Repealing Debt-Equity Regs Would Encourage American Investment

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On October 11 the IRS announced (Notice 2019-58, 2019-44 IRB 1) that taxpayers may rely on proposed section 385 rules (REG-130314-16) if applied consistently in light of the temporary section 385 regulations (T.D. 9790) expiring for periods after October 13. Interestingly, the Office of Management and Budget's Office of Information and Regulatory Affairs received a related pre-rule document (RIN 1545-BP51) October 8 — three days before the notice was issued.

The pre-rule is titled the same as the proposed section 385 regulations, “The Treatment of Certain Interests in Corporations as Stock or Indebtedness,” but unlike the proposed regulations, it is not identified as "economically significant." In other words, according to the OIRA website, the pre-rule does not have a significant effect on many taxpayers.

This seemingly benign information speaks volumes. Nearly any guidance on the section 385 regulations is economically significant. This is one of the reasons for the massive outpouring of requests for the repeal of some of the most burdensome and costly rules issued during the Obama administration. So the pre-rule must not have any new rules, because any interpretation of section 385 would be economically significant.

After three years with no guidance on the temporary section 385 regulations, Treasury and the IRS could have decided to let them lapse and not enforce them. Notice 2019-58 indicates that taxpayers can *choose* to follow the proposed rules. This is no surprise. The 72-month per se recharacterization rule converting debt into equity for “funding” transactions was simply not administrable and was inconsistent with the century of law that focused on substance for debt determinations.

So what’s left? Withdrawing the regulations altogether. Although Treasury may continue to study the issue, maintaining section 385’s onerous regulations would only confirm that the Tax Cuts and Jobs Act's limit on interest deductions under revised section 163(j) and its base erosion and antiabuse tax under new section 59A failed to curb base erosion.

Of course, one can say that the massive section 385 regulations were broader. But that's counterfactual to what proponents argued when implementing those regulations, as well as to policies underlying the TCJA. As you may recall, Obama-era Treasury officials conceded that the regulations were a blunt instrument, stating that the best way to address the underlying concerns "would be to enact comprehensive business tax reform." That is exactly what the TCJA accomplished: Section 163(j) eliminated 70 percent of interest expense deductions to curb base erosion, while the section 385 regulations recharacterized debt as equity in defiance of countless court decisions and simple logic. Further, the BEAT captures many related-party transactions, thereby mitigating the concerns that prompted the section 385 regulations.

Withdrawing the regulations would be consistent with Treasury's October 2017 report, "Identifying and Reducing Regulatory Burdens" (2019-03004), which identified them as among the candidates for revocation for violating President Trump's deregulatory policies and reforms. The report also indicated that the section 385 regulations are unduly burdensome and costly regulations as described in Executive Orders 13789 and 13777. (Those executive orders are also cited in the new Treasury-IRS priority guidance plan for 2019-2020, which was released the same day as the pre-rule, October 8.)

Finally, the TCJA was intended in part to increase America's economic competitiveness. The section 385 regulations would impose undue regulatory costs on foreign direct investment, which supports more than 7 million good-paying domestic jobs. Pushing away major U.S. employers that seek to benefit from U.S. economic strength by retaining rules obsoleted by the TCJA would run contrary to the administration's policies on regulation and trade.

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