July 6, 2016

United States Department of the Treasury

Via Federal eRulemaking Portal

This letter, signed by sixteen tax law academics, comments on proposed regulations regarding the "Treatment of Certain Interests in Corporations as Stock or Indebtedness," REG-108060-15, Docket RIN 1545-BN40, published at 81 Fed. Reg. 20,912-20,943 (April 8, 2016). This letter is a corrected version of a letter filed earlier on July 6, 2016. The correction provides the correct name spelling and affiliation for one of the signers.

We support Treasury's proposed regulations that would, among other effects, recharacterize certain related party debt as equity. The difficulty of distinguishing between related party debt and equity has long been acknowledged. Congress enacted I.R.C. Section 385 in 1969 to "specifically authorize" Treasury to provide rules to distinguish debt from equity. The proposed regulations at Treas. Reg. §§ 1.385-1 to 1.385-4 are a responsible and appropriate exercise of Treasury's authority.

Some transactions to which the proposed regulations would apply are earnings-stripping transactions undertaken by foreign-parented multinationals, including but not limited to corporations that have undergone so-called "inversion" or "redomiciliation" transactions. Inverted firms take advantage of intercompany debt to engage in earnings stripping to erode the tax base of U.S. subsidiaries of non-U.S. parents by causing U.S. subsidiaries to make deductible payments to non-U.S. parents. Not only inverted firms, but also foreign-parented multinationals in general, are able to earnings strip and pay less tax on their U.S. business profits compared to U.S. firms and U.S.-parented multinationals.

Treasury's regulations properly address certain earnings-stripping opportunities, as well as certain other situations of improper debt characterization, in an effort to ensure that an appropriate amount of tax is collected.

Prop. Treas. Reg. § 1.385-2 proceeds from an entirely reasonable premise, which is that documentation would improve Treasury's ability to administer the debt-equity distinction for related parties.

The proposed regulations also describe factors that give rise to the recharacterization of purported debt as equity. The first factor is a relatedness requirement, effected through the definition of "expanded group." Prop. Treas. Reg. § 1.385-1, Prop. Treas. Reg. § 1.385-3(a)(2). The second factor is that one of three transactions show that new capital is not invested. The three transactions are (1) a distribution of debt, (2) an exchange of debt for stock and (3) an exchange of debt for property in an asset reorganization. Prop. Treas. Reg. § 1.385-3(b)(3)(ii). We note that Treasury could also label provisions in the proposed regulations "factors" without changing their meaning.

The regulations also contain a rule that deems proximate transactions to be part of one of the three transactions that gives rise to reclassification. This also serves a reasonable purpose, since without such a provision the regulations would feature a tracing rule that would be too easy for taxpayers to avoid.

These regulations are without question within Treasury's regulatory authority under Section 385 of the Code.

First, the plain text of Section 385(a) reads as follows:

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

This statute gives Treasury broad discretion, and a reasonable interpretation of it in final notice-and-comment regulations merits deference.

Second, the proposed regulations draw support from the considerations provided in Section 385(b). The factor list is not exclusive, and Treasury is not limited by it. Indeed, the related case law suggests dozens of other possible factors. This case law does not adopt a formal analytical approach but rather has acknowledged that depending on the circumstance, some factors are more important than others. *See, e.g.*, William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 Tax L. Rev. 369 (1971).

In this case, the proposed regulations connect to those recited as relevant factors in the statute. The "expanded group" factor of relatedness is anticipated by IRC Section 385(b)(5), which points to the factor of "the relationship between holdings of stock in the corporation and holdings of the interest in question." The reference to transactions in which a purported debt instrument replaces an equity interest without new investment of capital is consistent with Section 385(b)(4). Section 385(b)(4) references the interchangeability of stock and debt when it invites consideration of "whether there is convertibility into the stock of the corporation."

Third, the legislative history supports the Treasury's action. It reveals that although one motivating factor for Section 385 was "the increasing use of debt for corporate acquisition purposes," the purpose of Section 385 was not limited to that context. For instance, the 1969 Senate report explained,

> [T]he committee further believes that it would be desirable to provide rules for distinguishing debt from equity in the variety of contexts in which this problem can arise. The differing circumstances which characterize these situations, however, would make it difficult for the committee to provide comprehensive and specific statutory rules of universal and equal applicability. In view of this, the committee believes it is appropriate to specifically

> authorize the Secretary of the Treasury to prescribe the appropriate rules for distinguishing debt from equity in these different situations.

We recognize that there are concerns about the administrative burden that these regulations may present for taxpayers and about various technical questions that may arise in the application of other provisions of the federal income tax law. We look to Treasury's judgment to identify meritorious hardship claims. But our general view is that these proposed regulations should be finalized. We do not believe that Treasury's response to comments must provide ex ante solutions to the myriad of technical objections that may be raised. Treasury has proposed a responsible and much-needed change in the way that the U.S. federal income tax law characterizes related parties' interests in each other, and has done so in a way that appropriately protects the U.S. fisc.

For particular provisions or purposes, it may be desirable to allow taxpayers time to adjust to changes in the law under the regulations. In such cases, it may be appropriate for Treasury in its discretion to specify a later effective date. This allows for transitional adjustments by taxpayers and the government and, if very significant problems emerge from experience prior to effectiveness of those provisions, the possibility of re-proposal and amendment.

The problem of properly characterizing related parties' interests as debt or equity is a challenge that reaches beyond the range of taxpayers and transactions considered in these proposed regulations. Treasury might pursue a broader solution after finalizing these regulations, for instance under a multi-stage regulatory project. Several ideas for broader solutions are available in the academic and policy literature. However, this is a different issue. With respect to the existing regulatory project, we believe that Treasury should work to finalize

these proposed regulations as expeditiously as prudently possible.

In signing this letter, each of us signs for himself or herself, rather than for his or her institution.

Sincerely,

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