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Final U.S. Treasury Regulations Disappoint by Retaining Broad Debt-Equity Recharacterization Rules

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The U.S. Treasury Department has issued regulations for debt-equity recharacterization under section 385 of the Internal Revenue Code (the Final Regulations) that finalize without substantive change proposed regulations promulgated in October 2016 (the 2016 Proposed Regulations).

Section 385 recharacterizes certain issuances of related-party debt as equity for U.S. federal tax purposes. (See our prior bulletin titled [Final U.S. Debt-Equity Regulations Are Not as Sweeping as Feared](#).) Under section 385's general recharacterization rule, debt issued by a corporation to an affiliated corporation (or a partnership controlled by an affiliated corporation) is recharacterized as equity if the debt is issued (i) in a distribution, (ii) in exchange for stock of an affiliate or (iii) in certain exchanges for property in an asset reorganization (collectively referred to as Specified Transactions).

The lack of substantive changes, as announced on May 13, 2020, is surprising and disappointing, as expectations for narrowing of the rules had been generated by two earlier developments. First, the need for the section 385 rules was reduced following the implementation of the provisions of the *Tax Cuts and Jobs Act* protecting the U.S. tax base, including further limitations on interest deductions under the expanded section 163(j) earnings stripping rules, adoption of broad anti-hybrid rules and imposition of the new base erosion and anti-abuse tax (which imposes a minimum tax on large corporations making deductible payments, like interest and royalties, to related foreign parties). Second, the Treasury Department and the Internal Revenue Service (IRS) announced in an advance notice of proposed rulemaking on October 31, 2019 (the 2019 ANPR), an intention to eliminate the 72-month "*per se*" funding rule that is both administratively difficult to apply and expected to create many traps for the unwary.

The 2016 Proposed Regulations cross-referenced contemporaneously issued temporary regulations (the 2016 Temporary Regulations), which expired on October 13, 2019. In advance of their expiration, the IRS released Notice 2019-58, which allowed taxpayers to rely on the 2016 Proposed Regulations once the 2016 Temporary Regulations expired, until further notice was given.

In addition to applying to Specified Transactions directly, section 385 also applies to debt issued to fund a Specified Transaction or debt issued close in time to a Specified Transaction. First, under a funding rule, debt issued by a corporation to an affiliate is recharacterized as equity if the debt is issued with a principal purpose of funding a Specified Transaction. Second, under the controversial *per se* rule, subject to certain limited exceptions, any issuance of debt during the 72-month period beginning 36 months before, and ending 36 months after, the date of a Specified Transaction is recharacterized as equity.

The 2016 Temporary Regulations (and, by cross-reference, the 2016 Proposed Regulations) provided exclusions from the recharacterization rule and the funding rule for certain types of debt, including the following:

- debt issued to or by a partnership that is not a "controlled partnership" (i.e., a partnership where one or more affiliated corporations own, directly or indirectly, 80% or more of the interests in the partnership's capital or profits): under this exception, debt issued by a portfolio company to a private equity fund generally would not be recharacterized as equity;
- short-term loans, including cash pool arrangements and international treasury centres; and
- debt issued from one member of a consolidated group to another member of the same consolidated group.

In addition, the rules described above do not apply to the first \$50 million of debt issued by a corporation.

Before the Final Regulations were issued, the Treasury Department and the IRS issued the 2019 ANPR, which announced an intention to issue proposed regulations that would eliminate the *per se* rule.

Although the Final Regulations provide additional clarity with respect to the exceptions from the recharacterization rule and the funding rule set forth in the 2016 Temporary Regulations and make application of certain aspects of the 2016 Proposed Regulations mandatory, the Final Regulations do not make any substantive changes to the section 385 debt-equity rules or the regulations under section 385. Moreover, taxpayers and practitioners are disappointed that the elimination of the *per se* rule promised in the 2019 ANPR is not included in the Final Regulations, and, although the preamble to the Final Regulations references the intention to issue proposed regulations withdrawing the *per se* rule, no timetable has been given for when such regulations might appear.

Effective Date

The Final Regulations are effective as of May 14, 2020. Presumably, however, any taxpayers who could benefit from the exceptions to the recharacterization rule and the funding rule have already been applying the exceptions that were included in the 2016 Temporary Regulations and the 2016 Proposed Regulations.

Conclusion

The Final Regulations adopt the provisions of the 2016 Temporary Regulations and the 2016 Proposed Regulations without substantive changes and without any further relief from these complex and often overly broad rules. Perhaps with the finalization of these regulations, the IRS will turn its attention to more narrowly tailoring the scope of section 385 by eliminating the *per se* rule. In fact, the preamble to the Final Regulations notes that, in accordance with the 2019 ANPR, the Treasury Department and the IRS intend to issue proposed regulations streamlining these rules, including by withdrawing the *per se* rule. However, as no timeline for these proposed regulations is provided, taxpayers should temper their expectations of being granted relief anytime soon and should remain cautious and aware of the potential consequences of financing transactions that could trigger recharacterization of debt as equity under section 385.

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