

Documentation Requirements for Related-Party Debt Instruments Under Proposed Section 385 Regulations

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Key Highlights

On April 4, 2016, the U.S. Department of the Treasury (“Treasury”) released proposed regulations that, if finalized, would dramatically change the treatment of intercompany debt issued among members of corporate groups.

Included in the proposed regulations is a rule that certain issuers of purported indebtedness to related parties must satisfy documentation requirements. For affected issuers, satisfying these requirements is necessary, but not sufficient, to achieve debt treatment for U.S. federal income tax purposes.¹

This article provides an overview of the documentation requirements. We address some of the issues only; there are other significant matters addressed in the proposed regulations that are not covered in this article.

We all know that inter-company debt is not always documented and supported as well as it should be. Sometimes, balances can build up in an intercompany account over a period of years with no loan agreement or debt study to support treatment as debt. This has never been a good strategy. But lack of documentation has not always been fatal to debt characterization.² If the recently proposed regulations are issued in final in their current form, that will change.

Background

On April 4, 2016, Treasury issued proposed regulations on the characterization of purported debt instruments. In doing so, it exercised authority granted under code section 385, enacted in 1969, to prescribe regulations deemed necessary or appropriate to determine whether an interest in a corporation is treated as stock or debt for U.S. federal income tax purposes.

The proposed regulations include, inter alia, provisions allowing bifurcation of a single instrument into debt and equity components, provisions determining equity treatment of purported debt instruments in numerous intra-group scenarios and – the subject of this article – provisions specifying contemporaneous documentation requirements that must be met if an instrument is to be respected as debt.

¹ Prop. Treas. Reg. 1.385-2.

² See, e.g., *C.M. Gooch Lumber Sales Co. v. Commissioner*, 49 T.C. 649 (1968) at 656 (noting that in the case of related-party debt, “the absence of a written debt instrument, security, or provision for the payment of interest is not controlling; formal evidences of indebtedness are at best clues to proof of the ultimate fact”); see also *Byerlite Corp. v. Williams*, 286 F.2d 285, 290-91 (6th Cir. 1960), citing *Ewing v. Commissioner*, 5 T.C. Memo 908 (1946) (“The fact that advancements to a corporation are made without requiring any evidence of indebtedness ... was not a controlling consideration . . .”)

Effective Date

The proposed documentation rules would generally apply to debt instruments issued or deemed issued after the regulations are issued as final.³ Treasury has indicated that they intend to move swiftly to finalize the regulations.⁴

Existing instruments in place before the regulations are issued in final form that undergo a significant modification *after* the effective date would be deemed issued after the regulations are final and, therefore, are expected to be subject to the new rules as of the date of significant modification. This is because a significant modification of debt is generally treated as an exchange of the original debt instrument for a modified instrument (i.e. there is deemed to be a new issuance for U.S. federal income tax purposes).⁵

Instruments Impacted

The proposed rules have broad application and generally apply to related-party interests, without regard to whether the issuer and holder are domestic or foreign.

More specifically, the documentation requirements apply to “expanded group instruments” (“EGIs”)⁶ - instruments issued between members of an “expanded group of companies.” The term ‘expanded group’ is new.⁷ It starts with the term “affiliated group”⁸ used in the consolidated return rules,⁹ but makes significant modifications to expand that term, as set out in the table below.

	Affiliated Group	Expanded Group
Key Differences	Includes only U.S. corporations	Includes U.S. corporations, non-U.S. corporations, exempt organizations, Real Estate Investment Trusts (REITs), and Registered Investment Companies (RICs)
	80 percent common vote <u>and</u> value is needed	80 percent common vote <u>or</u> value is sufficient linkage
	Requires direct ownership	Includes corporations held indirectly (e.g. through partnerships)

Exceptions

³ Prop. Treas. Reg. § 1.385-2(f).

⁴ <https://www.treasury.gov/press-center/press-releases/Pages/jl0404.aspx> (U.S. Department of the Treasury press center fact sheet)

⁵ Treas. Reg. § 1.1001-3(b).

⁶ Prop. Treas. Reg. § 1.385-2(a)(4).

⁷ Although the term ‘expanded group’ is new, it is very similar to the term ‘expanded affiliated group’ as defined in I.R.C. § 7874(c)(1).

⁸ I.R.C. § 1504(a).

⁹ Prop. Treas. Reg. § 1.385-1(b)(3).

There are two notable exceptions to the documentation requirements.

Consolidated Group Exception

Instruments held between members of a U.S. consolidated group debt are not subject to the documentation requirements.¹⁰ The enhanced documentation reporting requirements are intended to identify interests that have potential to reduce overall U.S. federal tax liability via interest deductions. Interests between members of a U.S. consolidated group (i.e. intra-group debts) generally do not have such potential.

De Minimis Exception

Taxpayers are generally subject to the documentation requirements only if they meet at least one of the following minimum threshold requirements:

- a. the stock of any member of the expanded group is publicly traded,
- b. On the date an applicable instrument first becomes an EGI, the expanded group has total assets exceeding \$100 million, *or*
- c. On the date an applicable instrument first becomes an EGI, the expanded group's annual total revenue exceeds \$50 million.

For purposes of the assets and revenue tests, financial statements of any member of the expanded group that are prepared as of any date within three years prior to the date the applicable instrument at issue first becomes an EGI are relevant. In other words, companies can't rely solely on the most recently filed financial statements and will need to look back three years to determine whether they qualify under the de minimis exception.¹¹

What needs to be documented?

Documentation requirements can be summarized as follows:

No.	Requirement
1	Written documentation establishing that the issuer has entered into an unconditional and legally binding obligation to pay a sum certain on demand or on one or more fixed dates.
2	Written documentation establishing that the holder has the rights of a creditor to enforce the obligation.
3	Written documentation containing information establishing that, as of the date of issuance, the issuer's financial position supported a reasonable expectation that the issuer intended to, and would be able to, meet its obligations pursuant to the terms of the applicable instrument.
4	Subsequent actions evidencing a debtor-creditor relationship: Evidence of payment of principal and interest, evidence of exercise of due diligence and judgment by lender where payments are not made.

The documentation must include complete and (if relevant) executed copies of all instruments, agreements and other documents evidencing the material rights and obligations of the issuer and the

¹⁰ Prop. Treas. Reg. § 1.385-2(c)(4).

¹¹ Prop. Treas. Reg. § 1.385-2(a).

holder relating to the EGI, and any associated rights and obligations of other parties, such as guarantees and subordination agreements. Additional documentation and information may be provided to supplement, but not substitute for, the documentation and information required.¹²

Requirements 1 and 2

For documentation requirements 1 and 2, taxpayers may have the information readily available (copies of executed loan agreements). However, special care should be given to the drafting of loan agreements to be sure that the debtor's legally binding obligation to pay principal and interest as well as the creditor's rights to enforce the contract are clearly spelled out. The rights of a creditor typically include, but are not limited to the following:

- a. the right to cause or trigger an event of default or acceleration of the EGI (when the event of default or acceleration is not automatic) for non-payment of interest or principal when due under the terms of the EGI,
- b. the right to sue the issuer to enforce payment, and
- c. a superior right to shareholders to share in the assets of the issuer in case of dissolution.¹³

Requirement 3

Documentation requirement 3, evidencing a reasonable expectation of repayment, may require additional work on behalf of taxpayers. Taxpayers must show that the issuer's financial position supports a reasonable expectation that the issuer intended to, and would be able to, meet its obligations pursuant to the terms of the applicable instrument. The documentation may include cash flow projections, financial statements, business forecasts, asset appraisals, determination of debt-to-equity and other relevant financial ratios of the issuer in relation to industry averages, and other information regarding the sources of funds enabling the issuer to meet its obligations pursuant to the terms of the applicable instrument.

If any member of an expanded group relied on any report or analysis prepared by a third party in analyzing whether the issuer would be able to meet its obligations pursuant to the terms of the EGI, the documentation must include the report or analysis.¹⁴

Requirement 4

Documentation requirement 4, evidencing an arm's-length debtor-creditor relationship, covers two separate issues. First, taxpayers must evidence that payments of principal and interest are being made in accordance with the contractual terms of the loan agreement. This is an ongoing requirement and can be satisfied with copies of wire transfers or bank statements showing the payments.¹⁵

In addition to the ongoing requirement covering regular payments on the instrument, taxpayers must substantiate efforts to collect unpaid amounts (e.g. in the event of default) consistent with a true third party relationship. The holder's reasonable exercise of the diligence and judgment of a creditor must be evidenced by written documentation.

Such documentation may include evidence of the holder's efforts to assert its rights under the terms of the EGI, including the parties' efforts to renegotiate the EGI or to mitigate the breach of an obligation under the EGI, or any change in material terms and conditions of the EGI, such as maturity date, interest rate, or

¹² Prop. Treas. Reg. § 1.385-2(b)(2).

¹³ Prop. Treas. Reg. § 1.385-2(b)(2)(i) and (ii).

¹⁴ Prop. Treas. Reg. § 1.385-2(b)(3)(iii).

¹⁵ Prop. Treas. Reg. § 1.385-2(b)(3)(iv)(A).

obligation to pay interest or principal, and any documentation detailing the holder's decision to refrain from pursuing any actions to enforce payment.¹⁶

Typically, related parties would not actively renegotiate debt terms or bring legal action against one another. Therefore, this requirement may necessitate the most monitoring and effort to put procedures in place in order to comply with the new requirements.

When does the documentation need to be collected?

Impacted taxpayers will need to collect a package of documentation to support requirements 1 through 3 shortly after an EGI is issued or otherwise created. This one-time collection of documents at the outset must be completed within 30 days of:

- the date of issuance of an EGI, or
- the date that an existing instrument otherwise becomes an EGI.

An existing instrument may become an EGI by reason of transfer, corporate reorganization, or acquisition, whereby the parties to an instrument become members of the same expanded group.¹⁷

Requirement 4

Documentation requirement 4, evidencing payments, is ongoing on a rolling basis. Impacted taxpayers will need to collect copies of wire transfers or bank statements supporting payments of principal and interest within 120 days of each date on which a payment is due.

Documentation requirement 4 also includes substantiation of the creditor's enforcement of its right to collect from the debtor in the event of default, acceleration event or similar event occurring under the terms of the EGI. Impacted taxpayers will have 120 days from the date of the significant event or action under the terms of the EGI to gather evidence supporting the creditor's efforts to collect.¹⁸

Maintenance / Retention of Documents

Taxpayers need to maintain documentation for all tax years that the EGI is outstanding and until the statute of limitations expires for any return with respect to which the treatment of the EGI is relevant.¹⁹

Example: Company A holds related-party Note Payable, which is determined to be an EGI from 2016 through 2020. Company A deducts interest accrued on Note Payable on its U.S. federal income tax returns for tax years 2016 through 2020. In tax year 2020, Company A settles Note Payable. Company A's statute of limitations for tax year 2020 closes in 2023.

Company A must maintain documentation with respect to Note Payable from tax year 2016 through 2023 when Company A's statute of limitations closes on the 2020 tax return.

¹⁶ Prop. Treas. Reg. § 1.385-2(b)(3)(iv)(B). Tax year 2020 is the last relevant tax return year because it is the last year that

¹⁷ Prop. Treas. Reg. § 1.385-2(b)(3)(ii). Company A benefited from an interest deduction on Note Payable.

¹⁸ Prop. Treas. Reg. § 1.385-2(b)(3)(ii).

¹⁹ Prop. Treas. Reg. § 1.385-2(b)(4).

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