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Global Tax Alert

US Treasury signals easing of Section 385 distribution rules, eliminates documentation requirements

Executive summary

In final regulations (TD 9880) (issued 31 October 2019), the United States (US) Treasury Department removed the minimum documentation requirements that must be satisfied to treat certain financial arrangements among related parties as indebtedness for federal tax purposes (the Documentation Regulations). The final regulations will be effective immediately upon publication in the Federal Register.

At the same time, Treasury announced in an advance notice of proposed rulemaking (REG-123112-19) that it is contemplating future changes and requesting comments on the so-called Distribution Regulations, which treat certain issuances of a debt instrument in a distribution (or similar transaction) as an issuance of stock. Treasury intends the proposed regulations to apply to tax years beginning on or after the date of publication of the Treasury Decision adopting those rules as final regulations in the Federal Register.

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Detailed discussion

Background

Final, temporary, and proposed regulations under Internal Revenue Code Section 385 were issued in 2016 (the 2016 regulations). Among other things, the 2016 regulations established extensive documentation requirements that had to be satisfied for a debt instrument to constitute indebtedness for US federal tax purposes (Treas. Reg. Section 1.385-2).

In addition, the 2016 regulations contained the Distribution Regulations, which recharacterize a debt instrument issued after 4 April 2016, as stock if the instrument is issued as part of a transaction listed in Treas. Reg. Section 1.385-3. Transactions listed in that section include the issuance of a debt instrument by a US corporation to an expanded group member: (i) in a distribution, (ii) in exchange for related-party stock (with certain exceptions), or (iii) in exchange for property in certain asset reorganizations. The Distribution Regulations include a per se funding rule, which recharacterizes debt as stock if it is issued during the period beginning 36 months before and ending 36 months after a transaction described in (i) – (iii), even if the debt instrument is not itself part of the transaction.

Executive Order 13789 (E.O. 13789), issued on 21 April 2017, instructed Treasury to review all significant tax regulations issued on or after 1 January 2016, and to take concrete action to alleviate the burdens of regulations that: (i) impose an undue financial burden on US taxpayers; (ii) add undue complexity to the federal tax laws; or (iii) exceed the statutory authority of the Internal Revenue Service (IRS). Notice 2017-38 (24 July 2017) included the 2016 regulations in a list of eight regulations identified by Treasury as meeting at least one of the first two criteria specified in E.O. 13789. On 24 September 2018, Treasury released proposed regulations that would withdraw the Documentation Regulations. (See EY Global Tax Alert, *US Treasury and IRS propose removing Section 385 documentation requirements*, dated 25 September 2018 for details.)

Taxpayers have long criticized the Documentation Regulations and Distribution Regulations as overly burdensome and disproportionate to the perceived abuses they were meant to combat. Following the *Tax Cuts and Jobs Act*, many questioned whether the Section 385 regulations are still needed, because several new provisions (such as Sections 267A, 163(j), and 59A) are aimed at reducing opportunities for base erosion.

Final Documentation Regulations

The final regulations adopt the proposed regulations (REG-130244-17) without any changes. In withdrawing the Documentation Regulations in their entirety, the Preamble to the final regulations explains that the burdens imposed by the Documentation Regulations outweighed the benefits.

Proposed changes to the Distribution Rules

While believing that the Distribution Regulations remain necessary, Treasury intends to make the regulations "more streamlined and targeted" by (i) substantially modifying the funding rule, and (ii) withdrawing the 36-month per se rule previously discussed.

In particular, Treasury expects that the proposed regulations would replace the funding rule's per se 36-month period before and after a distribution or similar transaction with a more "facts and circumstances" test. As a result, the proposed regulations are anticipated to treat the debt as stock only if its issuance has a sufficient factual connection to a distribution to a member of the taxpayer's expanded group or an economically similar transaction.

Implications

While the elimination of the Documentation Regulations significantly reduces the burden on taxpayers, those rules drew on the familiar principles of existing case law (such as *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972), and Fin Hay Realty Co. v. United States, 398 F.2d 694 (3d Cir. 1968)) for determining whether an instrument can be appropriately characterized as debt for tax purposes. Taxpayers should use those principles as a guidepost when documenting their intercompany debts. At the time these debts are issued, especially for significant intercompany debt, it would be wise to undertake an economic analysis to establish the borrower's expected ability to repay.

As for the Distribution Regulations, most corporate taxpayers likely welcomed Treasury's indication that it intends to issue proposed regulations that would substantially modify the funding rule, including withdrawing the per se rule. While most taxpayers likely would have preferred the Distribution Regulations to meet the same fate as the Documentation Regulations, the prospect of a funding rule that only applies to debt instruments with a "sufficient factual connection" to a distribution or economically similar transactions sounds less far-reaching than the current rules.

Until such scaled-back reliance regulations are actually issued, however, multinational groups are in a challenging compliance environment: they must continue to monitor, over a rolling six-year period, the timing and amount of covered debt instrument issuances versus the timing and amount of distributions or acquisitions among members of an expanded group. This exercise has been made more challenging by the lack of any currently applicable rules for how to treat consolidated return groups, given the recent expiration of Treas. Reg. Section 1.385-4T.[2]

Once final regulations are issued, it remains to be seen whether taxpayers will be able to establish that a debt issuance is factually distinct enough from a distribution (or similar transaction) to obtain comfort that the debt would not be recharacterized as equity under the funding rule. In any event, because the proposed regulations would only apply for tax years beginning on or after the date the proposed regulations are finalized, taxpayers will likely have to grapple with the per se rule and the other rules in the Distribution Regulations for the foreseeable future.

Endnotes

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. In Notice 2019-58, released 11 October 2019, the IRS announced that taxpayers may continue to rely on the exceptions laid out in the proposed portion of the 2016 regulations (including Treas. Reg. Section 1.385-4T), even though the related temporary regulations expired on 13 October 2019 (See EY Global Tax Alert, *US IRS announces that taxpayers can still rely on expired temporary Section 385 recharacterization rules*, dated 17 October 2019).

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