Are the Proposed Code Sec. 385 Regulations, Which Represent Significant Changes in Law, in Part, Impermissibly Retroactive?

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Kristen M. Garry summarizes the regulations and considers whether they are, at least in part, impermissibly retroactive. Kristen provides an overview on the limitations regarding retroactivity of legislative regulations and considers how those limits may apply to the Proposed Reg. §1.385-3 because it has been proposed to apply to certain debt instruments issued before the regulations are finalized.

I. Overview

On April 4, 2016, the Treasury and the IRS released proposed regulations under Code Sec. 385[1] addressing whether purported indebtedness issued to certain related parties will be treated as stock or indebtedness, or as in part stock and in part indebtedness (the "Proposed Regulations").[2] Although they were issued with other proposed regulations focused on preventing inversion transactions, the Proposed Regulations contain sweeping rules that would recharacterize many related-party debt instruments without regard to whether the parties are foreign or domestic.[3] This article provides a

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general summary of the Proposed Regulations, while pointing out a few of the key concerns that have been identified so far. It also raises the question of whether Proposed Reg. §1.385-3, if finalized with its proposed effective date, could be viewed as an impermissibly retroactive regulation and how any changes to the Proposed Regulations adopted in final regulations should be considered.

II. Code Sec. 385

Some brief history of Code Sec. 385 is warranted to understand some of the concerns with the Proposed Regulations. Code Sec. 385(a), enacted by Congress in 1969, authorizes the Treasury Secretary "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." It was intended that the regulations under Code Sec. 385 set forth factors that are to be taken into account to determine whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists in a particular factual situation. Under Code Sec. 385(b), those factors may include, among other factors, the following: "(1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest; (2) whether there is subordination to or preference over any indebtedness of the corporation; (3) the ratio of debt to equity of the corporation; (4) whether there is convertibility into the stock of the corporation; and (5) the relationship between holdings of stock in the corporation and holdings of the interest in question."

In 1989, Congress amended Code Sec. 385(a) to authorize the Secretary to issue regulations under which an interest in a corporation is treated as in part stock and in part indebtedness by adding the parenthetical "or as in part stock and in part indebtedness" to the end of the section.[4] This amendment provided that any regulations so issued may apply only with respect to instruments issued after the date on which the Secretary or the Secretary's delegate provides public guidance as to the characterization of such instruments (whether by regulation, ruling or otherwise). A short time thereafter, in 1992, Congress added Code Sec. 385(c) to prevent issuers and holders from inconsistently characterizing the same corporate instrument.[5] Code Sec. 385(c) provides that "[t]he characterization (as of the time of issuance) by the issuer as to whether an interest in a corporation is stock or indebtedness shall be binding on such issuer and on all holders of such interest (but shall not be binding on the Secretary)"; however, as provided in regulations, the issuer's characterization would not be binding on a holder that discloses such inconsistent treatment. Further, the Secretary was authorized to require under regulations such information as determined necessary to carry out Code Sec. 385(c).

Although final regulations under Code Sec. 385 were issued in 1980, after subsequent revisions to those regulations, they were withdrawn in 1983 because they did not "fully reflect the Treasury or IRS position on debt/equity matters."[6] The Treasury and the IRS previously had not issued any regulations regarding the 1989 amendment to Code Sec. 385(a), which authorizes the Secretary to issue regulations that treat an interest in a corporation as indebtedness in part or as stock in part. In addition, no regulations have been issued under Code Sec. 385(c), which authorizes the Secretary to require information related to an issuer's initial characterization of an interest for federal tax purposes or to affect the ability of a holder to treat an interest inconsistent with the initial treatment of the issuer.

III. Proposed Regulations

There are three main aspects to the Proposed Regulations: the bifurcation rule contained in Proposed Reg. §1.385-1(d), the documentation and record-keeping rules of Proposed Reg. §1.385-2 and the transaction-based rules in Proposed Reg. §1.385-3. It is important to understand first what types of related-party indebtedness would be impacted by the Proposed Regulations.

1. Which Taxpayers Would Be Subject to the Proposed Regulations?

The Proposed Regulations generally would apply to an "expanded group instrument" (EGI), that is, an interest in the form of a debt instrument[7] issued by a member of an "expanded group" to another member of the same "expanded group."[8] The IRS and Treasury intended to apply the Proposed Regulations to transactions between "highly related" parties.[9]

An expanded group is based on the definition of an affiliated group under Code Sec. 1504(a) with three important modifications to broaden it: (i) an expanded group includes all corporations (*e.g.*, foreign corporations, S corporations, real estate investment trusts, regulated investment companies and tax-exempt corporations); (ii) corporations can be held both directly or indirectly by the common parent; and (iii) the ownership threshold is reduced to 80-percent vote *or* value (as opposed to both vote "and" value).[10] While the definition has been broadened dramatically, the Proposed Regulations retain (i) the requirement of Code Sec. 1504(a) that there be a common parent corporation (even though it can now be, for example, a foreign corporation or an S corporation) and (ii) the requirement in Code Sec. 1504(a)(1)(B)(ii) that stock of each includible corporation (other than the parent) must be owned directly by one or more other includible corporations.[11] In light of the modification to allow the parent to own indirectly stock of another corporation, it is not clear whether the IRS or Treasury intended to keep these requirements in the Proposed Regulations.

Furthermore, the Proposed Regulations adopt the attribution rules of Code Sec. 304(c)(3) for purposes of indirect ownership.[12] As such, ownership of stock can be attributed proportionately from a corporation where a person owns five percent or more in value of a corporation and can be attributed proportionately to a corporation from a person who owns stock representing five percent or more in value of the corporation.

Notably, the Proposed Regulations treat consolidated groups as one corporation and therefore generally do not apply to instruments between members of a consolidated group.[13] The Proposed Regulations do not apply to members of a consolidated group because "the concerns addressed in the proposed regulations generally are not present when the issuer's deduction for interest expense and the holder's corresponding interest income offset on the group's consolidated federal income tax return."[14]

For purposes of Proposed Reg. §1.385-2, which are the documentation rules discussed below, controlled partnerships are treated as members of the expanded group, and the term "controlled partnership" is defined as any partnership, the capital or profits interest in which is 80-percent directly or indirectly owned by members of an expanded group.[15] If an EGI that is issued by a controlled partnership is recharacterized as stock under Proposed Reg. §1.385-2, the instrument is treated as an equity interest in the controlled partnership.[16] One interesting question is whether the IRS and Treasury have authority to recharacterize interests in partnerships under Code Sec. 385, which only addresses interests in corporations.

2. Documentation Requirements

An issuer of an EGI is required to produce information and documentation under Proposed Reg. §1.385-2 in order to substantiate its position that an instrument is debt for U.S. tax purposes. These documentation and information requirements only apply where "the stock of any member of the expanded group is publicly traded, all or any portion of the expanded group's financial results are reported on financial statements with total assets exceeding $100 million, or the expanded group's financial results are reported on financial statements that reflect annual total revenue that exceeds $50 million."[17] Commentators have pointed out that the documentation requirements are onerous and broad because if they apply, there are no exceptions for small or ordinary course loans.[18]

The documentation and information requirements that must be satisfied are: (i) a legally binding obligation to pay, (ii) creditors' rights to enforce the obligation, (iii) a reasonable expectation of repayment at the time the interest is created and (iv) an ongoing relationship during the life of the interest consistent with arm's-length relationships between unrelated debtors and creditors.[19] The documentation is to be maintained throughout all tax years 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.[20] The following guidance has been provided on how to satisfy the documentation requirements of the Proposed Regulations:

(i) *A Binding Obligation to Repay*. There must be written documentation timely prepared showing a binding legal obligation on behalf of the issuer to repay a sum certain on demand or at one or more fixed dates.[21]

(ii) *Creditor's Rights to Enforce Terms*. A holder must have the legal rights of a creditor to enforce the terms of the EGI. These rights typically include the right to trigger an event of default, the right to accelerate payments and the right to sue the issuer to enforce payments. Furthermore, the holder must have the "superior right" to share in the assets of the issuer in the event the issuer is dissolved or liquidated.[22]

(iii) *Reasonable Expectation of Repayment*. There must be written documentation evidencing that the issuer's financial position supports "a reasonable expectation that the issuer intended to, and would be able to, meet its obligations" under the terms of the EGI.[23] This 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 (compared to industry averages), and other information regarding the sources of funds enabling the issuer to meet its obligations pursuant to the terms of the EGI.[24] It is not clear under the Proposed Regulations what other funds can be considered in this ability-to-pay analysis. Any final regulations should clarify that it will be acceptable for a taxpayer to show the ability to borrow from third parties to support an expectation of repayment.

(iv) *Actions Evidencing a Genuine Debtor-Creditor Relationship*. The taxpayer must provide evidence of an ongoing debtor-creditor relationship. This would include timely documentation of payments under the EGI of both principal and interest, such as a wire transfer record or a bank statement reflecting the payment.[25] In the alternative of nonpayment or default under the EGI, the Proposed Regulations require evidence of a holder's reasonable exercise of the diligence and judgment of a creditor. The Proposed Regulations provide an example of documentation showing the holder's efforts to enforce the terms of the EGI or otherwise renegotiate the EGI in the event of default or similar events.[26] This requirement creates an unrealistic scenario where in the event of default, a wholly owned subsidiary would be required to seek judgment from its parent (or *vice versa*) as if it were a third-party creditor.

The documentation required with respect to the first three requirements must be prepared no later than 30 calendar days after the instrument becomes an EGI or the date the expanded group member becomes an issuer with respect to an EGI. For evidence of debtor-creditor relationship, the Proposed Regulations provide that documentation must be provided up to 120 calendar days after the payment or relevant event has occurred.[27] The relevant date for the debtor-creditor relationship documentation generally is when payment of interest or principal under the EGI is due or, in the event of default or similar event, the date of such default or similar event.[28] One significant question is whether the need to document a reasonable ability to pay upon a deemed modification of an existing EGI means that Reg. §1.1001-3(f)(7), which generally ignores a deterioration in the financial condition of an obligor, no longer applies in the context of modifications of related-party indebtedness.[29]

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The purpose for the information and documentation requirements is to "require a degree of discipline in the creation of necessary documentation, and in the conduct of reasonable financial diligence indicative of a true debtor-creditor relationship, that exceeds what is required under current law."[30] As such, these requirements are intended to better equip the IRS to analyze whether an EGI is appropriately characterized as debt for U.S. tax purposes. Satisfying the documentation requirements will not establish that an interest is debt for U.S. tax purposes but rather "acts as a threshold test for allowing the possibility of indebtedness treatment."[31] If, and only if, the documentation requirements are satisfied may the federal tax treatment be determined based on the information prepared and maintained by the taxpayer, "other facts and circumstances relating to the EGI and general federal tax principles."[32]

If the documentation requirements are not satisfied with respect to an EGI, then the EGI will be treated as stock.[33] This is a truly draconian penalty for failing to satisfy certain record-keeping requirements. In light of the purpose of the documentation requirements, which is to enable the IRS to determine whether instruments should be characterized as debt, equity or part debt and part equity in order to more accurately reflect the true substance and economics of the instrument, this penalty is disproportionately more severe and inconsistent with this purpose.

Furthermore, once an EGI is characterized as indebtedness, assuming the documentation and information requirements have been satisfied, the issuer, holders and any other person relying on the characterization of the EGI as debt for federal tax purposes must treat the EGI as such for all federal tax purposes. However, the IRS is not bound by the characterization of an EGI.[34]

The Proposed Regulations provide for a "reasonable cause exception," which allows the IRS to modify the requirements of Proposed Reg. §1.385-2 for taxpayers whose failure to comply with the requirements was due to reasonable cause.[35] In addition, there is a "no affirmative use" provision in the Proposed Regulations that prohibit the intentional failure of the information and documentation requirements with the principal purpose of reducing the federal tax liability of any member or members of its expanded group.[36] Lastly, there is an "anti-avoidance" provision that recharacterizes instruments that would not be considered EGIs as an EGI if such instrument had a principal purpose of avoiding the information and documentation requirements found in Proposed Reg. §1.385-2.[37] The Preamble provides an example of the anti-avoidance provision whereby a member of an expanded group issues an instrument to a trust held by members of the same expanded group.[38]

3. Bifurcation Rule

As the Preamble notes, there has been a long tendency by courts to characterize an instrument as either wholly debt or wholly stock, which is problematic in cases where the facts and circumstances "provide only slightly more support for characterization of the entire interest as indebtedness than for equity characterization, a situation that is increasingly common in the related-party context."[39] The Treasury and the IRS decided that this "all-or-nothing approach frequently fails to reflect the economic substance of related-party interests that are in form indebtedness and gives rise to inappropriate federal tax consequences."[40]

As such, Proposed Reg. §1.385-1(d) provides: "The Commissioner may treat an EGI … as in part indebtedness and in part stock to the extent that an analysis, as of the issuance of the EGI, of the relevant facts and circumstances concerning the EGI (taking into account any application of sec. 1.385-2) under general federal tax principles results in a determination that the EGI is properly treated for federal tax purposes as indebtedness in part and stock in part." This rule applies to debt issued within a modified expanded group (that is, a 50-percent vote or value threshold, rather than 80 percent); in addition, for purposes of this rule, any person (including an individual, trust or partnership) who is treated under the constructive ownership rules of Code Sec. 318 as owning at least 50 percent of the stock of a modified expanded group member will be treated as a member of the modified expanded group.[41] Although the Proposed Regulations do not provide any formal guidance, reasons for a debt instrument to be bifurcated likely would include that the issuer is too thinly capitalized to support the full amount of the debt or that the instrument includes equity-like features, such as equity kickers. The sole example provided in the Preamble involved a related-party interest that was documented as a $5 million debt instrument, but analysis demonstrated that as of the issuance the issuer could not reasonably be expected to repay more than $3 million of the principal amount as of its issuance, so the Preamble concluded that it would be appropriate for the IRS to treat the interest as part indebtedness ($3 million) and part stock ($2 million).[42]

The bifurcation rule, like the documentation rules, only applies to instruments that are debt in form. As such, it would not apply to sale-repurchase agreements, sale-leaseback transactions or instruments treated as debt by statute (*e.g.*, REMIC regular interests that could be in the form of equity). Taxpayers may not affirmatively use this provision to treat an instrument as part debt, part equity. This provision applies only to instruments issued (or deemed issued) on or after the date the regulations are finalized.

4. Transaction Rules of Proposed Reg. §1.385-3

Proposed Reg. §1.385-3 contains two rules that may recharacterize a debt instrument that otherwise qualifies as debt under Proposed Reg. §§1.385-1 and -2 (and under general tax principles) as stock: (i) debt issued to an expanded group member in a distribution or as consideration in certain transactions will be recharacterized as stock (the "General Rule"), and (ii) debt issued to an expanded group member in exchange for cash will be recharacterized as stock if a distribution or other transaction described in the General Rule occurs within three years before or after the debt is issued or the debt is issued with a principal purpose of funding such distribution or other transaction (the "Funding Rule").

Under the General Rule, a debt instrument (which includes an interest that is treated as debt, even if it is not in the form of debt) is treated as stock if it is issued by a corporation to a member of the corporation's expanded group: (i) in a distribution in which a subsidiary distributes a note to its parent, (ii) in exchange for expanded group stock (*e.g.*, in a Code Sec. 304 transaction) or (iii) as consideration in certain asset reorganizations (*e.g.*, in a D reorganization).[43]

The Funding Rule treats as stock any debt instrument issued by a corporation (that is, the "Funded Member") to fund one of the three identified transactions. Thus, the Funding Rule generally applies if a debt instrument is issued to fund: (i) a distribution of property by the Funded Member to a member of the Funded Member's expanded group; (ii) an acquisition of expanded group stock, other than in an "exempt exchange"; or (iii) an acquisition of property by the Funded Member in an asset reorganization.[44] When the Funding Rule applies, it changes the character of the funding, but not of the other transaction that was funded by the recharacterized debt instrument.

Under an irrebuttable presumption, because money is fungible, a debt instrument is treated as stock if it is issued by the Funded Member during the period beginning 36 months before the date of the distribution or acquisition and ending 36 months after the date of a distribution or acquisition by the Funded Member.[45] There is a narrow exception to this *per se* rule for extensions of credit for sale of inventory and the receipt of services in the ordinary course of business. This rule feels particularly draconian, as a taxpayer could be completely unaware that a distribution three years prior could impact whether a related-party debt is treated as equity for U.S. tax purposes. While money generally is fungible, it feels inappropriate to treat money in 2017 as fungible with money in 2020.

There are several exceptions to the General Rule and the Funding Rule. First, for purposes of applying the General Rule and the Funding Rule, the aggregate amount of any distributions or acquisitions is reduced by an amount equal to the current-year earnings and profits of the distributing or acquiring corporation.[46] Second, a debt instrument will not be treated as stock under the General Rule and the Funding Rule if, when the instrument is issued, the aggregate issue price of all expanded group debt instruments that would otherwise be treated as stock under the Proposed Regulations does not exceed $50 million.[47] This exception, however, functions as a cliff, such that all such debt is treated as equity once the $50 million threshold is exceeded. Third, an exception to the Funding Rule exists for funding acquisitions of subsidiary stock from the subsidiary.[48] Specifically, an acquisition of expanded group stock will not be treated as an acquisition for purposes of the Funding Rule if: (i) the acquisition results from a transfer of property by a funded member (the transferor) to an issuer in exchange for stock of the issuer; and (ii) for the 36-month period following the issuance of subsidiary stock, the transferor holds, directly or indirectly, more than 50 percent of the vote and value of the stock of the issuer.

Under a broad anti-abuse rule, a debt instrument will be treated as stock if it is issued with a principal purpose of avoiding the application of the Proposed Regulations.[49] Furthermore, interests that are not debt instruments for purposes of Proposed Reg. §§1.385-3 and 1.385-4 (for example, contracts to which Code Sec. 483 applies or nonperiodic swap payments) would be treated as stock if issued with a principal purpose of avoiding the application of Proposed Regulations. According to examples in the Proposed Regulations, the anti-abuse rule may be applicable where (i) a debt instrument is issued to, and later acquired from, a person that is not a member of the issuer's expanded group; (ii) a debt instrument is issued to a person that is not a member of the issuer's expanded group, and such person later becomes a member of the issuer's expanded group; (iii) a debt instrument is issued to an entity that is not taxable as a corporation; or (iv) a member of the issuer's expanded group is substituted as a new obligor or added as a co-obligor on an existing debt instrument, in each case, where the debt instrument is issued with a principal purpose of avoiding the application of the General Rule and the Funding Rule. Additionally, a taxpayer is prohibited from affirmatively relying on the Proposed Regulations to the extent that the taxpayer enters into a transaction that otherwise would be subject to the Proposed Regulations with a principal purpose of reducing the U.S. tax liability of any member of the expanded group.

The Proposed Regulations take an aggregate approach to controlled partnerships in order to prevent avoidance of these rules through the use of partnerships.[50] That is, where a member of an expanded group is a partner in a "controlled partnership" with respect to the expanded group, the member is treated as (i) owning its proportionate share of the partnership's assets, (ii) issuing its proportionate share of any partnership debt instrument, (iii) acquiring its proportionate share of any expanded group stock acquired by the controlled partnership and (iv) receiving its proportionate share of any "other property" received by the partnership in a transaction described in Code Sec. 356. A partnership is a "controlled partnership" if 80 percent or more of the interests in the capital or profits of the partnership are owned, directly or indirectly (under Code Sec. 304(c)(3)), by one or more members of an expanded group.

The Proposed Regulations treat all members of a consolidated group as one corporation. Consequently, debt between consolidated group members is not subject to recharacterization under the Proposed Regulations. When a debt ceases to be an intercompany obligation (but remains within an expanded group), it is treated as an EGI immediately afterward and becomes subject to the documentation requirements of Proposed Reg. §1.385-2 and the recharacterization rules of Proposed Reg. §1.385-3.

5. Consequences of Reclassification

If a debt instrument is reclassified as equity under the Proposed Regulations, the parties may experience adverse and uncertain U.S. tax consequences. The reclassification of the debt instrument as stock will cause deductible interest payments to be reclassified as nondeductible dividend payments. Further, a repayment of principal under a debt instrument that a U.S. holder anticipated would be a tax-free repayment of principal may be reclassified as a taxable dividend. Finally, where an instrument issued by a U.S. person is held by a non-U.S. person, the reclassification of an interest payment as a dividend may give rise to greater withholding tax to the extent that the parties are relying on a reduced treaty withholding tax rate for interest paid.

An instrument that is initially characterized as debt may become stock under the Proposed Regulations (*e.g.*, if the documentation requirements are met initially but are not met at a later date, or if a subsequent transaction causes a debt to be recharacterized under the Funding Rule). When that happens, the debt is deemed to be exchanged for stock. Consequences of the deemed exchange include: (i) the holder's amount realized equals its adjusted basis in the debt, (ii) the issuer is deemed to retire the debt for an amount equal to the adjusted issue price and (iii) any foreign currency gain or loss on the debt is recognized.[51]

The impact of the Proposed Regulations is unclear in other areas. In particular, it is unclear whether the recipient of a reclassified dividend will be entitled to a dividends-received deduction under Rev. Rul. 94-28,[52] which held a taxpayer was not entitled to a dividends-received deduction paid on stock that had creditor's rights. Additionally, where the reclassified debt instrument is treated as nonvoting stock, the holder of the reclassified instrument may not obtain an indirect foreign tax credit under Code Sec. 902 as a result of dividends paid on the reclassified instrument. Hopefully any final regulations will clarify the follow-on consequence that is intended because otherwise the indirect foreign tax credit for foreign income taxes paid by the issuer of the reclassified instrument could permanently disappear. Commentators also have questioned whether a reclassified instrument could be treated as "fast-pay preferred stock," which is a "listed transaction."[53] Moreover, the reclassification of debt instruments could raise concerns under base erosion and profit shifting (BEPS) with respect to hybrid instruments.

6. Effective Dates

The documentation requirements and the bifurcation rule will apply to debt instruments issued on or after the date the Proposed Regulations are issued as final regulations. However, Proposed Reg. §1.385-3 and its General Rule and Funding Rule will apply to debt instruments issued on or after April 4, 2016.[54] A distribution or acquisition that occurs before April 4, 2016 (other than one that is treated as occurring before April 4, 2016, as a result of a "check-the-box" election filed on or after April 4, 2016) is not taken into account for purposes of the Funding Rule. There is a transition rule that debt instruments subject to reclassification under these rules will continue to be classified as indebtedness for 90 days after the adoption of the final regulations.[55] This transition rule allows taxpayers the opportunity to repay or otherwise manage debt instruments subject to reclassification under these rules before such reclassification is effective.

IV. Concerns About Retroactivity

There already has been extended criticism of the breadth of the Proposed Regulations.[56] In particular, commentators have questioned whether the Proposed Regulations, if adopted as final regulations in substantially the same form, could be challenged as invalid regulations.[57] The rest of this article provides an overview on the limitations on retroactive regulations, then raises whether Proposed Reg. §1.385-3, which would apply to debt instruments issued on or after April 4, 2016, could be an impermissibly retroactive regulation, and if not, how any modifications to the Proposed Regulations would be evaluated under the general prohibitions on retroactivity.

1. Standards for Evaluating Retroactive Regulations

The Proposed Regulations are legislative regulations in that Congress granted to the Secretary the authority to prescribe regulations under Code Sec. 385. As a general matter, the Supreme Court has made clear since *Bowen v. Georgetown University Hospital*[58] ("*Bowen*") that retroactive legislative regulations are not valid unless specifically authorized by Congress. However, the question of whether retroactive Treasury regulations are valid has been a frequent and continuing source of confusion for decades.

As described in *Landgraf v. USI Film Products*[59] ("*Landgraf*"), the standard commonly employed by courts for determining whether a statute or regulation is retroactive depends on whether the application of the statute or regulation attaches new legal consequence to events completed before its enactment or promulgation. That is, retroactivity alters the "past legal consequences of past transactions."[60] While these axioms from *Landgraf* and *Bowen* are frequently cited, determining when a regulation or statute applies retroactively is not always a simple task. In most cases, courts find a regulation is retroactive where the regulation applies to, or "targets," conduct undertaken prior to the regulation's effective date and in the process supplants prior law.

As stated above, the scope of these Proposed Regulations, which represent dramatic changes in law, is extensive, so much so that there have been suggestions that they exceed the authority granted in Code Sec. 385.

Code Sec. 7805(a) sets forth the general grant of authority for the Treasury to issue regulations necessary for the enforcement of the Code. Former Code Sec. 7805(b) (before it was amended in 1996) gave the Treasury the authority to "prescribe the extent, if any, to which any ruling or regulation, relative to the internal revenue laws, shall be applied without retroactive effect." The original predecessor statute was enacted in the 1920s at the request of the Treasury in order to avoid serious administrative difficulties and out of concern for taxpayers who detrimentally relied on the Treasury's prior incorrect interpretive guidance.[61] In the 1920s, based on a declaratory theory of law,[62] interpretive regulations were understood to operate retroactively by default. As an agency's interpretation of a statute, an interpretive regulation purported to declare the meaning of the statute. If the agency's interpretation changed, the new interpretive regulation was understood to be the meaning of the law from the time of enactment, notwithstanding the prior interpretation. Legislative history related to former Code Sec. 7805(b)[63] and commentary by major tax scholars indicate that former Code Sec. 7805(b) was intended to address the problem of interpretive regulations operating automatically with retroactive effect.[64]

Legislative regulations, however, are understood to be fundamentally different from interpretive regulations, both in form and in function.[65] In general, an agency promulgates legislative regulations where Congress has specifically delegated the power to make new rules through a specific statutory grant of regulatory authority.[66] Since legislative regulations create new law, such regulations generally are not allowed to be retroactive. Despite the distinctions between interpretive and legislative regulations, a number of courts have held that former Code Sec. 7805(b) reflects a presumption that Treasury regulations will have retroactive effect without regard for such distinctions.[67]

Between those concerns and the retroactivity concerns noted herein, it may still be years before taxpayers know what rules they need to follow with any real certainty, particularly if the IRS and Treasury seek to have any changes to the Proposed Regulations to apply retroactively.

In 1996, as part of the Taxpayer Bill of Rights Act 2, Congress amended Code Sec. 7805(b) to specifically limit the Treasury's ability to issue regulations having retroactive effect, except in certain identified circumstances, such as the prevention of abuse or the correction of procedural defects.[68] Current Code Sec. 7805(b)(1)(B), which Treasury and the IRS appear to be relying on with respect to Proposed Reg. §1.385-3, provides that final regulations can be retroactive to the date on which any proposed regulations to which the final regulations relate was filed with the Federal Register.[69]

Current Code Sec. 7805(b) applies "with respect to regulations which relate to statutory provisions enacted on or after the date of the enactment of this Act" (*i.e.*, July 30, 1996).[70] In light of the literal language which refers to "statutory provisions enacted on or after" July 30, 1996, this effective date language should mean that current Code Sec. 7805(b), which allows final regulations to apply retroactively to the date of the proposed regulations, only applies to regulations promulgated under statutory provisions that are enacted on or after July 30, 1996. The 1996 House Report's description of the effective date contained in the statute is consistent with this reading: "The provision applies with respect to regulations that relate to statutory provisions enacted on or after the date of enactment."[71]

Despite this clear language and supportive legislative history, some commentators have argued that the current Code Sec. 7805(b) should be read as applying to all regulations issued on or after July 30, 1996, regardless of when the underlying statutory provision was enacted.[72] Arguments in support of this position include the supposition that the word "enacted" modifies "regulations" and not "statutory provisions," which stretches the meaning of the word "enacted" since most tax practitioners would not describe regulations as enacted. In addition, courts and the IRS have applied current Code Sec. 7805(b) to regulations issued with respect to statutory provisions enacted prior to July 30, 1996.[73] A correct reading should be that the effective date language means that current Code Sec. 7805(b) applies only with respect to regulations issued pursuant to statutory provisions (whether substantive provisions or provisions granting regulatory authority) that were enacted on or after July 30, 1996.

That leaves the question of whether retroactive application of a legislative regulation was permissible prior to the 1996 amendments to Code Sec. 7805(b). As suggested above with respect to the early guidance on former Code Sec. 7805(b), a very careful analysis of the law suggests that such retroactivity of a legislative regulation was only permissible if Congress explicitly sanctioned its application in connection with its legislative grant of regulatory authority. The legislative history to Code Sec. 385 does not provide any such explicit sanction for regulations under this grant to be retroactive.[74] In fact, with respect to the 1989 amendment to Code Sec. 385, Congress made clear that the regulatory authority which Treasury was granted to characterize an instrument as part debt and part equity applies only on a prospective basis.[75]

It seems clear that any final regulations issued to adopt the provisions of Proposed Reg. §1.385-3 from its proposed effective date of April 4, 2016, could create new legal consequences to events completed before the promulgation of the final regulations. In particular, a distribution or acquisition that occurs on or after April 4, 2016, could be taken into account for purposes of the "*per se*" rule to cause a related party debt instrument to be recharacterized as equity. Under the *Landgraf* description of retroactivity, it feels like such final regulations would attach new legal consequences to events completed before their finalization. However, a court could find that the 90-day transition rule in Proposed Reg. §1.385-3(h)(3), which provides that a debt instrument subject to reclassification under these rules will continue to be classified as indebtedness for 90 days after the adoption of the final regulations, prevents such regulations from being impermissibly retroactive. In any event, an understanding of the limitations on retroactive legislative regulations is necessary for the next part of this article.

2. Even If Not Impermissibly Retroactive, Real Concerns Would Exist with Any Changes to Proposed Reg. §1.385-3 Prior to Finalization

Furthermore, even if the Proposed Regulations would not be impermissibly retroactive if enacted as written, a significant challenge could be raised if the IRS or Treasury modified any key parts of Proposed Reg. §1.385-3 prior to its finalization. The scope of these Proposed Regulations is vast. If there are changes to the Proposed Regulations that are not known until final regulations are issued, the regulations as promulgated should be valid only on a prospective basis.

For example, as described above, there are a few exceptions to the Proposed Regulations, including one that, for purposes of applying the General Rule and the Funding Rule, would reduce the aggregate amount of any distributions or acquisitions by the current-year earnings and profits of the distributing or acquiring corporation. According to Treasury Deputy International Tax Counsel Douglas Poms, Treasury may decide to use a metric other than current-year earnings and profits for providing an exception from the transaction or recast rules for ordinary course related-party distributions when it finalizes the Proposed Regulations.[76] Given the inherent uncertainty of not knowing one's current-year earnings and profits (E & P) amount until the end of the year, discussion has been raised whether the use of the prior year's E & P may be more appropriate.[77]

Another topic of discussion is whether the final regulations could change from the Proposed Regulations such that brother-sister corporations would become subject to the regulations. As described above, the Proposed Regulations clearly do not cover brother-sister corporations because they preserve the requirement in Code Sec. 1504(a)(1)(B)(ii) that stock of an includible corporation must be owned directly by one or more other includible corporations. According to a recent article, the IRS is "definitely considering" whether brother-sister corporations should be included in the definition of an expanded group.[78]

If these or other changes alter the application of the Proposed Regulations or outcome to a taxpayer that engages in activity prior to the promulgation of any final regulations based upon then-current law or the Proposed Regulation provisions, then such final regulations should not be validly applicable to such activity prior to promulgation. In *Landgraf*, the Supreme Court stated that "since the early days of this Court, we have declined to give retroactive effect to statutes burdening private rights unless Congress had made clear its intent," in part because "requiring clear intent assures that Congress itself has affirmatively considered the potential unfairness of retroactive application and determined that it is an acceptable price to pay for the countervailing benefits."[79] The Court emphasized the historical concerns with retroactive legislation, stating:

> [T]he presumption against retroactive legislation is deeply rooted in our jurisprudence, and embodies a legal doctrine centuries older than our Republic. Elementary considerations of fairness dictate that individuals should have an opportunity to know what the law is and to conform their conduct accordingly; settled expectations should not be lightly disrupted.[80]

In *Landgraf*, the Supreme Court set forth a two-step inquiry: (1) whether Congress clearly intended for a statute to have retroactive effect and (2) if such clear intention is not found, whether the statute has an impermissible retroactive effect.[81] While *Landgraf* addressed a retroactive statute, it should be equally applicable to retroactive legislative regulations because Congress cannot authorize an agency to do more than it can do directly.[82] While *Bowen* and *Landgraf* are not tax cases, the standard derived from such cases should be no less applicable to Treasury regulations. In *Mayo Found. for Med. Educ. & Research*,[83] the Supreme Court established that general principles of administrative law are applicable to Treasury regulations.

Furthermore, a Tax Court case, which predates both *Bowen* and *Landgraf*, that illustrates this concern is *P. Elkins*,[84] where the IRS issued a final regulation with a grandfathering rule that differed significantly from the one contained in the proposed regulation. In *Elkins*, after proposed regulations under Code Sec. 612 had been issued that prohibited the accrual of mineral royalties in advance of production, the taxpayer became a limited partner in a partnership that was obligated to pay coal royalties. The proposed regulations specified an October 29, 1976, effective date but provided that they would not apply to royalties required to be paid under a mineral lease that was "binding prior to that date upon the party who in fact pays or accrues such royalties." When the regulations were finalized, they stated that in order to fall under the grandfathering rule in the case of advanced royalties paid or accrued by a partnership, the party who must be obligated to pay the royalties before the date of announcement was the partner, not the partnership. Accordingly, the IRS denied the taxpayer's deduction because he did not become a partner until after the proposed regulations had been announced.

The Tax Court disagreed, stating "[w]e think that the Secretary, having made that announcement, was required to abide by its terms, at least in his dealings with taxpayers who had acted in reasonable reliance on it."[85] The final regulation was not applied by the Tax Court to the partner due to the restriction on retroactivity. The Tax Court explained that:

> [t]he Secretary's discretion to apply his regulations retroactively is very broad, but its counterpart is the responsibility to provide taxpayers with adequate guidance as to the extent to which his power will be exercised, or at the very least to avoid misleading them. This he has not done in the present case. We think that it was unreasonable of the Secretary to require taxpayers to divine his meaning in using the word "payor" and the clause "party who in fact pays or accrues such royalties" without informing them prior to their investment that the words did not mean what they said. We think that it would constitute an abuse of discretion for respondent first to state a concise rule through the medium of an official pronouncement and then belatedly to alter that rule to the substantial disadvantage of a taxpayer who had meanwhile acted in reliance on the most reasonable interpretation of it.[86]

As stated above, the scope of these Proposed Regulations, which represent dramatic changes in law, is extensive, so much so that there have been suggestions that they exceed the authority granted in Code Sec. 385. Between those concerns and the retroactivity concerns noted herein, it may still be years before taxpayers know what rules they need to follow with any real certainty, particularly if the IRS and Treasury seek to have any changes to the Proposed Regulations to apply retroactively.

ENDOTES

* The author thanks Robert A. Rudnick and Eric Grosshandler for helpful comments on an earlier draft.

1 Unless otherwise stated, "Code Sec." references are to the Internal Revenue Code of 1986, as amended (the "Code"), and "Reg. §" references are to the Treasury regulations promulgated thereunder.

2 REG-108060-15.

3 Preamble to the Proposed Regulations (the "Preamble"), at 12.

4 Act Sec. 7208(a)(2) of P.L. 101-239, 103 Stat. 2106 (1989).

5 P.L. 102-486, 106 Stat. 2776 (1992). *See* H.R. Rep. No. 102-716, at 3 (1992).

6 *See* T.D. 7747 (45 FR 86438), Dec. 31, 1980; subsequently proposed to be withdrawn in 48 Fed. Reg. 31053 and withdrawn by T.D. 7920 (48 FR 50711), Nov. 3, 1983.

7 Proposed Reg. §1.385-2(a)(4)(i).

8 Preamble, at 31.

9 Preamble, at 32, 37.

10 Proposed Reg. §1.385-1(b)(3)(i).

11 Code Sec. 1504(a)(1)(B)(ii) ["stock meeting the requirements of paragraph (2) in each of the includible corporations (except the common parent) is owned directly by 1 or more of the other includible corporations"]; Proposed Reg. §1.385-1(b)(3)(i) (which makes no changes to Code Sec. 1504(a)(1)(B)(ii)).

12 Proposed Reg. §1.385-1(b)(3)(ii).

13 Proposed Reg. §1.385-1(e).

14 Preamble, at 35.

15 Proposed Reg. §1.385-2(c)(6)(i); Proposed Reg. §1.385-1(b)(1).

16 Proposed Reg. §1.385-2(c)(6)(ii).

17 Preamble, at 38. *See* Proposed Reg. §1.385-2(a)(2)(i)(B) and (C) ("[O]n the date that an applicable instrument first becomes an EGI, total assets exceed $100 million on any applicable financial statement, or on the date that an applicable instrument first becomes an EGI, annual total revenue exceeds $50 million on any applicable financial statement."). The Proposed Regulations are not clear on whether issuers or expanded groups who first surpass the thresholds in a given year must start compliance on the day it surpasses the threshold, since the beginning of the year that it first exceeds the threshold or once that year's financial statements are reported.

18 *See* Letter from United States Council for International Business in response to the collection of information requirements contained in the notice of proposed rulemaking (Section 385—REG 108060-15), Public Submission Posted: June 7, 2016, ID: IRS-2016-0014-0057, at 1 ("The costs could run to hundreds of millions or even billions of dollars across all persons affected by the regulations. This is in part because the documentation requirements are so broad with no exception for small or ordinary course loans, thereby potentially applying to hundreds of thousands or millions of loans per corporate group.").

19 Proposed Reg. §1.385-2(b)(2); Preamble, at 19–20.

20 Proposed Reg. §1.385-2(b)(4).

21 Proposed Reg. §1.385-2(b)(2)(i).

22 Preamble, at 40; Proposed Reg. §1.385-2(b)(2)(ii).

23 Proposed Reg. §1.385-2(b)(2)(iii).

24 Preamble, at 40–41; Proposed Reg. §1.385-2(b)(2)(iii).

25 Proposed Reg. §1.385-2(b)(2)(iv)(A).

26 Proposed Reg. §1.385-2(b)(2)(iv)(B).

27 Proposed Reg. §1.385-2(b)(3)(i).

28 Proposed Reg. §1.385-2(b)(3)(ii)(C)-(D).

29 *See* William Davis & Lee Sheppard, ***Debt-Equity Rules May Change Current Law***, 2016 TNT 89-6 (May 9, 2016) ("When there is a refinancing, a taxpayer must consider again the creditworthiness of the borrower, [Treasury tax deputy tax legislative counsel] Vallabhaneni said … He articulated that it is not the intention to repeal reg. section 1.1001-3(f)(7) for related parties, but that if there is going to be a new instrument, the creditworthiness must be tested again. He added that the issue will likely need to be clarified in the final regulations.").

30 Preamble, at 20.

31 Preamble, at 36.

32 Proposed Reg. §1.385-2(a)(1).

33 *Id*. In addition, if specified documentation is not provided to the IRS upon request, the IRS may treat the preparation and maintenance of documentation as not satisfied. Preamble, at 36.

34 Proposed Reg. §1.385-2(c).

35 Preamble, at 43; Proposed Reg. §1.385-2(c)(1).

36 Proposed Reg. §1.385-2(d).

37 Proposed Reg. §1.385-2(e).

38 Preamble, at 44.

39 Preamble, at 13.

[40] *Id*.

[41] Proposed Reg. §1.385-1(b)(5) ("In addition, if a person (as defined in section 7701(a)(1)) is treated, under the rules of section 318, as owning at least 50 percent of the value of the stock of a modified expanded group member, the person is treated as a member of the modified expanded group.").

[42] Preamble, at 33.

[43] Proposed Reg. §1.385-3(b)(2).

[44] Proposed Reg. §1.385-3(b)(3)(ii).

[45] Proposed Reg. §1.385-3(b)(3)(iv)(B).

[46] Proposed Reg. §1.385-3(c)(1).

[47] Proposed Reg. §1.385-3(c)(2).

[48] Proposed Reg. §1.385-3(c)(3).

[49] Proposed Reg. §1.385-3(b)(4).

[50] Proposed Reg. §1.385-3(d)(5).

[51] Proposed Reg. §1.385-1(c).

[52] Rev. Rul. 94-28, 1994-1 CB 86.

[53] *See* Notice 2009-59, 2009-31 IRB 170, section 2(6).

[54] Proposed Reg. §1.385-3(h)(1).

[55] Proposed Reg. §1.385-3(h)(3) ("When paragraphs (b) and (d)(1)(i) through (v) of this section otherwise would treat a debt instrument as stock prior to the date of publication in the Federal Register of the Treasury decision adopting this rule as a final regulation, the debt instrument is treated as indebtedness until the date that is 90 days after the date of publication in the Federal Register of the Treasury decision adopting this rule as a final regulation.").

[56] *See, e.g.*, Jim Peaslee of Cleary, Gottlieb comment letter on the Proposed Regulations (May 18, 2016), TAX NOTES Doc. 2016-10364; Scott Semer of Torys comment letter on the Proposed Regulations (June 6, 2016), 2016 TNT 111-20; United States Council for International Business comment letter on the Proposed Regulations (June 7, 2016), *supra* note 18.

[57] *See, e.g.*, Ron Creamer & Isaac Wheeler, *A Framework for Testing Regulatory Authority*, Presented to the Tax Club (Apr. 25, 2016).

[58] *Bowen v. Georgetown University Hospital,* SCt, 488 US 204 (1988).

[59] *Landgraf v. USI Film Products*, SCt, 511 US 244, 270 (1993).

[60] *Bowen*, SCt, 488 US, at 219 (Scalia, concurrence).

[61] H.R. Rep. No. 350, at 48–49 (1920), *reprinted in* J. S. Seidman, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS—1938–1861, at 886 (1953).

[62] *See, e.g.*, 1 William Blackstone, Commentaries *69–70 (formulating the declaratory theory as the basis for retroactivity: the law is not made but rather found and declared).

[63] *See, e.g.*, H.R. Rep. No. 1035, at 4 (1920), *reprinted in* J. S. Seidman, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS—1938–1861, at 888 (1953) ("[I]t is believed that *in the case of interpretive regulations* it is proper that a subsequent regulation reversing a prior ruling should be made to apply without retroactive effect and that such a ruling would greatly facilitate the work of the Treasury Department and avoid great embarrassment to both the taxpayer and the Treasury Department.") (emphasis added). The bill to which this explanation related was introduced on May 22, 1920, and only referred to the Senate Finance Committee without action. It, however, contained substantially the same language as Act Sec. 1314 of the Revenue Act of 1921, which was ultimately enacted.

[64] Stanley Surrey, *The Scope and Effect of Treasury Regulations Under the Income, Estate, and Gift Taxes*, 88 U. PA. L. REV. 556, 567–568 (1940) (stating that an interpretive regulation, like a court decision, "would obviously have to operate retroactively" without former section 7805(b)); Erwin Griswold, *A Summary of the Regulations Problem*, 54 HARV. L. REV. 398, 412 (1941) ("[A]n interpretive regulation is simply a construction of the statute and will normally be effective retroactively, just as a construction of the statute by judicial decision would be.").

[65] Ellsworth Alvord, *Treasury Regulations and the Wilshire Oil Case*, 40 COLUM. L. REV. 252, 259–261 (1940).

[66] *Id.*

[67] *See, e.g., Anderson, Clayton, & Co.*, CA-5, 77-2 USTC ¶9727, 562 F2d 972 (1977), *cert. denied*, SCt, 436 US 944, 98 SCt 2845 (1978).

[68] *See* Act Sec. 1101(a) of the Taxpayer Bill of Rights 2 of 1996 (P.L. 104-168), 110 Stat. 1452. *See* H.R. Rep. No. 506, 104th Cong., 2d Sess. 44 (1996) ("The Committee believes that it is generally inappropriate for Treasury to issue retroactive regulations.").

[69] Code Sec. 7805(b)(1)(B) provides: "Except as otherwise provided in this subsection, no temporary, proposed, or final regulation relating to the internal revenue laws shall apply to any taxable period ending before the earliest of the following dates: … (B) In the case of any final regulation, the date on which any proposed or temporary regulation to which such final regulation relates was filed with the Federal Register."

[70] *See* Act Sec. 1101(b) of the Taxpayer Bill of Rights 2 (P.L. 104-168).

[71] H.R. Rep. No. 104-506, at 44 (1996).

[72] *See, e.g.*, John Bunge, *Statutory Protection from IRS Reinterpretation of Old Tax Laws*, TAX NOTES, at 1177 (Sept. 8, 2014) (arguing that the "enacted after the date of enactment" language should be read as modifying "regulations" rather than "statutory provisions"); Amicus Brief of American College of Tax Counsel to the Fourth Circuit Court of Appeals in *Home Concrete & Supply LLC* (No. 11-139).

[73] *See, e.g., Murfam Farms*, FedCl, 2009-2 USTC ¶50,529, 88 FedCl 516 (2009) (Court of Federal Claims applied current Code Sec. 7805(b) to a post-1996 regulation under Code Sec. 752, which was enacted in 1954).

[74] *See* S. Rept. 91-552, on the Tax Reform Act of 1969, 91st Cong., 1st Sess. (1969), at 137–144; Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1969, JCS-16-70 (1970), 123–128.

[75] *See* S. Prt. 101-56 on the Revenue Reconciliation Act of 1989, 101st Cong., 1st Sess. (1989), at 66 ("Such authority can be exercised only with respect to instruments issued after public guidance is published, whether by regulation, ruling, or otherwise stating the position of the Treasury Department with respect to the characterization of such instruments.").

[76] Amy S. Elliott, *Debt-Equity Regs May Use Different E&P Exception, Poms Says*, TAX NOTES Doc. 2016-11473 (June 6, 2016).

[77] *Id*. ("Treasury and the IRS are 'considering what we might do in terms of alternatives to just looking at current E&P. Other possibilities are looking to [the] prior year's E&P' or looking at earnings before interest, taxes, depreciation, and amortization.").

[78] *See* Paul Stinson, *Debt-Equity Rules Could Include Brother-Sister Corporations*, 112 DTR G-3 (June 10, 2016).

[79] *Id.,* at 272–273.

[80] *Id.,* at 265.

[81] *Id.,* at 268.

[82] *See Kaiser Aluminum & Chemical Corp. v. Bonjorno*, SCt, 494 US 827, 855 (Scalia, concurrence) ("[t]he principle that the legal effect of conduct should ordinarily be assessed under the law that existed when the conduct took place has timeless and universal human appeal").

[83] *Mayo Found. for Med. Educ. & Research*, 562 US 44 (2011).

[84] *P. Elkins*, 81 TC 669, Dec. 40,514 (1983).

[85] *Id.,* at 671.

[86] *Id.,* at 681.