

US Treasury and IRS propose removing Section 385 documentation requirements

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The United States (US) Treasury Department and Internal Revenue Service (IRS) have issued proposed regulations ([REG-130244-17](#)) under Internal Revenue Code¹ Section 385 that would remove 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 Documentation Regulations were issued in final and temporary regulations published in October 2016.

Background

The Documentation Regulations were initially issued in proposed form as part of a Notice of Proposed Rulemaking published in April 2016 (REG-108060-15) and set forth the threshold level of documentation necessary to avoid per se recharacterization as equity (subject to limited exceptions). The requirements under the Documentation Regulations include a binding obligation to repay the funds advanced, a provision of standard creditor's rights, an initial analysis of the borrower's credit, and, if an event of default was waived, an explanation of why a diligent third-party creditor might decide to do so. Satisfaction of the Documentation Regulations would not guarantee that the obligation would be respected as debt for tax purposes. The obligation would still have to be tested under the common-law rules for distinguishing debt and equity.

The Document Regulations were published in temporary and final form (T.D. 9790).² In finalized form, the Documentation Regulations applied to financial interests issued (or deemed issued) on or after 1 January 2018.³

In Executive Order 13789, issued on 21 April 2017, the Treasury Department was called upon to review all “significant tax regulations” issued on or after 1 January 2016, and to identify those regulations deemed to impose undue financial burden, add undue complexity or exceed statutory authority.

In Notice 2017-38, released in July 2017, the IRS identified the Documentation Regulations as among eight regulation packages requiring additional review. Shortly thereafter, Notice 2017-36 announced the delayed application of the Documentation Regulations by 12 months - making them applicable only to financial arrangements issued on or after 1 January 2019.⁴ Treasury subsequently announced, in October 2017, its intention to revoke the Documentation Regulations and develop new simplified rules.⁵

Removal of Documentation Regulations

The new proposed regulations would remove the Documentation Regulations and make corresponding conforming amendments, but do not include new modified rules. The Preamble to the proposed regulations states that Treasury and the IRS will continue to consider whether to develop and issue a modified, simplified version of the minimum documentation requirements to be met to characterize related-party financial interests as debt. It adds that any such regulations would have a prospective effective date and would allow taxpayers sufficient time to comply.

As a formal matter, the regulations removing the Documentation Regulations are proposed to be effective when final regulations are published. However, until that date, taxpayers may rely on the proposed regulations to treat the Documentation Regulations as though they had been withdrawn.

Implications

The removal of the Documentation Regulations will surely be welcomed by many taxpayers, because they were generally perceived as overturning decades of long-standing principles developed by case law and settled expectations as to the facts-and-circumstances analysis applied to determine whether financial interests should be characterized as debt or equity under Section 385.

Treasury’s intent underlying promulgation of the Documentation Regulations was to impose discipline on related parties by requiring timely documentation and financial support, which met four factors, similar to the documentation and support created when debt is issued to third parties. Accordingly, notwithstanding revocation of the rules, a best practice approach for taxpayers would be to prepare similar loan documentation and economic analysis (e.g., cash flow projections, financial statements, relevant financial ratios), supporting the classification of related-party financial interests as indebtedness. The Documentation Regulations also should serve as a warning not to ignore events of default without documenting why a reasonable creditor would have waived an event of default.

Additionally, the Recharacterization Rules under Section 385 remain in effect as to related-party debt issued in connection with certain targeted transactions and their applicability should still be considered in connection with new issuances of related-party debt.

Endnotes

1. All “Section” references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. See EY Global Tax Alert, [Final and temporary US Section 385 regulations significantly narrow the scope of earlier proposed regulations](#), dated 19 October 2016.
3. The final and temporary regulations under Section 385 included the Documentation Regulations described herein, and rules that treat as stock certain debt issued by a corporation to a controlling shareholder in, or to fund, a distribution, or issued in, or funding, another related-party transaction that achieves an economically similar result. See Treas. Reg. Section 1.385-3 (the Recharacterization Rules).
4. See EY Global Tax Alert, [US IRS delays Section 385 debt-equity documentation requirements by one year](#), dated 7 August 2017.
5. See EY Global Tax Alert, [US Treasury releases report on reducing regulatory tax burdens](#), dated 5 October 2017.

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