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In this edition of Audit & Beyond, the authors discuss the proposed IRC section 385 regulations. They conclude that despite initial interest in the regulations, because of uncertainty surrounding them and states' frequent reliance on common law principles, states may opt to forgo adopting the regulations.

It has been more than nine months since Treasury and the IRS released final and temporary regulations under IRC section 385. On their release, taxpayers and tax practitioners feverishly reviewed the complex and challenging set of standards to determine their potential impact at both the federal and state levels. However, just nine months later, and amid speculation that the regulations may be withdrawn under the Trump administration,[1] the flurry has died down. With the time to more carefully consider the effect of the regulations, one wonders whether many states will decide not to adopt them. In this article, we examine a few reasons why, at the state level, the section 385 regulations may be much ado about nothing.

I. Overview of the Regulations

Section 385 permits the Treasury "to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated . . . as stock or indebtedness."[2] That authority is limited to an analysis of whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists.[3] The statute outlines a non-exhaustive list of factors that may be considered, but are not required, in determining the character of an instrument.[4] Those factors are: (1) whether there is a written unconditional promise to pay or a sum certain on a specified date at a fixed rate of interest; (2) whether the debt is subordinated or preferred to other debt; (3) the debt-equity ratio; (4) whether there is convertibility into the corporation's stock; and (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.[5] The secretary is also authorized to require as much information as necessary to carry out the functions of the statute.[6]

In April 2016 the IRS published a broad set of proposed regulations under section 385 to minimize tax avoidance achieved through debt-equity characterizations.[7] In October 2016, after numerous critical comments concerning the

[1] *See* Alison Bennett and Allyson Versprille, "Trump Order Sparks Debate Over Inversions, Debt-Equity Rules," Bloomberg BNA, Apr. 24, 2017.

[2] 26 U.S.C. section 385(a).

[3] 26 U.S.C. section 385(b).

[4] *Id.*

[5] *Id.*

[6] 26 U.S.C. section 382(c)(3).

[7] Treasury, "Fact Sheet: Treasury Issues Inversion Regulations and Proposed Earnings Stripping Regulations" (Apr. 4, 2016) (The "proposed regulations address the issue of earnings stripping by . . . targeting transactions that increase related-party debt that does not finance new investment in the United States").

proposal, the IRS issued final and temporary versions that tried to "significantly reduce compliance and administrative burdens, while still placing effective limits on the transactions most responsible for inappropriately reducing U.S. tax revenue."[8]

The section 385 regulations generally apply to debt issued by domestic corporations to members of an expanded group — entities related by at least 80 percent ownership by vote or value.[9] Under the regulatory framework, the regulations set forth documentation requirements that must be met by some related-party debt instruments to avoid per se treatment as stock. Instruments that survive the documentation requirements must then survive a set of recharacterization rules. While the section 385 regulations provide a more structured framework for analyzing whether some instruments should be treated as debt or equity, the regulations make clear that the common law factors developed in the absence of such regulations remain the ultimate determinant of whether an interest in a corporation is treated as stock or indebtedness.[10]

II. Three Reasons States May Not Adopt the Regulations

While many practitioners have written about the potential application of the section 385 regulations to state tax transactions, an equally important question is whether states are likely to apply the regulations to challenge purported debt transactions. In the absence of regulations under section 385, numerous states have used the tools available, such as common law factors and expense disallowance statutes, to determine whether a related-party interest should be characterized as indebtedness. We believe there are at least three reasons why state revenue agencies may simply pass on incorporating the language or principles from the section 385 regulations into their own standards.

[8]T.D. 9790 (Oct. 21, 2016).

[9]26 C.F.R. section 1.385-1(c)(4).

[10]*See* 26 C.F.R. section 1.385-1(b).

A. States May Find That Many Transactions Are Excluded

Some states may find that the section 385 regulations have limited application because they exclude some types of taxpayers and transactions. Specifically, the regulations are "intended to apply primarily to large C corporations that engage in substantial debt transactions, or purported debt transactions, between highly-related businesses."[11] The regulations do not apply to debt issued by non-U.S. persons, S corporations, or noncontrolled regulated investment companies and real estate investment trusts.[12] Instruments issued by regulated financial groups and insurance entities also are excluded,[13] as are transactions among affiliated members of a consolidated group return.[14] Most notably, the regulations are expressly inapplicable to cash management and other short-term debt arrangements, as determined by a specified current assets test or 270-day test.[15] Lastly, the regulations make allowances that further limit their scope and effect; for instance, a taxpayer may exclude the first $50 million of debt.[16] Also, if the aggregate amount of distributions or acquisitions does not exceed the entity's earnings and profits during a specific period, then such distributions and acquisitions will fall outside the scope of the regulations.[17]

Considering the number of exemptions and exceptions, a state may decide that the section 385 regulations restrict its ability to review some transactions. For example, in *Massachusetts Mutual Life Insurance Co. v. Commissioner of Revenue*,[18] the Massachusetts Appellate Tax Board (ATB) reviewed the Department of Revenue's disallowance of some intercompany advances made by an insurance company to its wholly owned, non-insurance subsidiary on the basis that the advances did not constitute bona fide

[11]T.D. 9790.

[12]26 C.F.R. section 1.385-1(c)(2), (c)(4)(i).

[13]26 C.F.R. section 1.385-3(g)(3)(i), (g)(3)(iv)-(v).

[14]26 C.F.R. section 1.385-1(e).

[15]T.D. 9790 and 26 C.F.R. section 1.385-3T(b)(3)(vii).

[16]26 C.F.R. section 1.385-3(c)(4).

[17]26 C.F.R. section 1.385-3(c)(3)(i).

[18]Nos. C305276, C305277 (Mass. App. Tax Bd. 2015).

debt. However, under the regulations, such a transaction would not be covered because instruments issued by regulated insurance entities would be excluded from review. Further, in two Massachusetts cases that serve as part of the foundation for the state's common law tests for evaluating debt-equity characterizations, the transactions at issue involved cash management systems, which are also excluded under the regulations.[19]

Also potentially troublesome for states is the consolidated group exclusion, which disregards for purposes of the regulations transactions between members of an affiliated group that files a federal consolidated return. For instance, in *National Grid Holdings Inc. v. Commissioner of Revenue*,[20] the Massachusetts Appeals Court upheld the DOR's determination that intercompany hybrid instruments that were debt for U.S. tax purposes and equity for a foreign state's tax purposes could not be considered true debt.[21] The affiliated taxpayers in the case were members of a Massachusetts combined group return for the tax year in question. Under a strict reading of the regulation, payments between affiliates, such as the payments at issue in *National Grid Holdings*, would be eliminated when the transaction occurs between members of the same consolidated group. While one could argue that the consolidated return exception would not apply in most states — either because the state is a separate return jurisdiction or the state permits or mandates consolidated or combined return filings but does not follow the federal consolidated return rules — some states (particularly combined return states) may decide to avoid a potential challenge altogether by declining to adopt the regulations.

[19]*See New York Times Sales Inc. v. Commissioner of Revenue*, 40 Mass. App. Ct. 749 (1996) (affirming the ATB's decision that cash transfers were "distributions with respect to the stock of a subsidiary. . . to be treated as a dividend . . . and [were] not properly characterized as an intercompany loan" and outlining a nine-factor test similar to that in *Fin Hay Realty*); and *Overnite Transportation Co. v. Commissioner of Revenue*, 54 Mass. App. Ct. 180 (2002) (holding that a promissory note issued by a subsidiary to its parent was not bona fide debt after considering whether the advance satisfies the core definition of debt and whether the conduct of the parties was consistent with that of a debtor and creditor).

[20]*National Grid Holdings Inc. v. Commissioner of Revenue*, 89 Mass. App. Ct. 506 (2016).

[21]*Id.* at 508.

B. States May Prefer to Rely on Common Law and Other State Authority

Many state tax practitioners and state courts have followed federal case law when addressing debt-equity characterizations. The decision by the U.S. Court of Appeals for the Third Circuit in *Fin Hay Realty Co. v. United States*[22] — in which the court identified 16 factors relevant for distinguishing between indebtedness and stock — has long served as the flagship authority.[23] However, in later decisions,both federal and state courts have taken liberties with the 16-factor analysis, either ignoring the relevance of some factors or adding factors. "The inconsistent analysis of the relevant factors by different courts"[24] thus served as a primary motivation behind the promulgation of the section 385 regulations. Some aspects of the regulations' more streamlined framework, however, may result in states deciding to remain with their own authority.

For instance, the regulations are centered on three main provisions that automatically recharacterize expanded group instruments: the general rule, the funding rule, and the antiabuse rule (collectively, the recharacterization rules).[25] The general rule proclaims that debt between members of an affiliated group will be recharacterized as equity to the extent it is issued as a distribution, in exchange for stock of an affiliate, or as part of an internal reorganization.[26] The funding rule declares that debt issued to an affiliate in exchange for property will be

[22]398 F.2d 694 (3d Cir. 1968).

[23]The 16 factors identified by the Third Circuit are: (1) the intent of the parties; (2) the identity between creditors and shareholders; (3) the extent of participation in management by the holder of the instrument; (4) the ability of the corporation to obtain funds from outside sources; (5) the 'thinness' of the capital structure in relation to debt; (6) the risk involved; (7) the formal indicia of the arrangement; (8) the relative position of the obligees as to other creditors regarding the payment of interest and principal; (9) the voting power of the holder of the instrument; (10) the provision of a fixed rate of interest; (11) a contingency on the obligation to repay; (12) the source of the interest payments; (13) the presence or absence of a fixed maturity date; (14) a provision for redemption by the corporation; (15) a provision for redemption at the option of the holder; and (16) the timing of the advance with reference to the organization of the corporation. See *id*. at 696.

[24]Notice of proposed rulemaking, REG 108060–15, 72862 IRB 2016-17 (Apr. 25, 2016). *See also* S. Rep. No. 91-552, at 138 (1969).

[25]*See* 26 C.F.R. section 1.385-3(b).

[26]26 C.F.R. section 1.385-3(b)(2).

recharacterized as equity if the principal purpose is to allow the issuer to fund some distributions or acquisitions.[27] The antiabuse rule serves as a catchall, stating that debt will be characterized as stock if issued with the principal purpose of avoiding these provisions and reducing tax liability.[28]

The absolutes set forth by these recharacterization rules are a departure from the broader standards set out in the common law. States that have common law doctrines that are arguably stricter than the recharacterization rules may prefer to rely on their own state standards rather than the new rules.

Similarly, the documentation rules under reg. section 1.385-2 may give some states pause. The rules require taxpayers to prepare and maintain minimum documentation to substantiate the treatment of related-party instruments as indebtedness.[29] Where once documentary evidence was potentially advantageous to the taxpayer, it is now necessary to maintain the status of the instrument.[30] If the requirements are not met, the proposed debt will be treated as equity, regardless of whether it satisfies the other provisions of the regulations.[31] The documentation rules require not only that documents be timely, but also that sufficient information be available to demonstrate the presence of: (1) a sum certain, (2) the creditor's rights to enforce terms, (3) the borrower's ability to repay, and (4) a genuine debtor-creditor relationship.[32] While at first blush the documentation rules may appear to be a welcome tool in a state's recharacterization tool box — after all, noncompliance with the rules is dispositive of an instrument's equity characterization — there are at least three reasons why some states may decide that the documentation rules are less useful than they appear.

First, the documentation rules apply only to a defined set of taxpayers. A taxpayer is not subject to reg. section 1.385-2 unless it belongs to a group of related entities that includes at least one publicly held company, has annual total group revenue more than $50 million, or the total group assets exceed $100 million.[33] Many states may find these criteria greatly limit the number of taxpayers on which they may impose the documentation requirements. Of course, states may implement the rules and change their requirements to increase their application.

Second, some states disregard documentary evidence in determining whether an instrument is true debt. In particular, case law in Massachusetts suggests that the state looks to whether tax avoidance was a motivation behind a transaction as the ultimate factor in determining true debt.[34] The Massachusetts ATB has repeated that books and records are not controlling for tax purposes.[35] Otherwise, a taxpayer could "achieve desired tax results simply by presenting financial statements crafted to support such results,"[36] the board said.

States accepting the final regulations may be forced to give real consideration to the documentation regarding an instrument. While compliance with the documentation rules does not prevent a state from recharacterizing an instrument, state courts will be hard pressed to simply dismiss that under the regulations such documentation is evidence of certain characteristics of third-party debt.

Third, despite the addition of the documentation rules, the common law factors continue to be the heart of the debt-versus-equity analysis. As noted above, if a taxpayer satisfies the documentation requirements, the instrument simply moves on to be analyzed under the recharacterization rules — a streamlined set of rules based on the common law factors. If a taxpayer does not satisfy the documentation requirements, the instrument

[27] 26 C.F.R. section 1.385-3(b)(3).

[28] 26 C.F.R. section 1.385-3(b)(4).

[29] 26 C.F.R. section 1.385-2.

[30] 26 C.F.R. section 1.385-2(b).

[31] *Id.*

[32] 26 C.F.R. section 1.385-2(c)(2).

[33] 26 C.F.R. section 1.385-2(a)(3)(ii)(1)-(3).

[34] *See, e.g.*, *Overnite Transportation*, 54 Mass. App. Ct. at 188 ("There has been argument that all that should count was the intention or frame of mind of the parties at the time of the launching of the note").

[35] *Massachusetts Mutual Life*, Nos. C305276, C305277.

[36] *Staples Inc.*, No. C310639 at 450 (*citing Manning v. Boston Redevelopment Authority*, 400 Mass. 444, 453 (1987)).

will be treated as stock unless an exception from per se treatment applies.[37]

The regulations provide a host of exceptions.[38] One is for taxpayers that establish they already have a high percentage of expanded group instruments that comply with the documentation rules.[39] That kind of showing creates a rebuttable presumption that the instrument is stock, which the taxpayer can overcome by clearly establishing that there are sufficient common law factors present to treat the instrument as debt.[40] Accordingly, if a taxpayer meets the documentation rules, it is subject to a test that essentially consolidates common law, and if the taxpayer does not meet the rules, it is subject to common law. Thus, many states may find that layering in the documentation rules makes the overall process of analyzing whether an instrument is indebtedness or stock unnecessarily more complex, particularly when the common law factors continue to be the ultimate determining factor.

C. Uncertainty Surrounding the Longevity and Content of the Regulations

There is speculation that the regulations could be revoked under the Trump administration.[41] If so, the question of state adoption becomes moot. The very speculation that the regulations are in danger of being withdrawn or severely weakened has stolen a bit of the thunder surrounding their promulgation. States may be less inclined to rely on regulations that could be carved back or revoked — particularly in a state with established regulatory and judicial guidance of its own.

III. Conclusion

Much of the concern over the section 385 regulations and their state impact may be misplaced. States may find that the complexity of the regulations, coupled with some limitations, may complicate the existing state common law or statutory authority already available to them. States with a robust debt-equity jurisprudence like Massachusetts will likely experience little difference in adopting the rules and thus may determine that the burden of administering the new regulations outweighs any potential benefits. However, states with less developed guidance may decide that the regulations provide a framework they lack. Only time will tell whether, at the state and local tax level, the promulgation of the section 385 regulations is much ado about nothing. ■

[37] *See* 26 C.F.R. section 1.385-2(b)(1).

[38] 26 C.F.R. section 1.385-2(b)(2).

[39] 26 C.F.R. section 1.385-2(b)(2)(i).

[40] *Id. See also supra* note 1.

[41] In fact in July 2017 the U.S. Treasury Department identified the section 385 regulations as one of eight Obama-era regulations needing to be potentially rescinded or modified.