



**Presentation:**  
**“SECTION 385 TRAPS & PITFALLS”**  
**64<sup>TH</sup> ANNUAL TAXATION CONFERENCE**  
**UNIVERSITY OF TEXAS**  
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## Overview

Section 385(a): “The Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title **as stock** or **indebtedness** (or as **in part stock** and **in part indebtedness**).

Section 385(b): includes a list of non-exhaustive factors that may be taken into account.

Section 385(c): issuer’s characterization of an instrument is binding on the holder.

- 1. Enacted.** See Tax Reform Act of 1969, PL 91-172, 83 Stat. 487
  - a. Amended by Omnibus Budget Reconciliation Act of 1989, P.L. 101-239, 103 Stat. 2106 to expressly authorize Secretary to treat an instrument as part stock / part debt.
  - b. Amended by Energy Policy Act of 1992, Pub. L. 102-486, §1936(a), 106 Stat. 3032, which added Section 385(c) to provide that the issuer’s characterization of an interest is binding on the issuer and all holders (but not the Secretary).
- 2. Prior Effort:**
  - a. Proposed: Notice of Proposed Rulemaking, 45 Fed. Reg. 18,959 (May 24, 1980)
  - b. “Finalized:” TD 7747, 45 Fed. Reg. 86,438 (Dec. 31, 1980); amended by TD 7774, 46 Fed. Reg. 24,945 (May 4, 1981); amended by TD 7801, 47 Fed. Reg. 147 (Jan. 5, 1982); amended by TD 7822, 47 Fed. Reg. 28,915 (July 2, 1982)
  - c. Withdrawn: TD 7920, 48 Fed. Reg. 50,711 (Nov. 3, 1983)
- 3. New Effort:**
  - a. Notice of Proposed Rulemaking, 81 Fed. Reg. 20,912 (April 4, 2016).
  - b. “Finalized” T.D. 9790, 81 Fed. Reg. 72858 (Oct. 21, 2016)



## **Proposed Regulations: Enormous Number of Public Comments**

An avalanche of comment letters attacked the proposed regulations. Some highlights of the critical comments included the following:

1. The proposed regulations used factors that were not specifically contemplated when section 385 was enacted and achieve objectives other than those contemplated at the time of section 385's legislative enactment.
2. The proposed regulations apply to a broad range of transactions other than just earning stripping transactions and corporate inversion transactions; thus, the breadth of the proposed regulations creates unduly harsh results in non-objectionable fact patterns.
3. The proposed regulations would apply to a significant number of ordinary business transactions and would negatively impact common treasury operations such as cash pooling arrangements.
4. The bifurcation rule was roundly criticized.

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## **Procedural Issues**

FOIA Type Litigation already has existed to acquire documents related to the 1980s regulatory project on Section 385. See *Judkins v. IRS*, D.D.C. No. 1:16-cv-01794 (Sept. 8, 2011).

APA challenge?

Cf., *Chamber of Commerce and Texas Association of Business v. IRS*, No. 1:16-cv-944 (D. Ct. Tex. Aug. 4, 2016) (suit to invalidate regulations issued under section 7874 on grounds that the notice and comment period of the APA were not followed).

Assessing Possible APA Challenge to the Final Regulations:

1. The preamble to the final regulations is voluminous and systematically addresses the submitted comment letters in mind-numbing detail. See 83 Fed. Reg. 72,858-72,950 (92 pages in federal register type-set print).
2. The final regulations (i) reserve on the most controversial aspects of the proposed regulations, significantly expanded exceptions to the funding rule, and relaxed the most onerous aspects of the documentation rules to address the harsh impacts on treasury management operations.

Conclusion (to this speaker): It will be difficult to argue that the Treasury Department did not seriously consider public comments.

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## Major Components of Final Regulations

The controversial final regulations under section 385 have the following main parts:

- I. Operating rules (Reg. §1.385-1 and -2(d) and -3(g)(3)):** the final regulations restricted the definition of an Expanded Group Instrument (EGI) to include only certain instruments issued by a “covered member” (a domestic issuer), so foreign issuer debt instruments are not addressed. The **bifurcation rule** and the **modified expanded group rules**, which were very controversial aspect of the proposed regulations, were **deleted** in the final regulations.
- II. Documentation and Maintenance Requirements (Reg. §1.385-2):** at their core, these rules remain unchanged, but some meaningful modifications were made.
- III. Per se and Funding rules (Reg. §1.385-3):** the final regulations retained these rules but limited their recharacterization of debt into stock to only those specified transactions where debt is issued by a “covered member” (US issuer).
- IV. Consolidated group rule (Reg. §1.385-4)** exception to these rules remains unchanged.
- V. General Anti-Abuse Rule (Reg. §1.385-3(b)(4)):** Debt issued with a principal purpose of avoiding the application of -2 or -3 are subject to being treated as stock.

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## Operational Rules of Reg. §1.385-1: Expanded Group and “Covered Member”

### Expanded Group (Reg. §1.385-1(c)(4))

Utilizes a unique definition that starts with section 1504(a), incorporates section 318 attribution principles, but then “reserves” on how to apply the downward attribution principles of section 318(a)(3).

**Implication:** Reservation on section 318(a)(3) appears to have the effect that an EGI is not created between a brother-sister arrangement that is controlled by a noncorporate owner, nor does it appear to allow for attribution through controlled partnerships.

### Covered Member (Reg. §1.385-1(c)(2))

A covered member is a US domestic corporation or a DRE that is owned by a covered member. In the definition of a “covered member,” the regulations “reserve” (have a place-holder) for non-US issuers. See Reg. §1.385-1(c)(2)(ii).

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