

US Treasury finalizes proposed Section 385 regulations with no substantive changes, leaves distribution rules in effect for now

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In final regulations ([TD 9897](#)) issued on 13 May 2020 (the 2020 Final Regulations), the United States (US) Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) finalized proposed regulations (81 FR 72751) (the 2016 Proposed Regulations) that provide guidance for applying the Internal Revenue Code¹ Section 385 regulations to qualified short-term debt instruments, transactions involving controlled partnerships and transactions involving consolidated groups.

Background

Overview of the 2016 Regulations

Final, temporary and proposed regulations under Section 385 were issued in 2016. The 2016 regulations contained rules in Treas. Reg. Sections 1.385-1, 1.385-3, 1.385-3T and 1.385-4T (the Distribution Regulations) that recharacterize a debt instrument issued by a domestic corporation as stock if the instrument is issued to a member of the domestic corporation's expanded group: (i) in a distribution; (ii) in exchange for related-party stock; or (iii) in exchange for property in certain asset reorganizations (each, a covered transaction). The Distribution Regulations include a funding rule that recharacterizes as stock a debt instrument issued to a member of the issuer's expanded group in exchange for property (including money) to fund a covered transaction. For

this purpose, a **per se** funding rule treats a debt instrument issued during the period beginning 36 months before and ending 36 months after a covered transaction as funding the covered transaction.

The 2016 Proposed Regulations provided rules on the treatment under the Distribution Regulations of certain qualified short-term debt instruments, transactions involving controlled partnerships, and transactions involving consolidated groups. The 2016 Proposed Regulations cross-referenced identical 2016 temporary regulations, which applied until they expired on 13 October 2019.

Executive Order 13789

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 IRS.

Notice 2017-38 (24 July 2017) included the regulations under Section 385 in a list of eight regulations identified by Treasury as meeting at least one of the first two criteria specified in E.O. 13789. Subsequently, an advance notice of proposed rulemaking (84 FR 59318, published in the Federal Register on 4 November 2019) (ANPRM) announced that Treasury and the IRS intended to propose more streamlined and targeted Distribution Regulations. In particular, the ANPRM indicated that Treasury and the IRS intended to issue prospectively effective proposed regulations substantially modifying the funding rule, including by withdrawing the **per se** rule. The **per se** rule would be replaced with a standard that linked a debt instrument and a covered transaction only when a “sufficient factual connection” between the two existed.

Reliance on the 2016 Proposed Regulations

Following the expiration of the Temporary Regulations on 13 October 2019, Treasury and the IRS announced in Notice 2019-58 (issued 28 October 2019) that taxpayers could rely on the 2016 Proposed Regulations, until further notice, provided that they consistently applied the 2016 Proposed Regulations in their entirety. The ANPRM obsoleted Notice 2019-58 but provided identical reliance guidance. Specifically, the ANPRM permitted taxpayers to rely on the 2016 Proposed Regulations, provided that they consistently applied the 2016 Proposed Regulations in their entirety.

2020 Final Regulations

The 2020 Final Regulations adopt the 2016 Proposed Regulations with no substantive changes. Accordingly, the 2020 Final Regulations include the following rules.

- ▶ *Qualified short-term debt instrument definition.* A qualified short-term debt instrument is exempt from the Distribution Regulations. The 2020 Final Regulations define the term “qualified short-term debt instrument” to include certain short-term funding arrangements, ordinary course loans, interest-free loans and deposits with cash pool headers.
- ▶ *Treatment of controlled partnerships.* The 2020 Final Regulations generally treat a controlled partnership as an aggregate of its partners. For this purpose, 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.
- ▶ *Treatment of consolidated groups.* The 2020 Final Regulations generally treat a single consolidated group as a single corporation for purposes of the Distribution Regulations. The 2020 Final Regulations also provide operative rules for consolidated groups, including for corporations or debt instruments that enter or leave a consolidated group.

The portions of the 2020 Final Regulations relating to qualified short-term debt instruments and the treatment of controlled partnerships apply to tax years ending after 19 January 2017 (and for debt instruments issued after 4 April 2016).

When a consolidated return is filed or is required to be filed, Section 1503(a) generally requires the tax to be determined, computed, assessed, collected and adjusted in accordance with the regulations under Section 1502 “prescribed before the last day prescribed by law for the filing of such return.” Portions of the 2020 Final Regulations on consolidated groups are issued, in part, under Section 1502. Thus, the portions of the 2020 Final Regulations on consolidated groups (primarily Treas. Reg. Section 1.385-4) apply solely to tax years for which a US Federal income tax return is due, determined without regard to extensions, after 14 May 2020.

Implications

The expiration of the 2016 temporary regulations on 13 October 2019, coupled with the delayed applicability date of the 2020 Final Regulations for the consolidated return provisions, results in a “gap period” during which portions of the 2016 Proposed Regulations on consolidated groups are effectively elective. The rules in Treas. Reg. Section 1.385-3 on qualified short-term debt instruments and controlled partnerships (other than when one or more expanded group partners is a member of a consolidated group), by contrast, were finalized retroactively, leaving no gap period for those rules.

The gap period in the consolidated return rules would likely come up more often for taxpayers that use the calendar year as their tax year. For example, the consolidated return provisions of the 2020 Final Regulations apply to tax years beginning on 1 January 2020, for a taxpayer that uses the calendar year as its tax year. Thus, for the portion of 2019 after 13 October 2019, there were no mandatory

consolidated return rules in the Distribution Regulations. Accordingly, while consolidated groups may continue to apply the 2016 Proposed Regulations during this relatively brief period, they are not obligated to do so; presumably other different, reasonable positions could be considered as well for such period.

The 2020 Final Regulations also indicate that Treasury and the IRS continue to study the appropriate approach to making the Distribution Regulations more streamlined and targeted through future proposed regulations. The 2020 Final Regulations offer no additional information as to how, or when, new proposed regulations will be issued.

Any such relief would be prospective, so taxpayers must continue to navigate the current Distribution Regulations for all tax years before the finalization of any future guidance. Until that time, taxpayers must 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.

Endnote

1. All “Section” references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.

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EYG no. 003200-20Gbl

1508-1600216 NY
ED None

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