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Tax Alert

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Key Points

- The New Regulations do not apply to debt issued by investment partnership funds, including publicly traded partnership funds, or blockers-at least, not now.
- The New Regulations can apply to preferred partnership interests in lieu of debt, but should not apply to most investment partnership funds.
- Although not required, best practices may suggest that investment funds comply, to the extent possible, with the new documentation rules, including ability to pay, to fend off a potential IRS debt versus equity challenge on audit.

Funds Escape Debt-Equity Regulation Net—For Now

Introduction

On October 13, 2016, the Internal Revenue Service (IRS) and the Treasury Department issued final and temporary regulations (T.D. 9790) (the “New Regulations”) under Section 385 of the Internal Revenue Code (“Code”). Section 385 of the Code, titled “Treatment of Certain Interests in Corporations as Stock or Indebtedness,” authorizes the issuance of regulations to determine whether an interest in a corporation is to be treated as stock or indebtedness. Regulations were initially issued under the statute in the early 1980s, but were subsequently withdrawn without ever taking effect. Until regulations were once again proposed under the statute in April of this year, no substantive guidance was provided under the statute for determining whether an interest in form as debt was to be treated as equity. Although the regulations as proposed earlier this year were initiated as a result of the public furor over corporate inversions, the regulations that were proposed went far beyond corporate inversions and generated a great deal of uncertainty.

The New Regulations are generally applicable for taxable years ending on or after January 19, 2017, which is 90 days after the official publication date of the New Regulations[1] in the Federal Register, and generally apply to debt instruments issued April 5, 2016, and thereafter.

[1] November 21, 2016.

The New Regulations make many changes to the scope of the proposed regulations[2], principally relating to eliminating the bifurcation rule (treating debt issued as part debt and part equity); eliminating the documentation requirement for partnerships that would have otherwise been subject to the rules; narrowing, in many cases, the scope of the application of the rules (such as adding an exception for dealers in securities, short-term loans and cash pools)[3]; and reserving on the treatment of downward attribution under Section 318 for brother-sister controlled groups[4].

Application of the New Regulations to the Fund Industry

Of particular interest to the fund industry after the Proposed Regulations were issued were two requests for comments in the preamble to those Proposed Regulations relating to (1) investment partnerships and blocker entities, and (2) preferred equity issued by partnerships in lieu of debt.

The Proposed Regulation preamble specifically asked for comments on "whether certain indebtedness commonly used by investment partnerships, including indebtedness issued by certain "blocker" entities, implicates similar policy concerns as those motivating the proposed regulations, such that the scope of the proposed regulations should be broadened." The reason for this separate request for comments is that debt issued by investment partnerships or blocker entities would not ordinarily be treated as issued by either a controlled partnership (where 80 percent or more of capital or profits in the partnership were owned, directly or indirectly, by corporate related parties) or a controlled corporate blocker entity (that is, a blocker owned, directly or indirectly, more than 80 percent by a related corporate entity). As a result, under most typical fund structures, investment fund partnerships and blocker entities, including, of course, publicly traded partnership funds,[5] would not have been subject to the Proposed Regulations.

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[2] REG-108060-15, 2016-16 IRB 636, April 8, 2016 (the "Proposed Regulations").

[3] The Appendix at the end of this document summarizes the New Regulations as they pertain generally to partnerships and partners.

[4] The preamble to the New Regulations states in this regard: "The principal consequence of requiring downward attribution for purposes of determining indirect ownership under the proposed regulations is that an expanded group included so-called "brother-sister" groups of affiliated corporations that are commonly controlled by non-corporate owners. Similarly, the principal consequence of applying section 318(a)(1) (in connection with section 318(a)(3)), which attributes stock owned by individual members of a family, would also be the treatment of brother-sister groups with non-corporate owners as part of an expanded group. The Treasury Department and the IRS continue to study the issue of brother-sister groups, including the implications of applying the final and temporary regulations to groups with identical members but different expanded group member corporate parents. As a result, the final regulations reserve on the application of section 318(a)(1) and (a)(3) for purposes of determining indirect ownership pending further study." The text of the New Regulations states that downward attribution under Section 318(a)(3) does not apply except to the extent that rules are subsequently issued (this section is reserved in the regulation text at the present time) dealing with brother-sister groups with non-corporate owners. As a result, there will be much fewer cases under the New Regulations at present where partnership funds and their owners will be subject to the controlled expanded group rules of the New Regulations.

[5] Publicly traded partnerships were never explicitly subject to these new rules because of their widely held nature. As a result, it would be extremely unlikely that controlled corporate entities would own 80 percent or more of partnership capital or profits and the publicly traded partnership would therefore not be a "controlled partnership" and only controlled partnerships are subject to the new rules.

In addition, the Proposed Regulation preamble also stated:

"The Treasury Department and the IRS are aware that the issuance of preferred equity by a controlled partnership to an expanded group member may give rise to similar concerns as debt instruments of a controlled partnership issued to an expanded group member, and that controlled partnerships may, in some cases, issue preferred equity with a principal purpose of avoiding the application of § 1.385-3 of the proposed regulations. The Treasury Department and the IRS are considering rules that would treat preferred equity in a controlled partnership as equity in the expanded group partners…."

Of particular interest to the fund industry is the response of the IRS and Treasury Department to these two issues in the preamble to the New Regulations. First, on the investment fund blocker issue, the preamble states:

"The preamble to the proposed regulations requested comments on whether certain debt instruments used by investment partnerships, including indebtedness issued by certain "blocker" entities, implicate similar policy concerns as those motivating the proposed regulations, such that the scope of the proposed regulations should be broadened. Several comments recommended that the scope of the proposed regulations should not be broadened to apply to such transactions (by, for example, treating a partnership that owns 80 percent or greater of the stock of a blocker corporation as an expanded group member). **The final and temporary regulations do not adopt special rules for debt instruments used by investment partnerships, including indebtedness issued by certain "blocker" entities**. The Treasury Department and the IRS continue to study these structures and transactions in the context of the Section 385 regulations." (Emphasis added).

As to the second issue relating to preferred equity being subject to the New Regulations, the preamble states:

"The Treasury Department and the IRS continue to study whether it is appropriate to subject preferred equity in a controlled partnership to the rules that would apply to a debt instrument issued by a controlled partnership. As described in the preamble to the proposed regulations, the IRS intends to closely scrutinize, and **may challenge under the anti-abuse rule**, transactions in which a controlled partnership issues preferred equity to an expanded group member and the rules . . . would have applied had the preferred equity been denominated as a debt instrument issued by the partnership." (Emphasis added).

Taken at face value, these statements by the IRS and the Treasury Department in the preamble to the New Regulations are both good and potentially bad news for the fund industry.

First, the good news. The New Regulations make crystal clear that debt issued by investment partnerships (including, of course, publicly traded partnerships) or by blocker entities is not, on the face of the New Regulations, subject to either (1) the new documentation of loan rules or (2) the rules recharacterizing certain loans made by controlled corporations as equity rather than debt. However, corporate fund controlled groups remain subject to the New Regulations.

This exclusion for investment partnerships does not mean that the anti-abuse rules in the New Regulations cannot be applied by the IRS to investment partnerships. They can. The anti-abuse rule looks to transactions that have a principal purpose of circumventing the rules of the New Regulations. However, there are no illustrations of how these anti-abuse rules could or would apply to investment partnership funds, and so the new rules should not apply to investment partnerships and blocker entities that engage in transactions that they undertook prior to the issuance of the Proposed Regulations.

Although not subject to the documentation requirements or the recharacterization rules of the New Regulations, best practices for the fund industry may suggest complying, to the extent possible, with the new documentation rules (including ability to pay). IRS agents may view any taxpayer who does not maintain contemporaneous documentation of the debt issued by that taxpayer as suspect because, although exempt from the rules of the New Regulations (absent application of the anti-abuse rules in the regulations), investment fund partnerships' loans to blocker entities and any similar type loans remain subject to the case law and IRS rulings relating to treating debt in form as in substance equity of the taxpayer.

Second, with respect to the potential for treating preferred equity as partnership indebtedness under the anti-abuse rule, the preamble references only cases where the preferred equity is issued to expanded group members, and these entities are mostly domestic corporate entities that own a controlling (80 percent or more of capital or profits) interest in the investment partnership (including, of course, publicly traded partnerships). Thus, in most cases, the potential threat of recasting preferred equity as debt will not apply to investment partnership funds.

However, if the prohibited controlled partnership relationship does exist in an investment fund structure, then there may be potentially bad news for the industry in those cases. Thus, although the New Regulations do not expressly treat preferred equity as if it were debt issued by an investment fund (or other partnership), the preamble does state that the anti-abuse rules could apply to preferred equity if the New Regulations would have applied if the preferred equity were actually debt.

Although admittedly vague, it appears that what the IRS is saying here is that, if the entire interest held by a related corporate party (part of the 80 percent controlled group) is solely preferred equity in a partnership with no meaningful residual common interest (meaning no upside potential or downside risk), then the New Regulations could apply if the IRS believes that the taxpayer is using preferred equity instead of debt in order to avoid the New Regulations. That seems to imply that an economic equivalence of preferred equity, as compared to actual debt of the partnership, is a precondition to application of the anti-abuse rules in those cases. Since actual indebtedness would have priority in payment to preferred equity, it may be that the presence or absence of unrelated third-party creditors and the existence of some meaningful upside potential and downside risk to the preferred equity will most likely determine whether the application of the anti-abuse rules in the New Regulations will be warranted in those cases. Caution is in order here as purely preferred equity interests of a controlled (80 percent or more) entity with no third-party unrelated debt could end up being treated as subject to the New Regulations.

Set forth below in the Appendix is a summary of the new rules as they generally pertain to partnerships and partners inside and outside of the fund industry.

Appendix

This document summarizes the major changes in the New Regulations to the treatment of partnerships and its partners:

I. Unlike the Proposed Regulations, the New Regulations do **not** impose documentation requirements upon any partnership, except in the very limited circumstance when the regulation Section 1.385-2 (pertaining to the documentation requirements) anti-abuse rule applies. This is a huge change from the Proposed Regulations, which imposed documentation requirements upon certain controlled partnerships and treated a failure to comply with those rules as if the partnership issued equity in itself in lieu of the partnership debt. However, partners in the partnership who are part of an expanded group and who are domestic corporations (called “covered members”) can be subject to the reporting requirements for other debt issued by that entity (but its share of partnership debt is not subject to the documentation rules). In addition, members of the expanded group who engage in transactions with a controlled partnership (80 percent or more of capital or profits) may have reporting obligations under the New Regulations (but again, not with respect to its share of partnership debt which is not subject to the documentation rules).

II. The Proposed Regulations dealing with distributions of expanded group notes, the funding rule and related matters (Section 1.385-3) had proposed a regime whereby, if the recharacterization rules of this regulation applied, partners of the partnership who were expanded group members (expanded group corporate partners) would be treated as issuing their share of the partnership debt that would have been recharacterized as stock of the corporate expanded group partner. Those rules also deemed the corporate partners who were members of the expanded group as if they owned their share of the controlled partnership’s assets. Ownership was generally determined based on shares of partnership profits. Under these proposed rules, so-called “appropriate adjustments” had to be made to the inside and outside tax basis of partnership assets and partnership interests so as to eliminate or minimize any book-tax disparity of the partners. Examples in the Proposed Regulations deemed the corporate expanded group partners as issuing their stock to the lender in exchange for the cash payment that funded the note, and the corporate partner was then deemed to contribute that cash to the partnership. This regime raised a number of uncertainties.

III. The New Regulations change this regime and do **not** recharacterize partnership indebtedness issued to an expanded group member. Instead, the lender-in-form of the partnership indebtedness is treated as transferring a share of the loan receivable to the corporate expanded group partners, and these partners are then deemed to issue their stock to the lender-in-form. The partnership debt remains outstanding and is **not** recharacterized as stock in the partnership. When payments are made on the partnership note-in-form, the partnership is treated as a paying agent, and the corporate expanded group partners end up with net interest income/deduction of zero (what would be the interest deduction nets against what would be interest income because the corporate expanded group partner(s) is treated as both issuing its share of the partnership debt and receiving its share of interest income). A special rule under the Section 752 regulations was added to say that this deemed transfer of the loan receivable to the corporate expanded group partner is disregarded under the liability allocation rules of the Section 752 regulations.

IV. Unlike the Proposed Regulations, the New Regulations determine a partner's share of corporate assets using a deemed liquidation of the partnership approach and determine the partner's share of partnership debt based on the projected ratio of interest expense that would be allocated to the corporate expanded group partner as compared to the projected allocations of all of the partners.

V. Partnerships, in particular, controlled partnerships, are treated (with one limited exception) as aggregates of their partners in applying all of the rules of the New Regulations (except the documentation rules whereby neither the controlled partnership nor its related corporate members are subject to the documentation rules for their shares of partnership debt issued by the partnership). The one exception is that the short-term loan exception to the New Regulations is computed at the partnership level. All other computations and determinations are made at the partner level.

VI. The New Regulation preamble discusses the open-ended question of how to determine a partner's share of profits and capital of the partnership in order to determine whether the partnership is a controlled partnership. The New Regulation preamble refuses to answer this question because, it states, the same issue arises under various other sections of the Code, such as Sections 707(b) and 708(b). Thus, determining shares of profits where there are preferred returns and flipping allocations remain open-ended issues as does determining shares of capital.

VII. The New Regulations reserve on the question of the application of brother-sister attribution under Section 318 in determining whether a domestic corporation (who is a covered member) is a member of an expanded group. In discussing that issue, the New Regulation preamble refuses to give guidance on what the term "proportionate" means in applying the attribution rules of Section 318[6], saying that this is a long-standing issue not tied specifically to Section 385. Thus, this question also remains unresolved.

VIII. The New Regulations do not contain the bifurcation rule from the Proposed Regulations, saying that this issue remains under study. Thus, under the New Regulations, controlled partnerships will not be at risk under the New Regulations from having part of their debt being treated as debt and part as equity.

6 The Section 318 attribution rules reference "proportionate" ownership when attributing stock owned by a partnership to its partners. Many other attribution rules in the Code use similar terminology.

IX. The New Regulations also change the treatment of disregarded entities[7]. These entities are generally regarded under the New Regulations as separate tax entities in regard to the documentation requirements of regulation Section 1.385-2. However, if the debt is recharacterized under the New Regulations (Section1.385-3), it is treated as if the regarded owner of the entity issued its stock to the formal holder of the debt-in-form issued by the disregarded entity. Unlike the Proposed Regulations, disregarded entities will not become partnerships under the New Regulations. Only disregarded entities that are owned by a regarded member that is a covered member (a domestic corporation) are subject to the documentation rules if the threshold requirements[8] to be subject to the documentation rules apply.

[7] In addition, S Corporations are exempt from the New Regulations.

[8] Relating to either the stock of the expanded group member being publicly traded, total assets exceeding $100 million on any applicable financial statement, or annual total revenue exceeding $50 million on any applicable financial statement.

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