceeding" in which their retained equity would typically become worthless.[32]

Despite the nuance between testing relatedness and testing relative overlap in debt and equity interests, it should not be surprising that the relatedness of parties should be an important factor when viewing the tax treatment of any commercial arrangement, let alone a debt-equity issue. In this matter, general restrictive authorities based on even lower relatedness thresholds are instructive, such as Sections 482, 267 and 163(j), which generally apply a 50% ownership- or control-based relatedness test. As such, applying a heightened standard for supporting indebtedness treatment for related party financial instruments does not superficially appear to expand the existing common law. However, the way that the new regulations establish relatedness as a gateway for a more rigorous review of certain judicial debt-equity factors above others is a significant departure from existing law. The courts have found that relatedness of parties in a debt financing attracts scrutiny, but this scrutiny is applied in performing the traditional formulation of the debt-equity factors.

Documentation/Diligence

The Documentation Rules require evidence of the following: (1) a legally binding obligation for the issuer to pay a fixed or determinable sum certain on demand or at one or more fixed dates; (2) creditor's rights to enforce the debtor's obligation; (3) the debtor's financial position supported a reasonable expectation that the issuer intended, and would be able, to meet its obligations under the terms of the debt; and (4) actions evidencing a debtor-creditor relationship.

The first two documentation categories can be lumped together into a single requirement – there must be written evidence of the purported indebtedness relationship consistent with third-party debt. Courts addressing this factor have found that the lack of documentation for purported debt (such as under an undocumented open account indebtedness arrangement) supports equity treatment, but have not elevated this factor to automatically require equity characterization. [33] For example, the Seventh Circuit in J&W Fence Supply Co. v. United States refuted the government's assertion that lack of documentation inherently supports equity treatment by finding it was equally plausible that debt treatment is supported; that is, the court was not in a position to say that lack of documentation supports either characterization.[34] Thus, it appears (and the preamble to the proposed regulations confirms) that the requirements with respect to the first two documentation categories are more stringent than what has been required by the courts.

The third category unquestionably expands the common law factor test for debt treatment. This requirement effectively forces parties entering into indebtedness arrangements to go through the time and expense of performing a credit analysis supporting certainty of repayment. While this documentation goes to the heart of whether a financial instrument is debt – whether the parties intend and reasonably expect the advance and associated stated interest to be repaid regardless of the fortunes of the issuer—courts have not required contemporaneous documentation to support this intent and expectation. Instead, courts addressing this factor employ more of an objective approach to reviewing intent; that is, was it reasonable for the lender to expect repayment regardless of the success of the debtor.[35]

The fourth Documentation Rule category also broadens the common law standard for enforcement of a purported debt instrument, most notably by requiring the lender to document the reason for not enforcing its rights under the loan agreements. Courts generally test a financial instrument for debt characterization as of the time the instrument is issued.[36] However, certain courts have reviewed subsequent events for related party debt to test the validity of the instrument's characterization based on whether the lender continued to act as a creditor.[37] These courts have not required the parties to document the reasons the lender acted the way it did.

Sum Certain

The Documentation Rules require that a purported debt instrument include an unconditional right to demand a sum certain. This reflects the classic judicial articulation that an indebtedness relationship involves a promise to pay a "sum certain" to the lender.[38] The modern understanding of this factor, however, does not mean that the repayment term must be fossilized upon entry into the arrangement without deviation during the period it is outstanding, but merely that it

effectively constrains an otherwise unlimited upside more indicative of equity. If this factor were not so flexible, all financial instruments with contingent payment terms would automatically be treated as indebtedness rather than equity, a result that is clearly not contemplated by the tax law.[39] The government responded to comments it received to the proposed regulations on this issue, clarifying that debts with contingent payment features did not inherently violate the Documentation Rules. As such, this factor in the Documentation Rules does not appear to expand on the existing common law factor.

Right To Enforce Payment of Principal and Interest

The Documentation Rules require a debt holder to have creditor's rights to enforce the payment of principal and interest. This requirement generally comports with the existing common law, although the courts have not expressed this as a dispositive factor in a debt-equity determination.[40]

Subordination

The Documentation Rules do not respect purported debt that is subordinated to the rights of holders of the issuer's capital stock. Under the common law, if repayment of an advance is subordinated to the claims of general creditors upon liquidation of the issuer, this factor suggests that the advance is a capital contribution rather than a loan,[41] but is not dispositive.[42] The Documentation Rules' requirement that purported debt not be subordinated to capital stock, a less onerous standard than the common law standard referenced in the prior sentence, should not be a surprise and likely does not alter the common law standard.

Thin Capitalization

The Documentation Rule credit analysis requirement, as well as the bifurcation rule of the proposed regulations, implicates the thin capitalization debt-equity factor. The "thin capitalization" of the borrower refers to a relatively high proportionate capital mix of a company's debt as compared to its equity, generally determined on an industry-specific standard.[43] While courts historically have performed a debt-to-equity ratio based analysis for this factor, the more modern judicial approach turns on whether there is evidence of a reasonably certain stream of cash flow sufficient to service the financial instrument in question.[44] The new regulations reflect this more modern view by requiring documentation supporting that the parties reasonably expected the debt to be paid as agreed regardless of the success of the issuer.

New Capital

The Transaction Rules focus on whether a debt issuance introduces new capital into the issuer. This superfactor is best understood as only pertaining to indebtedness among related parties. These rules should not impact debt issuances not supported by an immediate infusion of capital between unrelated parties, such as seller financing of third-party purchase transactions.[45]

In the related party context, the seminal authority respecting indebtedness not supported with an infusion of capital is the Second Circuit's decision in Kraft Foods v. Commissioner[46] (as recognized by the preambles to the proposed and new regulations). This case involved an intercompany debt structure implemented by Kraft Foods during a period in which Congress had abolished consolidated federal tax returns. Kraft Foods issued debentures to satisfy large declared dividends up to its corporate parent ostensibly as a means of achieving an overall tax result mirroring the result under consolidation (to utilize the parent's substantial losses to shelter subsidiary level operating income). After concluding that the parent-subsidiary relationship between the creditor and debtor did not inherently compel stock characterization as a sham transaction, the court found that the lack of new capital for the debt instrument similarly did not support stock treatment where the issued debt instrument in form reflected debt-like characteristics. The court first recognized that conversions of equity into debt are clearly contemplated by the tax law, such as under a nontaxable recapitalization. The court also found that Kraft Food's declaration of a dividend created an enforceable obligation and that the issuance of the debentures to satisfy this obligation should be treated as a distribution and simultaneous borrowing back of funds. The court ultimately ruled in favor of the taxpayer by respecting the form of the transaction: "the debenture is unambiguous and contains all the characteristics of a debt instrument." More recently, the Tax Court in NA General Partnership[47] upheld a related party debt financing without an accompanying infusion of cash capital without even analyzing this particular factor under its debt-equity analysis.

Given this background, the Transaction Rules' elevation of lack of new capital to a dispositive factor certainly alters the common law standard. The new regulations' many exceptions to the Transaction Rules, particularly for ordinary course short-term financing often used to fund working capital needs, provides some level of comfort that the government's emphasis of this factor is really to combat extraordinary transactions as asserted. Absolute confidence on this point, however, is tempered by the 72-month *per se* presumption rule of a bad purpose for a funding transaction and the inability to trace funding debt issuances to particular ordinary course expenditures.

CONCLUSION

The new regulations under Section 385 are generally limited to large multinational enterprises; and, therefore, many taxpayers and tax advisors may not directly be impacted by this set of rules. Despite its lack of reach, however, the new regulations signal the government's general view of related party indebtedness and how the judicially developed debt-equity factors should be applied in these situations. In other words, although the government has stated that it is not attempting to displace the general judicial factor-based analysis for making a debt-equity determination, it inherently has elevated the importance of certain factors for reviewing debt issued between related parties. Although beyond the scope of this article, it is also worth noting that it is uncertain if or how the states will impose the new regulations, particularly in those jurisdictions not permitting consolidated or combined entity tax reporting. The new regulations therefore should be viewed as an important development in the evolving distinction between what constitutes debt or equity for tax purposes regardless of its application in a particular situation.

Thus, parties not subject to the new regulations should strongly consider whether to use them as guideposts for best practices in structuring and documenting their related party debt. The Transaction Rules clearly signal that the government continues to disapprove of certain debt financing arrangements with earning-stripping potential, particularly ones without any accompanying infusion of capital into the issuer. From a practical standpoint, it is advisable for taxpayers to memorialize related party debt arrangements in a manner cognizant of the four Documentation Rule requirement categories and the underlying common law debt-equity factors.

Notes

1 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

2 T.D. 9790.

3 REG-108060-15 (Apr. 4, 2016).

4 For a more in-depth description of the new regulations, see Devon M. Bodoh et al., The Final Debt-Equity Regulations: The Sky is Not Falling, Tax Notes, Feb. 20, 2017, p. 979.

5 See, e.g., Section 163(j) (discussed in footnote 15 below).

6 For U.S. parented groups, debt financing can be deployed as an efficient repatriation strategy.

7 Compare Model Treaty Article 11(1) (generally applying 0% interest withholding rate in source country) with Model Treaty Article 10(2) (generally applying 5% dividend withholding rate in source country for affiliates).

8 For example, the distribution may be made at a time when the U.S. subsidiary has no or minimal earnings and profits out of which a taxable dividend is created under Section 301(c)(1).

9 Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 4.05[1][a], Thomson Reuters/Tax & Accounting (7th ed. 2015).

10 S. Rep. No. 91-552, at 138 (1969).

11 See, e.g., Estate of Mixon v. United States, 464 F.2d 394, 402 (5th Cir. 1972) (listing thirteen factors); Dixie Dairies Corp. v. Comm'r, 74 T.C. 476, 493 (1980) (listing thirteen factors); Fin Hay Realty Co. v. United States, 398 F.2d 694, 696 (3d Cir. 1968) (listing sixteen factors); Hardman v. United States, 827 F.2d 1409, 1411-12 (9th Cir. 1987) (listing eleven factors).

12 See Estate of Mixon, supra, 464 F.2d at 402.

13 See Gilbert v. Comm'r, 248 F.2d 399, 406 (2d Cir. 1957).

14 An "inversion" generally refers to a transaction pursuant to which a U.S. business enterprise is acquired or otherwise restructured so that it becomes owned by a foreign entity. See Section 7874. The government has long sought to limit U.S. companies inverting in manners it perceives as abusive attempts to obtain a tax benefit from the foreign-parented structure (for example, an inversion transaction that does not significantly alter the beneficial ownership or operations of the inverted U.S. companies).

15 Section 163(j) is aimed at debt financing earnings stripping arrangements as it generally limits the deductibility of interest paid to related persons in which all or a portion of such interest is exempt from U.S. taxes. However, this limitation only applies to debt issuers who are thinly capitalized, based on a 1.5-to-1 debt-to-equity ratio.

16 See, for example, PepsiCo Puerto Rico, Inc. v. Comm'r, T.C. Memo 2012-269, and NA General Partnership & Subsidiaries v. Comm'r, T.C. Memo 2012-172, which were both cited in the preamble to the proposed regulations.

17 As described below, partnership issued debt may now generally only be subject to recast under the Transaction Rules and not under the Documentation Rules.

18 There is an additional set of rules in Treas. Reg. § 1.385-4T coordinating these rules for debt instruments becoming and ceasing to be issued among consolidated group members.

19 Partnership issued debt may be subject to these rules only if it is issued with a principal purpose of avoiding the Documentation Rules under Treas. Reg. § 1.385-2(f).

20 This requirement is analogous to the transfer pricing contemporaneous documentation standards. *See, e.g.*, Section 6662(e)(3); Treas. Reg. § 1.482-7(k)(2).

21 An "exempt exchange," as defined in Treas. Reg. § 1.385-3(g)(11), includes an acquisition of EG member stock in which either: (1) in the case of an asset reorganization, either Section 361(a) or (b) applies to the transferor of the EG stock and the stock is not transferred by issuance, or Section 1032 or Treas. Reg. § 1.1032-2 applies to the transferor of the EG stock and the stock is distributed by the transferee pursuant to the plan of reorganization; (2) the transferor of the EG stock is a shareholder that receives property in a complete liquidation to which Section 331 or 332 applies; or (3) the transferor of the EG stock is an acquiring entity that is deemed to issue the stock in exchange for cash from an issuing corporation in a transaction described in Treas. Reg. § 1.1032-3(b).

22 An "exempt distribution," as defined in Treas. Reg. § 1.385-3(g)(10), includes (1) a distribution of stock that is permitted to be received without the recognition of gain or income under Section 354(a)(1) or 355(a)(1), or, if section 356 applies, that is not treated as other property or money described in Section 356; or (2) a distribution of property in a complete liquidation under Section 336(a) or 337(a).

23 This absolute $50 million threshold in the new regulations limits the potential Transaction Rule debt recast even for taxpayers exceeding the threshold, replacing the "cliff effect" version of the provision in the proposed regulations that would have subjected dollar 1 of CDI to the Transaction Rules if the $50 million threshold were exceeded.

24 Under effective date transition rules, for a CDI issued after April 4, 2016 but before January 19, 2017 that would have been treated as stock under the Transaction Rules during this interim period but for the delayed effective date, the CDI (if it is still treated as such at this time) is deemed to be exchanged for stock immediately after January 19, 2017. Treas. Reg. § 1.385-3(j)(1).

25 Section 956(c)(1)(C) treats an obligation of a U.S. person as Section 956 U.S. property potentially included in a U.S. shareholder's gross income pursuant to Section 951(a)(1). See also T.D. 9792 (Nov. 3, 2016) (proposed and final regulations under Section 956 that, in part, focus on transactions between controlled foreign corporations and taxable partnerships, including financing arrangements).

26 See Notice 88-108, 1988-2 C.B. 445; AM 2007-0016 (Sept. 25, 2007).

27 T.C. Memo 2012-269, supra.

28 Id. (citing United States v. Uneco, Inc., 532 F.2d 1204, 1207 (8th Cir. 1976); Cuyuna Realty Co. v. United States, 382 F.2d 298, 301 (Ct. Cl. 1967).

29 See Kraft Foods Co. v. Comm'r, 232 F.2d 118, 123 (2d Cir. 1956) ("Since the sole stockholder can deal as it pleases with the corporate entity it controls, the transaction is not the result of arm's-length dealing. Consequently, it may be a sham." (citing Higgins v. Smith, 308 U.S. 473 (1940)).

30 See Kraft Foods, supra; Hardman, supra, 827 F.2d at 1414. In NA General Partnership v. Comm'r, supra, another related party debt case mentioned in the preamble to the proposed regulations, the Tax Court applied the factor-based test with relatedness (more specifically, identity of interest between creditor and sole shareholder) as an equity-supportive factor. The Tax Court nevertheless found the intercompany notes at issue to be valid debt for tax purposes, importantly imposing a relatively lax standard for the analytically similar factor of whether outside lenders would have made similar advances based on "whether the terms of the purported debt were a 'patent distortion of what would normally have been available' to the debtor in an arm's-length transaction." (quoting Litton Business Systems v. Comm'r, 61 T.C. 367, 379 (1973) (additional citations omitted)).

31 Gilbert, supra, 248 F.2d at 406, 407.

32 Bittker & Eustice, supra, ¶ 4.05[1][c].

33 See American Offshore Inc. v. Comm'r, 97 T.C. 579 (1991); see also Section 1275(a)(1) (definition of debt instrument under OID rules).

34 230 F.3d 896 (7th Cir. 2000).

35 Gilbert v. Comm'r, supra, 248 F.2d at 406 (2d Cir. 1957); Dillin v. United States, 433 F.2d 1097 (5th Cir. 1970).

36 David C. Garlock, Federal Income Taxation of Debt Instruments ¶ 102.2, Aspen Law & Business (2017 ed.).

37 See, e.g., Cuyuna Realty Co. v. United States, supra.

38 See, e.g., Gilbert, supra, 248 F.2d at 402.

39 See, for example, Treas. Reg. §§ 1.1275-4 and 1.1275-5, which inherently respect designated debt instruments with contingent and variable payment terms as debt for tax purposes.

40 Estate of Mixon, supra, 464 F.2d at 405 (citing Campbell v. Carter Found. Prod. Co., 322 F.2d 827 (5th Cir. 1963)).

41 Hardman, supra, 827 F.2d at 1413 ("equity participants take a subordinate position to creditors regarding right to payment upon liquidation.").

42 Jack Daniel Distillery v. United States, 379 F.2d 569 (Ct. Cl. 1967); cf. Treas. Reg. § 1.1361-1(l)(5)(ii) (subordination to other debt does not prevent "straight debt" safe harbor status for S corporation issued debt).

43 See NA General Partnership, supra ("For example, companies with high levels of business risk, such as those in highly uncertain environments (e.g., high-tech) or in cyclical or volatile industries generally cannot bear the risk of significant leverage. The opposite is true generally for companies with low business risk (e.g., utilities).").

44 See Id.

45 See, e.g., Section 108(e)(5); Treas. Reg. §§ 1.1001-1(g); 1.1012-1(g).

46 232 F.2d 118 (2d Cir. 1956).

47 supra.