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The Debt-Equity Regulations (Section 385)

Felix B. Laughlin

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THE DEBT-EQUITY REGULATIONS (SECTION 385)*

FELIX B. LAUGHLIN

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I. INTRODUCTION

A. History of Section 385 and the Debt-Equity Regulations.

The distinction between debt and equity has long been controversial. As one commentator has suggested, although one might anticipate that the terms “debt” and “equity” would be well understood, the process of distinguishing between debt and equity for Federal income tax purposes has generated a “jungle” of several hundred court decisions which “defy symmetry.” See Plumb, “The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal,” 26 Tax Law Rev. 369 (1971).

It was in this light that section 385 was added to the Internal Revenue Code in the Tax Reform Act of 1969. That section authorizes the Secretary of the Treasury to issue regulations “as may be necessary or appropriate to determine whether an interest in a corporation is to be treated...as stock or indebtedness.” In addition, in section 385 Congress suggested various factors which were to be taken into account in the regulations, such as: whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money, and to pay a fixed rate of interest; whether there is subordination to or preference over other indebtedness of the corporation; the debt-to-equity ratio of the corporation; whether the purported debt is convertible into stock of the corporation; and the relationship between holdings of stock in the corporation and holdings of the interest in question.

More than a decade later, in March 1980, the Treasury first published proposed regulations to implement section 385. These regulations became “final” on December 31, 1980, and were to be effective after April 30, 1981. This effective date was later changed to December 31, 1981. Then, on December 30, 1981, the currently proposed regulations were issued.

As initially issued the currently proposed regulations were to be effective with respect to corporate instruments created after June 30, 1982. After a hearing on March 10, 1982, in order to allow Treasury and the Internal Revenue Service additional time to prepare and publish revisions to certain provisions of the regulations, the effective date was amended so that the regulations would not be applicable until 90 days after the regulations become final. Further, the regulations were not to become effective prior to January 1, 1983. Revisions to the currently proposed regulations have not yet been published, and it was recently reported that the regulations would not become effective prior to April 1, 1983.

B. Circumstances in Which the Distinction Between Debt and Equity has Tax Significance.

The characterization of an interest in a corporation as debt or equity is significant to both the corporate debtor and the holder of the
interest. The following is a list of some of the principal situations in which such a characterization could be significant:

1. As a general rule interest payable on debt is fully deductible by the corporate payor, while distributions with respect to equity interests are not deductible.

2. Interest is fully taxable to the non-corporate creditor as ordinary income. Distributions with respect to equity interests held by non-corporate shareholders may also be taxed as ordinary income, but only to the extent of the corporation's earnings and profits.

3. Interest is fully taxable to a corporate creditor as ordinary income, while dividends from domestic corporations are either "eliminated" under the consolidated return regulations, or are taxed only to a limited extent as a result of the dividends received deduction under section 243.

4. Repayment of debt is a tax-free return of capital to the creditor to the extent of the creditor's tax basis in the debt. Repayment of a shareholder's investment in a corporation's capital in a distribution other than in liquidation of the shareholder's interest (i.e., in redemption of such interest) may be treated as a dividend to the extent of the corporation's earnings and profits. Only after the corporation's earnings and profits have been exhausted will such distributions be treated as a return of capital.

5. A sale of property to a controlled corporation by a shareholder in exchange for purported debt, or a transfer by a shareholder to a controlled corporation under section 351 that is intended to be taxable in part as a result of receipt of debt not constituting a "security," may be transformed into a non-taxable exchange of property for stock if the purported debt is treated as stock.

6. Characterization of purported debt as equity might result in disqualification of a corporation's Subchapter S election.*

7. Recharacterization of purported debt as stock might cause the holder to fail to qualify for installment treatment under section 453.

8. Losses resulting from bad debts may, under certain circumstances, result in an ordinary loss for Federal income tax purposes. Losses resulting from the disposition of equity interests that are capital assets in the hands of the holder are likely to be capital losses.

II. OVERVIEW OF CURRENTLY PROPOSED SECTION 385 REGULATIONS

A. Initial Treatment.

The principal objective of the proposed regulations is to determine when a purported loan to a corporation should be reclassified for Federal income tax purposes as an equity interest in the corporation. A

* The Subchapter S Revision Act of 1982 limits the circumstances in which purported debt would be treated as a disqualifying second class of equity by providing a safe harbor for "straight debt." See new section 1361(c)(5).
number of fairly objective standards are set forth to be used in making the determination, such as whether or not the borrowing corporation has "excessive" debt and whether or not the lender is a shareholder of the borrowing corporation whose holdings of stock and debt are "substantially proportionate." There are few subjective standards, and where they do exist (e.g., "facts and circumstances" are referred to for purposes of defining an "independent creditor"), generally an objective safe harbor rule is also provided.

B. "Second Look" (or "Subsequent Conduct") Rules.

The "second look" rules are intended to assure that, if an instrument is initially treated as debt, the subsequent conduct of the borrowing corporation and the lender is consistent with such treatment.

1. Loans initially treated as debt can later be recharacterized as equity under the second look rules in the event, for example, of non-payment of principal or interest, or of a change in the terms of the instrument. See Prop. Reg. §§ 1.385-4(b)(2) and 1.385-6(k), (l), and (m).

2. Loans initially treated as equity, or later recharacterized as equity under the second look rules, will always remain equity. See Prop. Reg. §§ 1.385-4(b)(1) and 1.385-7(d)(2).

C. Effect of Characterization of Debt as Equity.

1. Effect on "Instruments."

a. If a loan evidenced by a written "instrument" is initially characterized as equity, the instrument will be treated as preferred stock for all purposes of the Code. Prop. Reg. § 1.385-4(c)(1)(i). Thus:

(1) All payments of "interest" will be treated as distributions to which section 301 applies and, to the extent of the distributing corporation's earnings and profits, taxed as dividends at ordinary income rates, and

(2) All payments of "principal" will be treated as distributions in redemption of stock and may be taxed as dividends.

b. If an instrument initially characterized as debt is later recharacterized as equity under the second look rules, the holder of the instrument will be treated as having exchanged the instrument for preferred stock in a recapitalization pursuant to section 368(a)(1)(E), without recognition of gain or loss to the holder. Prop. Reg. § 1.385-4(c)(1)(ii).

2. Effect on Unwritten Obligations. Unwritten obligations initially characterized as equity, or later recharacterized as equity under the second look rule, will be treated as contributions to capital, and presumably will increase the basis of the holder's interest in the issuer's stock. Prop. Reg. § 1.385-7(c). All payments of "interest" and "principal" will be treated as section 301 distributions. Prop. Reg. § 1.385-7(d).
3. All Purposes of the Code. Although the proposed regulations state that the characterization of instruments and unwritten obligations is to be effective for all purposes of the Code, the significance of re-characterization is limited in certain areas. For example, the impact of the proposed regulations on DISCs is limited by a safe harbor rule for DISCs contained in Reg. § 1.992-1(d)(2)(ii).

D. Coverage Exceptions.

1. International Transactions. The preamble to the proposed regulations explains that a number of comments submitted on the proposed regulations raised questions about the application of the regulations in the international context, and therefore that an exception was being made for such transactions in order to give the Treasury and the Internal Revenue Service time to consider these questions. Thus, the proposed regulations are not applicable to any loan made by or to (i) a person that is not a United States person (presumably within the meaning of section 7701(a)(30)) or (ii) a domestic corporation dividends from which are or would be treated under section 861(a)(2)(A) as income from sources without the United States.

2. Hybrid Instruments Issued Nonproportionately in Exchange for Property (Other than Money). If a “hybrid instrument” is issued in exchange for property and is not issued substantially proportionately to the stock of the issuing corporation, the hybrid instrument will be treated as stock or debt under applicable principles of law outside the section 385 regulations. This provision is apparently intended to limit the situations in which application of the debt-equity regulations would cause a taxpayer receiving, in exchange for property, an installment note providing for contingent payments to fail to qualify for installment sales treatment under section 453.

3. Guaranteed Loans. The prior section 385 regulations had set forth rules governing when a third-party loan to a corporation guaranteed by its shareholder would be recharacterized as a loan to the shareholder followed by a capital contribution to the borrowing corporation. The preamble to the present proposed regulations explains that these rules were omitted from the proposed regulations in order to make it clear that the section 385 regulations are not intended to change existing case law (e.g., Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir. 1972), cert. denied, 404 U.S. 1076 (1972)).

4. Preferred Stock. The preamble to the proposed regulations explains that rules governing when preferred stock would be recharacterized as debt were omitted from the present proposed regulations and that existing case law will continue to govern whether preferred stock bears a sufficient substantive resemblance to debt for it to be treated as debt for tax purposes. The preamble also states that the Treasury and the Internal Revenue Service are continuing to study this area to determine whether further guidance should be provided to taxpayers.
III. CORE CONCEPTS

A. Substantial Proportionality.

This concept is relevant in the case of a purported loan evidenced by an “instrument” but not in the case of an unwritten obligation.

1. More than 50% Overlap Factor. “Substantial proportionality” exists where there is a more than 50% “total overlap factor” with respect to the class of instruments in question and the stock of the issuing corporation. The total overlap factor is the sum of the overlap factors of each person who holds (actually and constructively) both a portion of the class of instruments and stock of the issuing corporation. Each holder’s overlap factor is the lesser of such holder’s percentage ownership (taking into account constructive ownership) of (i) the stock or (ii) the class of instruments. Prop. Reg. § 1.385-6(a)(2)(i).

Examples: If the sole shareholder of a corporation owns 50% of a class of instruments and an independent creditor owns the other 50% of the class of instruments, the sole shareholder’s overlap factor would be 50% and the holdings of the corporation’s stock and the class of instruments would not be substantially proportionate. However, if the sole shareholder owned more than 50% of the class of instruments, such shareholder’s overlap factor would be in excess of 50% and the holdings of the stock and the class of instruments would be substantially proportionate. Similarly, if a 50% shareholder owns 100% of a class of instruments, then the overlap factor for such shareholder would be only 50% and the holdings of the corporation’s stock and class of instruments would not be substantially proportionate. However, if a more than 50% shareholder owned 100% of a class of instruments, then the overlap factor for such shareholder would exceed 50% and the holdings of the corporation’s stock and class of instruments would be substantially proportionate.

2. Major Shareholders. An instrument will be treated as held substantially proportionately if (i) the instrument is held by a person who owns (actually and constructively) 25% or more of the value or voting power of the issuing corporation’s stock and (ii) the issuing corporation’s debt-to-equity ratio exceeds 10:1 at the end of its taxable year in which the instrument is issued. Prop. Reg. § 1.385-6(a)(2)(vi).

3. Exceptions.

a. Widely Held. The proportionality rules do not apply where the corporation’s stock and instruments are widely held and the instruments are separately traded and readily marketable. Prop. Reg. § 1.385-6(a)(3)(i).

b. Held by Independent Creditor. The proportionality rules do not
apply with respect to instruments held by independent creditors. Prop. Reg. § 1.385-6(a)(3)(ii).

B. Excessive Debt.

1. General Rules. “Excessive” debt exists where all of the instrument's terms and conditions (including the stated interest rate) and the corporation's financial structure, taken together, would not be satisfactory to an independent creditor. (The stated interest rate is considered satisfactory if a rate one point higher or lower would be satisfactory.) Prop. Reg. § 1.385-6(g)(2). Safe harbor where (i) the corporation's “outside” debt-to-equity ratio is not greater than 10:1, and (ii) its “inside” debt-to-equity ratio (i.e., determined without taking into account liabilities to independent creditors) does not exceed 3:1. Prop. Reg. § 1.385-6(g)(3).

2. Determination of “Equity.” The “equity” in a corporation is excess of the corporation's adjusted basis (not the fair market value) of its assets over its liabilities. Prop. Reg. § 1.385-6(h)(2). A “special rule” is provided for computing the adjusted basis of property subject to an allowance for depreciation, under which the deductions for depreciation are to be determined in the same manner as under section 312(k) for purposes of computing earnings and profits (i.e., generally using the straight-line method of depreciation). Prop. Reg. § 1.385-6(h)(6).*

C. Reasonable Rate of Interest.

A rate of interest is “reasonable” if it is within the normal range of rates paid to independent creditors on similar instruments by corporations of the same general size and in the same general industry, geographic location, and financial condition. Prop. Reg. § 1.385-6(f)(1). Safe harbor where (i) the borrowing corporation's debt-to-equity ratio is not greater than 3:1, and (ii) the interest rate is equal to or between any two of the following rates: the prime rate (or two points above prime) in effect at any local commercial bank, the rate in effect under section 6621 (16% effective January 1, 1983), a safe harbor rate under Reg. § 1.482-2(a)(2)(iii)(B)(1) (presently 11-13%), or the rate paid by Treasury on U.S. obligations of comparable maturity. Prop. Reg. § 1.385-6(f)(2).

D. Independent Creditor.

Whether or not a lender is an “independent creditor” is determined based on all relevant facts and circumstances. Safe harbor for creditor (i) who owns, actually and constructively, less than 5% of the stock

* A number of other important “special rules” are set forth in Prop. Reg. § 1.385-6(h)(6). See, e.g., the favorable rules in Prop. Reg. § 1.385-6(h)(6)(iv) with respect to banks and corporations “primarily engaged in a lending or finance business.”
of the borrowing corporation (and less than 5% of the stock owned by the borrowing corporation), and (ii) whose percentage ownership of the class of instruments in question (taking into account constructive ownership) is at least twice as great as the greater of the creditor's percentage ownership of (a) the value or (b) the voting power of the stock of the borrowing corporation. Prop. Reg. § 1.385-6(b).

IV. BASIC DISTINCTIONS AND OPERATING RULES

A. Unwritten Obligation v. "Instrument."

Where there is a "loan" of money by a shareholder to a corporation, the first question under the proposed section 385 regulations is whether or not the loan is evidenced by an "instrument." A very simple set of rules is applicable where there is no instrument, whereas a much more complicated set of rules deals with those cases where an instrument is present.

1. Unwritten Obligations. Unwritten obligations include simple cash advances and loans recorded only on a corporation's books or in a board of director's resolution. See Prop. Reg. § 1.385-0(b)(1).

2. "Instruments." The term "instrument" means any bond, note, debenture, or similar written evidence of an obligation. Prop. Reg. § 1.385-3(b). There is also a suggestion in the proposed regulations that the written evidence of the obligation must be treated, under local law, as indebtedness in order for there to be an "instrument." Prop. Reg. § 1.385-0(b)(1).

B. Rules Applicable to Unwritten Obligations (No Instrument).

1. Basic Distinction: Presence or Absence of Excessive Debt.

   a. Excessive Debt. If the borrowing corporation has excessive debt when the unwritten loan is made, then the loan will be treated as a capital contribution. Prop. Reg. § 1.385-7(b)(2).

   b. No Excessive Debt. If the borrowing corporation does not have excessive debt when the unwritten loan is made, then the loan will be initially treated as debt. Prop. Reg. § 1.385-7(b)(1).

2. Proportionality Not Relevant. The concept of proportionality is not relevant where there is only an unwritten obligation. Thus, for example, a cash advance not evidenced by an instrument can be treated as a capital contribution even where proportionality does not exist.

3. Exceptions. There are several special rules provided in the proposed regulations dealing with situations where unwritten obligations may be treated as debt notwithstanding that the borrowing corporation has excessive debt.

   a. Repaid Within 120 Days After Year-End. An unwritten loan repaid within 120 days after the end of the borrowing corporation's taxable year in which the loan is originally made will be treated as debt. Prop. Reg. § 1.385-7(a)(2)(i).
(1) In some cases this rule would permit an unwritten loan to be outstanding for up to 16 months without running the risk that the loan will be recharacterized as a capital contribution. The preamble to the proposed regulations explains that the reason for the 120 day rule is to give the accountant for a small corporate business time to complete his annual review of the corporation's books and to advise the corporation to repay unwritten obligations if necessary to avoid having the obligations irrevocably classified as capital contributions.

(2) Note that there is no maximum amount or ceiling on the amount of the unwritten loan subject to the 120 day repayment rule.

(3) There is an imputed interest rule which may be applicable to unwritten loans repaid within the 120 day period. If such a loan is not repaid with interest at an arm's length rate (within the meaning of Reg. § 1.482-2(a)(2)), then interest at the rate set forth in Reg. § 1.482-2(a)(2)(iii)(B)(2) (presently 12%) will be imputed. Prop. Reg. § 1.385-7(a)(2)(ii).

(4) A loan is not considered to be actually repaid if it is renewed. A loan will be presumed not to be renewed to the extent that, within the "prohibited period," the lender (or a related person) does not make another cash advance to the corporation or make a loan to the corporation in exchange for a demand note. The prohibited period begins on the day the loan is repaid and extends for the number of days the loan was outstanding. The Internal Revenue Service may rebut this presumption that a loan has not been renewed. Prop. Reg. § 1.385-7(a)(2)(iii).

b. Evidenced by an Instrument Within 120 Days After Year-End. If an unwritten loan is evidenced by an instrument within 120 days after the end of the taxable year in which the loan is originally made, then the instrument will be considered to be issued in consideration of the loan and will be characterized under the rules generally applicable to instruments. Prop. Reg. § 1.385-7(a)(1)(ii).

c. Loan Made by Independent Creditor. An unwritten loan made by an independent creditor will be treated as debt. Prop. Reg. § 1.385-7(a)(1)(i).

4. Second Look Rule. If an unwritten loan is initially treated as debt and thereafter the borrowing corporation fails to pay interest at a reasonable rate, then the loan will be reclassified as a contribution to capital as of the later of (i) the first day of the taxable year in which there is a failure to pay interest or (ii) the date of the loan. Prop. Reg. § 1.385-7(c). For these purposes a corporation is considered to have paid interest during a taxable year if interest is actually paid within 90 days after the end of such taxable year. (Query what happens if no interest is paid on an unwritten loan within 90 days after year-end but the loan itself is repaid within 120 days after year-end?)

5. Brother-Sister Advances. If a wholly owned subsidiary of a parent corporation makes an unwritten loan to another subsidiary of the same parent corporation and the loan is not repaid within 120 days after the end of the borrowing subsidiary's taxable year, the lending sub-
sidiary will be deemed to have distributed to the parent corporation an amount equal to the amount of the loan, and the parent corporation is then treated as if it had contributed such amount to the capital of the borrowing subsidiary. Prop. Reg. § 1.385-7(e) (Example 5).

C. Rules Applicable to “Instruments.”

1. Basic Distinctions:

a. Hybrid v. Straight Debt Instruments. All instruments are categorized as either “hybrid instruments” or “straight debt instruments,” and different rules apply to each type of instrument.

b. Presence or Absence of Proportionality. The rules applicable to proportionately held instruments are much stricter (i.e., more likely to result in having the instrument treated as stock) than those applicable to nonproportionately held instruments.

c. Presence or Absence of Excessive Debt. A proportionately issued straight debt instrument will be characterized as stock if immediately after it is issued the issuing corporation’s debt is “excessive.”

d. Issued for Property v. Money. Instruments issued for property (other than money) are subject to different rules than instruments issued for money in the case of either (i) a nonproportionately issued hybrid instrument (which, if issued for property, is outside the scope of the section 385 regulations) or (ii) a proportionately issued straight debt instrument (which, if issued for property, is subject to possible classification as stock if the stated interest rate is not reasonable). (Note that the accompanying diagram deals only with purported loans of money.)

e. Payable on Demand v. Fixed Maturity Date. A proportionately issued or held instrument payable on demand is subject to stricter rules than instruments having a fixed maturity date, i.e., demand instruments are subject to classification as stock if the stated interest rate upon issuance is not reasonable and, if initially treated as debt, to reclassification as stock if the interest rate is not adjusted each year to a reasonable rate.

f. Excessive or Inadequate Consideration. Even if a proportionately issued straight debt instrument is characterized as debt upon issuance, the instrument is subject to having its issue price adjusted under the excessive or inadequate consideration rules if the consideration paid for the instrument is more or less than its fair market value.

2. Hybrid Instruments. A “hybrid instrument” is any 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).* Prop. Reg. § 1.385-3(d).

*“Locked interests” (e.g., an investment unit consisting of a bond with non-detachable warrants) should be contrasted with hybrid instruments. Under the proposed regulations, each part of the locked interests is characterized separately. Prop. Reg. § 1.385-8. Thus, if one of the interests is a straight debt instrument, that interest can be characterized as debt, even though it might be treated as stock if it were tested together with the warrants as one instrument (e.g., a convertible bond) under the hybrid rules.
a. Not Issued Proportionately to Stock. A class of hybrid instruments that is issued for money and not issued substantially proportionately to the stock of the issuer is characterized as stock or debt on the basis of the relative fair market values of the instrument's debt and equity features on the date of issue.* This determination is made by comparing the fair market value of the hybrid instrument's "straight debt payments" (defined below) with the fair market value of the instrument as a whole.

(1) More than 50% of FMV is Equity. If on the date of issue the fair market value of the hybrid instrument's "straight debt payments" is less than 50% of the fair market value of the instrument (i.e., more than 50% of the instrument's value is attributable to its equity features), the hybrid instrument will be treated as stock. Prop. Reg. § 1.385-5(a).

(2) 50% or More of FMV is Debt. On the other hand, if on the date of issue the fair market value of the "straight debt payments" is 50% or more of the fair market value of the instrument, the instrument will be treated as debt. (Under the second look rules discussed below, a nonproportionately issued hybrid instrument that is initially characterized as debt is subject to possible later recharacterization as stock if, at a later time, the hybrid instrument is held substantially proportionately to the issuing corporation's stock.)

(3) Special 45% Rule. If the fair market value of the "straight debt payments" is less than 50% but at least 45%, then the hybrid instrument will be treated as debt if clear and convincing evidence shows that, on the date of issue, both the issuer and the holder reasonably believed that the fair market value of the straight debt payments equaled at least 50% of the fair market value of the instrument. Prop. Reg. § 1.385-5(b).

(4) Determination of Straight Debt Payments. The "straight debt payments" with respect to a hybrid instrument are determined as follows:

(a) The straight debt payments with respect to the right to fixed payments of principal or interest are the fixed payments themselves. Prop. Reg. § 1.385-5(d)(2)(i).

(b) The straight debt payments with respect to the right to contingent payments (other than a call premium) are the payments that must be made on the occurrence of the contingencies resulting in the lowest possible fair market value of payments under the instruments. Prop. Reg. § 1.385-5(d)(2)(ii). "Least" and "latest" assumptions:

(i) To the extent the payments are contingent in amount, the straight debt payments are computed assuming the occurrence of the contingency providing the smallest possible payment under the instrument.

(ii) To the extent the payments are contingent as to timing, the straight debt payments are computed assuming the occurrence of the

* Note that if a hybrid instrument is issued to a 25% shareholder and the corporation's debt-to-equity ratio exceeds 10:1, then the instrument will be treated as if it were issued proportionately.

(6) Exception for Hybrid Instruments Issued for Property. As stated previously, if a hybrid instrument is issued nonproportionately in exchange for property (e.g., a sale of a business to a corporation unrelated to the seller in exchange for a note providing contingent payments), the instrument is outside the scope of the section 385 regulations. Prop. Reg. § 1.385-1(b)(4).

b. Issued Proportionately to Stock.

(1) Generally Treated as Stock. Any hybrid instrument that is issued (whether for money or property) substantially proportionately to the stock of the issuer is generally characterized as stock immediately after its issuance. Prop. Reg. § 1.385-6(d)(1).

(2) Exceptions.

(a) Issued to Independent Creditors. Any hybrid instrument directly held by an independent creditor will not be considered to be held proportionately and therefore will not be characterized as stock under this rule. Prop. Reg. § 1.385-6(a)(3)(ii).

(b) Independent Creditors Owning 20%. A class of hybrid instruments issued substantially proportionately is not automatically treated as stock if, immediately after the class is issued, independent creditors (determined without regard to the "safe harbor" definition of independent creditor and without taking into account the creditor's holdings of the hybrid instruments at issue) own at least 20% of such class. In this situation, the rules discussed above for initially characterizing nonproportionately issued hybrid instruments will apply. Thus, if 50% or more of the fair market value of the instrument is attributable to "straight debt payments," then it would appear that the instrument will initially be treated as debt, subject to later recharacterization under the second look rules. (Such a class of instruments may technically be subject to testing under the excessive debt and the excessive or inade-
quate consideration rules (both of which are discussed below), but presumably would not be affected by those rules since at least 20% of the class would be owned by independent creditors.) Prop. Reg. § 1.385-6(d)(2).

(c) Widely Held. If the hybrid instruments and the issuer's stock are widely held and the instruments are separately traded and readily marketable, the hybrid instruments will not be considered to be held proportionately, and therefore the rules discussed above for non-proportionately issued hybrid instruments will apply. Prop. Reg. § 1.385-6(a)(3)(i).

3. Straight Debt Instruments. A “straight debt instrument” is any instrument other than a hybrid instrument. Prop. Reg. § 1.385-3(e). Essentially, a straight debt instrument is one that provides only for fixed payments of principal and interest.

a. Not Held Proportionately to Stock. A class of straight debt instruments (whether issued for money or property) that is not issued substantially proportionately to stock will be treated as debt.* Prop. Reg. § 1.385-2(b)(1). (Under the second look rules discussed below, a nonproportionately issued straight debt instrument that is initially characterized as debt is subject to possible later recharacterization as stock if, at a later time, the straight debt instrument is proportionately held.)

b. Held Proportionately to Stock. A class of straight debt instruments is subject to possible characterization as stock if it is held substantially proportionately to the stock of the issuer.** Such instruments must be tested for possible characterization as stock where (i) the issuer's debt is excessive, (ii) the instrument is issued in exchange for property (other than money), (iii) the instrument is payable on demand, (iv) the terms of the instrument are changed in a later year, or (v) the issuer fails to pay interest or principal when due. In addition, upon issuance such instruments are subject to having their issue price adjusted under the excessive or inadequate consideration rules discussed below.

(1) Presence or Absence of Excessive Debt.

(a) Excessive Debt. If the issuing corporation's debt is excessive immediately after the straight debt instrument is issued and the instrument is issued substantially proportionately to the stock of the issuer, then the instrument will be treated as stock. Prop. Reg. § 1.385-6(g)(1). (Note that there is no “safety net” exception for repayments within 120 days after the end of the year in which the instrument is issued, as there is in the case of unwritten obligations.)

* Note, however, that if a straight debt instrument is issued to a 25% shareholder and the corporation's debt-to-equity ratio exceeds 10:1, then the instrument will be treated as if it were issued proportionately.

** A straight debt instrument is not considered to be held proportionately (i) if held directly by an independent creditor or (ii) if the corporation's stock and the instruments are widely held and the instruments are separately traded and readily marketable. Prop. Reg. § 1.385-6(a)(3)(i) and (ii).
(b) **No Excessive Debt.** If the issuing corporation's debt is not excessive when the instrument is issued, then the instrument will be initially treated as debt where it is issued for money and not payable on demand. Prop. Reg. § 1.385-2(a)(1). (The instrument, however, is subject to having its issue price adjusted under the excessive or inadequate consideration rules discussed below.)

(2) **Instruments Issued for Property.**

(a) **General Rule.** A proportionately issued straight debt instrument that is issued in exchange for property (other than money) will be characterized as stock upon issuance if the stated annual rate of interest on the instrument on the date it is issued is not reasonable. Prop. Reg. § 1.385-6(e)(1).

(b) **Exceptions.** The above rule relating to instruments issued for property does not apply to instruments issued (i) in exchange for an equal or greater principal amount of indebtedness of the issuing corporation if the exchange would have been agreed to between the corporation and an independent creditor, both exercising ordinary diligence (Prop. Reg. § 1.385-6(e)(3)), or (ii) in exchange for property that can give rise to original issue discount or amortizable bond premium (e.g., stock or securities traded on an established securities market) (Prop. Reg. § 1.385-6(e)(1)(iii)).

(3) **Payable on Demand.**

(a) **Initial Classification.** A proportionately issued straight debt instrument that is payable on demand will be characterized as stock upon issuance if the stated annual rate of interest on the instrument is not reasonable. Prop. Reg. § 1.385-6(m)(1).

(b) **Exception for Retirement Within 120 Days After Year-End.** The above rule relating to demand loans does not apply to demand instruments actually retired within 120 days after the end of the taxable year in which they are issued. Prop. Reg. § 1.385-6(m)(4)(i). As in the case of unwritten obligations repaid within 120 days after year-end, this exception will not apply to the extent the loan is later renewed. See Prop. Reg. § 1.385-6(m)(4)(iii). If a demand instrument is retired within 120 days after the end of the taxable year of its issue but interest at an arm's length rate within the meaning of section 482 is not paid, then interest at the rate set forth at Reg. § 1.482-2(a)(2)(ii)(B)(2) will be imputed. Prop. Reg. § 1.385-6(m)(4)(ii).

(c) **Reclassification.** As discussed below, under a special second look rule applicable to proportionately held demand loans that are initially treated as debt, such loans will be recharacterized as stock unless the issuing corporation adjusts the interest rate each year to assure that it is a reasonable rate for that year. Prop. Reg. § 1.385-6(m)(2).

(4) **Excessive or Inadequate Consideration.** If an instrument issued substantially proportionately to the stock of the issuing corporation is treated under the above rules as debt, the proposed regulations require a determination of the fair market value of the instrument at the time of its issuance. This is because of the Treasury's concern that the consideration paid for an instrument issued substantially proportionately
to the issuer's stock may be more or less than the instrument's fair market value. This problem will typically arise where the stated interest rate on the instrument is below or above a reasonable rate.

(a) *Excessive Consideration.* The excess of the consideration paid for an instrument over its fair market value will ordinarily be treated as a contribution to capital. Prop. Reg. § 1.385-6(c)(1).

*Example:* Corporation X issues a debenture to its sole shareholder in exchange for its face amount of $1,000. Assuming that the debenture is treated as indebtedness and that its fair market value is $700, the issue price of the debenture would be considered to be $700 and the shareholder would be deemed to have made a contribution to capital of $300. The shareholder's basis in the debenture would be $700 and there would be original issue discount of $300, which would be deductible by the corporation and taxable as ordinary income to the shareholder under section 1232 over the life of the instrument.

(b) *Inadequate Consideration.* The excess of the fair market value of an instrument over the consideration paid for it will ordinarily be treated as a distribution subject to the rules of section 301. Prop. Reg. § 1.385-6(c)(2).

*Example:* Corporation X issues a debenture to its sole shareholder having a face amount of $1,000 in exchange for $600. Assuming that the debenture is treated as indebtedness and that its fair market value is $800, the issue price of the debenture would be considered to be $800 and the shareholder would be deemed to have received a dividend of $200. The shareholder's basis in the debenture would be $800, and there would be original issue discount of $200.

(c) *Fair Market Value.*

(i) *General Rule.* “Fair market value” is defined as the price at which the instrument would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of all relevant facts. Prop. Reg. § 1.385-3(a)(1)(i).

(ii) *Rule of Convenience.* The fair market value of a straight debt instrument on the day of issue will be equal to its face amount if the stated interest rate is reasonable and the consideration paid is equal to the face amount. Prop. Reg. § 1.385-3(a)(2)(i).

(iii) *Publicly Sold.* If an instrument is registered with the SEC and sold to the public for money, then the fair market value of the instrument on its day of issue is the issue price (as defined in section 1232(b)(2)). Prop. Reg. § 1.385-3(a)(2)(ii).

4. *Second Look Rules.* If an instrument—whether a hybrid or a
straight debt instrument—is initially treated as debt, it is subject to possible later recharacterization as stock under the second look rules if, at a later time, the instrument is held substantially proportionately to the issuing corporation's stock. Thus, recharacterization as stock under the second look rules can occur not only with respect to instruments that were initially issued and continue to be held proportionately, but also with respect to either a hybrid or a straight debt instrument that was initially issued nonproportionately but is later held proportionately.

a. Non-Payment of Interest.

(1) General Rule. If an issuing corporation fails to pay all or part of the interest when due on an instrument held substantially proportionately on the last day of the corporation's taxable year, and if the holder fails to exercise the ordinary diligence of an independent creditor, the instrument will be recharacterized as stock beginning on the later of (i) the first day of the taxable year in which the failure to pay occurs or (ii) the first day the instrument is held proportionately. Prop. Reg. § 1.385-6(l)(1).

(2) 90 Day Payment Rule. A corporation will be considered to fail to pay interest on an instrument during a taxable year of the corporation if the interest is not actually paid within 90 days after the end of such taxable year. Prop. Reg. § 1.385-6(l)(3).

(3) Automatic Recapitalization Rule. If an instrument becomes stock as a result of the non-payment of interest, then the instrument is treated as having been exchanged, without recognition of gain or loss to the holder, for preferred stock in a recapitalization to which section 368(a)(1)(E) applies, apparently without regard to whether or not the instrument constituted a "security" within the meaning of section 354(a)(1). Prop. Reg. § 1.385-4(c)(1)(ii).

b. Non-Payment of Principal. If an issuing corporation fails to make a scheduled payment of principal on an instrument within 90 days after payment is due, and the holder of the instrument fails to exercise the ordinary diligence of an independent creditor, then the instrument will be considered to be payable on demand beginning on the day after the day the principal is due. Prop. Reg. § 1.385-6(m)(3). See the discussion below of the special second look rule for demand loans.

c. Substantial Change in Terms.

(1) General Rule. If, at the time an instrument treated as debt is proportionately held, the holder of the instrument agrees to postpone the maturity date or otherwise to make a "substantial change" in the terms of the instrument, then the instrument is treated as newly issued in exchange for property on the day of the agreement. Prop. Reg. § 1.385-6(k)(1).

(2) "Substantial Change." A change in the terms of an instrument is considered to be "substantial" if the fair market value of the instrument could be materially affected by the change. Thus, for example, subordination (however effected) or a change in interest rate is ordi-
narily a substantial change. On the other hand, a mere substitution of collateral need not be a substantial change. In addition, prepayment will not be considered a substantial change. Prop. Reg. § 1.385-6(k)(2).

(3) **Debt-Equity Effect.** If an instrument is treated as newly issued in exchange for property under the above rule applicable to substantial changes in terms, then beginning on the day of the agreement to make the change in terms the instrument may be recharacterized as stock—

(a) Under the rules in Prop. Reg. § 1.385-6(d) applicable to hybrid instruments (if, *e.g.*, the change in terms adds a convertibility or contingent payment feature),

(b) Under the rules in Prop. Reg. § 1.385-6(e) applicable to instruments issued for property (if on the day of the agreement the stated interest rate on the instrument is not reasonable and the "ordinary diligence" exception in Prop. Reg. § 1.385-6(e)(3) does not apply), or

(c) Under the rules in Prop. Reg. § 1.385-6(m) applicable to demand loans (if, *e.g.*, the change in terms makes the instrument payable on demand and the stated interest rate is not reasonable).

The instrument will not, however, be subject to recharacterization as stock under the excessive debt rule in Prop. Reg. § 1.385-6(g), unless there is an increase in the principal amount of the instrument. Prop. Reg. § 1.385-6(k)(1).

(4) **Automatic Recapitalization Rule.** If an instrument becomes stock under the above rule applicable to substantial changes in terms, then the instrument is treated as having been exchanged, without recognition of gain or loss to the holder, for preferred stock in an "E" recapitalization, apparently without regard to whether or not the instrument constituted a "security" within the meaning of section 354(a)(1). Prop. Reg. § 1.385-4(c)(1)(ii).

**d. Repayment with New Instrument.**

(1) **General Rule.** If an outstanding instrument initially classified as debt is later actually repaid with a new instrument, the new instrument will be tested under the proposed section 385 regulations as an instrument issued for property. Similarly, if there is a change in terms of an instrument and the change in terms is sufficiently substantial to be considered an exchange of instruments under applicable principles of tax law (ascertained without reference to the section 385 regulations), then the instrument will be treated as newly issued for property.

(2) **Debt-Equity Effect.** The section 385 rules generally applicable to instruments issued for property will apply. Thus, if the new instrument (or the instrument treated as newly issued under preexisting tax law) is held substantially proportionately to the issuer's stock, the instrument will be subject to classification as stock under the rules applicable to proportionately held instruments, *i.e.*, the rules relating to hybrid instruments, instruments issued for property, demand loans, and excessive debt. (Note that the excessive debt rule could apply in the case of such a proportionately held new instrument, or an instrument treated as newly issued under preexisting law, whereas as stated
above the excessive debt rule would generally not apply in the case
of an instrument treated as newly issued by reason of a change in terms
within the meaning of Prop. Reg. § 1.385-6(k).)

(3) No Automatic Recapitalization Rule. An actual repayment with
a new instrument or a constructive exchange of instruments resulting
under preexisting tax law is not included within the automatic re-
capitalization rule of Prop. Reg. § 1.385-4(c)(1)(ii). Thus, such
actual or constructive exchanges of instruments could result in the
recognition of gain or loss to the holder (if, e.g., gain or loss is realized
and the instruments do not constitute “securities”).

e. Special Rule for Demand Loans. A special second look rule is
applicable to demand loans. If an instrument is by its terms a demand
loan, or is treated as such because of the non-payment of principal
within 90 days after it is due, then the instrument will be recharacterized
as stock if for any taxable year during which it is outstanding and held
substantially proportionately to the issuer’s stock, the issuing corpora-
tion fails to adjust the interest rate on the instrument to a rate that
is reasonable for that year. See Prop. Reg. § 1.385-6(m)(2) and
compare Examples (2) and (3) of Prop. Reg. § 1.385-6(m)(5). (A
rate of interest is considered reasonable for this purpose if it is reason-
able as of any day of the taxable year.)

V. POSSIBLE REVISIONS TO CURRENTLY PROPOSED REGU-
LATIONS

A. Determination of Equity for Purposes of the Debt-to-Equity Cal-
culation.

Representatives of Treasury have suggested that, in the next set of
regulations, the rules for valuing assets in computing a corporation’s
debt-to-equity ratio may be modified. Under the currently proposed
regulations, “equity” is determined by reference to the corporation’s
adjusted tax basis in its assets. For many corporations, adjusted tax
basis may not be an appropriate measure of their shareholders’ equity.
The Treasury may decide to permit corporations to use the fair market
value of their assets in computing their debt-to-equity ratio.

B. Small Business Safe Harbor.

The rules in the proposed section 385 regulations have been criticized
as being overly complex. Many taxpayers have submitted comments
to the Treasury and the Internal Revenue Service arguing that imple-
mentation of these rules would place a great burden on “small business,”
and some have urged that a safe harbor for small business be added
to the regulations. We understand that Treasury is giving serious con-
sideration to this suggestion.
C. *International Transactions.*

Treasury has stated that the next set of regulations is likely to provide rules for characterizing purported loans made in international transactions.

D. *Modification of Proportionality.*

Under the currently proposed regulations, proportionality is deemed to exist if an instrument is held by a 25% shareholder and the issuing corporation's debt-to-equity ratio exceeds 10:1. Treasury has indicated that this rule may be liberalized.

E. *Valuation of Terms of Hybrid Instrument.*

Treasury has indicated that the proposed provision regarding the appropriate discount rate to be used in valuing the straight debt payments of hybrid instruments may be amended to provide further guidance.