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KPMG report: Removal of documentation rules under section 385; future proposed regulations may eliminate per se funding rule

The U.S. Treasury Department and IRS on October 31, 2019, released for publication in the Federal Register the following items relating to section 385:

- [Treasury decision \(T.D. 9880\)](#) [PDF 313] (the “Section 385 TD”) removing final regulations in Reg. §1.385-2 that set forth documentation requirements for certain related-party interests in a corporation to be treated as indebtedness (the “Documentation Rules”).
- [Advance notice of proposed rulemaking \(REG-123112-19\)](#) [PDF 261 KB] (the “Section 385 ANPRM”) announcing an intention to issue proposed regulations that will eliminate the per se application of the funding rule in Reg. §1.385-3 (the “Recast Rules”).

In addition, the Section 385 ANPRM announces that taxpayers may rely on the 2016 proposed regulations until further notice, provided that the taxpayer “consistently applies the rules” in the 2016 proposed regulations in their entirety.

Background

In October 2016, final and temporary regulations (T.D. 9790) under section 385 were released by Treasury and the IRS to address the treatment of certain interests in corporations as stock or indebtedness. These regulations were primarily comprised of:

- Documentation Rules (Reg. §1.385-2) which established minimum documentation requirements that ordinarily must be satisfied in order for purported debt obligations among related parties to be treated as debt for federal tax purposes; and

- Recast Rules (Reg. §§1.385-3, 1.385-3T, 1.385-4T) which treat as stock certain debt that is issued by a corporation to a controlling shareholder in a distribution or in another specified related-party transaction that achieves an economically similar result

Together, these are the “Section 385 Regulations.”

The temporary regulations provided guidance on the application of the Recast Rules with respect to short-term funding and cash pool arrangements, certain partnerships, and consolidated groups. The temporary regulations expired on October 13, 2019. However, the text of the temporary regulations (Reg. §§1.385-3T and 1.385-4T) also serves as the text of simultaneously published proposed regulations (REG-130314-16). [Notice 2019-58](#) [PDF 10 KB] (October 2019) provided that taxpayers may rely on the proposed regulations following the expiration of the temporary regulations, provided that a taxpayer consistently applies the rules in the proposed regulations in their entirety.

In April 2017, Executive Order (E.O.) 13789 directed Treasury to examine regulations published after January 1, 2016, to determine whether such regulations: (1) imposed an undue financial burden on U.S. taxpayers; (2) added undue complexity to the federal tax laws; or (3) exceeded the statutory authority of the IRS. According to the executive order, Treasury was to take “appropriate steps” to delay or suspend the effective date of the identified regulations, and to modify or rescind the regulations, through notice and comment rulemaking.

In July 2017, [Notice 2017-38](#) [PDF 40 KB] included the Section 385 Regulations in the list of eight regulations identified by Treasury as meeting at least one of the first two criteria specified in E.O. 13789.

Pursuant to the executive order, in September 2018, Treasury and the IRS issued proposed regulations (REG-130244-17) that would remove the Documentation Rules. The preamble to these proposed regulations provided that taxpayers could rely on the removal of the Documentation Rules pending their finalization.

In addition to requesting relief from the Documentation Rules, commentators have argued that the Recast Rules also needed to be repealed or relaxed, particularly in light of the 2017 enactment of the “Tax Cuts and Jobs Act” (“TCJA”) (Pub. L. No. 115-97), which reduced the corporate rate from 35% to 21% and included anti-interest-stripping and anti-base-erosion measures. As a result, the TCJA reduced the incentives for inversions, and the attendant base-stripping that the Recast Rules were intended to address. Treasury and the IRS had indicated publicly that they would continue to study whether the Recast Rules are necessary and appropriate after the enactment of the TCJA.

Perhaps the most controversial aspect of the Recast Rules is the “per se” application of the “Funding Rule” under Reg. §1.385-3(b)(3)(iii). Subject to certain exceptions (for instance, the E&P and qualified contribution exceptions), the “General Rule” of Reg. §1.385-3(b)(2) provides that a debt instrument issued by a domestic corporation to a member of the corporation’s expanded group in a distribution or certain economically similar transactions (i.e., a reorganization with “boot” or a section 304 exchange) is treated as stock.

The “Funding Rule” of Reg. §1.385-3(b)(3)(i) expands the General Rule by providing that the issuance to an expanded group member of a debt instrument that funds a distribution to a member or a specified economically similar transaction is also treated as stock.

The “Per Se Funding Rule” of Reg. §1.385-3(b)(3)(iii) provides that any debt instrument issued by a domestic corporation to a member of the corporation’s expanded group will be treated as funding a distribution to a member of the expanded group or specified economically similar transaction (and thus the debt instrument will be recharacterized as equity) if the distribution or economically similar transaction occurs within a 36-month period that includes the issuance. Thus, a distribution by a domestic corporation that occurs within a 36-month period—either preceding or subsequent to—the

issuance of a debt instrument to a member of the same expanded group can cause the debt instrument to be recharacterized as equity under the Per Se Funding Rule, even if the distribution and the issuance are entirely unrelated. This linking of unrelated transactions requires companies to implement potentially onerous tracking systems to monitor their distributions and issuances and presents a trap for companies that do not implement such systems.

Section 385 TD (final regulations)

The Section 385 TD finalizes “with no change” the September 2018 proposed regulations (REG-130244-17), thus removing the Documentation Rules in their entirety. According to the Section 385 TD, Treasury and the IRS “...determined that the burdens imposed on taxpayers by the [Documentation Rules] outweigh the regulations’ intended benefits.”

The preamble states that Treasury and the IRS, however, continue to consider the issues raised by the Documentation Rules, and may subsequently propose a substantially simplified and streamlined version of those rules with a prospective effective date. Taxpayer comments are invited on approaches to minimize taxpayer burdens while still ensuring the collection of information necessary for tax administration.

Section 385 ANPRM (intention for future proposed regulations)

The Section 385 ANPRM announces that Treasury and the IRS intend to propose “more streamlined and targeted” Recast Rules, which would substantially modify the Funding Rule, including through the elimination of the Per Se Funding Rule. Accordingly, these future proposed regulations would apply the Funding Rule to a debt instrument only if its issuance has a sufficient factual connection to a distribution (or one of the specified economically similar transactions) to a member of the taxpayer’s expanded group (for example, when the funding transaction and distribution transaction are pursuant to an integrated plan). Thus, under the future proposed regulations, a debt instrument issued without a factual connection to a distribution or economically similar transaction would not be treated as stock. Treasury and the IRS also are considering substantial revisions to, or removal of, certain exceptions in the regulations, consistent with the revised standard.

The Section 385 ANRPM acknowledges comments recommending that the Recast Rules be withdrawn in their entirety, similar to the Documentation Rules. However, according to the Section 385 ANRPM, Treasury and the IRS:

...are cognizant that a complete withdrawal of the Distribution Regulations could restore incentives for multinational corporations to generate additional interest deductions without new investment. Accordingly, the Treasury Department and the IRS have determined that the [Recast Rules] continue to be necessary at this time.

Treasury and the IRS have requested comments on all aspects of the Recast Rules, including the standard that should apply for determining the factual connection between the issuance of a debt instrument and distributions (or specified economically similar transactions), and whether the rules should include particular factors that would aid such analysis. Significantly, Treasury and the IRS intend to provide that the proposed regulations would apply only to tax years beginning **on or after** the date those rules are **finalized**.

Additionally, the Section 385 ANPRM incorporates the guidance in Notice 2019-58 permitting taxpayers to rely on the 2016 proposed regulations until further notice, provided that the taxpayer consistently applies the rules in the 2016 proposed regulations in their entirety. Accordingly, Notice 2019-58 is obsolete.

KPMG observation

The withdrawal of the Documentation Rules and the proposed elimination of the Per Se Funding Rule will be a welcome relief for some taxpayers. However, for taxpayers anticipating that the Recast Rules would be withdrawn in their entirety after TCJA, the Section 385 ANRPM may come as a disappointment. Moreover, because the future proposed regulations eliminating the Per Se Funding Rule are anticipated to be effective only upon their finalization, and given that such proposed regulations have not yet been issued, the relief announced in the Section 385 ANRPM may come months, if not years, in the future. In the meantime, taxpayers must continue to monitor their distributions and issuances in light of the continued applicability of the Per Se Funding Rule.

Additionally, the announcement that Treasury and the IRS may propose a modified version of the Documentation Rules signals that even the relief afforded by the elimination of the Documentation Rules may, at least in part, be temporary.

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