US IRS announces that taxpayers can still rely on expired temporary Section 385 recharacterization rules

In Notice 2019-58, released 11 October 2019, the United States (US) Internal Revenue Service (IRS) announced that taxpayers may continue to rely on the October 2016 proposed regulations on characterizing certain corporate interests as stock or debt under Internal Revenue Code[1] Section 385, even though the related temporary regulations expired on 13 October 2019.

The expiration of a significant portion of the overall regulatory framework is expected to raise numerous questions regarding ongoing taxpayer compliance with the regulations that remain in place.

Background

The October 2016 proposed regulations consisted of a cross-reference to the temporary regulations issued at the same time as the final Section 385 regulations (TD 9790). See EY Global Tax Alert, *US IRS releases much-anticipated final and temporary Section 385 regulations*, dated 14 October 2016 for a full explanation of the final and temporary regulations.

The final and temporary regulations (i) established extensive documentation requirements that must be satisfied for a debt instrument to constitute indebtedness for US federal tax purposes (Treas. Reg. Section 1.385-2); and (ii) recharacterized a debt instrument issued after 4 April 2016, as stock if the instrument was issued as part of a transaction listed in Treas. Reg. Section 1.385-3 and Treas. Reg. Section 1.385-3T. Proposed regulations were subsequently issued proposing to revoke the documentation rules. (See EY Global Tax Alert, *US Treasury and IRS propose removing Section 385 documentation requirements*, dated 25 September 2018 for details.)

Notice 2019-58

The October 2016 proposed regulations were to apply to tax years ending on or after 19 January 2017, and do not expire. Notice 2019-58 made clear that taxpayers may rely on the October 2016 proposed regulations for periods after the temporary regulations expire until further notice is given, provided that taxpayers consistently apply the proposed rules in their entirety.

Implications

Significant portions of Treas. Reg. Section 1.385-3 that were final, including the essential recharacterization rules of Treas. Reg. Section 1.385-3(b), are not affected by Notice 2019-58. Those portions of the Section 385 regulations that have expired (for which the October 2016 proposed regulations remain in place) generally define the "qualified short-term debt" exception and address the treatment of controlled partnerships. In addition, Treas. Reg. Section 1.385-4T, which provided special rules for consolidated return groups, also expired. Thus, these subject areas are likely to be most affected by the expiration of the temporary regulations.

We expect that many taxpayers will simply continue applying the entire Section 385 regulatory framework, including the October 2016 proposed regulations representing the expired portions of the Section 385 regulatory regime. This expectation is based partly on the assumption that Notice 2019-58 is not the Government's final word on when debt instruments might be recharacterized as equity. The Office of Information and Regulatory Affairs is currently reviewing other guidance involving the Section 385 regulations, the details of which are unclear. Thus, there may be a relatively small "gap period," or window of time, between the expiration of the Section 385 temporary regulations and whatever new direction, if any, that Treasury may announce for the treatment of covered debt instruments.

Endnote

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

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EYG no. 004719-19Gbl

1508-1600216 NY
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