On April 4, the Treasury and the Internal Revenue Service (IRS) released proposed regulations under IRC § 385 (the Proposed Regulations)¹ that are intended to combat perceived concerns associated with indebtedness between related group entities. **Significantly, the Proposed Regulations apply to indebtedness between related entities, without regard to whether the parties are domestic or foreign.** The Proposed Regulations reaffirm the application of existing common law principles in the debt-equity analysis, but the Proposed Regulations also:

- Impose on large taxpayer groups new documentation requirements for related-party indebtedness to be treated as debt for U.S. tax purposes;
- Treat debt instruments issued to related parties in connection with certain transactions, generally distributions, stock sales and asset reorganizations, as equity for U.S. tax purposes; and
- Provide the IRS with authority to treat related-party debt as debt in part and as equity in part for tax purposes.

The Proposed Regulations generally would be effective with respect to debt issued on or after the date the regulations are published in final form; however, the proposed rules relating to the characterization of debt instruments issued in distributions or acquisition transactions would apply to debt instruments issued on or after April 4, 2016, that are still outstanding 90 days after the finalization of the rules. Significantly, members of a consolidated group of corporations are treated as a single taxpayer under the Proposed Regulations.

### New Documentation Requirements for Related-Party Indebtedness

While recognizing that common law principles still apply for purposes of determining the existence of indebtedness for U.S. tax purposes, the Proposed Regulations introduce documentation and information retention requirements that must be satisfied for a debt instrument issued to a related party to be treated as indebtedness for such purposes. If these rules are not satisfied, the related-party indebtedness is treated as equity for U.S. tax purposes.

The documentation requirements are intended to demonstrate the existence of what the Treasury and the IRS describe as the essential characteristics of indebtedness:

1. A legally binding obligation to pay;
2. Creditors’ rights to enforce the obligation;

3. A reasonable expectation of repayment at the time the instrument is created, the documentation for which may include cash-flow projections, financial statements, business forecasts, asset appraisals, determination of debt-to-equity and other relevant financial ratios of the issuer (compared to industry averages); and

4. An ongoing relationship during the life of the instrument consistent with arm’s-length relationships between unrelated debtors and creditors.

These factors have been highlighted in recent cases and are indicative of what the Treasury and the IRS believe are the most significant factors in the analysis. Although the documentation must be prepared and retained to establish that a debt instrument is debt for U.S. tax purposes, the presence of such documentation does not itself establish that an instrument will be treated as debt. Rather, the multi-factor analysis set forth in the relevant case law still must be applied.

The Proposed Regulations also would permit the IRS to treat a single debt instrument as debt in part and as equity in part for U.S. tax purposes. Courts historically have required that an instrument be treated as all debt or all equity for U.S. tax purposes.

Sutherland Observation. The documentation requirements generally are proposed to be effective with respect to debt instruments issued on or after the date the regulations are published as final; however, taxpayers should consider the Proposed Regulations when documenting related-party loans today because they suggest the factors that the Treasury and the IRS will focus on in applying the common law multi-factor test.

Treatment of Debt Instruments Issued to Related Parties in Distributions, Stock Sales and Asset Reorganizations

In addition to the general documentation requirements, in order to address “significant” policy concerns, the Proposed Regulations would treat debt instruments issued in connection with certain transactions as stock for U.S. tax purposes. Specifically, debt instruments issued in the following situations generally would be treated as stock for U.S. tax purposes:

- Debt instruments distributed by a company to a related shareholder;

- Debt instruments issued in exchange for affiliate stock (including “hook stock” issued by a related shareholder); and

- Debt instruments issued by an acquiring company as consideration in an
exchange pursuant to an internal asset reorganization (i.e., a reorganization within the meaning of IRC §§ 368(a)(1)(A), (C), (D), (F), or (G)).

The Proposed Regulations also would cause related-party loans that are issued in a separate transaction with a principal purpose of funding one of the above transactions—a distribution of cash or other property, the acquisition of affiliate stock or an internal asset reorganization—to be treated as equity for U.S. tax purposes. This funding rule would have potentially far-reaching implications because there is a non-rebuttable presumption that such rule would apply if a related-party debt is issued within 36 months before or after one of the above transactions. Whether these rules apply in a given situation is subject to a number of limited exceptions, including certain overall debt thresholds and limitations on the application of the rules for ordinary course obligations.

Sutherland Observation. The foregoing rules generally are proposed to apply to any debt instrument issued on or after April 4, 2016, that is still outstanding 90 days after these regulations are published in final form. The Proposed Regulations are very broad, and their application to specific factual situations is complex, particularly with respect to any available exceptions. If finalized in their current form, the Proposed Regulations may require taxpayers to modify their typical intercompany funding arrangements.

Consolidated Group Exception

Notably, the Proposed Regulations do not apply to obligations between members of a consolidated group, although general tax principles continue to apply. Prop. Treas. Reg. § 1.385-1(e) achieves this result by treating a consolidated group as one corporation. That said, the Proposed Regulations do provide several rules affecting consolidated groups (e.g., in an instance where an intercompany obligation becomes an obligation that is not an intercompany obligation).

Sutherland Observation. The potential application of these rules by state tax authorities, where the consolidated group exception may not be relevant, also must be considered.

Consequences of Equity Characterization

Related-party debt that is treated as equity under the Proposed Regulations would be treated as equity for all U.S. tax purposes, including, for example, sections 302, 304 and 305. The Proposed Regulations do not, however, provide any specific guidance on whether such instruments should be treated as common or preferred stock. The preamble simply states that such determination should be based on the terms of the instrument.
**Sutherland Observation.** The collateral consequences of such treatment for the initial transaction as well as future repayment or other transactions are not addressed in these rules and require careful consideration of a host of other rules, including potentially the “fast pay” rules in Treas. Reg. § 1.7701(l)-3.

**Comments Requested**

The Proposed Regulations reflect a significant departure from the existing rules relating to debt and equity, particularly as they relate to debt issued in connection with distributions and acquisition transactions. Accordingly, the Treasury and the IRS have requested comments on all aspects of the Proposed Regulations, including comments on the clarity of these rules and how they can be made more administrable. In addition, comments have been requested on a number of specific topics, including those described below:

- Whether other instruments should be subject to the Proposed Regulations, including other types of instruments that are not indebtedness in form but should be subject to the documentation requirements described above;
- Whether special rules are warranted for cash pools, cash sweeps and similar arrangements for managing the cash of a group of companies;
- The application of these rules to any entity with respect to a year in which the entity is not a U.S. person, is not required to file a U.S. tax return, and is not a controlled foreign corporation or a controlled foreign partnership, but in a later year becomes one of the foregoing; and
- Whether certain indebtedness commonly used by investment partnerships, including indebtedness issued by certain “blocker” entities, implicate similar policy concerns as those motivating the Proposed Regulations, such that the scope of the Proposed Regulations should be broadened.

Written or electronic comments and requests for a public hearing must be received by the IRS by **July 7, 2016**.

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