DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–108060–15]

RIN 1545–BN40

Treatment of Certain Interests in Corporations as Stock or Indebtedness

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under section 385 of the Internal Revenue Code (Code) that would authorize the Commissioner to treat certain related-party interests in a corporation as indebtedness in part and stock in part for federal tax purposes, and establish threshold documentation requirements that must be satisfied in order for certain related-party interests in a corporation to be treated as indebtedness for federal tax purposes. The proposed regulations also would treat as stock certain related-party interests that otherwise would be treated as indebtedness for federal tax purposes. The proposed regulations generally affect corporations that issue purported indebtedness to related corporations or partnerships.

DATES: Written or electronic comments and requests for a public hearing must be received by July 7, 2016.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–108060–15), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–108060–15), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC 20224 or sent electronically via the Federal eRulemaking Portal at *http://www.regulations.gov* (IRS REG–108060–15).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations under §§ 1.385–1 and 1.385–2, Eric D. Brauer, (202) 317–5348; concerning the proposed regulations under §§ 1.385–3 and 1.385–4, Raymond J. Stahl, (202) 317–6938; concerning submissions of comments or requests for a public hearing, Regina Johnson, (202) 317–5177 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by June 7, 2016. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information;

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in this proposed regulation is in *§ 1.385–2(b)(2).* This collection of information is necessary to determine whether certain interests between members of an expanded affiliated group are to be treated as stock or indebtedness for federal tax purposes. The likely respondents are entities that are affiliates of publicly traded entities or meet certain thresholds on their financial statements.

Estimated total annual reporting burden: 735,000 hours.

Estimated average annual burden per respondent: 35 hours.

Estimated number of respondents: 21,000.

Estimated frequency of responses: Monthly.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Background

As described further in this preamble, courts historically have analyzed whether an interest in a corporation should be treated as stock or indebtedness for federal tax purposes by applying various sets of factors to the facts of a particular case. In 1969, Congress enacted section 385 to authorize the Secretary of the Treasury (Secretary) 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 for purposes of the Code. Because no regulations are currently in effect under section 385, the case law that developed before the enactment of section 385 has continued to evolve and to control the characterization of an interest in a corporation as debt or equity.

I. Section 385 Statute and Legislative History

A. Original Enactment of Section 385

Section 385(a), as originally enacted as part of the Tax Reform Act of 1969 (Pub. L. 91–172, 83 Stat. 487), authorizes the Secretary to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is treated as stock or indebtedness for purposes of the Code.

Section 385(b) provides that the regulations prescribed under section 385 shall set forth factors that are to be taken into account in determining in a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. Under section 385(b), those factors may include, among other factors, the following: (1) Whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest; (2) whether there is subordination to or preference over any indebtedness of the corporation; (3) the ratio of debt to equity of the corporation; (4) whether there is convertibility into the stock of the corporation; and (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

In enacting section 385(a) and (b), Congress authorized the Secretary to prescribe targeted rules to address particular factual situations, stating:

> In view of the uncertainties and difficulties which the distinction between debt and equity has produced in numerous situations . . . the committee further believes that it would be desirable to provide rules for distinguishing debt from equity in the variety of contexts in which this problem can arise. The differing circumstances which characterize these situations, however, would

make it difficult for the committee to provide comprehensive and specific statutory rules of universal and equal applicability. In view of this, the committee believes it is appropriate to specifically authorize the Secretary of the Treasury to prescribe the appropriate rules for distinguishing debt from equity in these different situations.

S. Rep. No. 91–552, at 138 (1969). The legislative history further explains that regulations applicable to a particular factual situation need not rely on the factors set forth in section 385(b):

The provision also specifies certain factors which may be taken into account in these [regulatory] guidelines. It is not intended that only these factors be included in the guidelines or that, with respect to a particular situation, any of these factors must be included in the guidelines, or that any of the factors which are included by statute must necessarily be given any more weight than other factors added by regulations.

Id. Accordingly, section 385(b) provides the Secretary with discretion to establish specific rules for determining whether an interest is treated as stock or indebtedness for federal tax purposes in a particular factual situation.

B. 1989 and 1992 Amendments to Section 385

Congress amended section 385 in 1989 and 1992. In 1989, the Omnibus Budget Reconciliation Act of 1989 (Pub. L. 101–239, 103 Stat. 2106) amended section 385(a) to expressly authorize the Secretary to issue regulations under which an interest in a corporation is to be treated as in part stock and in part indebtedness. This amendment also provides that any regulations so issued may apply only with respect to instruments issued after the date on which the Secretary or the Secretary's delegate provides public guidance as to the characterization of such instruments (whether by regulation, ruling, or otherwise). *See* Public Law 101–239, sec. 7208(a)(2). The legislative history to the 1989 amendment notes that, while ''[t]he characterization of an investment in a corporation as debt or equity for Federal income tax purposes generally is determined by reference to numerous factors, . . . there has been a tendency by the courts to characterize an instrument entirely as debt or entirely as equity.'' H.R. Rep. No. 101–386, at 3165–66 (1989) (Conf. Rep.).

In 1992, Congress added section 385(c) to the Code as part of the Energy Policy Act of 1992 (Pub. L. 102–486, 106 Stat. 2776). Section 385(c)(1) provides that the issuer's characterization (as of the time of issuance) as to whether an interest in a corporation is stock or indebtedness shall be binding on such issuer and on all holders of such interest (but shall not be binding on the Secretary). Section 385(c)(2) provides that, except as provided in regulations, section 385(c)(1) shall not apply to any holder of an interest if such holder on his return discloses that he is treating such interest in a manner inconsistent with the initial characterization of the issuer. Section 385(c)(3) authorizes the Secretary to require such information as the Secretary determines to be necessary to carry out the provisions of section 385(c), including the information necessary for the Secretary to determine how the issuer characterized an interest as of the time of issuance.

Congress added section 385(c) in response to issuers and holders characterizing a corporate instrument inconsistently. H.R. Rep. No. 102–716, at 3 (1992). For example, a corporate issuer may designate an instrument as indebtedness for federal tax purposes and deduct as interest the amounts paid on the instrument, while a corporate holder may treat the instrument as stock for federal tax purposes and claim a dividends received deduction with respect to the amounts paid on the instrument. *See id.*

II. Regulations

There are no regulations currently in effect under section 385. On March 24, 1980, the Department of the Treasury (Treasury Department) and the IRS published a notice of proposed rulemaking (LR–1661) in the **Federal Register** (45 FR 18959) under section 385 relating to the treatment of certain interests in corporations as stock or indebtedness. Final regulations (TD 7747) were published in the **Federal Register** (45 FR 86438) on December 31, 1980. Subsequent revisions of the final regulations were published in the **Federal Register** on May 4, 1981, January 5, 1982, and July 2, 1982 (46 FR 24945, 47 FR 147, and 47 FR 28915, respectively). The Treasury Department and the IRS published a notice of proposed withdrawal of TD 7747 in the **Federal Register** on July 6, 1983 (48 FR 31053), and in TD 7920, published in the **Federal Register** (48 FR 50711) on November 3, 1983, the Treasury Department and the IRS withdrew TD 7747.

The Treasury Department and the IRS have not previously published any regulations regarding the 1989 amendment to section 385(a), which authorizes the Secretary to issue regulations that treat an interest in a corporation as indebtedness in part or as stock in part. In addition, no regulations have been published with respect to the 1992 addition of section 385(c) authorizing the Secretary to require information related to an issuer's initial characterization of an interest for federal tax purposes or to affect the ability of a holder to treat an interest inconsistent with the initial treatment of the issuer.

III. Case Law

In the absence of regulations under section 385, the pre-1969 case law has continued to evolve and control the characterization of an interest as debt or equity for federal tax purposes. Under that case law, courts apply inconsistent sets of factors to determine if an interest should be treated as stock or indebtedness, subjecting substantially similar fact patterns to differing analyses. The result has been a body of case law that perpetuates the ''uncertainties and difficulties which the distinction between debt and equity has produced'' and with which Congress expressed concern when enacting section 385. *See* S. Rep. No. 91–552, at 138. For example, in *Fin Hay Realty Co.* v. *United States,* 398 F.2d 694 (3d Cir. 1968), the U.S. Court of Appeals for the Third Circuit identified sixteen factors relevant for distinguishing between indebtedness and stock:

(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.

Id. at 696. By contrast, in *Estate of Mixon* v. *United States,* 464 F.2d 394 (5th Cir. 1972), the U.S. Court of Appeals for the Fifth Circuit identified thirteen factors that are similar to, but not the same as, those used in *Fin Hay* to distinguish between indebtedness and stock:

(1) the names given to the certificates evidencing the indebtedness; (2) The presence or absence of a fixed maturity date; (3) The source of payments; (4) The right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) the status of the contribution in relation to regular corporate creditors; (7) the intent of the parties; (8) 'thin' or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) the ability of the

corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets; and (13) the failure of the debtor to repay on the due date or to seek a postponement.

Id. at 402. The weight given to the various factors in a particular case also differs, and is highly dependent upon the relevant facts and circumstances. *See, e.g., J.S. Biritz Construction Co.* v. *Commissioner,* 387 F.2d 451, 456–57 (8th Cir. 1967) (stating that the factors ''have varying degrees of relevancy, depending on the particular factual situation and are generally not all applicable to any given case'').

Under this facts-and-circumstances analysis, as developed in the case law, no single fact or circumstance is sufficient to establish that an interest should be treated as stock or indebtedness. *See, e.g., John Kelley Co.* v. *Commissioner,* 326 U.S. 521, 530 (1946) (''[N]o one characteristic . . . can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts.''); *Fin Hay,* 398 F.2d at 697 (''[N]either any single criterion nor any series of criteria can provide a conclusive answer in the kaleidoscopic circumstances which individual cases present.''). It was this emphasis on particular taxpayer facts and circumstances, coupled with inconsistent analysis of the relevant factors by different courts, that led Congress to delegate to the Secretary the authority to provide regulations under section 385 for distinguishing debt from equity that could depart from the factors developed in case law or enumerated in the statute. *See* S. Rep. No. 91–552, at 138.

IV. Other Relevant Statutory Provisions

Section 701 provides that a partnership as such shall not be subject to federal income tax, but that persons carrying on business as partners shall be liable for federal income tax only in their separate or individual capacities.

Section 1502 provides that the Secretary shall prescribe such regulations as the Secretary deems necessary in order that the federal tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the federal income tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability. In prescribing such regulations, section 1502 authorizes the Secretary to prescribe rules that are different from the provisions of chapter 1 of subtitle A of the Code that would apply if such corporations filed separate returns.

Section 7701(l) provides that the Secretary may prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any two or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by the Code.

V. Earnings Stripping Guidance Described in Notice 2014–52 and Notice 2015–79

Notice 2014–52, 2014–42 IRB 712 (Oct. 14, 2014), and Notice 2015–79, 2015–49 IRB 775 (Dec. 7, 2015), described regulations that the Treasury Department and the IRS intend to issue with respect to corporate inversions and related transactions. Notice 2014–52 and Notice 2015–79 also provided that the Treasury Department and the IRS expect to issue additional guidance to further limit the benefits of post-inversion tax avoidance transactions. The notices stated, in particular, that the Treasury Department and the IRS are considering guidance to address strategies that avoid U.S. tax on U.S. operations by shifting or ''stripping'' U.S.-source earnings to lower-tax jurisdictions, including through intercompany debt.

VI. Purpose of the Proposed Regulations

These proposed regulations under section 385 address whether an interest in a related corporation is treated as stock or indebtedness, or as in part stock or in part indebtedness, for purposes of the Code. While these proposed regulations are motivated in part by the enhanced incentives for related parties to engage in transactions that result in excessive indebtedness in the cross-border context, federal income tax liability can also be reduced or eliminated with excessive indebtedness between domestic related parties. Thus, the proposed rules apply to purported indebtedness issued to certain related parties, without regard to whether the parties are domestic or foreign. Nonetheless, the Treasury Department and the IRS also have determined that the proposed regulations should not apply to issuances of interests and related transactions among members of a consolidated group because the concerns addressed in the proposed regulations generally are not present when the issuer's deduction for interest expense and the holder's corresponding interest income offset on the group's consolidated federal income tax return.

Section A of this Part VI addresses bifurcation of interests that are indebtedness in part but not in whole. Section B of this Part VI addresses documentation requirements for related-party indebtedness. Section C of this Part VI addresses distributions of debt instruments and similar transactions.

A. Interests That Are Indebtedness in Part but Not in Whole

As previously noted, Congress amended section 385(a) in 1989 to authorize the issuance of regulations permitting an interest in a corporation to be treated as in part indebtedness and in part stock. The legislative history to the 1989 amendment explained that ''there has been a tendency by the courts to characterize an instrument entirely as debt or entirely as equity.'' H.R. Rep. No. 101–386, at 562 (1989) (Conf. Rep.). No regulations have been promulgated under the amendment, however, and this tendency by the courts has continued to the present day. Consequently, the Commissioner generally is required to treat an interest in a corporation as either wholly indebtedness or wholly equity.

This all-or-nothing approach is particularly problematic in cases where the facts and circumstances surrounding a purported debt instrument provide only slightly more support for characterization of the entire interest as indebtedness than for equity characterization, a situation that is increasingly common in the related-party context. The Treasury Department and the IRS have determined that the all-or-nothing approach frequently fails to reflect the economic substance of related-party interests that are in form indebtedness and gives rise to inappropriate federal tax consequences. Accordingly, the Treasury Department and the IRS have determined that the interests of tax administration would best be served if the Commissioner were able to depart from the all-or-nothing approach where appropriate to ensure that the provisions of the Code are applied in a manner that clearly reflects the income of related taxpayers. To that end, these proposed regulations would exercise the authority granted by section 385(a) to permit the Commissioner to treat a purported debt instrument issued between related parties as in part indebtedness and in part stock for federal tax purposes. However, the proposed regulations would not permit issuers and related holders to treat such an instrument in a manner inconsistent with the issuer's initial characterization. The proposed regulations described in