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The Collateral Damage of the §385 Regulations

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Section 385 is the last section within Subchapter C of the Code. It is a grant of authority to the IRS to write regulations to treat an interest in a corporation as stock or as debt "for purposes of this title." "This title," of course, is Title 26, the entire Internal Revenue Code. Thus, if an interest in a corporation is treated as stock under §385, it will be treated as stock for all purposes of the Code.

The recently finalized regulations under §385[1] take this rule seriously, such that an instrument characterized as stock under the regulations is treated as stock "for all federal tax purposes" — hereafter the "FAFTP" rule.[2] Comments received by the IRS concerning the proposed version of these regulations had suggested that the regulations apply only for certain purposes of the Code, rather than FAFTP. Comments suggested that where the regulations apply to treat as stock an instrument that is in form (and often in substance) debt, this characterization apply only for purposes of disallowing an interest deduction. At last count I came up with a list of 17 Code sections that commentators mentioned as possible candidates for exclusion from the FAFTP rule. Notable among them were:

- Qualification as an "interest other than solely as a creditor" under §897(c);
- Treatment of repayments as a §302 redemption;
- Treatment as stock for purposes of the reorganization rules, e.g. §368(c);
- Application of the §246 holding period rule for the dividends-received deduction;
- Eligibility for the indirect foreign tax credit under §902;
- Application of §382; and
- Treatment as stock under §1504, with possible deconsolidation effects.

Some of these collateral consequences were addressed in the final §385 regulations through the introduction of numerous exceptions from the general rule, including an exception for foreign issuers. The specter of deconsolidation was specifically addressed by accepting the suggestion of commentators that debt characterized as equity under the regulations be treated as §1504(a)(4) preferred stock. This decision was justified in the preamble of the final regulations as necessary to take into account "the purposes of §1504(a)."[3]

As far as the other collateral consequences of the FAFTP rule were concerned, the preamble to the final §385 regulations insisted that an instrument characterized as stock under the regulations should be treated as stock FAFTP. The FAFTP rule has myriad collateral consequences, many of which are likely yet to be

[1] T.D. 9790, 81 Fed. Reg. 72,858 (Oct. 21, 2016).

[2] Reg. §1.385-3(b)(1).

[3] Reg. §1.385-3(d)(7). T.D. 9790, 81 Fed. Reg. at 72,885.

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discovered.[4] One example of the approach that the regulations take to the FAFTP rule — that involving interests in U.S. real property holding corporations (''USRPHCs'') — is illustrative of the general problem presented by the FAFTP rule.

The preamble to the regulations correctly explains the various permutations of the USRPHC issue.[5] At its simplest, §897 treats a foreign person's gain from the disposition of stock of a USRPHC as taxable, but does not tax gain from the disposition of an ''interest solely as a creditor'' in a USRPHC. The policy behind the distinction between debt and equity interests in USRPHCs is to tax foreign persons on U.S. real property interests held indirectly through certain USRPHCs. It was thought that a foreign person who owns only straight debt of a USRPHC should not be treated as indirectly owning the USRPHC's real property. Thus, if a foreign person holds straight, nonparticipating debt of a USRPHC, any gain on the disposition of such debt is not subject to U.S. tax. But if the §385 regulations treat that debt as stock, because for example it is issued as a dividend, any gain on its disposition would be taxable under §897.

The policy underlying the distinction in §897 between stock and debt of a USRPHC rule is unrelated to any policy underlying the §385 regulations. If a foreign person holds an interest in a USRPHC that would under normal rules be respected as debt, he or she does not participate even indirectly in the growth of the value of any U.S. real property owned by the USRPHC. Nevertheless, the preamble to the §385 regulations states that the IRS is prepared to do nothing to solve the collateral damage problem. The reason for refusing to deal with the problem is not that the result makes sense; it quite clearly does not make sense given the policy of the USRPHC rule. Instead, the IRS justified the application of the FAFTP rule by asserting that *the same result would arise in any case in which debt of a USRPHC is characterized for federal tax purposes as stock*.[6]

This justification is completely illogical. Outside of §385, debt will be treated as equity only when it in fact resembles equity economically and in substance. In fact the regulations under §897 go to some length to prescribe the circumstances in which debt is treated as an interest other than solely as a creditor, for example, where the debt incorporates an equity kicker feature. Debt that is straight debt can be recharacterized as stock under the §385 regulations even where the debt bears all the hallmarks of indebtedness and none of the hallmarks of stock. It is also illogical for the §385 regulations to create an exception from the FAFTP rule for §1504 based on the policy of §1504, without making other exceptions based on the policies of other rules.

Because the §385 regulations can have the effect of treating as stock an instrument that is debt in substance, the rules turn upside down many provisions of the Code — the USRPHC rules of §897 being just one. The rules of the Code that turn on the distinction between debt and equity are predicated on the assumption that the distinction is one going to the substance of the relationship created by the terms of the instrument itself, and not by the circumstances in which the instrument is issued.

The steps down the path at which the §385 regulations arrived at this through-the-looking-glass world are not difficult to reconstruct. Step One was the IRS's desire to curb interest-stripping of the U.S. tax base by foreign persons, particularly in and following inversions. Step Two was the IRS's realization that it lacked plausible authority to take any action in this respect, given the statutory rules in §163(j), tax treaties and elsewhere. As stated in the preamble to the regulations, ''although section 385 authorizes the Secretary to prescribe rules to determine whether an interest in a corporation is treated as stock or indebtedness, neither section 385 nor section 163 authorizes a broad rule that disallows an interest deduction under section 163 with respect to an instrument *that is otherwise treated as indebtedness*.''[7] Step Three was the IRS's discovery of its long-dormant and unused authority under §385 to treat debt as equity — but only FAFTP.

Step Four was the IRS's realization that many inverted companies managed to push debt down into the U.S. target via a debt dividend, particularly where the U.S. target has little or no earnings and profits. This technique became the target of the §385 proposed regulations. All of the verbiage in Reg. §1.385-3 and §1.385-3T is designed to backstop the general rule that a debt dividend gives rise, *per se*, to an equity instrument.

Having settled on §385 as the solution, at Step Five the IRS was required to live with the statutory injunction that an instrument treated as stock under §385 must be so treated FAFTP. This explains why the rules could not be limited to interest stripping or to inversions. But because the distinction between debt and equity is assumed to be one of substance throughout

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[4] While I was writing this, a colleague raised the following frightening possibility: What if a subsidiary of a tax-exempt parent makes a loan to the parent characterized as stock under these rules? If that loan were treated as equity, the resulting hook stock could destroy the parent's exemption on private inurement grounds.

[5] T.D. 9790, 81 Fed. Reg. at 72,919–72,920.

[6] This explanation appears in several other passages of the preamble addressing the FAFTP rule.

[7] T.D. 9790, 81 Fed. Reg. at 72,884 (emphasis added).

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the Code, the decision to treat as equity what is in economic substance debt cannot but have very far-reaching collateral consequences. Most of the consequences will not make sense, because the underlying substantive rules were predicated upon the assumption that we can distinguish debt from equity based on the terms of the instrument.

The IRS clearly recognized the conundrum it created by treating debt as stock FAFTP. Accordingly, Step Six was the adoption, particularly in the final regulations, of an extensive patchwork of exceptions, carve-outs and limitations from the general rule. None of these exceptions is grounded in any substantive distinction between debt and equity; all of them are designed expressly to ameliorate the undue reach of the FAFTP rule.

The final §385 regulations are now narrowly targeted rules. Their obvious aim is to combat interest stripping by foreign parents from their U.S. subsidiaries. In light of this, for the IRS to insist on the FAFTP principle is beyond disingenuous. The IRS insists on applying this principle only because, if it did not, then §385 cannot logically be the authority for these regulations.

This state of affairs cannot possibly be what Congress had in mind in enacting §385. The reason that §385 was made to apply FAFTP is that Congress envisioned rules that would distinguish debt from equity based on generally applicable indicia, taking into account the terms of the instrument in question. Section 385 itself lists five criteria that Congress envisioned might apply, including proportionality and subordination. With the exception of proportionality (incorporated using an 80% relationship test), not a single one of these criteria is reflected in the final §385 regulations. If Congress had intended §385 to apply to instruments depending on the circumstances in which they were issued, as opposed to the actual terms of the instrument in question, it would not have made §385 apply FAFTP. It follows that the final §385 regulations cannot be authorized by that section of the Code.

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