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[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-130244-17]

RIN 1545-BO02

Proposed Removal of Section 385 Documentation Regulations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document proposes removing final regulations setting forth minimum documentation requirements that ordinarily must be satisfied in order for certain related-party interests in a corporation to be treated as indebtedness for federal tax purposes (Documentation Regulations). This notice of proposed rulemaking also proposes conforming amendments to other final regulations to reflect the proposed removal of the Documentation Regulations. The final regulations to be amended and removed generally affect corporations that issue purported indebtedness to related corporations or partnerships.

DATES: Written or electronic comments and requests for a public hearing must be received by [**INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER**].

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-130244-17), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-130244-17), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC 20224 or sent electronically via the Federal eRulemaking Portal at http://www.regulations.gov (IRS REG-130244-17).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed removal and amendments, Austin Diamond-Jones, (202) 317-6847; concerning submissions of comments or requests for a public hearing, Regina Johnson, (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

**Paperwork Reduction Act**

In accordance with the Paperwork Reduction Act (44 U.S.C. chapter 35), the information collection included in these regulations under control number 1545-2267 will be discontinued upon the adoption of a final rule.

**Background**

Overview

Section 385 of the Internal Revenue Code (Code) authorizes the Secretary of the Treasury (Secretary) to prescribe rules to determine whether an interest in a corporation is treated for purposes of the Code as stock or indebtedness (or as in part stock and in part indebtedness) by setting forth factors to be taken into account with respect to particular factual situations.

On April 8, 2016, the Department of the Treasury (Treasury Department) and the IRS published proposed regulations (REG-108060-15) under section 385 of the Code (proposed regulations) in the **Federal Register** (81 FR 20912 (April 8, 2016)) concerning the treatment of certain interests in corporations as stock or indebtedness. A public hearing on the proposed regulations was held on July 14, 2016. The Treasury Department and the IRS also received numerous written comments in response to the proposed regulations, all of which are available at http://www.regulations.gov.

On October 21, 2016, the Treasury Department and the IRS published final and temporary regulations under section 385. TD 9790 (I.R.B. 2016-46, 81 FR 72858 (October 21, 2016)). The preamble to TD 9790 describes in detail the comments received on the proposed regulations and the thorough consideration given to each comment. The preamble to TD 9790 also explains the decisions reached by the Treasury Department and the IRS and the revisions that were made to the proposed regulations.

The final and temporary regulations under section 385 are primarily comprised of (i) the Documentation Regulations, which establish minimum documentation requirements that ordinarily must be satisfied in order for purported debt obligations among related parties to be treated as debt for federal tax purposes; and (ii) rules that treat as stock certain debt that is issued by a corporation to a controlling shareholder in a distribution or in another related-party transaction that achieves an economically similar result (together, the Section 385 Regulations).

Under the proposed regulations, the Documentation Regulations would have been applicable with respect to interests issued or deemed issued on or after the date the regulations were finalized. However, when finalized, the Documentation Regulations were made applicable with respect to interests issued or deemed issued on or after January 1, 2018. See §§1.385-1(f), 1.385-2(d)(2)(iii), and 1.385-2(i). This delayed applicability date responded to taxpayer concerns of inadequate time to begin complying with the Documentation Regulations once they were finalized

Executive Order 13789

Executive Order 13789, issued on April 21, 2017 (E.O. 13789), instructs the Secretary to review all significant tax regulations issued on or after January 1, 2016, and to take concrete action to alleviate the burdens of regulations that (i) impose an undue financial burden on U.S. taxpayers; (ii) add undue complexity to the federal tax laws; or (iii) exceed the statutory authority of the IRS.

E.O. 13789 further instructs the Secretary to submit to the President within 60 days a report (First Report) that identifies regulations that meet these criteria. Notice 2017-38 (2017-30 I.R.B. 147 (July 24, 2017)) included the Section 385 Regulations in a list of eight regulations identified by the Secretary in the First Report as meeting at least one of the first two criteria specified in E.O. 13789. E.O. 13789 further instructs the Secretary to submit to the President a second report (Second Report) that recommends specific actions to mitigate the burden imposed by regulations identified in the First Report.

Notice 2017-36

As previously noted, the final Documentation Regulations were originally promulgated to be applicable with respect to interests issued or deemed issued on or after January 1, 2018. However, in response to continued taxpayer concern with the application of the Documentation Regulations, and in light of contemplated further actions concerning the Section 385 Regulations in connection with the review of those regulations under E.O. 13789, the Treasury Department and the IRS determined that a further delay in the application of the Documentation Regulations would be appropriate. Accordingly, in Notice 2017-36 (2017-33 I.R.B. 208 (August 14, 2017)), the Treasury Department and the IRS announced the intent to amend the Documentation Regulations to delay the applicability of the regulations for 12 months, making the regulations applicable only to interests issued or deemed issued on or after January 1, 2019.

Comments Received in Connection with E.O. 13789

In response to Notice 2017-38 and Notice 2017-36, the Treasury Department and the IRS received approximately 40 comment letters submitted by professional and trade associations, private businesses, public interest groups, and trade unions, as well as over 68,500 comments submitted by individual taxpayers on http://www.regulations.gov (website comments) regarding the Section 385 Regulations. The approximately 40 comment letters reflect a wide range of opinions, advocating everything from strengthening to eliminating the Documentation Regulations. The individual taxpayer comments, however, uniformly urged that the Section 385 Regulations as a whole be retained or strengthened.

1. Supporting retaining or strengthening the Documentation Regulations

At one end of the spectrum are comment letters from various public interest groups, trade unions, and other associations that, together, represent almost 500 organizations, comment letters from private citizens, and the 68,502 website comments. These comments strongly urged that the Section 385 Regulations be retained and enforced, if not strengthened. These commenters would not be subject to the Documentation Regulations. However, they are concerned with the possibility of their withdrawal because they view the Section 385 Regulations as an important tool for maintaining the federal income tax base so that small, domestic businesses and working people and families would not be forced to bear an unfair and disproportionate portion of the cost of U.S. society and infrastructure. Further, these commenters view the Section 385 Regulations as an important step in leveling the playing field for small, domestic businesses that cannot take advantage of earnings stripping tax planning, thus allowing such domestic businesses to compete with large multinational companies based solely on their products and services, and not their ability to take advantage of tax planning. In addition, these commenters argued that allowing large multinational corporations to shift earnings offshore does not create jobs or economic growth in the United States and only serves to disadvantage domestic companies.

2. Supporting limiting or withdrawing the Documentation Regulations

All of the remaining commenters raised concerns about the complexity, cost, and burden imposed by the Documentation Regulations. Most of these commenters made various suggestions for modifications that would reduce the scope and burden of the Documentation Regulations in ways they believed would make the rules more reasonable. Few disputed the Treasury Department's authority to promulgate the Documentation Regulations, however.

Among the commenters that made suggestions for modifications to the Documentation Regulations, there was considerable consensus on the modifications being recommended. Most commenters urged that transactions done in the ordinary course of business, including trade payables, be removed from the application of the Documentation Regulations. Many also urged that "market standards" be broadly adopted as the test for determining whether the documentation requirements are satisfied.

Another common concern raised by these commenters was that the consequences of failing to satisfy the Documentation Regulations are too harsh, and commenters suggested expanding the rules to make it easier to cure or avoid noncompliance and to modify the consequences of noncompliance to make these consequences more proportionate to the concerns addressed by the Documentation Regulations. For example, commenters noted that the time for curing defects in documentation could be expanded, the rules for establishing substantial compliance or reasonable cause could be expanded, and an exception could be added to excuse transactions that pose no base-erosion concern. In addition, there were comments suggesting that the consequences of failing to satisfy the regulations could be limited to a denial of interest deductions, which would avoid the collateral effects of re-characterizing the interest as equity.

Most of these commenters also requested that the application of the Documentation Regulations be delayed so that taxpayers would have adequate time to comply with the Documentation Regulations, taking into account any potential additional modifications. Some suggested delaying applicability for an additional year or two, while others suggested delaying applicability until a date that would presumably allow the effects of any tax reform legislation to be taken into account. But many urged that applicability simply be delayed until the Treasury Department and IRS have completed their review, to avoid the expense of putting systems in place that would not satisfy the Documentation Regulations that are ultimately applicable.

There were also various other modifications suggested. Some modifications would apply to taxpayers generally, such as excluding transactions between commonly held consolidated groups, removing the "reserved" sections, and replacing the entire rule with an anti-abuse rule. Other modifications were specific to the industry of the commenter or its constituents, such as raising the threshold amounts for certain businesses with higher gross asset levels and exempting industries that are perceived as less likely to engage in abusive transactions or more likely to engage in activities that further public policy.

While a number of commenters supported the withdrawal of the Documentation Regulations, most of those commenters were among those also offering suggestions for modifications. However, there were a few commenters that argued only for withdrawal.

**Explanation of Provisions**

On October 16, 2017, the Secretary published the Second Report in the **Federal Register** (82 FR 48013 (October 16, 2017)) stating that the Treasury Department and the IRS are considering revoking the Documentation Regulations and are actively considering developing and proposing streamlined regulations. After careful consideration of the comments received on the Documentation Regulations in connection with E.O. 13789, including with respect to Notice 2017-36 and Notice 2017-38, this notice of proposed rulemaking proposes the removal of the Documentation Regulations.

The Treasury Department and the IRS will continue to study the issues addressed by the Documentation Regulations. When that study is complete, the Treasury Department and the IRS may propose a modified version of the

Documentation Regulations. Any such regulations would be substantially simplified and streamlined to reduce the burden on U.S. corporations and yet would still require sufficient documentation and other information for tax administration purposes. Further, they would be proposed with a prospective effective date to allow sufficient lead-time for taxpayers to design and implement systems to comply with those regulations.

**Proposed Effective/ Applicability Date**

The proposed removal of §1.385-2 and conforming modifications are proposed to be applicable as of the date of publication in the **Federal Register** of a Treasury decision adopting these proposed regulations as final regulations. However, taxpayers may rely on these proposed regulations, in their entirety, until the date a Treasury decision adopting these regulations as final regulations is published in the **Federal Register**.

**Statement of Availability of IRS Documents**

IRS Revenue Procedures, Revenue Rulings, Notices, and other guidance cited in this document are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS Web site at http://www.irs.gov.

**Special Analyses**

I. Regulatory Planning and Review

Executive Order 13777 directs agencies to alleviate unnecessary regulatory burdens placed on the American people by managing the costs associated with the governmental imposition of private expenditures required to comply with federal regulations. Executive Orders 13771, 13563, and 12866 direct agencies to prudently manage the cost of planned regulations by assessing costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility.

These proposed regulations have been designated as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) (the "Treasury-OMB MOA") between the Treasury Department and the Office of Management and Budget regarding review of tax regulations. These proposed regulations have been designated a "significant regulatory action" by OIRA under section 3(f) of Executive Order 12866 because they raise novel policy issues. This proposed rule, when final, is expected to be an Executive Order 13771 deregulatory action.

Pursuant to section 6(a)(3)(B) of Executive Order 12866, the following analysis discusses the anticipated economic effects of these proposed regulations. Although not required by that section, the Treasury Department and the IRS have generally provided monetized estimates in this analysis. These proposed regulations have been reviewed by the Office of Management and Budget.

A. Affected population

This analysis uses an expansive definition of the estimated affected population in order to minimize the risk that the analysis will not capture the effects on collateral groups.

1. Application to C Corporations

As discussed in TD 9790, this regulatory action affects approximately 6300 large C corporations out of 1.6 million C corporations and 5.8 million corporations of all types. This is because only C corporations that are part of expanded affiliated groups in which one or more members have sufficient assets ($100 million) or revenue ($50 million), or are publicly traded, would have been required to document the relevant transactions.

2. Documentation of Intercompany Loans and Compliance

While there is variation across businesses, longer-term intercompany debt would typically be documented, in some form of agreement containing terms and rights, by corporations following good business practices. However, some information that would have been required by the Documentation Regulations, such as a debt capacity analysis, may not typically be prepared in some cases. If applicable, the Documentation Regulations would not have required that a specific type of credit analysis or documentation be prepared in order to establish a related-party debtor's creditworthiness and ability to repay, but merely would have imposed a standard intended to be closer to commercial practice. To the extent that information supporting such analysis is already prepared in accordance with a company's normal business practice, removal of the Documentation Regulations would have a relatively low compliance cost savings. However, where a business has not typically prepared and maintained written debt instruments, term sheets, cash flow, or debt capacity analyses for intercompany debt, compliance cost savings related to the removal of the Documentation Regulations would have been higher. While the level of documentation required is clearly evident in third-party lending, there is little available information on the extent to which related parties document their intercompany loans. Anecdotal evidence and comments received indicate that businesses vary in the extent to which related-party indebtedness is documented.

B. Description of the Documentation Regulations

1. In General

If applicable, the Documentation Regulations would have prescribed the nature of the documentation necessary to substantiate the federal income tax treatment of related-party interests as indebtedness, including documentation of factors analogous to those found in third-party loans. This generally means that taxpayers would have had to be able to provide such things as: evidence of an unconditional and binding obligation to make interest and principal payments on certain fixed dates; that the holder of the loan has the rights of a creditor, including superior rights to shareholders in the case of dissolution; a reasonable expectation of the borrower's ability to repay the loan; and evidence of conduct consistent with a debtor-creditor relationship. The Documentation Regulations would have applied to relevant intercompany debt issued by U.S. borrowers beginning in 2019 and would have required that the taxpayer's documentation for a given tax year be prepared by the time the borrower's federal income tax return is filed.

The Documentation Regulations would have applied only to related groups of corporations in which the stock of at least one member is publicly traded or the group's financial results report assets exceeding $100 million or annual revenue exceeding $50 million. Because there is no general definition of a small business under the Code, these asset and revenue limits were designed to exceed the maximum receipts threshold used by the Small Business Administration in defining small businesses (U.S. Small Business Administration, Table of Small Business Size Standards, 2016). In addition, these thresholds exclude about 99 percent of C corporation taxpayers while retaining 85 percent of economic activity as measured by total income. Approximately 1.5 million out of 1.6 million C corporation tax filers are single entities and therefore have no affiliates with which to engage in tax arbitrage. The intent was to limit the Documentation Regulations to large businesses with highly-related affiliates, which are responsible for most corporate activity. For example, large foreign-controlled domestic C corporations (FCDCs) (those having assets over $100 million or total income over $50 million) make up 3 percent of FCDCs but report 90 percent of FCDC interest deductions and 93 percent of FCDC total income. Similarly, the Documentation Regulations would have exempted most ordinary course transactions.

C. Assessment of the Documentation Regulations' effects

The Treasury Department and the IRS estimate that 6,300 or 0.4 percent of C corporation taxpayers would have been affected by the Documentation Regulations, mainly because 95 percent of taxpayers do not have affiliated corporations, and the regulations would have affected only transactions between affiliates.

While only a small fraction of corporate taxpayers will be affected by the removal of the Documentation Regulations, these 6,300 taxpayers tend to be the largest C corporation tax filers, claiming 65 percent of total interest deductions claimed by C corporations, 53 percent of total income claimed by C corporations, 81 percent of total income subject to tax claimed by C corporations, and 75 percent of total income tax after credits claimed by C corporations. Of these C corporations, approximately one-third are FCDCs that report about 20 percent of the affected total income and 20 percent of the affected interest deductions.

1. Monetized Estimates

The revenue and compliance burden effects are measured against a no-action baseline, which captures tax-related behavior in the absence of the proposed regulatory action and includes taxpayer behavior the Treasury Department and the IRS expect as a result of the enactment of P.L. 115-97 (TCJA). While this particular regulation does not implement TCJA requirements, it interacts with the TCJA. There are several provisions of the TCJA that reduced the tax advantages of Foreign Controlled Domestic Corporations (FCDCs) over domestically controlled companies (DCCs) and thus may affect the tax revenue and compliance burden consequences of the removal of the Documentation Regulations. First, for taxable years beginning after December 31, 2017, the TCJA reduced the statutory corporate tax rate from 35 percent to 21 percent, which lowers the effective tax rate for DCCs more than for FCDCs. Second, the ability of FCDCs to strip earnings out of the United States using deductions for interest expense was significantly reduced by the TCJA through amendments to section 163(j) of the Code. Specifically, the section 163(j) statutory amendments (1) eliminated the debt-equity ratio safe harbor, (2) reduced the maximum net interest deductions' share of adjusted taxable income from 50 percent to 30 percent, (3) limited all, rather than just related-party, interest deductions, and (4) eliminated the carryforward of excess limitation under pre-TCJA section 163(j). The TCJA's Base Erosion Anti-abuse Tax (BEAT) further reduces this ability. Thus, the benefits of the Documentation

Regulations in reducing foreign acquisitions of U.S. assets and interest stripping were reduced by the TCJA.

The vast majority of TCJA provisions are self-executing, which means that they are binding on taxpayers and the IRS without any regulatory action and therefore their applicability and potential taxpayers' responses to such applicability are assumed in the baseline. The Treasury Department and the IRS recognize, however, that the section 163(j) amendments and the BEAT, along with other TCJA provisions, while self-executing, provide interpretive latitude for taxpayers and the IRS and that, without further implementation guidance, those provisions could prompt a variety of potential taxpayer responses. Faced with ambiguous tax provisions that are susceptible to a range of reasonable interpretations, some taxpayers will take conservative filing positions, others will take aggressive filing positions, and still others will simply forego business activity that implicates any uncertain provisions. Accordingly, the Treasury Department and the IRS have included in the baseline their best assessment of taxpayer behavior under current law and regulatory guidance; the baseline does not assume regulatory guidance that has not yet been issued. To the extent that taxpayer responses to any future legislation or rules regarding section 163(j) or the BEAT differ from this assessment, the revenue and compliance burden estimates with respect to the proposed removal of the Documentation Regulations would also be affected.

The Treasury Department and the IRS solicit comments on the revenue and compliance burden estimates with respect to the proposed removal of the Documentation Regulations.

a. <u>Revenue effects of proposed regulations</u>

The Treasury Department and the IRS previously addressed revenue effects in the original regulatory impact analysis (RIA) published in the preamble to T.D. 9790 and have received comments that address the revenue effect of the Documentation Regulations. The removal of the Documentation Regulations may slightly increase the ability of some firms to strip earnings out of the United States and so reduce their tax payments. The Treasury Department and the IRS estimate that removal of the Documentation Regulations will reduce revenue by $407 million over the period 2019-2028, using standard revenue reporting conventions (undiscounted nominal total). The net present value of the revenue loss is $302 and $243 ($2018 millions) using real discount rates of 3 and 7 percent, respectively. The annualized amounts are $35.4 and $34.5 ($2018 millions), again based on 3 percent and 7 percent real rates respectively. The revenue effects were estimated using the methodology described in the original RIA published in the preamble to T.D. 9790, although the estimate now covers 2019 to 2028 and includes factors that have changed as a result of TCJA as well as other technical adjustments.

Annualized discounted revenue effects are shown in the following table.

| | Fiscal Years 2019 to 2028 (3% real discount rate) | Fiscal Years 2019 to 2028 (7% real discount rate ) |
|---|---|---|
| Estimated change in annual tax revenue (annualized value, $2018 millions) | -$35.4 | -$34.5 |

b. <u>Compliance burden effects from proposed regulations</u>

The Treasury Department and the IRS estimate that removal of the Documentation Regulations will reduce compliance costs by $924 million over the period 2019-2028 (undiscounted nominal total). The net present value of the compliance cost savings is $773 and $685 ($2018 millions) using real discount rates of 3 and 7 percent respectively. These amounts are $90.6 million and $97.5 million on an annualized basis, again based on 3 percent and 7 percent real rates respectively. The methodology for estimating the compliance cost savings also followed the methodology described in the original RIA published in the preamble to T.D. 9790, with analogous adjustments due to the change in the period covered, the effects of TCJA, and other technical adjustments. The Treasury Department and the IRS view the proposed action (removal of §1.385-2) as reducing both tax revenues and compliance costs but they view the TCJA as primarily affecting the reduction in tax revenue from the action due mainly to reduced allowable interest deductions (163(j)) and to a lesser extent, taxation of certain base eroding payments to related parties (BEAT), including interest. The Treasury Department and the IRS do not expect a significant reduction in the number of relevant related party transactions, only a reduction in the dollar amounts, and therefore see a smaller effect of the TCJA on compliance cost savings than on revenue losses, relative to previous estimates.

In addition, the analysis includes a sensitivity analysis in which the compliance costs were estimated for a 90 percent interval around the central estimate. Annualized discounted ongoing and start-up changes in compliance costs ($2018 millions) are shown in the following table.

| Estimated change in annual compliance costs (annualized value, $2018 millions) | Fiscal Years 2019 to 2028 (3% real discount rate) | Fiscal Years 2019 to 2028 (7% real discount rate, ) |
|---|---|---|
| Central estimate | -$90.6 | -$97.5 |
| High estimate | -$113.3 | -$121.9 |

| | | |
|---|---|---|
| Low estimate | -$68.0 | -$73.1 |
| Technical note: In this rulemaking, the Treasury Department made technical adjustments relative to the 2016 rulemaking in calculating the annualized compliance cost estimates. The cost stream in this rulemaking is in 2018 dollars, reflects a two-year delay in effective date (relative to the previous estimates), and applies real discount rates of 3 and 7 percent. Technical adjustments account for part of the difference in the estimates between the rulemakings. | | |

2. Non-Monetized Effects

a. Reduced Tax Compliance

By slightly increasing the ability of some taxpayers to strip earnings out of the United States through transactions with no meaningful economic or non-tax benefit, and so reducing their tax payments, removal of the Documentation Regulations is likely to slightly reduce the overall perceived legitimacy of the U.S. tax system, and hence reduce voluntary compliance.

b. Efficiency and growth effects

By changing the treatment of certain transactions and activities, removal of the Documentation Regulations potentially affects economic efficiency and growth (output). While the removal of the Documentation Regulations may have multiple and to some extent offsetting effects, on net they are likely to slightly reduce economic efficiency. For example, the removal of the Documentation Regulations will likely increase the tax advantage foreign owners have over domestic owners of U.S. assets, and consequently will increase the propensity for foreign acquisitions and ownership of U.S. assets that are motivated by tax considerations rather than economic substance. While these effects will likely be small, they likely reduce efficiency and growth. By increasing the ability to undertake tax-motivated acquisitions or ownership structures, removal of the Documentation Regulations may slightly reduce the incentive for assets to be owned or managed by those most capable of putting the assets to their highest-valued use. Moreover, removal of the Documentation Regulations may put purely domestic U.S. firms on less even tax footing than their foreign-owned competitors operating in the United States. On the other hand, removal of the Documentation Regulations may slightly reduce the effective tax rate and compliance costs on U.S. inbound investment. While the magnitude of this reduction is small, to the extent that it increases new capital investment in the United States, its effects would be efficiency and growth enhancing. Most inbound investment is via acquisition of existing U.S. companies rather than greenfield (new) investment in the United States, however, and thus such investment changes the ownership of existing assets, without necessarily adding to the stock of capital employed in the United States. On balance, the likely effect of the removal of the Documentation Regulations is to reduce the efficiency of the corporate tax system slightly.

c. Higher Tax Administrative Costs for the IRS.

The reduced loan documentation required of large corporations as a result of the removal of the Documentation Regulations will reduce the ability of the IRS to more effectively administer the tax laws by making it harder for the IRS to evaluate whether purported debt transactions are legitimate loans. This will raise the cost of auditing and evaluating the tax returns of companies engaged in these transactions.

## II. Regulatory Flexibility Act

Pursuant to the Regulatory Flexibility Act (5 U.S.C. Chapter 6), it is hereby certified that the proposed regulations will not have a significant economic impact on a substantial number of small entities.

As discussed earlier in this preamble, on October 21, 2016, the Treasury Department and the IRS published final and temporary regulations under section 385. The final and temporary regulations under section 385, among other things, established minimum documentation requirements that must be satisfied in order for purported debt obligations among related parties to be treated as debt for federal tax purposes. When finalized in October 2016, the Documentation Regulations were made applicable with respect to interests issued or deemed issued on or after January 1, 2018. In response to continued taxpayer concern with the application of the Documentation Regulations, the Treasury Department and the IRS, in Notice 2017-36, further delayed the applicability of the regulations by making the regulations applicable only to interests issued or deemed issued on or after January 1, 2019. This proposed rule, if finalized, would remove these Documentation Regulations that have not yet been made applicable to any interests issued by any taxpayer.

Section 1.385-2, if applicable, would have provided documentation requirements to substantiate the treatment of certain related party instruments as indebtedness. Section 1.385-2 would have applied to large corporate groups (specifically, those that are publically traded, or have assets exceeding $100 million or annual total revenue exceeding $50 million in its expanded group), thus limiting the scope of small entities affected. Section 1.385-2 would have applied to financial institutions, which are considered small entities under the Regulatory Flexibility Act if they have less than $550 million in assets (13 CFR 121). The Treasury Department and the IRS believe that §1.385-2 would not affect a substantial number of small entities other than small financial institutions. Even if the regulations affected a substantial number of small entities in that sector, the economic impact of this rule would be minimal because the proposed regulations would remove the currently inapplicable documentation requirements in §1.385-2. Accordingly, a regulatory flexibility analysis is not required.

Pursuant to section 7805(f), this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. In 2018, that threshold is approximately $150 million. This proposed rule does not include any mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

Executive Order 13132: Federalism

Executive Order 13132 (entitled "Federalism") prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This proposed rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

**Comments and Requests for Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the ADDRESSES heading. All comments will be available at http://www.regulations.gov or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place of the public hearing will be published in the **Federal Register**.

**Drafting Information**

The principal author of this notice of proposed rulemaking is Austin Diamond-Jones of the Office of the Associate Chief Counsel (Corporate). However, other personnel from the Treasury Department and the IRS participated in its development.

**List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

**Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

**PART 1--INCOME TAXES**

Paragraph 1. The authority citation for part 1 is amended by removing the sectional authority for §1.385-2 to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

* * * * *

Par. 2. Section 1.385-1 is amended by revising paragraph (a), the last sentence of paragraphs (c) introductory text and (c)(4)(iv), paragraph (d)(1)(i), the first sentence of paragraph (d)(1)(ii), and paragraphs (d)(1)(iii) and (d)(1)(iv)(A), and removing and reserving paragraph (d)(2)(i).

The revisions read as follows:

<u>§1.385-1 General provisions</u>.

(a) <u>Overview of section 385 regulations</u>. This section and §§1.385-3 through 1.385-4T (collectively, the section 385 regulations) provide rules under section 385 to determine the treatment of an interest in a corporation as stock or indebtedness (or as in part stock and in part indebtedness) in particular factual situations. Paragraph (b) of this section provides the general rule for determining the treatment of an interest based on provisions of the Internal Revenue Code and on common law, including the factors prescribed under common law. Paragraphs (c), (d), and (e) of this section provide definitions and rules of general application for purposes of the section 385 regulations. Section 1.385-3 sets forth additional factors that, when present, control the determination of whether an interest in a corporation that is held by a member of the corporation's expanded group is treated (in whole or in part) as stock or indebtedness. * * * * *

(c) * * * For additional definitions that apply for purposes of their respective sections, see §§1.385-3(g) and 1.385-4T(e).

* * * * *

(4) * * *

(iv) * * * For purposes of the section 385 regulations, a corporation is a member of an expanded group if it is described in this paragraph (c)(4)(iv) of this section immediately before the relevant time for determining membership (for example, immediately before the issuance of a debt instrument (as defined in §1.385-3(g)(4)) or immediately before a distribution or acquisition that may be subject to §1.385-3(b)(2) or (3)).

* * * * *

(d) * * *

(1) * * *

(i) In general. If a debt instrument (as defined in §1.385-3(g)(4)) is deemed to be exchanged under the section 385 regulations, in whole or in part, for stock, the holder is treated for all federal tax purposes as having realized an amount equal to the holder's adjusted basis in that portion of the debt instrument as of the date of the deemed exchange (and as having basis in the stock deemed to be received equal to that amount), and, except as provided in paragraph (d)(1)(iv)(B) of this section, the issuer is treated for all federal tax purposes as having retired that portion of the debt instrument for an amount equal to its adjusted issue price as of the date of the deemed exchange. In addition, neither party accounts for any accrued but unpaid qualified stated interest on the debt instrument or any foreign exchange gain or loss with respect to that accrued but unpaid qualified stated interest (if any) as of the deemed exchange. This paragraph (d)(1)(i) does not affect the rules that otherwise apply to the debt instrument prior to the date of the deemed exchange (for example, this paragraph (d)(1)(i) does not affect the issuer's deduction of accrued but unpaid qualified stated interest otherwise deductible prior to the date of the deemed exchange). Moreover, the stock issued in the deemed exchange is not treated as a payment of accrued but unpaid original issue discount or qualified stated interest on the debt instrument for federal tax purposes.

(ii) Section 988. Notwithstanding the first sentence of paragraph (d)(1)(i) of this section, the rules of §1.988-2(b)(13) apply to require the holder and the issuer of a debt instrument that is deemed to be exchanged under the section 385 regulations, in whole or in part, for stock to recognize any exchange gain or loss, other than any exchange gain or loss with respect to accrued but unpaid qualified stated interest that is not taken into account under paragraph (d)(1)(i) of this section at the time of the deemed exchange. * * *

(iii) Section 108(e)(8). For purposes of section 108(e)(8), if the issuer of a debt instrument is treated as having retired all or a portion of the debt instrument in exchange for stock under paragraph (d)(1)(i) of this section, the stock is treated as having a fair market value equal to the adjusted issue price of that portion of the debt instrument as of the date of the deemed exchange.

(iv) * * *

(A) A debt instrument that is issued by a disregarded entity is deemed to be exchanged for stock of the regarded owner under §1.385-3T(d)(4); * * *

* * * * *

**§1.385-2 [Removed]**

Par. 3. Section 1.385-2 is removed.

Par. 4. Section 1.385-3 is amended by revising paragraph (g)(4) to read as follows:

§1.385-3 Transaction in which debt proceeds are distributed or that have a similar effect.

* * * * *

(g) * * *

(4) Debt instrument. The term debt instrument means an interest that would, but for the application of this section, be treated as a debt instrument as defined in section 1275(a) and §1.1275-1(d).

* * * * *

Par. 5. Section 1.1275-1 is amended by revising the last sentence of paragraph (d) to read as follows:

**§1.1275–1 Definitions.**

* * * * *

(d) * * * See §1.385–3 for rules that treat certain instruments that otherwise would be treated as indebtedness as stock for federal tax purposes.

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