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The Debt-Equity Labyrinth: A Case for the New Section 385 Regulations

Alexander Lewitt*

"Our present taxing system has become a labyrinth for the wary and unwary alike, filling endless volumes with its exceptions to exceptions, and indecipherable differentiations in the way we tax various sources of income."[1]

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* Juris Doctorate candidate at Washington and Lee University School of Law, Class of 2018. I thank Dean Hellwig for all his helpful feedback and guidance throughout the process of writing this Note. I would also like to thank my parents, Michael and Marcie Lewitt for always being a source of support and inspiration in my life.

1. Norman B. Ture, *Puerto Rico: Hostage to U.S. Tax Reform*, WALL ST. J., Aug. 9, 1982, at 12.

I. Introduction

Corporations routinely borrow money from subsidiaries, shareholders, and other related parties.[2] This often occurs when they are in financial trouble and unrelated parties are reluctant to lend to them.[3] In recent years, for example, Sears Holdings, Inc., parent company of iconic American retailers Sears and Kmart, borrowed hundreds of millions of dollars from hedge funds controlled by its chairman and largest shareholder, Edward Lampert, to fund massive losses.[4] These types of related-party loans raise important tax questions regarding whether they should be characterized as debt or equity.[5] Loans between related parties

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2. *See* Christopher Matthews, *The Next Big Thing in Corporate-Tax Avoidance*, TIME (Apr. 3, 2013), http://business.time.com/2013/04/03/the-next-big-thing-in-corporate-tax-avoidance/ (last visited Dec. 7, 2017) ("U.S. multinational companies routinely set up units in low tax jurisdiction to pool cash from their global operations and lend to other parts of the business . . . .") (on file with the Washington and Lee Law Review).

3. *See* SANDEEP DAHIYA, ANTHONY SAUNDERS & ANAND SRINIVASAN, FINANCIAL DISTRESS AND BANKING LENDING RELATIONSHIPS 25 (2002), http://people.stern.nyu.edu/asaunder/Financial_Distress_and_Relationship_bankpap_Jan7_2002.pdf ("The risk of loan default is the one of the most important risks faced by banks."). *But see* Daniel McNulty, *Why Hedge Funds Love Distressed Debt*, INVESTOPEDIA, http://www.investopedia.com/articles/bonds/08/distressed-debt-hedge-fund.asp (last visited Dec. 7, 2017) (arguing that hedge funds love to invest in companies with distressed debt) (on file with the Washington and Lee Law Review).

4. *See* Antoine Gara, *As Ailing Sears Bleeds Cash, Billionaire Eddie Lampert Increases Loans to Retailer*, FORBES (Aug. 25, 2016, 11:22 AM), http://www.forbes.com/sites/antoinegara/2016/08/25/as-ailing-sears-bleeds-cash-billionaire-eddie-lampert-increases-loans-to-retailer/#6f07e786af36 (last visited Dec. 7, 2017) ("Sears reported yet another large quarterly loss and said Lampert will loan the company $300 million as it seeks to sell or divest brands . . . .") (on file with the Washington and Lee Law Review).

5. *See* Nathan Bomey, *How Sears CEO Lampert Cashes In as Stores Cash Out*, USA TODAY (Mar. 22, 2017, 4:24 PM), https://www.usatoday.com/story/money/2017/c3/22/sears-holdings-ceo-eddie-lampert/99487518/ (last visited Dec. 7, 2017) (noting how Lampert is structuring transactions with Sears to have his $389 million in unsecured notes issued to Sears be treated as debt in anticipation

often involve different motives and terms than arm's length loans and involve the potential for abuse.[6] Even when related parties do not own a majority of a company's stock, they may effectively sit in a position of control that allows them to manipulate events to their advantage.[7] This is especially true in situations when companies are in financial distress and have limited options for raising capital.[8] Related parties are willing to extend credit when unrelated parties are not because they face different consequences and can earn potential benefits that are not available to unrelated parties.[9] This is an age-old problem that corporate taxpayers and the government wrestled over for decades.[10] Corporations desire clarity with respect to tax rules and flexibility with respect to the ability to raise capital (especially when they are in financial trouble),[11] while the government wants to prevent abuse of the tax

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of liquidation) (on file with the Washington and Lee Law Review).

6. *See* Art Berkowitz & Richard Rampell, *Related-Party Transactions Can Be an Investment Red Flag*, WALL ST. J. (Aug. 29, 2002, 6:37 PM), https://www.wsj.com/articles/SB1030635386991264875 (last visited Feb. 27, 2017) ("[Related-party transactions] aren't necessarily wrong, but because of their delicate nature and the risk of abuse or fraud, they must be carefully scrutinized and usually fully disclosed.") (on file with the Washington and Lee Law Review).

7. *See, e.g.*, Zetlin v. Hanson Holding, Inc., 397 N.E.2d 387, 388 (N.Y. 1979) (noting that control of 44.4% of a corporation's stock "represented effective control").

8. *See infra* Part VII.C (providing an example of this type of situation and applying the common law, the 1980 regulations, and 2016 regulations on how to distinguish debt from equity).

9. *See* Tong Yan & Wang Huacheng, *Related Party Transactions, Benefits of Control and Earnings Quality*, 2 FRONTIER BUS. RES. CHINA 187, 187 (2008) (concluding that "when the share ratio of controlling shareholder is less than 50%, they prefer pursuing private benefits of control via related party transactions").

10. *Compare* William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 412–530 (1971) (outlining the various factors courts have taken into consideration in determining whether an instrument should be treated as debt or equity), *with* Treas. Reg. §§ 1.385-1–1.385-10 (1980) (setting forth the various rules on how to distinguish debt from equity), *and* Treas. Reg. §§ 1.385-1–1.385-3T (2016) (prescribing rules on how to differentiate debt from equity).

11. *See* Kimberly Clausing, *The Real (and Imagined) Problems with the U.S. Corporate Tax Code*, HARV. BUS. REV. (Dec. 6, 2016), https://hbr.org/2016/12/the-real-and-imagined-problems-with-the-u-s-corporate-tax-code (last visited Dec. 7, 2017) ("The U.S. raises less corporate tax revenue than peer countries do, and the system is mind-numbingly complex, rife with distortion, and widely perceived to be unfair. The corporate community is also concerned that our current system inhibits competiveness, holding American companies back.") (on file with the

laws by corporations trying to disguise equity investments as debt in order to take advantage of interest deductions or to create large tax carryforwards that increase their value to potential acquirers.[12]

Take the example of Company A, which is on the verge of bankruptcy.[13] It will not meet its next monthly payroll or other monthly obligations unless it immediately raises $100 million. It spoke to its banks, who are unwilling to extend it any further credit, and its investment bankers told it that the public markets are inhospitable to a public debt or equity offering. Its only option is to borrow money from a hedge fund, Vulture Hedge Fund, that accumulated its stock and, more importantly, its bonds at significant discounts to their face value. Vulture is willing to lend Company A $100 million on the following terms (subject to a binding written agreement): (1) a one-year loan with a fixed maturity date secured by all of Company A's real estate; (2) interest payable monthly in arrears at an annual rate of ten percent with a five-day grace period, after which Vulture can demand immediate repayment of principal, declare an immediate default, and pursue its remedies as a creditor; (3) the loan is convertible into seventy-five percent of Company A's stock in the event of default; (4) Vulture gets three of Company A's seven board seats now and two more board seats upon default; and (5) Vulture is provided with access to monthly financial reports from the company and whatever other information it reasonably requests. The loan ranks senior to all of Company A's existing debt and equity. At the time Vulture offers to make the loan, it owns thirty-five percent of Company A's common stock and forty-five percent of its public bonds. While this does not constitute majority

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12. *See* Leslie Picker, *Companies Hurt by Treasury Crackdown Win Exemptions*, N.Y. TIMES (Oct. 13, 2016), http://www.nytimes.com/2016/10/14/business/dealbook/exemptions-made-to-treasurys-tax-saving-restriction-rules.html?_r=1 (last visited Dec. 7, 2017) ("Part of the Treasury's goal [in enacting Section 385] was to clamp down on a tax-saving strategy called earnings stripping, where the American subsidiary of an inverted company borrows money from its foreign parent and uses the interest payments on the loans to take a tax deduction.") (on file with the Washington and Lee Law Review).

13. This example is taken up in more depth at the end of this Note. *See infra* Part VII.C (providing an analysis of how the common law, the 1980 regulations, and the 2016 regulations would characterize this example).

ownership, it effectively constitutes control. Having no alternative, Company A agrees to the deal. The question is whether this loan should be characterized as debt or equity even though Vulture does not own a majority of Company A's stock or bonds. As we will see, bright-line rules fail to effectively address this type of real world situation and a flexible approach is needed to deal with the complexities of modern corporate finance.

Part II of this Note provides background information on ways the government has attempted to distinguish debt from equity.[14] Part III offers a primer on why corporations choose to finance their operations with debt.[15] Part IV details how the courts have dealt with determining whether an instrument should be considered debt or equity prior to 1980.[16] Part V discusses how the Treasury Department's 1980 regulations determined an instrument's status as either debt or equity.[17] Part VI describes the 2016 regulations, which were issued to make the same determination.[18] Part VII provides illustrative examples of debt-financed companies (including Company A) to show how the common law, the 1980 regulations, and the 2016 regulations would affect each example differently, for better or worse.[19] Next, Part VIII argues that the 2016 regulations are an appropriate response to the debt-equity issue.[20] Part VIII also notes that although the 2016 regulations are an appropriate response, there is still room for improvement within the regulations.[21] Finally, Part IX proposes targeted improvements for the regulations and recommendations for how corporations can deal with this issue.[22]

14. *Infra* Part II.
15. *Infra* Part III.
16. *Infra* Part IV.
17. *Infra* Part V.
18. *Infra* Part VI.
19. *Infra* Part VII.
20. *Infra* Part VIII.
21. *Infra* Part VIII.
22. *Infra* Part IX.

II. Background

Since the inception of the interest deduction,[23] the courts,[24] Congress,[25] and the Treasury Department[26] all tried to address situations like Company *A*'s with inconsistent results. Until 2016, the government relegated this problem to the courts.[27] Due to a lack of guidelines regarding how to distinguish debt from equity,[28] the common law produced multi-factored tests.[29] The courts' use of these multi-factored tests resulted in inconsistent outcomes based on balancing the relevant facts of each case.[30] Concerned with the

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23. *See* Payne-Aldrich Act, ch. 6, § 38, 36 Stat. 11, 113 (1909) (current version at 26 U.S.C. § 163 (2012)) (allowing a corporation to deduct "interest actually paid within the year on its bonded or other indebtedness"). Originally, a corporation was limited to deducting interest on debt in an amount of debt that was equal to the amount of money a corporation received from its shareholders in exchange for shares of stock. *See id.* (limiting the amount of interest deductions a corporation could take within a given year). Congress eliminated this limitation in 1918. *See* Revenue Act of 1918, ch. 18, § 234(a)(2), 40 Stat. 1057, 1077 (eliminating the limitation on the amount of debt a corporation could deduct).

24. *See* Plumb, *supra* note 10, at 369 (revealing how the courts have dealt historically with the debt-equity debacle).

25. *See* S. REP. NO. 91-552, at 106 (1969) (agreeing with the House that "it is appropriate to specifically authorize the Secretary of the Treasury to prescribe the appropriate rules for distinguishing debt from equity").

26. *See generally* Treas. Reg. §§ 1.385-1–1.385-10 (1980); Treas. Reg. §§ 1.385-1–1.385-3T (2016).

27. Although legislation was passed that gave the Treasury Department the authority to prescribe regulations to distinguish debt from equity in 1969, regulations never achieved full affect until 2016. *See* Tax Reform Act of 1969, Pub. L. No. 91–172, § 415(a), 83 Stat. 487, 613 (current version at 26 U.S.C. § 385 (2012)) (delegating to the Secretary of the Treasury Department the authority to prescribe regulations that distinguish debt from equity); T.D. 7920, 1983-2 C.B. 69 (withdrawing the 1980 proposed regulations); Treas. Reg. §§ 1.385-1–1.385-3T (2016) (enacting final regulations).

28. *See* Plumb, *supra* note 10, at 369 n.4, n.8 (noting the lack of a statutory definition and the Court's reluctance to define equity or debt); Lawrence M. Stone & C. Kevin McGeehan, *Distinguishing Corporate Debt from Stock Under Section 385*, 36 TAX L. REV. 341, 344 (1981) ("Despite the importance of this distinction, the Code contains no definition of either stock or debt.").

29. *See* Plumb, *supra* note 10, at 407 (mentioning that courts have "habitually recite[d] a varying list of as many as 16 criteria or factors to be considered").

30. *See id.* at 408 ("In consequence, it has justly been said that the courts are at liberty to arrive at opposite results on identical facts depending upon their own whims as to which factors they wish to stress . . . ." (quoting Stuart M. Weis, *The Labyrinth of the Thin Corporation*, 40 TAXES 568, 589 (1962))).

lack of a bright-line rule, Congress enacted provisions to address the issue in the Tax Reform Act of 1969,[31] which gave the Secretary of the Treasury Department authority to prescribe regulations to classify instruments as either debt or equity.[32]

The Treasury Department did not exercise its express administrative authority in this area until 1980, when it issued final regulations under § 385 (1980 regulations).[33] That exercise was far from successful.[34] The main criticism of the 1980 regulations concerned their complexity.[35] Fortunately for critics, the regulations' effective date was delayed until 1983, when the Treasury Department withdrew them altogether.[36] The stated reason for the Treasury Department's decision was that the proposed regulations did "not fully represent the position of the Treasury or Internal Revenue Service (I.R.S.) on matters concerning debt and equity."[37] While the Treasury Department's stated reason left many unanswered questions, some viewed the

31. *See* Tax Reform Act of 1969, Pub. L. No. 91–172, § 415(a), 83 Stat. 487, 613 (current version at 26 U.S.C. § 385 (2012)) (adding § 385 to the I.R.C.).

32. *See id.* (authorizing the Treasury Department to "prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated . . . as stock or indebtedness").

33. *See generally* Treas. Reg. §§ 1.385-1–1.385-10 (1980) (issuing for the first time regulations to distinguish debt from equity).

34. The Treasury Department regulations were postponed multiple times before ultimately being withdrawn. *See id.* § 1.385-1(a)(1) ("The regulations under section 385 apply . . . after April 30, 1981"); T.D. 7774, 1981-1 C.B. 168 (amending the regulations to apply after December 31, 1981); T.D. 7801, 1982-1 C.B. 60 (extending the regulations effective date to June 30, 1982); Treas. Reg. § 1.385-1(a)(1) (as amended by T.D. 7822 in 1982) (postponing the regulations effective date until after comments are incorporated into a final rule); T.D. 7920, 1983-2 C.B. 69 (withdrawing the regulations).

35. *See, e.g.*, Stone & McGeehan, *supra* note 28, at 392 (questioning how the problems surrounding the classification of an instrument as either debt or equity can be resolved with these complex and comprehensive provisions); Felix B. Laughlin, *The Debt-Equity Regulations (Section 385)*, 28 WM. & MARY ANN. TAX CONF. 9, 30 (1982) (noting that the rules "have been criticized as being overly complex"); Jack S. Levin & Stephen S. Bowen, *The Section 385 Regulations Regarding Debt Versus Equity: Is the Cure Worse than the Malady?*, 35 TAX LAW. 1, 41 (1982) ("It can only be hoped that the Secretary or the Congress will ultimately realize that more law does not always mean more certainty, and will take steps to simplify these regulations.").

36. *See* T.D. 7920, 1983-2 C.B. 69 (providing for the withdrawal of the 1980 final regulations).

37. *Id.*

decision to withdraw the regulations as an implicit recognition of their flaws.[38] Thirty-three years later in 2016, under the Obama administration, the Treasury Department issued proposed regulations under § 385.[39] The new Proposed Regulations were initially very broad in scope,[40] yet when promulgating final regulations under § 385, the Treasury Department substantially restricted their scope.[41]

III. Debt Financing

Corporations can choose to finance their business operations by issuing either bonds or stocks, or both.[42] A corporate bond represents a debt instrument that is held by a creditor.[43] Notes

38. *See, e.g.*, James J. Tobin, *Proposed § 385 Regulations Go Way Too Far*, BLOOMBERG BNA (Aug. 16, 2016), https://www.bna.com/proposed-385-regulations-n73014446402/ (last visited Dec. 7, 2017) ("Treasury issued proposed and final regulations under § 385 in 1980 that were subsequently withdrawn, presumably after recognition of their many problems.") (on file with the Washington and Lee Law Review).

39. The Obama administration's motive in finalizing regulations under § 385 was because of tax inversion and earning stripping transactions. *See* Reuters, *Republicans Want the Obama Administration to Delay Corporate Inversion Rules*, FORTUNE (Oct. 6, 2016, 7:46 AM), http://fortune.com/2016/10/06/republicans-obama-administration-corporate-inversion-rules/ (last visited Dec. 7, 2017) (disclosing that the proposed regulations were issued as "part of the Obama administration's effort to stop a wave of tax inversion mergers") (on file with the Washington and Lee Law Review).

40. *See generally* Prop. Treas. Reg. §§ 1.385-1–1.385-4, 81 Fed. Reg. 20912 (April 8, 2016); Victor Fleischer, *On Inversions, the Treasury Department Drops the Gloves*, N.Y. TIMES (Apr. 5, 2016), https://www.nytimes.com/2016/04/06/business/dealbook/on-inversions-the-treasury-department-drops-the-gloves.html?_r=0 (last visited Dec. 7, 2017) ("The proposed regulations are . . . aggressive and expansive . . . .") (on file with the Washington and Lee Law Review).

41. S*ee* Wade Sutton, *Donald Trump, Section 385, and Consolidated Groups*, 44 J. CORP. TAX'N 33, 33 (2017) (noting that many of the issues associated with the proposed regulations "have been satisfactorily addressed in the final rules"). *Compare* Prop. Treas. Reg. §§ 1.385-1–1.385-4, 81 Fed. Reg. 20912 (April 8, 2016) (giving the Treasury Department broad discretion to treat instruments as either debt or equity), *with* Treas. Reg. §§ 1.385-1–1.385-3T (2016) (cutting back on the proposed regulations).

42. *See* Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055, 1058 (2000) ("Corporations finance their operations by raising debt and equity capital.").

43. *See id.* at 1059 n.5 (describing the terminology for debt instruments).

refer to short term loans made by lenders to a corporation.[44] Bonds refer to long term loans (i.e., for a period of five or more years).[45] A debt instrument is governed by a contract between borrower and lender that sets forth the terms of the loan (often called a "Note" or an "Indenture"). Typically, the debt contract sets forth the stated term of the bond, a maturity date, the amount the corporate issuer is obligated to pay on the maturity date, and the interest rate paid to the holder throughout the term of the bond.[46] A corporation that chooses to finance its operations through the issuance of bonds must pay interest, whether stated or effective, on the bonds to the bondholder.[47] Under the Internal Revenue Code (I.R.C.), corporations can deduct the interest payments on the bond from taxable income.[48] Dividends paid to shareholders do not reduce the corporation's taxable income.[49]

If a corporation issues stock instead of debt, the shareholder becomes an equity owner of the corporation.[50] A corporation that issues stocks is not required to pay dividends to stockholders.[51] Rather, cash distributions on equity generally rest within the discretion of the corporate board after considering the need for and potential use of retained earnings.[52] Often, corporations may choose to finance operations through debt financing because it

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44. *Id.*

45. *See id.* (defining bonds).

46. *See id.* at 1059 n.5 (giving the characteristics of a typical bond).

47. *See id.* at 1060 (explaining debt financing).

48. I.R.C. § 163(a) (2012); *see also* Pratt, *supra* note 42, at 1061 (delineating the different tax consequences of debt financing and equity financing).

49. *See* Pratt, *supra* note 42, at 1061 ("[A] corporation . . . cannot deduct the dividends it pays on the shares it issues.").

50. *See* *Equity*, INVESTOPEDIA, http://www.investopedia.com/terms/e/equity.asp (last visited Dec. 7, 2017) ("In finance, you can think of equity as one's degree ownership in any asset after all debts associated with that asset are paid off.") (on file with the Washington and Lee Law Review).

51. *See* Pratt, *supra* note 42, at 1061 (noting that a corporation can retain earnings instead of paying out earnings in the form of dividends).

52. *See* Leonard Chazen, *How the Influx of Dividend-Minded Shareholders Will Impact Shareholder Activism*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (NOV. 22, 2016), https://corpgov.law.harvard.edu/2016/11/22/how-the-influx-of-dividend-minded-shareholders-will-impact-shareholder-activism/ (last visited Dec. 7, 2017) (examining the role of the board of directors in making dividend payments) (on file with the Washington and Lee Law Review).

reduces a corporation's tax liability and reduces their net cost of capital.[53]

IV. The Common Law

In the early years of dealing with the issue of whether a financial instrument constituted debt or equity, courts addressed the issue by looking to "the four corners of the instrument."[54] This "four corners" approach ultimately failed because courts had difficulty dealing with hybrid securities and intracompany loans made by shareholders.[55] In response, courts developed multi-factor tests to aid in making a determination under the "four corners" approach.[56] Nevertheless, these factors failed to provide a bright-line rule because courts varied on the number of factors used[57] and the weight of those factors.[58] In reviewing the problems encountered by the courts, some patterns can be identified from

53. *See* Pratt, *supra* note 42, at 1062–64 (summarizing the differences between debt and equity financing by way of example). Although the use of debt financing has its advantages, it also has its disadvantages. *See* Claire Boyte-White, *How Does a Company Choose Between Debt and Equity in Its Capital Structure?*, INVESTOPEDIA (Mar. 25, 2015, 1:11 PM), http://www.investopedia.com/ask/answers/032515/how-does-company-choose-between-debt-and-equity-its-capital-structure.asp (last visited Dec. 7, 2017) ("The downside of debt financing is that lenders require the payment of interest, meaning the total amount repaid exceeds the initial sum. In addition, payments on debt must be made regardless of business revenue.") (on file with the Washington and Lee Law Review).

54. *See* Plumb, *supra* note 10, at 405–06 (observing that courts initially relied on the text of an instrument "to draw the distinction that the law required").

55. *See id.* at 406–07 (discussing the difficulties courts encountered by taking the four corners approach).

56. For a complete list of factors courts habitually utilized, see *Fin Ray Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968) (listing sixteen factors courts have taken into consideration in the Third Circuit) and *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972) (highlighting thirteen factors courts in the Fifth Circuit have taken into consideration).

57. *Compare Mixon*, 464 F.2d at 402 (indexing thirteen factors), *with Fin Ray Realty Co.*, 398 F.2d at 696 (specifying sixteen factors), *and* Anchor Nat'l Life Ins. Co. v. C.I.R., 93 T.C. 382, 400 (1989) (finding eleven factors).

58. *See* Plumb, *supra* note 10, at 408 ("[I]t has justly been said, that the courts are at liberty to arrive at opposite results on identical facts depending upon their own whims as to which factors they wish to stress . . . ." (quoting Stuart M. Weis, *The Labyrinth of the Thin Corporation*, 40 TAXES 568, 589 (1962))).

their application.[59] These patterns divide into three criteria regarding whether an instrument constitutes debt or equity: formal rights and remedies of creditors, objective determination of intent, and risk and economic reality.[60]

A. Formal Rights and Remedies of Creditors

Courts identified the following formal rights and remedies of creditors as characteristics of debt instruments: a fixed maturity date, remedies for default, subordination, certainty of income, absence or inadequacy of interest payments, participation in both success and failure of the business, participation in control of the business, and the name of the instrument.[61] Courts considered the presence of a fixed maturity date a critical factor.[62] While a fixed maturity date alone was insufficient to ensure treatment as debt,[63] the absence of a fixed maturity date was "most often conclusive" of equity treatment.[64] A fixed maturity date was lacking if the courts found an instrument to have no reasonable expectation of repayment in the future or if the courts found an unreasonable postponement of payment.[65]

Another important factor weighing in favor of equity treatment was the absence of a right to force payment upon default.[66] Generally, subordination of a debt to other creditors supported a finding of equity treatment, whereas a

59. *See id.* at 411–12 (providing a list of typical evidentiary factors employed by courts).

60. *See id.* (dividing the evidentiary factors into four sections).

61. *See id.* (listing the factors most commonly identified by the courts).

62. *See id.* at 413 ("The most important of the formal factors is a provision for a fixed . . . time when the purported creditor is unconditionally entitled to require payment of the principal.").

63. *See id.* ("The presence of a maturity date does not guarantee recognition of indebtedness, if other factors indicate an equity investment . . . .").

64. *Id.*; *see also* Lane v. United States, 742 F.2d 1311, 1315–16 (11th Cir. 1984) (analyzing the absence of a fixed maturity date under the multi-factored common law test).

65. Reasonableness was determined by a subjective evaluation of the particular circumstances of a corporation. *See* Plumb, *supra* note 10, at 415–16 (clarifying reasonableness).

66. *See id.* at 420 (revealing that this finding "is a very significant, if not essential factor").

non-subordinated debt supported a finding of debt treatment.[67] Courts gave participation in management or control of the corporation little weight.[68]

A debtholder is entitled to interest payments on a loan.[69] A court's finding that interest was payable regardless of whether it was "dependent upon a discretionary determination by the board of directors" helped establish the existence of a debt.[70] Typically where there was no or inadequate interest, courts treated the purported debt instrument as equity.[71]

Courts found a purported debt instrument that makes repayment of principal contingent on the success of the venture akin to an equity investment in the corporation.[72] As such, courts considered those types of arrangements to support a finding of equity treatment.[73] Labeling an instrument debt does not

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67. With respect to subordination, "the financial community regards subordinated debt as quasi-equity." *Id.* at 422. As a result, the holder of a subordinated debt was not seen as having rights significantly different from that of a preferred stockholder. *See id.* (noting this factor as one that "strongly indicates that the holders were sharing in the risk of the venture in a manner more compatible with the status of stockholders than creditors"). Usually subordination was determined at the time the instrument was issued. *Id.* at 423. Where there is a finding of subordination as one of a number of factors leading to treating an instrument as equity, courts have failed to recognize an instrument as equity. *See id.* at 426 ("Frequently, the courts will justify any degree of subordination, on the ground that it was necessary in order to meet . . . capital requirements or to facilitate outside financing and credit . . . ."). A finding of subordination, however, is not itself enough to cause a court to treat an instrument as equity. *See id.* at 423–24 (noting that although subordinated debt is similar in priority to preferred stock, it may differ significantly). Therefore, in weighing the multitude of factors, the weight given to subordination varies. *See id.* at 421–27 (detailing the varying weight courts have given to subordination).

68. *See id.* at 447–49 (describing that "it is all but impossible to find a decision in which [participation in control] has been applied").

69. *See id.* at 431 (furnishing that interest payments in some form are a common attribute of debt).

70. *Id.* Moreover, "some cases hold otherwise if the interest will become absolutely payable at a fixed ultimate maturity date." *Id.*

71. *See id.* at 433–34 (observing how courts have dealt with a lack of or failure to pay interest rates).

72. *See id.* at 442 (explaining that a purported debt instrument that seeks payment based on a percentage of profits or sales "lacks even the form of a debt").

73. *See id.* (stating that these types of arrangements are "generally viewed as resulting in a proprietary investment in the risk of the business, a device adopted in order to share the financial results of the operations along with the shareholders").

conclusively support a finding of debt, but a lack thereof, such as labeling an instrument preferred stock, supports a finding of equity.[74]

B. Objective Determination of Intent

Courts identified the following factors as bearing on the intention to create a debtor-creditor relationship: formal documentation, security and sinking fund provisions, proportionality, guarantees by shareholders, payment history, and failure to enforce a default.[75] Courts that assessed intent focused on the particular facts and circumstances that bore on each particular case.[76]

Neither formal documentation of an unconditional promissory note or bond, nor treatment of an instrument as a liability on a corporation's balance sheet, "can obscure the substance of the transaction."[77] The failure of a corporation to formally document an instrument as debt presented a strong indication of equity treatment.[78] The presence of a valid security interest that placed the lender in a position superior to general creditors supported a finding of debt.[79] In contrast, the absence of a security interest did not support a conclusive finding of equity.[80] The absence of a

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74. *See id.* at 450 ("If an instrument is labeled 'preferred stock,' the taxpayer has very little chance of getting it treated as debt . . . .").

75. *See id.* at 412 (indexing the various factors courts used to establish whether an intention to create a debtor-creditor relationship existed).

76. *See id.* at 458 ("[M]ost courts today would agree that the characterization of purported debt for tax purposes must be determined . . . [by looking at] the intent as objectively ascertained by looking beneath mere form to all relevant facts and circumstances." (internal quotation marks omitted)).

77. *Id.* at 461.

78. *See id.* at 462 (observing that "*failure* of the taxpayer to follow form may well be used as evidence that debt was not intended"). This factor is a precursor to the documentation requirements in the 2016 Regulations that disqualify an instrument from being treated as a debt instrument if the parties do not thoroughly document the terms of the instrument. *See* Treas. Reg. § 1.385-2 (2016) (setting forth the documentation requirements).

79. *See id.* at 466 (adding that this evidence is "powerful").

80. Some courts have found this failure to be merely "a permissible subordination of the debt, to certain other creditors and purchasers." *Id.* at 467. Other courts have found it to be "evidence of a lack of a bona fide intention to create a debt." *Id.*

sinking fund also did not conclusively support a finding of equity treatment, although the presence of a sinking fund provided strong evidence for a finding of debt treatment.[81]

With respect to proportionality, a finding of a purported debt held in substantial proportion to corporate stock created a strong inference of equity treatment.[82] Some courts only used this to support a finding of equity treatment if there were other significant factors present.[83] In contrast, when a court found a purported debt to be held disproportionately to the corporate stock, the court usually respected the instrument as debt.[84] The courts typically considered an instrument as debt when capital was extended by an outside creditor of the corporation, was guaranteed by shareholders to satisfy a general policy of a lender, and whose proceeds were used to prevent deterioration of assets of the corporation through salary or dividend payments.[85]

Timely repayment of a bond was considered evidence of an intent to create a debt.[86] Repayment of debt did not support this intent if offset by new advances, advances made for temporary purposes, advances made to equalize advances of different shareholders, if repayment was determined by the cash needs of the corporation and shareholders rather than pursuant to a binding obligation,[87] or if payments were precipitated by a tax audit.[88] Some courts found the existence of an intent to repay the debt only if a corporation made faithful payments of interest when

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81. *See id.* at 469 ("The absence of a sinking fund or some form of reserve to provide for the ultimate retirement of purported debt is often referred to as evidence of the lack of an unconditional intent that the obligation be repaid . . . .").

82. *See id.* at 470 (describing the importance of such a finding as "very pertinent" and one which gives rise to a "strong inference").

83. *See id.* at 471 ("But ordinarily there must be 'something more,' . . . to support the inference that the shareholder did not really intend to act like a creditor.").

84. *See id.* at 473 ("The farther we get from proportionality, the more respect is paid to the form in which the parties have cast their arrangement.").

85. *See id.* at 487 (finding that the "decisions have turned to a large extent on the finding that the creditor's insistence upon a guaranty did not signify that the corporate capital was thought to be inadequate, but reflected a general policy of banks").

86. *See id.* at 490–91 (specifying this factor is "persuasive").

87. *Id.* at 491.

88. *Id.* at 492.

earnings were lacking.[89] On the other hand, "[t]he significance of payment of interest as evidence of intention is limited when the corporation has earnings, which could as readily have been paid out as dividends."[90]

Failure to enforce a default was strong evidence of a lack of intent to establish a debtor-creditor relationship, especially if the creditor allowed extended defaults in principal payments, continued advances after multiple defaults, unreasonably extended the maturity date, or deferred a demand for payment.[91] These failures were evidence of a "state of mind . . . akin to that of an ordinary shareholder who understands that his investment is subject to the risks of the venture."[92] Defaults on the payment of interest were seen as less significant than principal defaults.[93] The failure to make interest payments completely, paying interest at a corporation's convenience, or creditors making interest payments themselves, supported findings of equity.[94] In assessing this factor, courts took into consideration the intent of the parties not only at the time of the loan but also at the time of default.[95]

C. Risk and Economic Reality

Courts overlooked debt formalities and the intent of the parties if the economic reality of the arrangement did not comport with the creation of a debt instrument.[96] In determining economic reality, courts looked at the adequacy of capitalization, the source of repayments, the use of funds advanced, and the willingness of an independent creditor to advance funds on comparable terms.[97]

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89. *Id.*

90. *Id.*

91. *Id.* at 493.

92. *Id.* at 493–94.

93. *Id.* at 494.

94. *Id.*

95. *See id.* at 496 ("Even if the requisite intention to be a true creditor existed at the outset, enlarged needs of the business or other altered circumstances may bring about a change in the intention, . . . and what was once a debt may thus be transformed into an equity investment.").

96. *See id.* at 503 (revealing that purported debts may not be respected if economic realities point to a sham).

97. *See id.* at 412 (recording the evidentiary factors court take into

Courts considered a corporation's capitalization, as evidenced by its debt-to-equity ratio, important, but not conclusive, in distinguishing debt from equity.[98] Since balance sheets do not always represent the true value of the assets available for debt repayment, courts looked further to determine if repayment of a purported debt was expected from other sources, such as off-balance sheet assets, balance sheet assets carried at values below their true market value, and profits or free cash flow, that showed a creditor expected to be repaid from these sources.[99] A court was more likely to treat an instrument as equity rather than debt if a corporation expected repayment primarily or exclusively from the liquidation of assets.[100] If the funds were used to purchase "core assets" of a business, a court was more likely to consider them equity rather than debt.[101] But if an independent party would have advanced the funds on similar terms, a court was more likely to find that the advance was debt rather than equity.[102]

V. The 1980s Approach

On December 31, 1980, the Treasury Department issued final regulations under § 385 of the Internal Revenue Code.[103] The Treasury Department sought to create bright-line rules that were largely absent under the common law.[104] Initially the regulations

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consideration).

98. *See id.* at 510 (noting that the courts came to realize that "an amount of equity capital that would be inadequate to launch a corporation in one industry may be quite sufficient by the standards of another, and that within one industry the standard may vary with the type of operation planned").

99. *See id.* at 513–20 (discussing how courts analyzed the debt-to-equity ratios of corporations).

100. *See id.* at 526 ("If the uncertainties of successful operation are such that only reasonably assured source of funds for repayment, at maturity or within a reasonable time, is the liquidation of the enterprise, a strong inference arises that no such drastic action would be contemplated by the purported creditor.").

101. *See id.* (pointing out that in the case of a corporation formed to sell real estate,"the very business of the corporation is the liquidation of its assets").

102. *See id.* at 530–35 (explaining the independent creditor test).

103. *See generally* Treas. Reg. §§ 1.385-1–1.385-10 (1980).

104. *See* Prop. Treas. Reg. § 1.385, 45 Fed. Reg. 18957, 18958 (Mar. 24, 1980) ("The question of whether an instrument in a corporation is stock or indebtedness has created considerable difficulties and led to much litigation.").

were not scheduled to take effect until April 30, 1981.[105] Because of the controversy fomented by these regulations, however, the Treasury Department continuously extended the deadline for their application until January 1, 1983.[106] Finally, on November 3, 1983, the Treasury Department withdrew the regulations retroactively.[107] Although these regulations never took effect, they illustrate how the Treasury Department overreached by trying to apply a rules-based approach to an area of corporate taxation that requires flexibility and the ability to focus on substance over form.[108]

A. Scope

The regulations issued in 1980 would have applied to all financial instruments,[109] including preferred stock,[110] some unwritten obligations,[111] and guaranteed loans.[112] All other interests[113] were outside the scope of the regulations and were treated as equity or debt under applicable principles of existing common law.[114]

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105. *See* Treas. Reg. § 1.385-1(a) (1980) (supplying the effective date).

106. *See* T.D. 7774, 1981-1 C.B. 168 (extending the effective date of the regulations from May 1, 1981, to January 1, 1982); T.D. 7801, 1982-1 C.B. 60 (changing the effective date of the regulations from January 1, 1982 to July 1, 1982).

107. *See* T.D. 7920, 1983-2 C.B. 69 (notifying taxpayers of the withdrawal of the 1980 regulations).

108. *See generally* Treas. Reg. §§ 1.385-1–1.385-10 (1980).

109. *See id.* § 1.385-3(c) (defining "instruments" as "any bond, note, debenture, or similar written evidence of an obligation").

110. *See id.* § 1.385-2(e)(4) (providing that § 1.385-10 contains rules pertaining to the treatment of purported preferred stock).

111. *See id.* § 1.385-2(e)(1) (noting that § 1.385-7 contains rules "that apply to certain loans of money made to a corporation by persons other than independent creditors that are not evidenced by an instrument within six months after the day they are made").

112. *See id.* § 1.385-2(e)(3) ("Section 1.385-9 contains rules that apply to loans made to a corporation and guaranteed by a shareholder.").

113. *See, e.g.*, *id.* § 1.385-1(b)(1) (setting forth a few examples of what constitutes other interests, "such as bank deposits, insurance policies, claims for wages, and trade accounts payable").

114. *Id.* § 1.385-1(b)(1).

B. Preliminary Rules

To understand the substantive rules set forth in the regulations it is necessary to lay out three operational rules that would have applied to more than one instrument classification. The first operational rule is the determination of the fair market value of an instrument.[115] The second is the calculation of the debt-to-equity ratios.[116] The third is the determination of a reasonable interest rate.[117]

1. Fair Market Value of an Instrument

Understanding fair market value is critical for three reasons. First, it aids in determining the proper classification of a hybrid instrument when holdings of stock and instruments are not in substantial proportion.[118] Second, it facilitates the determination of whether the consideration paid for an instrument is excessive or inadequate.[119] Finally, it assists in ascertaining whether a substantive change occurred in the terms of an instrument.[120]

The regulations defined the fair market value of an instrument as "the price at which it would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of all relevant facts."[121] To provide clarity, the regulations suggested that, in determining fair market value, a taxpayer may

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115. *See* Jesse V. Boyles & Randolph J. Rush, *The Regulations under Section 385: A Review, Evaluation, and Suggested Approach*, 27 VILL. L. REV. 52, 66 (1981) (laying forth the three operational rules of the 1980 § 385 regulations).

116. *Id.* at 67–74.

117. *See id.* at 74–82 (asserting why corporations need to ascertain a reasonable rate of interest).

118. *Id.* at 66; *see also* Treas. Reg. § 1.385-5(a) (1980) (laying forth the special rules for determining whether a hybrid instrument is held in substantial proportionality to stock).

119. Boyles & Rush, *supra* note 115, at 66; *see also* Treas. Reg. § 1.385-3(a) (1980) (prescribing the proper method in calculating excessive or inadequate consideration).

120. Boyles & Rush, *supra* note 115, at 66; *see also* Treas. Reg. § 1.385-6(j) (1980) (presenting what constitutes a change in terms).

121. Treas. Reg. § 1.385-3(b)(1)(i) (1980); *see also* Boyles & Rush, *supra* note 115, at 66 (reiterating the definition of fair market value).

use present value and standard bond tables under the § 1232 regulations.[122] The regulations also set forth two rules of convenience to help accommodate taxpayers.[123] The first rule provided that the fair market value of a straight debt instrument is equal to the face amount if the interest rate is reasonable[124] and the amount "paid for the instrument is equal to the face value."[125] The second rule provided that the fair market value of an instrument registered with the Securities and Exchange Commission and sold for cash to the public is the issue price.[126] When determining the fair market value of an instrument or the reasonableness of an interest rate, the Treasury Department, however, could disregard a non-commercial term of the instrument.[127]

2. Debt-to-Equity Ratio

Understanding and calculating a corporation's debt-to-equity ratio was important in determining whether a particular rate of interest was reasonable under the substantial proportionality rules,[128] whether a corporation had excessive debt under the substantial proportionality rules,[129] and whether a corporation had excessive debt in determining the proper classification of

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122. Treas. Reg. § 1.385-3(b)(1)(ii) (1980); *see also* Boyles & Rush, *supra* note 115, at 67 (restating the regulations).

123. Treas. Reg. § 1.385-3(b)(2) (1980); *see also* Boyles & Rush, *supra* note 115, at 67 (laying out the two rules of convenience).

124. Treas. Reg. § 1.385-3(b)(2)(i)(A) (1980); *see also* Boyles & Rush, *supra* note 115, at 67 (disclosing that reasonableness for the stated annual rate of interest is determined under § 1.385-6(e)).

125. Treas. Reg. § 1.385-3(b)(2)(i)(B) (1980); *see also* Boyles & Rush, *supra* note 115, at 67 (clarifying the rule of convenience for fair market value).

126. Treas. Reg. § 1.385-3(b)(2)(ii) (1980); *see also* Boyles & Rush, *supra* note 115, at 67 (noting that issue price is "defined in section 1232(b)(2)").

127. Boyles & Rush, *supra* note 115, at 67. This finding may only be made "if the principal purpose of the inclusion of the term is to increase or decrease the fair market value of the instrument (or a reasonable rate of interest for the instrument)." Treas. Reg. § 1.385-3(b)(1)(iii)(A) (1980).

128. Boyles & Rush, *supra* note 115, at 67; *see also* Treas. Reg. § 1.385-6(e)(2) (1980) (clarifying when a reasonable rate of interest will be found).

129. Boyles & Rush, *supra* note 115, at 67; *see also* Treas. Reg. § 1.385-6(f)(1) (1980) (specifying that if a debt is excessive then it will be treated as stock).

unwritten obligations.[130] The regulations defined a corporation's debt-to-equity ratio as: "[T]he corporation's liabilities (excluding trade accounts payable, accrued operating expenses and taxes, and other similar items) bear to . . . [t]he stockholder's equity."[131] Stockholder's equity was defined as a corporation's excess of the adjusted basis of its assets over its liabilities.[132] The regulations required the use of proper accounting principles in determining the adjusted basis of a corporation's assets (which is needed to determine stockholder's equity) and the amount of its liabilities, excluding treatment of any interest as equity or indebtedness by reason of § 385.[133] Preferred stock is a liability, however, if under § 385, it is treated as indebtedness.[134]

The debt-to-equity ratio analysis is incomplete because it fails to take into account off-balance sheet assets that have substantial value,[135] as well as the value of intangible assets carried on the balance sheet at less than their fair market value.[136] As a result, it provides an inadequate analysis of solvency and a corporation's ability to repay an instrument as of the time it enters into an obligation.[137]

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130. Boyles & Rush, *supra* note 115, at 67; *see also* Treas. Reg. § 1.385-7(b)(2) (1980) ("A loan to which this section applies is treated as a contribution to capital if the debtor corporation has excessive debt when the loan is made (under the principles of § 1.385-6(f)).").

131. Treas. Reg. § 1.385-6(g)(1) (1980); *see also* Boyles & Rush, *supra* note 115, at 67 (restating the definition of a corporation's debt-to-equity ratio).

132. Treas. Reg. § 1.385-6(g)(2) (1980); *see also* Boyles & Rush, *supra* note 115, at 68 (restating the definition of stockholder's equity).

133. Boyles & Rush, *supra* note 115, at 68; *see also* Treas. Reg. § 1.385-6(g)(3)(i) (1980) (setting forth the operating rules for determining the adjusted basis of a corporation's assets and the amount of a corporation's liabilities).

134. Boyles & Rush, *supra* note 115, at 68; *see also* Treas. Reg. § 1.385-6(g)(3)(ii) (1980) (establishing the effects of classifying indebtedness as preferred stock under § 385).

135. *See, e.g.*, LAWRENCE A. CUNNINGHAM, INTRODUCTORY ACCOUNTING, FINANCE AND AUDITING FOR LAWYERS 129 (6th ed. 2013) (1997) (giving four examples of off-balance sheet financing arrangements in which corporations engage).

136. *See id.* at 236 ("[E]conomic goodwill . . . is never recorded on a balance sheet.").

137. *See* Michael C. Thomsett, *Why Companies' Balance Sheets Can Be Misleading*, MINT LIFE: BLOG (OCT. 19, 2010), https://blog.mint.com/investing/balance-sheet-10192010/ (last visited Feb. 27,

3. Reasonable Rate of Interest

Identifying a reasonable rate of interest was essential for four reasons. First, it aided in determining whether an instrument issued for property other than money should be classified as equity or debt.[138] Second, it facilitated the determination of whether the rule of convenience under § 1.385-3(b) applies in determining the fair market value of the instrument.[139] Third, it helped in assessing whether a demand instrument should be classified as equity or debt under § 1.385-6(*l*)(1).[140] Fourth, it supported a finding of whether a demand instrument or certain other obligations, as defined in § 1.385-7(a), classified as debt may be reclassified as equity.[141]

The regulations provided that a reasonable interest rate is determined based on industry standards.[142] Further, the regulations provided greater ease of compliance by setting forth a rule of convenience. The rule of convenience considers an interest rate reasonable if equal to: (1) the rate in effect under § 6621;[143] (2) the prime rate in effect under any local bank; (3) "a rate determined from time to time by the Secretary taking into consideration the average yield on outstanding marketable obligations of the United States of comparable maturity"; or (4) a

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2017) ("A disturbing reality about financial statements is that they are inherently inaccurate and incomplete.") (on file with the Washington and Lee Law Review).

138. Boyles & Rush, *supra* note 115, at 74; *see also* Treas. Reg. § 1.385-6(d)(1) (1980) (describing what occurs when an instrument not issued for money is treated as equity).

139. Boyles & Rush, *supra* note 115, at 74; *see also* Treas. Reg. § 1.385-3(b)(2)(i) (1980) (providing the rule of convenience for determining fair market value).

140. Boyles & Rush, *supra* note 115, at 74; *see also* Treas. Reg. § 1.385-6(*l*)(1) (1980) (supplying rules for the initial classification of an instrument payable on demand).

141. Boyles & Rush, *supra* note 115, at 74; *see also* Treas. Reg. § 1.385-6(*l*)(2) (1980) (elaborating on the circumstances in which a demand instrument will be reclassified as equity); *id.* § 1.385-7(c)(1) (explaining the circumstances in which a certain other obligation will be reclassified as equity).

142. *See id.* § 1.385-6(e)(1) (imposing what is considered a reasonable annual rate of interest).

143. Section 6621 of the I.R.C. provides rules for determining an overpayment and underpayment rate of interest. For more information on these rules, see generally I.R.C. § 6621 (2012).

rate between any of the rates described and "at the end of the taxable year in which the determination is made, the debt-to-equity ratio is not greater than 1:1."[144]

C. Treatment of Instruments Generally

Under the regulations, the Treasury Department determined the status of an instrument as either debt or equity at the time of issuance.[145] All instruments treated as debt are treated as indebtedness for all purposes of the Code unless specifically recharacterized as equity.[146] Debt obligations reclassified as equity became preferred stock.[147] The only instruments that could be recharacterized as preferred stock are hybrid instruments[148] and straight debt instruments in certain enumerated circumstances.[149] A purported debt instrument reclassified as preferred stock can never be restored to the status of debt.[150]

D. Treatment of Straight Debt Instruments

The regulations defined straight debt instruments as any instrument that is not a hybrid instrument.[151] A corporation that issued a straight debt instrument would treat it as indebtedness if issued proportionately to the issuing corporation's shareholders.[152] There were five exceptions that reclassified a straight debt instrument as preferred stock. First, if a corporation had excessive debt.[153] Second, if an instrument was not issued for money and did

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144. Treas. Reg. § 1.385-6(e)(2)(i) (1980).

145. *Id.* § 1.385-4(b)(1).

146. *Id.* § 1.385-4(c)(1).

147. *Id.*

148. *See id.* § 1.385-5(a) (issuing rules for the treatment of hybrid instruments).

149. *See id.* § 1.385-6 (d), (f), (j), (k), (*l*) (describing the circumstances in which a straight debt instrument will be reclassified as preferred stock).

150. *Id.*

151. *Id.* § 1.385-3(f).

152. *Id.* § 1.385-2(a)(1).

153. *Id.*; *see also id.* § 1.385-6(f)(1) (prescribing the general rules on how to determine whether a corporation has excessive debt).

not meet all the requirements of § 1.385-6(d).[154] Third, if an instrument was payable on demand but the stated annual rate of interest was not reasonable.[155] Fourth, if a corporation failed to pay interest[156] or failed to pay the principal when due.[157] Lastly, if there was a substantial change in the terms of the instrument.[158]

E. Treatment of Hybrid Instruments

Hybrid instruments were defined as "an instrument that is convertible into stock or one (such as an income bond or a participating bond) that provides for any contingent payment to the holder (other than a call premium)."[159] The regulations initially characterized a hybrid instrument as equity if its fair market value, excluding equity features, was less than fifty percent of its actual fair market value, including equity features.[160] If the issuer and holder reasonably believed on the day of issue that the fair market value of the instrument excluding its equity features was below fifty percent of the actual fair market value including its equity features, then the percentage becomes forty-five percent.[161] Forty-five percent would be substituted for fifty percent only by a showing of clear and convincing evidence.[162] The regulations

154. *Id.* § 1.385-2(a)(1); *see also id.* § 1.385-6(d)(1), (3) (laying out when an instrument not issued for money will be treated as stock).

155. *Id.* § 1.385-2(a)(1); *see also id.* § 1.385-6(*l*)(1), (2) (highlighting the circumstances in which an instrument will initially be classified as stock and when it will later be reclassified as stock).

156. *Id.* § 1.385-2(a)(1); *see also id.* § 1.385-6(k)(1) (imposing rules for when the nonpayment of interest will result in a classification of an instrument as stock).

157. *Id.* § 1.385-2(a)(1); *see also id.* § 1.385-6(*l*)(3) (detailing when an instrument is considered payable on demand).

158. *Id.* § 1.385-2(a)(1). A substantial change in the terms of the instrument are any changes that materially affect "the fair market value of the instrument." *Id.* § 1.385-6(j)(2).

159. *Id.* § 1.385-3(e).

160. *Id.* § 1.385-5(a).

161. *Id.* § 1.385-5(c).

162. *Id.*

defined equity features as the right to contingent payments (excluding the call premium)[163] and convertibility to equity.[164]

F. The Substantial Proportionality Rules

The regulations provided seven tests to characterize instruments as preferred stock when an instrument was issued in substantial proportion to the holdings of common stock.[165] Although the regulations do not define the term "substantial proportionality," the Treasury Department determined substantial proportionality "from all relevant facts and circumstances, including family or other relationships."[166] Section 318 of the I.R.C. defined family or other relationships as relationships stemming from marriage, birth of a child (including adopted children) or grandchild, parents, partnerships, estates, trusts, and corporations.[167] The proportionality rules do not apply to a corporation's stock and instruments that were widely held, readily marketable, and separately traded,[168] or to instruments held by an independent creditor.[169] Further, two or more classes of instruments may be considered together depending on the facts and circumstances.[170]

1. Tests One & Two: Hybrid Instruments & Instruments Not Issued for Money

The first test is simple: if a corporation issued a hybrid instrument in substantial proportion to stock, then the regulations

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163. The regulations define contingent payment as "any payment other than a fixed payment of principal or interest." *Id.* § 1.385-5(d)(1).

164. *Id.* § 1.385-5(b).

165. *See generally id.* § 1.385-6.

166. *Id.* § 1.385-6(a)(2).

167. I.R.C. § 318(a) (2012).

168. Treas. Reg. § 1.385-6(a)(3)(i) (1980).

169. *Id.* § 1.385-6(a)(3)(ii). An independent creditor is considered independent depending on "all relevant facts and circumstances." *Id.* § 1.385-6(b)(1).

170. *Id.* § 1.385-6(a)(4). For examples of the facts and circumstances that would lead two instruments to be treated as one, see *id.* § 1.385-6(a)(4)(i), (ii).

treated the instrument as preferred stock.[171] The second test is more complex: if a corporation issues an instrument in exchange for property other than cash, then the regulations treated the instrument as preferred stock if two conditions were met.[172] First, the stated annual rate of interest was not reasonable.[173] Second, the issuance did not give rise to original issue discount under § 1232(a)(3) or amortizable bond premium under § 1.61-12(c)(2).[174] There was an exception, however, for a corporation that issued an instrument for an amount of consideration equal to or greater than the principal amount[175] of indebtedness of the issuing corporation.[176] Two requirements had to be met for the exception to apply. First, an independent creditor exercising ordinary diligence would agree to the exchange.[177] Second, "[t]he issuing corporation would, in the exercise of ordinary diligence, have agreed to make the exchange with an independent creditor holding the outstanding indebtedness."[178]

2. Test Three: Excessive Debt

The regulations treated an instrument as preferred stock, if a corporation with excessive debt issued an instrument in substantial proportion to stock.[179] The regulations find a

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171. *See id.* § 1.385-6(c)(1) ("If this section applies to a hybrid instrument immediately after it is issued, then the instrument is treated as stock."); *id.* § 1.385-4(c)(1)(i) (explaining that an instrument recharacterized as stock is treated as preferred stock).

172. *See id.* § 1.385-6(d)(1) (implementing rules pertaining to when an instrument is issued in exchange for property); *id.* § 1.385-4(c)(1)(i) ("If an instrument is treated as stock under section 385, then the instrument is treated as preferred stock . . . .").

173. *Id.* § 1.385-6(d)(1)(ii).

174. *Id.* § 1.385-6(d)(1)(iii).

175. The regulations explain that a principal amount of indebtedness includes "interest accrued but unpaid up until the date of the exchange, but only to the extent that such interest is paid with principal in the exchange." *Id.* § 1.385-6(d)(3)(ii).

176. *Id.* § 1.385-6(d)(3)(i).

177. *Id.* § 1.385-6(d)(3)(i)(A).

178. *Id.* § 1.385-6(d)(3)(i)(B).

179. *See id.* § 1.385-6(f)(1) (laying forth how an instrument issued to a corporation with excessive debt will be initially classified); *id.* § 1.385-4(c)(1)(i)

corporation's debt excessive if a bank, insurance company, or similar lending institution would find the terms of the instrument and the corporation's financial structure unsatisfactory.[180] A safe harbor provision in the regulations holds that a corporation's debt is not excessive if two conditions are met regarding (1) the outside ratio requirement and (2) the inside ratio requirement.[181] First, the corporation's outside ratio had to be less than or equal to 10:1.[182] A corporation's outside ratio is determined by the debt-to-equity ratio rules.[183] Second, the corporation's inside ratio had to be less than or equal to 3:1.[184] A corporation's inside ratio was determined in the same manner as a corporation's outside ratio,[185] but excluded liabilities to independent creditors.[186]

3. Test Four: Change in Terms of Outstanding Instruments

The regulations defined a substantial change in the terms of an instrument as one that materially affected the fair market value of the instrument.[187] In general, if an instrument was substantially proportional to the stock of the issuer on the day of agreement[188] and had a substantial change in the terms of the instrument, the regulations treated the instrument as newly issued in exchange for property on the day of agreement.[189] The amended terms are then tested under the substantial

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(explicating the effects of characterizing an instrument as stock).

180. *Id.* § 1.385-6(f)(2)(i), (ii). "For this purpose, the corporation's size, industry, geographic location, and financial condition must be taken into account." *Id.* § 1.385-6(f)(2)(ii).

181. *Id.* § 1.385-6(f)(3).

182. *Id.* § 1.385-6(f)(3)(i).

183. *See supra* notes 131–133 (summarizing the debt-to-equity ratio rules).

184. Treas. Reg. § 1.385-6(f)(3)(ii) (1980).

185. *See supra* notes 131–133 (summarizing the debt-to-equity ratio rules).

186. Treas. Reg. § 1.385-6(f)(4). The regulations provide that in determining stockholder's equity, as part of the calculation to determine the inside ratio, a corporation does not exclude liabilities. *See id.* § 1.385-6(f)(4).

187. *Id.* § 1.385-6(j)(2).

188. The regulations define "day of agreement" as "the day the issuer and the holder enter into a binding contract to change the terms of an instrument." *Id.* § 1.385-6(j)(3).

189. *Id.* § 1.385-6(j)(1)(iii).

proportionality rules to determine whether the instrument should be treated as equity or debt.[190]

4. Test Five: Nonpayment of Interest

The nonpayment of interest would convert a debt instrument into preferred stock if the owner of the instrument failed to exercise the ordinary diligence of an independent creditor and failed to receive payment of all or part of the interest due and payable during a taxable year.[191] The regulations determined the nonpayment of interest on the last day of the taxable year.[192] Further, if the regulations converted a corporation's purported debt instrument into preferred stock, "then the instrument [was] treated as stock beginning on the later of the first day of the taxable year during which the failure to pay occur[ed] or the first day on which this section applied to the instrument."[193]

5. Tests Six & Seven: Demand Instruments & Nonpayment of Principal

The regulations provided a two-part rule for the initial classification of an instrument payable on demand. If a demand instrument's stated annual rate of interest was not reasonable[194] and the demand instrument was issued in substantial proportion to the company's common stock,[195] then it became preferred stock.[196] The regulations also provided rules for an instrument that became payable on demand during the taxable year that are similar to the rule that pertained to initial classification.[197] The

190. *See id.* § 1.385-6 (outlining the seven tests under the substantial proportionality rules).

191. *Id.* § 1.385-6(k)(1)(i), (ii).

192. *Id.* § 1.385-6(k)(1)(ii).

193. *Id.* § 1.385-6(k)(1)(iii).

194. *Id.* § 1.385-6(*l*)(iii).

195. *Id.* § 1.385-6(*l*)(ii).

196. *Id.* § 1.385-6(*l*)(iii); *see also id.* § 1.385-4(c)(1)(i) (revealing that if an instrument is classified as stock then it is treated as preferred stock).

197. *See id.* § 1.385-6(*l*)(2) (setting forth the reclassification rules for instruments payable on demand).

only difference is that if it is reclassified, the regulations treated the reclassified instrument as issued at the start (or a portion) of that taxable year.[198] If an issuing corporation failed to make a scheduled payment of principal within ninety days after the payment was due and if the holder of the instrument failed to exercise the ordinary diligence of an independent creditor, then the instrument would be considered to be payable on demand.[199] The regulations determined an instrument subject to this rule to be "payable on demand beginning on the day after the day the principal was due."[200]

G. Treatment of Unwritten Obligations

In general, the regulations treated unwritten obligations, obligations not evidenced by a written instrument within six months after the day the loan is made,[201] differently than instruments evidenced by a writing. The rules that pertained to the treatment of unwritten obligations did not apply to independent creditors and excluded loans repaid within six months, but only if the outstanding balance, reduced by the outstanding balance of prior qualifying loans, did not exceed $25,000.[202] If not excluded, the regulations treated an unwritten obligation as indebtedness.[203] Further, if a corporation issued an unwritten obligation and had excessive debt,[204] the regulations treated it as a contribution to capital.[205] Moreover, if the debtor corporation failed to make a payment of interest on the loan at a reasonable rate of interest,[206] the regulations reclassified the loan

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198. *Id.* § 1.385-6(*l*)(2)(iii).

199. *Id.* § 1.385-6(*l*)(3)(i), (ii).

200. *Id.* § 1.385-6(*l*)(3)(ii).

201. *Id.* § 1.385-7(a)(1)(ii).

202. *Id.* § 1.385-7(a)(2)(i).

203. *See id.* § 1.385-7(a)(2)(ii) ("[A] loan to which this section applies is treated as indebtedness.").

204. For a definition of excessive debt, see *supra* note 180 and accompanying text.

205. *Id.* § 1.385-7(b)(2).

206. For a definition of reasonable rate of interest, see *supra* notes 142–144 and accompanying text.

as a contribution to capital.[207] Any unwritten obligation that was treated as a contribution to capital under these rules would be treated as a distribution of property under I.R.C. § 301.[208] Under I.R.C. § 301, the Treasury Department taxed any unwritten obligation on "that portion of the distribution that [was] not a dividend, to the extent that it exceed[ed] the adjusted basis of the stock."[209] As such, § 301 treated it "as a gain from the sale or exchange of property."[210]

H. Treatment of Guaranteed Loans

Relevant legal principles still applied to a corporation that incurred a loan guaranteed by a shareholder.[211] Further, if a court treated such a loan as made by the shareholder under relevant legal principles, then the common law treated the shareholder as having made a contribution to capital of the corporation.[212]

I. Treatment of Preferred Stock

The regulations treated preferred stock in one of two ways: (1) as equity if there were no fixed principal or interest payments;[213] or (2) as debt if there were.[214] Preferred stock classified as indebtedness was subject to the rules under the treatment of instruments generally, unless classified as equity. Therefore, under the regulations, preferred stock was subject to the hybrid instruments rules or the proportionality rules.[215]

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207. *Id.* § 1.385-7(c)(1).

208. *Id.* § 1.385-7(d) (describing the effect of a corporation's failure to pay reasonable interest on a loan).

209. I.R.C. § 301 (c)(3)(A) (2012).

210. *Id.*

211. *See id.* § 1.385-9(a) (laying out the various rules for guaranteed loans).

212. *See id.* § 1.385-9(a)(2) (conveying that guaranteed loans will be determined under relevant legal principles "applied without reference to the regulations under section 385").

213. *Id.* § 1.385-10(a).

214. *Id.*

215. *See id.* (explicating the rules under which preferred stock can be classified as indebtedness).

The rules for the treatment of preferred stock also set forth a rule of convenience that treated preferred stock as equity, but only if six conditions were met.[216] First, the preferred stock was denominated preferred stock and treated as preferred stock under non-tax law.[217] Second, the surplus of the preferred stock's redemption price over its issue price was a reasonable redemption premium under § 1.305-5.[218] Third, the preferred stock's current dividends were contingent.[219] Fourth, rights to receive dividend and redemption payments of preferred stock were not enforced under non-tax law because the issuing corporation was insolvent, would be rendered insolvent by making such payments, or because making those payments would impair the issuing corporation's capital.[220] Fifth, a default on dividend or redemption payment of preferred stock would not accelerate redemption payments at the election of the holder.[221] Sixth, there was at least a ten-year limitation during which the holder was not allowed to compel redemption.[222] This brief summary of the 1980 regulations illustrates why they were dropped after voluminous criticism: they were unduly complex and attempted to address every potential permutation, they were too rigid in places, and in other cases they failed to address real-world complexities.

VI. The 2016 Approach

A. Background

On April 8, 2016, the Treasury Department issued proposed regulations under § 385.[223] This time, the Treasury Department sought to provide rules to determine the true nature of an interest

216. *See id.* § 1.385-10(b) (providing the rule of convenience).
217. *Id.* § 1.385-10(b)(1).
218. *Id.* § 1.385-10(b)(2)
219. *Id.* § 1.385-10(b)(3).
220. *Id.* § 1.385-10(b)(4).
221. *Id.* § 1.385-10(b)(5).
222. *Id.* § 1.385-10(b)(6).
223. *See generally* Prop. Treas. Reg. §§ 1.385-1–1.385-4, 81 Fed. Reg. 20912 (Apr. 8, 2016).

in a corporation.[224] On October 21, 2016, the Treasury Department finalized the proposed regulations in an unusually rapid pace of adoption.[225] The regulations apply to expanded group instruments (EGI) and instruments issued by members of an expanded group that are domestic corporations.[226] An EGI is generally defined as an instrument denominated as debt (regardless of its ultimate characterization by the I.R.S.) that one member of an "expanded group" issued to another member.[227] An expanded group "generally includes all corporations connected to a common parent that owns, directly or indirectly, 80% of the vote or value of each such corporation."[228] Excluded from these regulations are S-corporations, non-controlled regulated investment companies, real estate investment trusts, partnerships and certain specified financial entities, financial groups, insurance companies,[229] and qualified short term debt instruments.[230] Further, taxpayers subject to these regulations are entitled to exclude the first $50 million of debt that is otherwise recharacterized as equity.[231]

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224. *See id.* (noting that the absence of regulations under § 385 resulted in courts applying inconsistent sets of factors).

225. *Compare id.* §§ 1.385-1–1.385-4 (proposing regulations under § 385 on April 8, 2016), *with* Treas. Reg. §§ 1.385-1–1.385-3T (2016) (finalizing regulations under § 385 on October 21, 2016).

226. *See id.* § 1.385-2(a)(3) (stipulating which instruments are subject to the documentation requirements).

227. *Id.* § 1.385-2(d)(3).

228. DELOITTE, FINAL/TEMPORARY REGULATIONS ADDRESS TREATMENT OF CERTAIN INTERESTS IN CORPORATIONS AS STOCK OR INDEBTEDNESS 2 (2016), https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-alert-new-section-385-regulations.pdf; *see also* Treas. Reg. § 1.385-1(c)(4)(i) (2016) (giving a definition of expanded group).

229. *See id.* § 1.385-3(c) (excluding certain types of companies from the scope of these rules).

230. The regulations contain a full section on rules pertaining to qualified short-term debt obligations, but because those rules are beyond the scope of this Note, they are not discussed in depth. For more information on qualified short-term debt instruments, see *id.* § 1.385-3T (exempting qualified short-term debt instruments).

231. *See id.* § 1.385-3(c)(4) (excluding the first $50 million of debt a corporation issues).

B. Documentation Rules

1. Scope

The rules set forth an explicit set of documentation requirements that must be followed to avoid the characterization of certain instruments as debt rather than equity.[232] The purpose of the documentation requirements is twofold. First, it provides the Treasury Department with the ability to make a proper determination as to whether an instrument is debt or equity by providing guidance on the necessary documentation and information a corporation must prepare, maintain, and provide to the I.R.S.[233] Second, it establishes "operating rules, presumptions, and factors to be taken into account" in making a proper determination under the regulations.[234]

The regulations point out that compliance alone with this section will not deem an instrument debt, but failure to maintain this documentation may disqualify an instrument from debt status.[235] The documentation rules require a corporation to maintain "complete copies of all instruments, agreements, subordination agreements, and other documents evidencing the material rights and obligations of the issuer and holder relating to the EGI."[236] A corporation must prepare these records by the time that the issuer's federal income tax return is filed.[237]

The application of the documentation requirements to an expanded group instrument is limited based on certain qualifications. First, this Section only covers an expanded group instrument if it is issued to a covered member.[238] Second, this Section applies to an expanded group instrument only if it meets any of three threshold requirements: (1) the stock by any member

232. *See id.* § 1.385-2(a)(1) (providing documentation requirements).

233. *Id.* § 1.385-2(a)(2).

234. *Id.*

235. *See id.* (revealing that compliance with the documentation rules only serves to "satisfy the minimum documentation for the determination to be made").

236. *Id.* § 1.385-2(c)(1)(i).

237. *Id.* § 1.385-2(c)(4)(i).

238. A covered member is regarded as a "member of an expanded group that is . . . a domestic corporation" or a disregarded entity as defined in § 1.385-1(c)(3). *Id.* § 1.385-1(c)(2).

of the expanded group is traded on an established financial market, (2) total assets of the issuing corporation exceed $100 million, or (3) annual total revenue of the issuing corporation exceeds $50 million.[239]

2. The Per Se Rule and Rebuttable Presumption

Under the Documentation Rules, there is a per se rule that characterizes an expanded group instrument as equity if a corporation fails to prepare, maintain, and provide the appropriate documents and does not qualify for an exception.[240] A rebuttable presumption from per se treatment exists if the corporation can clearly show under common law factors that the expanded group instrument is debt.[241] The rebuttable presumption only applies where a corporation has a high percentage of expanded group instruments (other than the one at issue) that comply with the documentation requirements.[242] For an expanded group to make this showing, one of two requirements must be met.

First, the average total adjusted issue price of all expanded group instruments at the close of each quarter that are undocumented and outstanding must be less than ten percent of the average amount of the total adjusted issue price of all expanded group instruments outstanding at the end of the taxable year.[243] Second, in the alternative, no expanded group instrument that is undocumented is determined to have an issue price in excess of either $100 million or in the alternative $25 million; a corporation can meet the requirement under either determination.[244] A corporation meets the $100 million test if the number of undocumented and outstanding expanded group instruments averaged at the close of each quarter is less than five percent of all averaged expanded group instruments that are outstanding at

239. *Id.* § 1.385-2(a)(3)(ii).

240. *Id.* § 1.385-2(b)(1).

241. *Id.* § 1.385-2(b)(2)(i)(A).

242. *See id.* § 1.385-2(b)(2)(i)(B) (requiring corporations to meet this threshold requirement in order to claim that a rebuttable presumption exists).

243. *Id.* § 1.385-2(b)(2)(i)(B)(1).

244. *Id.* § 1.385-2(b)(2)(i)(B)(2).

the end of the taxable year.[245] A corporation meets the $25 million test if the number of undocumented and outstanding expanded group instruments averaged at the close of each quarter is less than ten percent of all averaged expanded group instruments that are outstanding at the end of the taxable year.[246] Moreover, under the Anti-Stuffing Rule, manipulation of adjusted issue prices of expanded group instruments is discounted in making this determination.[247] When making this determination, the Treasury Department may find reasonable cause for a corporation's failure to adhere to the documentation requirements.[248] An expanded group member who fails to prepare the required documents and seeks redress must prepare those documents within a reasonable time and maintain those documents.[249]

3. Indebtedness Factors

Within an expanded group instrument's documentation, the regulations set forth certain criteria a corporation must meet to satisfy the documentation requirements. First, there must be a written unconditional and legal obligation by the issuer to pay a determinable sum on demand or on a specific date.[250] Second, there must be written documentation that establishes the creditor's right to enforce the obligation.[251] Third, there must be written documentation that there is a reasonable expectation that, on the date of issuance, the issuer's financial position creates a reasonable expectation that the issuer intends to repay the debt.[252] Fourth, subsequent to the issuance of the note, the parties must behave in a manner consistent with a debtor-creditor relationship.[253] It should be noted that the reasonable expectation requirement and consistent behavior requirements are more in the

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245. *Id.* § 1.385-2(b)(2)(i)(B)(2)(i).
246. *Id.* § 1.385-2(b)(2)(i)(B)(2)(ii).
247. *Id.* § 1.385-2(b)(2)(i)(B)(4).
248. *Id.* § 1.385-2(b)(2)(i)(C)(ii)(A).
249. *Id.* § 1.385-2(b)(2)(i)(C)(ii)(B).
250. *Id.* § 1.385-2(c)(2)(i).
251. *Id.* § 1.385-2(c)(2)(ii).
252. *Id.* § 1.385-2(c)(2)(iii).
253. *Id.* § 1.385-2(c)(2)(iv).

nature of substantive than procedural requirements; merely documenting a loan may not rise to the level of a genuine belief in repayment ability or genuine conduct as a debtor or a creditor.[254]

C. Recharacterization Rule

1. Scope

The Recharacterization Rules are intended to address situations in which a covered debt instrument is issued to a related person that does not result in a new investment in the operations of the issuing corporation.[255] Under the Recharacterization Rules, the Treasury Department treats a debt instrument as equity if it is described by the General Rule, does not fall under one of the exceptions of the Funding Rule, and is not subject to the Anti-Abuse Rule.[256] As a result, the Recharacterization Rule operates "to recast a debt instrument into [equity] if: (i) a member of the expanded group issues the instrument in a tainted transaction to another member of the expanded group; or (ii) the instrument is deemed to fund the tainted transaction."[257] Once a covered debt is treated as equity, the regulations specify its continued treatment as equity for all federal tax purposes.[258]

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254. *See id.* § 1.385-2(c)(2)(iii) (identifying what it means to have a reasonable expectation of repayment); *id.* § 1.385-2(c)(2)(iv) (clarifying that to meet the creditor-debtor relationship requirement there must be a showing of payments of principal and interest along with enforcement and non-enforcement of creditor's rights).

255. *Id.* § 1.385-3(a).

256. *Id.*

257. ERNST & YOUNG LLP, FINAL AND TEMPORARY US SECTION 385 REGULATIONS SIGNIFICANTLY NARROW SCOPE OF EARLIER PROPOSED REGULATIONS 6 (2016), http://www.ey.com/Publication/vwLUAssets/Final_and_temporary_US_Section_385_regulations_significantly_narrow_the_scope_of_earlier_proposed_regulations/$FILE/2016US_03460-161US_Final%20and%20temp%20US%20Sec%20385%20regs%20significantly%20narrow%20scope%20of%20earlier%20proposed%20regs%20GL.pdf [hereinafter FINAL AND TEMPORARY REGULATIONS].

258. Treas. Reg. § 1.385-3(b)(1) (2016).

2. General Rule

The General Rule specifies three types of transactions that the Treasury Department will characterize as equity when a corporation issues a covered debt instrument to a member of its expanded group. The first is a distribution.[259] The second is an exchange for expanded group stock that is not an exempt exchange.[260] The third is an exchange for property in an asset reorganization, but only if a shareholder in the transferor corporation that is also a member of the issuer's expanded group receives "immediately before the reorganization the covered debt instrument with respect to its stock in the transferor corporation."[261]

3. Funding Rule

The Funding Rule was put in place "to prevent taxpayers from achieving in multiple steps what the General Rule prevents taxpayers from achieving in one step."[262] Under the Funding Rule, a funded member[263] who issues a debt instrument to an expanded group member may have that debt instrument treated as equity if the principal purpose of funding that transaction is similar to the transactions described in the General Rule.[264] A per se rule under the Funding Rule deems any debt instrument (other than certain instruments issued both in the ordinary course of business and in connection with the purchase of property or services in non-capital transactions) as equity if a corporation issued the instrument during the period beginning thirty-six months before and ending

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259. *Id.* § 1.385-3(b)(2)(i).

260. *Id.* § 1.385-3(b)(2)(ii).

261. *Id.* § 1.385-3(b)(2)(iii).

262. FINAL AND TEMPORARY REGULATIONS, *supra* note 257, at 6.

263. A "funded member" is defined as a covered member that makes: (1) a distribution with respect to stock, (2) in exchange for "expanded group" stock (with limited exceptions for exempt exchanges), or (3) in exchange for property in an internal restructuring that is treated as an asset reorganization for U.S. federal income tax purposes (including an "A," "C," "D," "F," or "G" reorganization). Treas. Reg. § 1.385-3(b)(3)(i) (2016).

264. *See id.* § 1.385-3(b)(3)(i)(A), (B), (C) (laying forth the identical transactions).

thirty-six months after the date of a distribution or acquisition described in the General Rule.[265]

4. Anti-Abuse Rule

The Anti-Abuse Rule prevents a corporation from treating an instrument as debt if the instrument was issued to avoid the Anti-Abuse Rule or the rules for qualified short-term debt instruments.[266] The Anti-Abuse Rule exempts an acquisition of expanded group stock from the General Rule or Funding Rule if one condition is met:

> [T]he member of the expanded group from which the expanded group stock is acquired, and the acquirer does not relinquish control of the seller pursuant to a plan that existed on the date of the acquisition, other than in a transaction in which the seller ceases to be a member of the expanded group of which the acquirer is a member.[267]

Control of a corporation is defined as owning, directly or indirectly, more than fifty percent of the voting power of all classes of stock and more than fifty percent of the total value of the stock of the corporation.[268] Under the exception, there is a presumption that the acquirer of the expanded group stock has a plan to relinquish control to the seller within a thirty-six month period after the acquisition date.[269] This presumption may be rebutted only by clearly showing that the loss of control was neither contemplated on the date of acquisition, nor meant to avoid the Recharacterization Rules.[270]

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265. *Id.* § 1.385-3(b)(3)(iii)(A).

266. *Id.* § 1.385-3(b)(4). For a list of non-exhaustive examples to transactions that the Anti-Abuse Rule may apply, see *id.* § 1.385-3(b)(4)(i), (ii).

267. *Id.* § 1.385-3(c)(2)(i)(A).

268. *Id.* § 1.385-3(c)(2)(i)(B).

269. *Id.* § 1.385-3(c)(2)(i)(C).

270. *Id.*

VII. Analyzing the Common Law Approach, the 1980 Regulations, and the 2016 Regulations

To analyze the approaches followed by the common law and the 1980 and 2016 regulations, it is instructive to look at a set of examples of the types of transactions multinational corporations might enter into today. The first example is a straightforward loan from a wholly owned subsidiary to a parent company.[271] The second example is a more complex convertible loan from a large shareholder to a corporation.[272] The third is a loan extended in exchange for property by a troubled company to a large shareholder (Company *A*).[273] In all cases, we assume that the loan is documented by a written contract. For purposes of the 2016 regulations, we assume that the loans in question constitute an EGI,[274] the total assets of the corporation exceed $100 million,[275] the corporation satisfies the documentation rules with respect to the loan,[276] and each corporation already excluded the first $50 million of debt that is otherwise covered.[277]

A. Example 1: Traditional Loan

Company *A* borrows $250 million from its wholly owned subsidiary Company *B*. Company *A* is a multinational corporation with a book value of $1 billion and a public market capitalization of $5 billion. The loan is documented in a note that sets forth the

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271. *See infra* Part VII.A (analyzing a traditional loan under the common law, 1980 regulations, and 2016 regulations).

272. *See infra* Part VII.B (examining the determination of a convertible loan as either debt or equity under the common law, 1980 regulations, and 2016 regulations).

273. *See infra* Part VII.C (evaluating whether a troubled company loan should be characterized as debt or equity under the common law, 1980 regulations, and 2016 regulations).

274. *See supra* notes 227–228 and accompanying text (defining and describing what constitutes an EGI).

275. *See* Treas. Reg. § 1.385-2(a)(ii) (2016) (requiring a corporation to meet one of three threshold requirements to be subjected to the documentation rules).

276. *See id.* § 1.385-2(b)(1) (treating a corporation's instrument as equity if it fails to properly document and maintain certain documents).

277. *See supra* note 231 and accompanying text (describing the $50 million exclusion).

terms (Note 1). Note 1 is due in five years and pays interest at the rate of seven percent per annum on a semiannual basis in arrears. The debt is ranked *pari passu* with the company's bank debt and senior to its subordinated debt and common stock. In the event of non-payment, there is a thirty-day grace period after which the loan is declared in default. Company *B* has traditional creditor's remedies, including the right to sue Company *A* for payment.

1. Common Law Analysis

Under the common law analysis, which looks at the four corners of the Note, the intent of the parties to establish a debt instrument is clear.[278] Company *B* is vested with traditional creditors rights: interest payments are mandatory,[279] Company *B* has the right to demand payment and sue for non-payment,[280] the loan has a set maturity date,[281] the loan ranks senior to the company's equity and subordinated debt,[282] and the company's financial condition at the time the loan was extended makes it reasonable to expect repayment at maturity.[283]

2. 1980 Regulations

Under the 1980 regulations, the Note meets the test of a debt instrument; it does not possess any of the attributes of a hybrid instrument that gives rise to analysis creating potential characterization as preferred stock.[284] Issues regarding the fair

278. *See supra* notes 75–102 and accompanying text (identifying and explaining the common law factors that bear on an objective determination of an intent to create a debtor-creditor relationship).

279. *See supra* notes 71, 92–93 and accompanying text (discussing the weight of interest payments in making a determination of debt or equity treatment).

280. *See* Plumb, *supra* note 10, at 420 (explaining that the right to force payment upon default supports a finding of equity treatment).

281. *See supra* notes 62–65 and accompanying text (noting the value of having a fixed maturity date).

282. *See supra* note 67 and accompanying text (establishing the importance of subordination).

283. *See supra* notes 94–95 and accompanying text (detailing the significance of a corporation's failure to enforce a default).

284. *See supra* notes 151–158 and accompanying text (summarizing the

market value of the instrument,[285] the debt equity ratio,[286] or the reasonable rate of interest are all satisfied.[287]

3. 2016 Regulations

Under the new 2016 regulations, which corporations now must satisfy, the Note is considered debt. To determine whether the Note is equity under the Recharacterization Rules issued in 2016, the Note must fall within either the General Rule or the Funding Rule and avoid capture by the Anti-Abuse rule.[288] Under the General Rule, the regulations characterize a debt instrument as equity if it was issued by a corporation to a member of the corporation's "expanded group"[289] (a) in a distribution with respect to stock; (b) in exchange for "expanded group" stock (with limited exceptions for exempt exchanges); or (c) in exchange for property in an internal restructuring that is treated as an asset reorganization for U.S. federal income tax purposes (including an "A", "C", "D", "F", or "G" reorganization.).[290] In this case, Company *A* and *B* are part of an "expanded group" but the loan does not fall under any of the transactions described in the General Rule; therefore, the Note is not recharacterized as equity. Further, under the Funding Rule, the regulations reclassify a debt instrument as equity to the extent a corporation issued it to a member of the funded member's "expanded group" in exchange for property.[291] Again, because Company *A* and *B* are members of an "expanded

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treatment of straight debt instruments).

285. *See supra* notes 118–127 and accompanying text (revealing how a determination of the fair market value of an instrument is necessary).

286. *See supra* notes 128–134 and accompanying text (describing how a determination of a corporation's debt-to-equity ratio is needed for a proper evaluation).

287. *See supra* notes 138–144 and accompanying text (clarifying the importance of a proper determination of a reasonable rate of interest).

288. *See* Treas. Reg. § 1.385-3(a) (2016) (presenting how the Recharacterization Rules operate).

289. *See supra* notes 227–228 and accompanying text (defining "expanded group").

290. *See* Treas. Reg. § 1.385-3(b)(2) (2016) (providing the various transactions that fall under the general rule).

291. *See supra* notes 262–265 and accompanying text (examining the Funding Rule).

group" but the loan does fall under any of the transactions described in the Funding Rule, recharacterization of the instrument does not occur.

B. Example 2: Convertible Loan

Company *A* borrows $250 million from its largest shareholder, XYZ Hedge Fund, which owns ten percent of its common stock and appointed two of the company's seven directors. The terms of the loan (Note 2) are as follows: (1) the loan is convertible into ten percent of the company's common stock if the stock reaches a price of $25 per share (it is trading at $10 per share at the time the loan is made), (2) it pays interest at three percent per year semiannually in arrears, (3) interest can be paid in cash or by the issuance of additional bonds at the option of the company, (4) it matures in five years, and (5) the lender is given traditional remedies upon default. To illustrate the ability to pay interest via issuance of additional bonds, the company can choose to make the semiannual interest payment of $3.75 million (3% x $250,000,000 x 6 months) by issuing an additional $3.75 million face amount of bonds with the same terms as the Note rather than paying cash. The loan ranks senior to the company's equity and *pari passu* with its subordinated debt, but is subordinated to its senior debt (this is traditional for convertible debt instruments). There is a thirty-day grace period for interest payments, after which XYZ Hedge Fund can assert its rights as a creditor. Company *A* is solvent and otherwise financially sound at the time the loan is made.

1. Common Law Analysis

While a convertible note is a hybrid instrument possessing the attributes of both equity and debt,[292] Note 2 should be treated as a debt instrument prior to the time of conversion (if ever) into stock.

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292. *See* David Newton, *Understanding Convertible Loans*, ENTREPRENEUR (Oct. 28, 2002), https://www.entrepreneur.com/article/56512 (last visited Feb. 28, 2017) ("Typically, the conversion feature [of a convertible loan] gives the lender an option to convert all or a portion of the outstanding principal of the loan into some form of an equity position in the borrower's company.") (on file with the Washington and Lee Law Review).

Traditional creditors' rights vest with Company *B*: interest payments are mandatory,[293] Company *B* has the right to demand payment and sue for non-payment,[294] the loan has a set maturity date,[295] the loan ranks senior to the company's equity and *pari passu* with its subordinated debt,[296] and the company's financial condition at the time the loan was extended makes it reasonable to expect repayment at maturity.[297]

2. 1980 Regulations

The 1980 regulations raise unnecessary confusion regarding the treatment of this Note. Until the Note is converted or Company A defaults, this Note appears to meet the definition of a "hybrid instrument" under these regulations: "[a]n instrument that is convertible into stock or one (such as an income bond or a participating bond) that provides for any contingent payment to the holder (other than a call premium)."298 A hybrid instrument is treated as equity on the day of issuance if the fair market value of the instrument excluding its equity features is less than fifty percent of the actual fair market value of the instrument including its equity features.[299] In this case, however, because XYZ Hedge Fund is financially sound, it is unlikely that more than fifty percent of the value of the Note is attributable to its equity component, and therefore, the Note should not be recharacterized as equity. Further, Company A did not issue the Note proportionately to the common stock, and therefore, it would not

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293. *See supra* notes 71, 92–93 and accompanying text (observing the various weight interest payments have received under the common law).

294. *See* Plumb, *supra* note 10, at 420 ("The 'right to force payment of the sum as a debt in the event of default' is a very significant, if not essential factor." (quoting United States v. S. Ga. Ry., 107 F. Supp. 382, 395 (N.D. Ohio (1968))).

295. *See supra* notes 62–65 and accompanying text (establishing the significance of having a fixed maturity date).

296. *See supra* note 67 and accompanying text (describing the weight courts have given subordination under a common law multi-factored analysis).

297. *See supra* notes 94–95 and accompanying text (specifying the consequences of a corporation's failure to enforce a default).

298. Treas. Reg. § 1.385-3(e) (1980).

299. *See id.* § 1.385-5(a) (setting forth the initial classification rules for hybrid instruments).

implicate the tests under the regulations that would lead to its becoming preferred stock.[300] Finally, Company A is not an excessively leveraged company issuing an instrument proportionately to its common stock, so again, the Note is not subject to recharacterization as preferred stock.[301] The regulations introduce significant and unnecessary complexity into the analysis.

3. 2016 Regulations

Under the new 2016 regulations, Note 2 is also considered debt. Under the General Rule,[302] Company *A* and XYZ Hedge Fund are not considered part of an "expanded group,"[303] and therefore, the regulations do not recharacterize the Note as equity. Further, under the Funding Rule,[304] Company *A* and XYZ Hedge Fund also are not members of an "expanded group,"[305] and therefore, no recharacterization of the instrument occurs. Regarding the documentation requirements, it appears that there was a reasonable expectation of repayment at the time the loan was extended and the parties appear to be maintaining an arm's length debtor-creditor relationship in their commercial relationship as stockholder/corporation.[306] Application of the new regulations produces the correct result, i.e., treatment of Note 2 as debt.

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300. *See supra* Part IV.F (supplying the substantial proportionality rules).

301. *See supra* Section IV.F.2 (elaborating on the excessive debt test under the substantial proportionality rules).

302. *See* Treas. Reg. § 1.385-3(b)(2) (2016) (setting forth the transactions that are subject to the general rule).

303. *See supra* notes 227–228 and accompanying text (providing a definition for expanded group).

304. *See* Treas. Reg. § 1.385-3(b)(3)(i) (2016) (indexing the transactions to which the Funding Rule applies).

305. *See supra* notes 227–228 and accompanying text (establishing the definition for "expanded group").

306. *See supra* notes 232–239 and accompanying text (outlining the documentation requirements necessary to support a finding of debt treatment).

C. Example 3: Distressed Company Loan

Company *A* is in financial distress. It is running out of cash to fund its payroll and is at risk of filing for bankruptcy unless it can obtain immediate funding. It borrows $100 million from its largest shareholder (Note 3), Vulture Hedge Fund (Vulture), which invests in distressed companies. Vulture has accumulated a thirty-five percent stake in Company *A* over the last few months at very low stock prices because the market knows that the company is in trouble. Vulture drives a very hard bargain. It agrees to lend Company *A* the money only on the following terms: a one-year loan secured by all of Company *A*'s real estate at a rate of ten percent (the Prime Rate is one percent) payable monthly convertible into seventy-five percent of Company *A*'s stock in the event of default; interest is payable monthly with a five-day grace period after which Vulture can demand immediate payment; Vulture gets three of Company *A*'s seven board seats now and two more board seats upon default; and Vulture gets access to monthly financial reports from the company. The loan ranks senior to all of Company's *A* existing debt and equity. Having no alternative, Company *A* agrees to the deal.

1. Common Law Analysis

Note 3 highlights the shortcomings of the common law approach to the debt/equity issue. Under the common law analysis, looking at the four corners of the agreement leads to the conclusion that this is a debt instrument. It appears from Note 3 that the parties intended to establish a debt instrument. Vulture is invested with traditional creditor's rights: interest payments are mandatory,[307] Vulture has the right to demand payment and sue for non-payment,[308] the loan has a set maturity date,[309] and the

307. *See supra* notes 69–71, 92–93 and accompanying text (pointing out the various ways courts have dealt with interest payments).

308. *See* Plumb, *supra* note 10, at 420 (evaluating the treatment of remedies for default).

309. *See id.* at 413 ("The most important of the formal factors is a provision for a fixed . . . time when the purported creditor is unconditionally entitled to require payment of the principal.").

loan ranks senior to the company's debt and equity.[310] But the company is on the verge of insolvency, so regardless of what the company intended, it may not be realistic to expect repayment of the loan in cash. Instead, a more reasonable expectation may be repayment through conversion of the loan to equity, and an award of two more board seats and effective control of the company to Vulture. Accordingly, the common law approach falls short in this distressed loan situation because courts limited their analysis to the four corners of a debt contract which omits important facts regarding the company's financial condition, leading them to weigh factors in these types of situations without regard to commercial realities.[311]

2. 1980 Regulations

Surprisingly, the much-maligned 1980 regulations may work best in this type of situation where a hybrid instrument is used to bail out a financially troubled company. Application of the preliminary three-part test analyzing the fair market value of the instrument, the debt-to-equity ratio, and the reasonable rate of interest on the loan leads to the conclusion that Note 3 should be treated as equity rather than as debt.[312] This test highlights the reality that Note 3 is likely worth far less than face value at the time Vulture extended the loan because much of the proceeds will likely be used to pay arrearages on payables and other obligations of the company to keep it operating.[313] The company's debt-to-equity ratio is also likely to be extremely elevated, suggesting that the new funds invested should be treated as equity because they are at high risk of not being repaid.[314] The 1980

310. *See supra* note 67 and accompanying text (elaborating on the significance of subordination).

311. *See* Plumb, *supra* note 10, at 408 (asserting that the courts "arrive at opposite results on identical facts" depending on which factors they wish to stress).

312. *See supra* Part IV.B and accompanying text (explicating the importance of the preliminary rules).

313. *See supra* Part IV.B.1 and accompanying text (exploring the treatment of an instrument deemed to have a fair market value).

314. *See supra* Part IV.B.2 and accompanying text (disclosing the effect in determining the reasonableness of a company's debt-to-equity ratio).

Regulations would likely treat Note 3 as equity, a sound result in view of the likelihood that Vulture will end up with control over most of the stock and the company's board in a relatively short period of time.

3. 2016 Regulations

Under the new 2016 regulations, the determination whether Note 3 should be considered debt or equity likely comes down to an application of the documentation requirements, rather than the Distributed Debt Rules.[315] To determine whether Note 3 is equity under the Distributed Debt Rules, it must fall within either the General Rule or the Funding Rule.[316] Technically, under the General Rule,[317] Company *A* and Vulture are not considered part of an "expanded group,"[318] and therefore, Note 3 would not be recharacterized as equity. Further, under the Funding Rule, a debt instrument is considered equity to the extent a corporation issued the instrument to a member of the funded member's "expanded group"[319] in exchange for property in a tax-free internal organization because while the Note is secured by Company *A*'s property, no property has changed hands yet.[320] But the documentation requirements create an additional hurdle that may cause Note 3 to be recharacterized as equity, nonetheless. Due to Company *A*'s dire financial condition, the I.R.S. could reasonably find that there was not a reasonable expectation of repayment at the time the loan was extended.[321] The Treasury Department could

315. *Compare supra* Part VI.C (describing the Recharacterization Rules), *with supra* Part VI.B (stating the Documentation Rules).

316. *See* Treas. Reg. § 1.385-3(a) (2016) (summarizing how the Recharacterization Rules operate).

317. *See id.* § 1.385-3(b)(2) (supplying the transactions to which the General Rule applies).

318. *See supra* notes 227–228 and accompanying text (defining "expanded group").

319. *See supra* notes 227–228 and accompanying text (giving a definition for expanded group).

320. *See* Treas. Reg. § 1.385-3(b)(3)(i)(C) (2016) (providing that the funding rule applies to transactions in which a funded member in an asset reorganization acquires property).

321. *See id.* § 1.385-2(c)(2)(iii) ("There must be written documentation containing information establishing that, as of the date of issuance . . . and taking

find that certain terms of the loan, such as the board representation and provision of monthly financial reports to Vulture, are not characteristic of a normal debtor-creditor relationship.[322] These findings could fail to meet the documentation requirements and lead the I.R.S. to find that the Note should be treated as equity and not debt.[323] In this case that may well prove to be the correct result.

VIII. A Case for the 2016 Regulations

In the first two examples, the common law approach, the 1980 regulations, and the 2016 regulations all end up in the same position in terms of characterizing an instrument.[324] This consistency disappears in example three.[325] The troubled company loan example provides insight into the strengths of the 2016 regulations.[326]

In fashioning a regulatory approach that balances the need to provide corporations with clarity and flexibility and the government with appropriate tools to fight tax abuse, the government adopted the 2016 Regulations. The 2016 Regulations give broad discretion to the I.R.S. to recharacterize debt as equity in circumstances where the economic reality does not support a showing that repayment of an instrument denominated as debt is likely or where the parties do not appear to conduct themselves as arm's length debtors and creditors.[327] Moreover, the 2016 regulations eschew the ambiguity of the common law approach, as

into account all relevant circumstances . . . the issuer's financial position supported a reasonable expectation that the issuer intended to, and would be able to, meet its obligations . . . .").

322. *See id.* § 1.385-2(c)(iv) (informing the taxpayer of the documentation that must be provided in order to prove a debtor-creditor relationship existed).

323. *See id.* § 1.385-2(a)(2) ("[C]ompliance with this section does not establish that an interest is indebtedness; it serves only to satisfy the minimum documentation for the determination to be made under general federal tax principles.").

324. *See supra* Parts VII.A–B (supplying and analyzing examples).

325. *See supra* Part VII.C (comparing the results under the common law, the 1980 regulations, and the 2016 regulations).

326. *See supra* Part VI.C.3 (analyzing the result under the 2016 regulations).

327. *See* Treas. Reg. § 1.385-2(c)(2) (2016) (establishing the indebtedness factors under the documentation requirements).

well as the specificity provided in the 1980 regulations, in favor of a more intent-based inquiry to prevent parties from engaging in tax avoidance transactions through use of complex corporate finance techniques.[328] Years of aggressive tax practice by corporations, intended to elevate form over substance and make it as difficult as possible for the I.R.S. to challenge transactions designed to turn equity into debt and to confer the tax benefits associated with debt on *de facto* related parties, necessitated such an approach.[329]

It was long apparent that giving a financial instrument one or more of the formal indicia of debt as set forth in the common law tests (e.g., a maturity date, an interest rate, a senior ranking, etc.) was an exercise in elevating form over substance.[330] This is true particularly in cases where the borrower's financial condition renders repayment unlikely, or when extension or terms of the loan ultimately confer corporate control on the lender (intentionally or not).[331] Even where a party owns less than eighty percent of a borrower or controls less than eighty percent of the seats on the board of directors,[332] it may as a practical matter own a sufficient amount of stock or control enough board seats to exercise *de facto* control of the company even if the relationship between the parties falls outside the definition of an expanded

328. *Compare supra* Part IV (describing the common law approach), *with supra* Part V (outlining the 1980 regulations), *and supra* Part VI (exploring the 2016 regulations).

329. *See* Reuven S. Avi-Yonah, *Just Say No: Corporate Taxation and Corporate Social Responsibility* 19 (Law & Econ. Research Paper Series, Paper No. 14-010, 2014), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2423045 (stating that there is an increase in aggressive tax behavior among corporations).

330. *See supra* note 56 and accompanying text (revealing that courts developed multi-factored test to help determine whether an instrument should be treated as debt or equity).

331. Sears, for example, took a $425 million loan from Edward Lampert (a sixteen percent shareholder in Sears) through his hedge fund. *See* Gara, *supra* note 4 (mentioning that amount of loans Sears has taken from Lampert). Although Lampert does not own eighty percent of Sears' vote or value, Lampert, through his loans,"secured by a junior liens against Sears' inventory, receivables and working capital," and his sixteen percent ownership stake in Sears, gives him *de facto* control. *Id.*

332. *See supra* notes 226–229 and accompanying text (laying out that the regulations apply to expanded group instruments).

group.[333] This is particularly true in distressed situations like Company *A*, where Vulture Hedge Fund owns substantial equity, controls several board seats, and extends a substantial loan that gives it payment priority ahead of common shareholders. In the real world, such an arrangement discourages unrelated third parties from extending credit or investing equity in the company because they are more likely than not to be dealing with Vulture Hedge Fund and not Company *A*.[334] The common law approach attempted to attack the problem with a narrow focus that led to inconsistent results.[335] The 1980 regulations mimicked this approach and were abandoned because they were too complex and promised no better outcome.[336] The 2016 regulations broke new ground in their breadth, which gives the I.R.S. the explicit authority to use the well-recognized tax doctrines of economic substance and substance-over-form to look through the formalities attached to financial instruments to prevent corporations from disguising equity as debt.[337] As adopted, the final regulations give the I.R.S. the appropriate tools with which to fight abuse, while leaving corporations the flexibility necessary to operate their businesses.[338] Despite this allowance for flexibility, the final regulations still provide notice to corporations that any abuses will be vulnerable to attack and reversal.[339]

At the end of the day, statutory specificity[340] and ambiguity[341] need to be in balance in an area as complex as the characterization

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333. *See supra* Part VII.C.3 (analyzing a distressed company loan).

334. *See supra* notes 6–9 and accompanying test (providing background information on unrelated party loans).

335. *See supra* Part IV (describing the common law approach).

336. *See supra* Part V (explaining the 1980 regulations).

337. *See supra* Part VI (outlining the 2016 regulations).

338. *See generally* Treas. Reg. § 1.385-2 (2016).

339. *See generally id.*

340. *See* Jeffrey Partlow, *The Necessity of Complexity in the Tax System*, 13 WYO. L. REV. 305, 316 (2013) ("As taxpayers unearth new loopholes, Congress makes changes to the tax laws to avoid and close loopholes, and the result is a frequently changing Code with a predisposition toward detailed, complex provisions.").

341. *See* Bayless Manning, *Hyperlexis and the Law of Conservation of Ambiguity: Thoughts on Section 385*, 36 TAX LAW. 9, 12 (1982) (arguing that elaborate regulations on whether an instrument is considered debt or equity will not reduce the aggregate of residual ambiguity).

of financial instruments as debt or equity. Excessive specificity is ill-suited to this area of the law, not merely because of the ability of corporations and their advisors to weave around technical rules,[342] but because of the reality that in certain cases, particularly those involving distressed companies, there may be little practical difference between debt and equity. When a highly leveraged company cannot pay its bills, the entire capital structure is, for all intents and purposes, equity, and calling a particular part of its capital structure debt is an exercise in hope over experience.[343] The I.R.S. needs the tools to prevent insiders and other related parties from avoiding taxes by mischaracterizing equity investments as debt in such circumstances.[344] At the same time, excessive ambiguity is undesirable because distressed corporations need as much certainty and guidance as reasonably possible in ascertaining the tax consequences of their financing arrangements.[345] The 2016 regulations balance these competing interests and largely succeed where its predecessors failed.[346]

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342. *See* M.V., *Corporate Tax Avoidance: The Price Isn't Right*, ECONOMIST: SCHUMPETER BLOG (Sept. 21, 2012, 7:23 PM), http://www.economist.com/blogs/schumpeter/2012/09/corporate-tax-avoidance (last visited Dec. 7, 2017) (observing that large corporations push into legal grey areas with aggressive tax planning strategies) (on file with the Washington and Lee Law Review).

343. *See* David Bagley, *Liquidity is King in the Financial Structure of a Struggling Company*, DAILY DAC (Apr. 30, 2013), https://www.dailydac.com/commercialbankruptcy/alternatives/articles/liquidity-is-king-financial-structure-issues-in-advance-of-insolvency-proceedings (last visited Dec. 7, 2017) (noting that a distress company's capital structure can be highly relevant to whether the company will be able to continue operations) (on file with the Washington and Lee Law Review).

344. *See* Press Release, U.S. Department of the Treasury (Oct. 13, 2016) ("[T]oday's final regulations narrowly target problematic earnings stripping transactions – transactions that generate deductions for interest payments on related-party debt that does not finance new investment in the United States—while minimizing unintended consequences for regular business activities.").

345. *See* David M. Driesen, *Complexity and Simplicity in Law: A Review Essay (Cass R. Sustein, Simpler: The Future of Government (2013))*, 45 ENVTL. L. 181, 186 (2015) (noting that "most complexity commentators associate uncertainty with the proliferation of very specific rules").

346. *See supra* Part VII (providing examples and analyzing the various governmental approaches to distinguishing debt from equity).

IX. Proposed Improvements and Recommendations

Any proposed improvements to the documentation requirements under the 2016 regulations should focus on providing greater certainty to corporations while preserving the ability of the government to challenge abusive corporate behavior. This means addressing two provisions in the regulations that give the government the authority to recharacterize instruments if it determines there was no reasonable prospect of repayment[347] or if the parties do not conduct themselves as debtors or creditors.[348] The final regulations, while eliminating broad provisions of the initial proposed regulations, retain the government's open-ended ability to recharacterize a broad array of financial instruments as equity in the documentation requirements, without providing sufficient guidance to corporations.[349]

If the government finds there was no reasonable prospect of repayment of capital invested in a corporation at the time of the transaction,[350] or that the parties are not conducting themselves as traditional debtors and creditors,[351] it can treat the instrument as equity.[352] But the regulations do not set forth any guidance regarding how to make these determinations and presumably would look to common law tests for instruction.[353] But we see how common law tests resulted in inconsistent results in this area of the law.[354] More specific guidance is needed that sets forth in detail

347. *See* Treas. Reg. § 1.385-2(c)(2)(iii) (2016) (prescribing the third indebtedness factor that a corporation must meet to be in compliance with the documentation requirements).

348. *See id.* § 1.385-2(c)(2)(iv) (setting forth the fourth indebtedness factor a corporation must retain in their documents).

349. *See id.* § 1.385-2(c)(2) (presenting broad indebtedness factors).

350. *See id.* § 1.385-2(c)(2)(iii) ("There must be written documentation containing information establishing that, as of the date of issuance of the applicable interest . . . the issuer's financial position supported a reasonable expectation that the issuer intended to, and would be able to, meet its obligations . . . .").

351. *See id.* § 1.385-2(c)(2)(iv) (providing that actions evidencing a debtor-creditor relationship include payment of principal and interest, enforcement of default and similar events).

352. *See id.* § 1.385-2(c)(2) (requiring a corporation's documents to include proof of the indebtedness factors prescribed in the regulation).

353. *See id.* (furnishing broad explanations of the indebtedness factors).

354. *See* Plumb, *supra* note 10, at 408 (stipulating that courts arrive at

the characteristics of debt that must be present to avoid recharacterization of an instrument as equity.

In order to bring greater certainty to the law, the regulations should provide greater specificity regarding the standards for determining what constitutes reasonable certainty of repayment at the time a loan is extended. Rather than a rigid balance sheet test, however, this should involve a practical analysis of the company's current and future liquidity; cash flow; fair market, value rather than the book value of all of its assets (both balance sheet and off-balance sheet assets); and business prospects as of the time the instrument is created. Financial statements often fail to provide a complete picture of a company's financial health, particularly for companies in the technology industry, companies with significant amounts of intangible assets whose fair market value does not appear on the balance sheet, companies with off balance sheet assets, or companies in financial distress whose assets are quickly declining in value.[355] To obtain an accurate and independent assessment of the likelihood of repayment, corporations should obtain fairness opinions or similar types of independent evaluations of their financial condition from an independent party (i.e., an investment bank, commercial bank, or consulting firm) at the time the loan is made.[356] The Treasury Department would be free to challenge such analyses.[357]

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different results depending on which common law factors the court wishes to stress).

355. *See* TIMOTHY J. GALLAGHER & JOSEPH D. ANDREW, FINANCIAL MANAGEMENT: PRINCIPLES AND PRACTICE 88 (Freeload Press 4th ed. 2007) (1997) (assessing financial health and finding that "for some firms the financial statements do not provide the entire picture").

356. *See Fairness Opinion*, INVESTOPEDIA, http://www.investopedia.com/terms/f/fairness-opinion.asp (last visited Feb. 27, 2017) (defining a fairness opinion as "[a] report evaluating the facts of a merger or acquisition" which "examines the fairness of the offered acquisition price") (on file with the Washington and Lee Law Review).

357. Under the 2016 regulations, a corporation may provide additional documentation to supplement the required documents, but in no circumstance will it be able to act as a substitute for the required documents. *See* Treas. Reg. § 1.385-2(c)(1)(i) (explaining the role of additional documents provided to the Treasury Department). Third party reports or analysis on whether the issuer would be able to meet its obligations pursuant to the terms of the loan are not taken into account if an assertion is made "under law[s] governing an inquiry or proceeding with respect to the EGI." *Id.* § 1.385-2(b)(2)(iii)(C).

With respect to whether parties conduct themselves as genuine debtors and creditors, parties seeking debt treatment should specify their respective rights and obligations in an indenture or note whose provisions are strictly followed and enforced. The common law tests placed significant emphasis on parties enforcing or waiving traditional creditors' rights when re-characterizing certain instruments as equity.[358] If parties want to avoid the Treasury Department rewriting their contracts, they should not only "talk the talk" of lenders but "walk the walk" and behave like lenders. The more punctilious they are about behaving like they really loaned and borrowed money, the more difficult it will be for the government to claim they did not.[359] Form only subsumes substance where substance is illusory; if substance is real, it should be respected. Drafting agreements with specificity and conducting themselves in accordance with their agreements, corporations should minimize the chances that the government will rewrite their contracts retroactively under the broad discretion granted by the new regulations.

X. Conclusion

The 2016 Regulations are the end of decades of government efforts to develop an effective approach to distinguishing debt from equity. The regulations seek to provide corporations with reasonable clarity while giving the government the ability to challenge abusive transactions. The regulations grant the government broad powers to recharacterize corporate transactions under two standards contained in the documentation requirements: (1) whether it is reasonable to expect repayment of an instrument at the time is entered into,[360] and (2) whether the parties conduct themselves as true debtors and creditors.[361] While

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358. *See supra* Part IV.B (explicating how the common law determined whether there was an objective determination of an intent to create a debtor-creditor relationship).

359. *See* Treas. Reg. § 1.385-2 (a)(1) (2016) (specifying that the documentation requirement is necessary "for the proper determination of whether certain instruments will be treated as indebtedness for federal tax purposes").

360. *Id.*

361. *Id.* § 1.385-2(c)(2)(iv).

an important and useful step forward, these standards should be improved. The first standard lacks specificity, imposing on corporations a burden to make the case for the type of treatment of their transactions that they seek. The common law provides guidance on the second standard;[362] corporations should conduct themselves in accordance with long-established norms of debt-creditor relationships to prevent the government from challenging them. Overall, the 2016 Regulations strike a fair balance between providing corporations with the type of clarity that allows them to plan their affairs and giving the government the ability to challenge abusive transactions that deprive it of tax revenue.

While the new regulations are in place, there is a possibility that more change is on the way as part of the Trump administration's tax reform efforts[363] and litigation challenging the lawfulness of the 2016 Regulations.[364] On April 21, 2017, President Trump signed an executive order directing the Treasury Department to review "significant" regulations that were issued in 2016 and 2017 to determine if the regulations are too expensive, too complex, or exceed the IRS's statutory authority.[365] The order does not define "significant," but does state that any earlier determination under Executive Order 12866 (Sept. 30, 1993) or whether a tax regulation is "significant" will not be controlling.[366] The § 385 regulations may come under review pursuant to this Order, though at this time the fate of these regulations is unknown, as are the prospects for serious tax reform. Further, on

362. *See supra* Part IV.B (presenting the evidentiary factors the common law uses in order to determine whether there was an objective determination of an intent to create a debtor-creditor relationship).

363. *See* Exec. Order No. 13789, 3 C.F.R. § 2 (2017) ("In furtherance of the policy described in section 1 of this order, the Secretary of the Treasury (Secretary) shall immediately review all significant tax regulations issued by the Department of the Treasury on or after January 1, 2016 . . . .").

364. *See* Chris Sanders, *U.S. Court Strikes Down Obama-Era Rule on Tax Inversions*, U.S. NEWS (Sept. 29, 2017, 11:03 PM), https://money.usnews.com/investing/news/articles/2017-09-29/us-court-strikes-down-obama-era-rule-on-tax-inversions (last visited Dec. 7, 2017) (reporting on the litigation) (on file with the Washington and Lee Law Review).

365. *See* Exec. Order No. 13789, 3 C.F.R. § 2 (2017) (providing for review of Obama-Era rules on taxes).

366. *Id.*

September 29, 2017 "a federal court in Texas ruled that the Obama administration acted unlawfully last year when its Treasury Department cracked down on U.S. companies that try to reduce their U.S. taxes by rebasing abroad, in a process known as inversion."[367] While the lawfulness of § 385 is beyond the scope of this Note, both Trump's Order and the federal district court decision from Texas raise questions regarding the ultimate fate of the § 385 regulations. Corporations are already adjusting to the new regulations and this uncertainty needs to be resolved as soon as possible. For the moment, however, the new § 385 regulations are the only game in town.

367. Sanders, *supra* note 364.