



## Federal Tax ADVISORY ■

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### Interest High in Section 385 Proposal

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On April 4, 2016, the Treasury proposed regulations to redefine corporate, and in some cases partnership, debt as equity in many ways that will heavily impact normal corporate transactions. Fortunately, the regulations would be limited to related party debt, but those are the only ones that the issuers might be concerned about anyway.

By now readers will have learned the general outlines of the regulation proposal and the general types of transactions they might impact: normal intercompany borrowing, the use of notes as corporate distributions or acquisition currency within the group, Section 304 transactions, etc.

If they are to be believed, Treasury officials think they are just making corporations true up related party debt to commercial standards, don't think that "real" transactions will be much impacted, and are very confident of their ability to sustain the regulations if attacked in court.

The regulations, if finalized, will be attacked in court. Generally an attacker will have to pay additional tax and sue for refund or suffer denial of an interest deduction and petition the Tax Court. Undoubtedly, some groups will seek ways to challenge the regulations in advance of such delayed events.

As a substantive matter, the authority for these regulations as proposed is not strong. The Treasury asserts that it has the authority to write per se rules rather than rules that evaluate factors. That will be the major issue in the litigation over the regulations.

The court will ask whether the regulations are arbitrary or capricious. That sounds like a low bar, but as applied by the courts in recent years, it is not. Courts are able to see all sorts of arbitrariness in the agency's explanations of its reasoning, its failure to explain and its failure to address all comments.

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Indeed, a surprising number of decisions have turned on the agency's failure to take account of all of the factors Congress has listed in a statute. Of course, Section 385 lists factors that the agency may include in consideration, but prefaces that with a direction that the regulations shall apply the relevant considerations to particular facts.

The proposed regulations, in contrast, apply newly minted considerations in a rigid fashion and produce results far beyond denying interest deductions.

For additional information, call [Jack Cummings](#) at 919.862.2302.

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