CHAPTER 32

International Implications of Internal Revenue Code Section 385 and Related Regulations

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§ **32.04 Summary**

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§ 32.01 ENACTMENT OF SECTION 385 AND ISSUANCE OF REGULATIONS

The distinction between corporate debt and equity has plagued taxpayers and courts for at least as long as there has been an income tax. Although the Supreme Court has stated that the terms "interest" and "dividends" were well understood[1] and that interest deductions could be determined without "subtle and theoretic analysis,"[2] the myriad cases which have considered the debt-equity issue are testimony to the impossibility of deriving a consistent set of rules through litigation.[3]

Recognizing this dilemma, Congress enacted Code Section 385 in 1969[4] authorizing the Treasury Department to prescribe regu-

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[1] John Kelley Co. v. Comm'r, 326 U.S. 521, at 530 (1946).

[2] Old Colony R.R. Co. v. Comm'r, 284 U.S. 552, at 561 (1932).

[3] See generally, Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal,* 26 Tax L. Rev. 369 (1971).

[4] Tax Reform Act of 1969, Pub. L. No. 91–172, 12/31/69, § 415(a).

SEC. 385. TREATMENT OF CERTAIN INTERESTS IN CORPORATIONS AS STOCK OR INDEBTEDNESS.

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

(b) FACTORS—The regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a

lations "to determine whether an interest in a corporation is to be treated . . . as stock or indebtedness." The expectation that the Treasury would be able to develop guidelines to settle debt-equity questions once and for all appears unduly optimistic.

The inherent complexity of the Treasury's task is reflected in the fact that its initial proposed regulations were issued more than ten years after the enactment of Section 385.[5] Following the filing of comments, the proposed regulations were extensively revised and issued as final regulations on December 29, 1980,[6] to become effective May 1, 1981. On April 14, 1981, the Internal Revenue Service (the Service) announced the postponement of the effective date to January 1, 1982.[7] Shortly thereafter, Assistant Secretary of the Treasury for Tax Policy, John Chapoton, stated that the Reagan Administration Treasury Department was reviewing the regulations under Section 385 published by the Carter Administration but no further delay in their implementation was expected even if revisions were made.[8] In an interview in September, 1981, Assistant Secretary Chapoton stated that: "Under Section 385, deciding what is debt or equity has a tremendous impact on the foreign area and I really think those original regs didn't give sufficient consideration to that."[9]

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particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. The factors so set forth in the regulations may include among other factors:

(1) whether there is a written unconditional promise to pay on demand or on a specified date a certain sum of money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,

(2) whether there is subordination to or preference over any indebtedness of the corporation,

(3) the ratio of debt to equity of the corporation,

(4) whether there is convertibility into the stock of the corporation, and

(5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

[5] 45 Fed. Reg. 18957 (1980).

[6] 45 Fed. Reg. 86438 (1980).

[7] 71 Daily Tax Report G–6 (April 14, 1981) (hereinafter cited as DTR); See also 46 Fed. Reg. 24945 (1981).

[8] 98 DTR G–8 (May 21, 1981).

[9] 183 DTR K–6 (Sept. 22, 1981).

On January 5, 1982, the Service had published in the Federal Register revised proposed Section 385 regulations, applicable to domestic transactions only, effective June 30, 1982.[10] The application of the regulations to international transactions was deferred for further consideration. Consequently, this paper, which was presented prior to the January 5, 1982 reissuance of proposed Section 385 regulations, discusses the final regulations issued December 29, 1980 which were applicable to international transactions, and all cites herein to the Section 385 regulations are to such regulations. With minor exceptions, extension of the revised proposed regulations would raise all of the problems discussed below.

The proposed regulations which appeared in March of 1980 were distinguished by the fact that they brought under their aegis lenders who never dreamed they might be considered equity investors. Thus, a bank making a loan to an unrelated highly leveraged corporation might have found itself acquiring stock in the company with all of the attendant tax consequences for both lender and borrower.

The December, 1980 regulations under Section 385 had a more limited scope than the proposed regulations and primarily affect related parties only. Before proceeding to a discussion of the interrelationship between the Section 385 regulations and international transactions, a brief outline of the portions of the regulatory pattern which are most likely to impinge on such transactions appears useful.

Since, from an income tax perspective, debt is generally more advantageous than stock, most of the cases considering debt-equity controversies find the Commissioner contending for the equity position and the taxpayer for debt. The regulations are written from this perspective.

§ 32.02 SUMMARY OF SECTION 385 REGULATIONS

For the most part, the regulations apply only to purported

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[10] 47 Fed. Reg. 147, at 164 (1982).

written debt instruments which are issued proportionately to equity interests. There are two principal exceptions to this rule, one of which applies to bona fide loans by any person owning stock in the borrowing corporation, and the other of which applies to loans which are not evidenced by a written instrument. The first of these rules is discussed immediately below. The discussion of the second more appropriately follows the summary of the proportionality rules. Indebtedness arising from such interests as bank deposits, insurance policies, claims for wages, and trade accounts payable are outside the scope of the regulations.[11]

[1] Interest Rate Adjustments

If a shareholder makes a loan to the issuing corporation, the fair market value of the instrument acknowledging the loan, taking into consideration the interest terms, must be compared with the amount of the loan; i.e., the amount paid for the instrument. If the fair market value of the instrument exceeds the amount paid for it, the difference is treated as a Section 301 distribution to the lender-stockholder[12] which will most frequently have dividend consequences. If the fair market value of the instrument is less than the amount paid for it, the lender-stockholder is deemed to have made a contribution to capital in the amount of the difference.[13] In either situation, the lender's basis in the instrument is equal to its fair market value.[14]

These rules both have the direct effect of adjusting the stated interest rate. Depending on the facts, both types of adjustment can give rise to additional interest in the form of original issue discount[15] or a reduction in interest in the form of amortizable bond premium.[16]

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[11] Reg. § 1.385–1(b).

[12] Reg. § 1.385–3(a)(2).

[13] Reg. § 1.385–3(a)(1).

[14] Reg. § 1.385–3(a)(3), Examples (1) and (2).

[15] I.R.C. § 1232; Reg. § 1.163–4(a).

[16] Reg. § 1.61–12(c)(2); I.R.C. § 171.

The following table demonstrates these alternatives:

Fair Market Value of Instrument	Face Value of Instrument	Amount Paid for Instrument	Original Issue Discount of (Amortizable Bond Premium)
120	100	100	(20)
80	100	60	20
80	100	100	20
120	100	140	(20)

As the table demonstrates, if the fair market value of the instrument exceeds the face value, any difference between the fair market value and the amount paid for the instrument produces amortizable bond premium whether there is a contribution to capital or a distribution. If the fair market value of the instrument is less than the face value, any difference between fair market value and the amount paid will always produce original issue discount regardless of whether the difference produces a contribution to capital or distribution.

The regulations provide general rules for determining the fair market value of an instrument.[17] If, under a facts and circumstances test, the interest rate prescribed by the debt instrument is reasonable, the fair market value and face value of the instrument are deemed to be identical.[18] Safe haven reasonable interest rates are provided, but these may not be used in the case of any corporation with a debt to equity ratio in excess of one-to-one[19] and are therefore of limited application in the foreign area. In addition, the safe-haven rates are geared exclusively to dollar loans.

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[17] Reg. § 1.385–3(b)(1). The willing buyer-willing seller test is prescribed. Standard bond tables are optional.

[18] Reg. § 1.385–3(b)(2). In addition, the consideration paid for the instrument must equal the face value for the reasonable rate of interest rule to apply. Regulations Section 1.385–6(e)(1) provides a general rule for the determination of reasonable interest rates.

[19] Reg. § 1.385–6(e)(2). The safe haven rates are the deficiency interest rate under Section 6621, the prime interest rate at any local commercial bank, a rate determined from time to time by the Treasury based upon marketable obligations of the United States, and any rate between any of the foregoing three rates.

[2] Proportionality Rules

The next set of significant rules applies only to persons holding stock and debt in "substantially proportionate" amounts.[20] They do not apply to readily marketable widely held stock and debt which can be treated separately.[21] The term "substantially proportionate" is not defined and the regulations provide only that determinations will be based on "all relevant facts and circumstances, including family or other relationships described in Section 318(a)."[22]

When an instrument is subject to the proportionality provisions the following rules are applicable:

[a] *Hybrid Instruments*

All hybrid instruments are treated as stock.[23] (Whenever an instrument is treated as stock under the Section 385 regulations it will be treated as preferred stock.[24]) A hybrid instrument is an instrument which is convertible into stock or one which provides for any contingent payments (other than call premiums) to the holder.[25] Variable interest rates based on external standards not related to the performance of the borrower's business are not contingent payments.[26]

[b] *Instruments Not Issued for Money*

An instrument issued for property other than money is treated as stock if the interest rate paid on the instrument is not reasonable unless the issuance of the instrument can give rise to original issue discount or amortizable bond premium[27] in which case only the

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[20] Reg. § 1.385–6(a)(1).

[21] Reg. § 1.385–6(a)(3).

[22] Reg. § 1.385–6(a)(2).

[23] Reg. § 1.385–6(c)(1).

[24] Reg. § 1.385–4(c)(1)(i).

[25] Reg. § 1.385–3(e).

[26] Reg. § 1.385–5(d)(2)(i) and (4)(i).

[27] Reg. § 1.385–6(d)(1). Under Regulations Sections 1.1232–3(b)(2)(iii) and

interest adjustment rules applicable to shareholder-lenders generally would apply. A second exception applies for instruments issued in exchange for an equal or greater amount of the issuer's indebtedness if independent parties would have made the exchange.[28] The reasonable rate of interest rules relating to instruments issued for property are the same as those applicable to shareholder-lender loans.[29]

[c] *Excessive Debt*

An instrument will be treated as stock if the issuing corporation's debt is excessive[30] except that instruments issued in exchange for an equal or greater amount of indebtedness are exempt from this rule[31] as they are covered by the rule pertaining to instruments issued for property. The determination of excessiveness is a factual one based on whether a bank, insurance company or similar lending institution would have made the loan on similar terms and conditions, given the borrower's financial structure and condition, size, industry and geographic location.[32] A corporation's debt automatically will be treated as not excessive if both its outside debt-to-equity ratio does not exceed ten-to-one and its inside debt-to-equity ratio does not exceed three-to-one.[33]

The outside ratio, determined at the end of the taxable year, is the ratio of all of the corporation's liabilities (excluding trade accounts payable, accrued operating expenses and taxes and other similar items) to the book equity in the corporation owned by stockholders.[34] The year-end equity is increased by the amount of

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1.61–12(c)(2), when debt is issued for property, original issue discount or amortizable bond premium can arise only if the debt is traded in an established securities market or if the property consists of stock or securities traded in an established securities market.

[28] Reg. § 1.385–6(d)(3).

[29] Reg. § 1.385–6(d)(1)(ii).

[30] Reg. § 1.385–6(f)(1).

[31] Reg. § 1.385–6(f)(5).

[32] Reg. § 1.385–6(f)(2).

[33] Reg. § 1.385–6(f)(3).

[34] Reg. § 1.385–6(f)(4) and (g).

any net operating loss for the year, exclusive of capital losses.[35] The debt-to-equity ratio for banks and insurance companies is subject to further adjustment to account for the unique nature of those businesses.[36] In the case of affiliated groups (determined without the exclusions found in Section 1504(b)) the assets and liabilities of each company are increased or decreased by the assets and liabilities of a lower tier company.[37]

The inside ratio, also determined at the end of the taxable year, is calculated in the same manner as the outside ratio except that liabilities to independent creditors are excluded from debt but not from equity.[38]

[d] *Change in Terms*

If the holder of an instrument which is treated as debt agrees to postpone the maturity date or agrees to a substantial change in terms, the instrument is treated as newly issued for property and is subject to the three proportionality rules described above.[39] A substantial change in terms is any change which materially affects the fair market value of the instrument, e.g., a reduction in the interest rate or acceptance of subordination.[40]

[e] *Nonpayment of Interest*

If a corporation fails to pay any portion of the interest on an instrument and the owner of the instrument fails to exercise the same remedies which an independent creditor would be expected to take, the instrument is treated as stock on the later of the first day of the taxable year during which failure to pay occurs or the first day of the taxable year in which the holder fails to exercise the appropriate remedies.[41] Interest is not treated as unpaid, al-

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[35] Reg. § 1.385–6(g)(5)(ii)(A).

[36] Reg. § 1.385–6(g)(5)(iii) and (iv).

[37] Reg. § 1.385–6(h).

[38] Reg. § 1.385–6(f)(4).

[39] Reg. § 1.385–6(j)(1).

[40] Reg. § 1.385–6(j)(2).

[41] Reg. § 1.385–6(k)(1).

though paid late, if it is paid within 90 days after the end of the year; presumably the obligor's year, although the provision is ambiguous.[42] Interest may be paid with property, including a note, to the extent of the fair market value of the property.[43]

[f] *Instruments Payable on Demand*

If an instrument is payable on demand and the initial stated interest rate is not reasonable (using the tests described previously) the instrument is treated as stock.[44] Similarly, if, subsequent to the issuance of a demand instrument, the issuing corporation fails to pay a reasonable rate of interest (other than as a result of failure to make timely payment) the instrument is treated as stock on the first day of that taxable year.[45] If a corporation fails to make any principal payment within 90 days after the date it is due and the holder fails to pursue the remedies of an independent creditor, the instrument is considered to be payable on demand on the day after the principal is due.[46]

When an instrument is treated as stock under the rules described above, as of the time it is issued, the excess, if any, of the fair market value of the security issued over the amount paid for it, will be treated as a distribution subject to Section 305.[47] When an instrument is converted to stock under the foregoing rules, the exchange is treated as a recapitalization under Section 368(a)(1)(E) and no gain or loss is recognized by the lender.[48]

[3] Unwritten Obligations

The second important rule which affects loans even in the absence of proportionality is one which applies to unwritten obligations. Any loan to a corporation made by a person other than an

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[42] Reg. § 1.385–6(k)(3).

[43] *Ibid.*

[44] Reg. § 1.385–6(l)(1).

[45] Reg. § 1.385–6(l)(2) and (4)(ii)(A).

[46] Reg. § 1.385–6(l)(3).

[47] Reg. § 1.385–3(a)(2)(ii).

[48] Reg. § 1.385–4(c)(1)(ii).

independent creditor which is not evidenced by a written instrument within six months after the loan is made, will be treated as a contribution to capital if the debtor corporation has excessive debt (i.e., its debt-to-equity ratios exceed the ten-to-one and three-to-one limits discussed above[49] and the loan would not be acceptable to a bank, insurance company or similar lending institution[50]) when the loan is made.[51] If the borrower's debt is not excessive when the loan is made, but the borrower thereafter fails to pay interest at a reasonable rate,[52] the loan is reclassified as a contribution to capital as of the first day of the taxable year but not earlier than the date of the loan.[53] As with respect to the nonpayment of interest rules considered above,[54] interest is not considered unpaid until 90 days after the end of the year and may be paid with property to the extent of the property's fair market value.[55] Except as stated above, loans not evidenced by written instrument are subject only to the proportionality rules.

[4] The Scope of the Section 385 Regulations May Exceed the Statutory Mandate

As the above summary indicates, the Treasury has made the Section 385 regulations intensely interest oriented. Arguably, the Treasury has exceeded its mandate in providing its original issue discount amortizable bond premium rules[56] since Section 385 merely authorized it to prescribe regulations to determine whether an interest in a corporation is stock or indebtedness.[57] Nothing in the statute authorizes the Service to prescribe regulations to adjust

[49] See § 32.02[2][c].

[50] *Ibid.*

[51] Reg. § 1.385–7(a) and (b).

[52] Reg. § 1.385–6(e).

[53] Reg. § 1.385–7(c)(1).

[54] See § 32.02[2][e].

[55] Reg. § 1.385–7(c)(2).

[56] See § 32.02[1].

[57] See text of Section 385 at N. 4. In particular, the absence of a reasonable interest rate is not one of the factors specifically enumerated in Section 385(b) as having a bearing on the debt-equity issue.

interest rates with respect to purported debt instruments which are treated as such under Section 385.

§ 32.03 EFFECT OF SECTION 385 REGULATIONS ON INTERNATIONAL TRANSACTIONS

[1] Interest Adjustments

[a] *Section 482 Safe Haven Interest Rates Superseded*

The Section 385 regulations provide interest adjustment rules which supersede the regulations under Section 482. The regulations under Section 482 have in fact been amended to provide that the interest adjustments under the Section 385 regulations take precedence over the rules of the Section 482 regulations.[58] This extra layer of imputed interest rules has many ramifications.

[b] *Difficulty of Determining Reasonable Interest Rate*

In this day of 14 percent long-term interest rates and 20 percent prime rates, the 11 to 13 percent safe harbor spread which is applicable under Section 482[59] is rendered meaningless. This is likely to present companies with a serious conflict. Foreign governments are just as concerned about legitimate interest rates as is the United States and many have their own rules concerning reasonable rates of interest. The central banking authorities of many foreign countries must also approve interest rates paid to nonresident lenders before interest payments may be made. These foreign central banks are quite familiar with Section 482 and an applicant for exchange control authority can easily point to the 11, 12, and 13 percent rates in the Section 482 regulations and explain why one of these rates should be approved. Explaining the Section 385 regulations to a foreign bureaucrat may be quite another thing, however.

The Service apparently believes that companies will be able to

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[58] Reg. § 1.482–2(a)(5).

[59] Reg. § 1.482–2(a)(2)(iii).

obtain letters from banks concerning reasonable interest rates for purposes of the Section 385 regulations but since many banks in the United States have indicated a lack of enthusiasm for providing such letters, one can only imagine the reception requests for letters from foreign banks will bring.

[c] *Loan to Foreign Subsidiary—Effect of Section 385 Original Issue Discount on Double Taxation and Foreign Tax Credits When Face Value Exceeds Fair Market Value*

If one assumes a typical loan, which is treated as a loan under the Section 385 regulations, made by an American parent to a wholly owned foreign subsidiary at 12 percent, when the "reasonable" rate[60] is considerably higher and the borrower's debt-to-equity ratio exceeds one-to-one,[61] the fair market value of the instrument (all loans discussed below will be presumed to involve written evidence satisfying the "instrument" requirement[62] of the Section 385 regulations unless otherwise stated) is less than face value and additional interest in the form of original issue discount is created.[63] Furthermore, the lender's equity in the foreign subsidiary has been increased by the amount of the original issue discount.[64]

In the United States the lender is taxed on a greater amount of interest than is actually received in the form of stated interest payments as required under Section 482. If the foreign country is not a treaty partner of the United States, the borrower is unlikely to have any opportunity to reduce its taxes by claiming a larger interest deduction and the original issue discount will be taxed twice. The earnings and profits of the borrower will nonetheless be decreased by the amount of the original issue discount. In some cases this will have the beneficial effect of increasing the lender's

[60] Reg. § 1.385–6(e).

[61] See § 32.02[1].

[62] Reg. §§ 1.385–3(c) and 1.385–4(a).

[63] See § 32.02[1].

[64] *Ibid.*

foreign tax credits when the borrower distributes dividends,[65] but in others, foreign tax credits may be lost permanently. This will occur if the additional interest charge to the borrower's earnings and profits eliminates the borrower's earnings for the year,[66] a happenstance which may exist for many taxpayers given their inability to know in advance what interest rate will be considered reasonable.

In those cases where reduced earnings and profits based on original issue discount may produce larger Section 902 foreign tax credits, the benefit may be offset if the Service can successfully contend that foreign taxes paid do not qualify for the credit to the extent they are paid on taxable income which should have been reduced by the original issue discount. In short, the Service might contend that the borrower made a voluntary payment to the foreign government by failing to actually claim, and obtain a deduction for, the interest payment required by U.S. law.[67]

If the Service successfully denied credit under Section 902 for the taxes which relate to the original issue discount, the lender may have a good case for claiming a direct credit, however, to the extent the imputed interest would have been subject to a withholding tax at the borrower's domicile.[68]

If the borrower is a resident of a foreign country which is a treaty partner of the United States, the original issue discount adjustment may give rise to additional problems. Most U.S. income tax treaties contain a so-called "competent authority" procedure which provides for consultations between the Service and the foreign taxing authority to negotiate adjustments to avoid double taxation.[69] If the Service makes an adjustment to the inter-

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[65] The amount of the Section 902 deemed paid foreign tax credit is based on the ratio of dividends paid to earnings and profits so any decrease in the latter (not below zero) while the former remains constant, increases the value of the fraction and therefore the allowable foreign tax credit.

[66] Rev. Rul. 74–550, 1974–2 C.B. 209.

[67] Rev. Rul. 78–83, 1978–1 C.B. 79. See also Temp. Reg. § 4.901–2(f)(5).

[68] Cf. Rev. Rul. 72–371, 1972–2 C.B. 438.

[69] See e.g., Article 25 of the Income Tax Treaty between the United States and

est income of the U.S. lender in the above example, and the transaction is subject to a treaty with a competent authority provision, the borrower is required to seek a reduction in its foreign taxes to reflect the original issue discount and the lender is required to seek competent authority consideration or forfeit the related foreign tax credit.[70]

Calling the issue to the attention of the foreign country involved may be unwarranted for many reasons. First, the cost of seeking, much less obtaining, a refund, may well exceed the tax involved. Second, raising the issue may call the attention of the foreign taxing authority to other tax issues which would not otherwise come under close scrutiny.

In addition, a competent authority request may produce some anomalous results. If the effective direct income tax rate in the foreign country is less than the withholding rate, the foreign government may be only too willing to allow the deduction for additional interest paid. Even apart from competent authority treatment, sophisticated foreign taxing authorities might look for Section 385 imputed interest adjustments to impose withholding taxes on the original issue discount the U.S. Government has created. In the case of treaties which impose a higher withholding tax on interest than on dividends, the competent authority procedure may simply lead to an increase in foreign taxes with a resulting increase in foreign tax credit and net decrease in taxes collected by the United States.

[d] *Constructive Violation of Foreign Exchange Control Laws*

In those foreign countries which require exchange control clearance prior to an equity investment by a foreign entity, the Section 385 rules which create a contribution to capital at the same time as original issue discount may also place the U.S. lender in constructive violation of foreign law.

France, Article XVII of the Income Tax Treaty between the United States and the Federal Republic of Germany, and Article 25 of the Income Tax Treaty between the United States and the United Kingdom.

[70] Rev. Rul. 76–508, 1976–2 C.B. 225.

[e] *Loan to Foreign Subsidiary—Fair Market Value Exceeds Face Value*

While most U.S. corporations making loans to foreign subsidiaries more often than not prefer to set interest rates as low as possible, there are many instances when they prefer to set them as high as possible; e.g., when the subsidiary is located in a country with a tax rate which exceeds the U.S. rate, when the U.S. corporation is in a loss situation and the foreign subsidiary is in a profit position, or when the U.S. parent has excess foreign tax credits which enable it to absorb the interest income without paying additional tax. In such cases, instruments may be issued which have a fair market value in excess of face value. Amortizable bond premium and Section 301 distributions are the result.

The bond premium will tend to dilute the lender's foreign tax credits because of the additional earnings created for the borrower.[71] The borrower can reverse this result by reporting the bond premium for local tax purposes but is unlikely to do so voluntarily. Again, however, sophisticated foreign tax authorities may be looking for such adjustments on audit.

Bond premium will be treated as Subpart F income[72] and may thereby become subject to U.S. income tax. Subpart F treatment of the premium may also be the trigger which causes the taxation of other Subpart F income which would not have been taxed otherwise. This problem is discussed in § 32.03[2][a] with Subchapter C issues since it is more likely to arise in that context.[73]

The deemed distribution which occurs when the fair market value of an instrument exceeds the amount paid for it (typically, this will be the case when fair market value exceeds face value since the amount paid for an instrument by one related party to another will almost always equal face value) may well produce adverse tax results. In most situations, the deemed distribution is

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[71] See N. 62. The opposite result is obtained in this situation.

[72] I.R.C. §§ 952(a)(2), 954(a)(1), 954(c) and 553(a)(1).

[73] See § 32.03[2][a][i].

likely to be treated as dividend. Frequently, the dividend will carry with it sufficient foreign tax credits to offset any incremental U.S. tax but this will certainly not be the invariable result. In some instances, the deemed distribution rule may provide a useful planning tool. For instance, a company with expiring net operating losses might plan a deemed distribution to create income without actually requiring a subsidiary to distribute cash.

One serious drawback to the distribution rule is that tax planning becomes subject to circumstances which may be altered retroactively. For example, a foreign subsidiary is located in a foreign country with a two-tier tax structure; i.e., one where the corporate tax rate is reduced to the extent earnings are distributed currently.[74] Furthermore, it should be assumed that the subsidiary has operated at a loss for local tax purposes for a period of years but has earnings for U.S. tax purposes, and then has a very profitable year in which it both pays substantial local tax and borrows money from its parent. If the subsidiary has paid out all of its current earnings to take advantage of the lower foreign tax rate which is afforded by distribution and the interest rate on its loan from the parent is later determined on audit of the parent to be unreasonably high, the deemed distribution will be attributable to a prior year's earnings in which the subsidiary paid no foreign tax. Consequently, the dividend will be fully taxable in the United States with no foreign tax credits. Had this result been known at the end of the year in which the loan was made, the parent might have reduced the amount of the dividend actually paid to permit the deemed distribution to be attributable to current earnings which would bring a foreign tax credit to the parent.

In this situation, if foreign taxing authorities came to understand the Section 385 regulations, they might attempt to impose a withholding tax on the constructive dividend created under the regulations.

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[74] The Federal Republic of Germany has such a tax system.

[f] *Foreign Brother-Sister Company Loan*

Loans from a U.S. parent to a foreign subsidiary are not the only ones affected by the interest adjustment procedure of the Section 385 regulations. Loans from one foreign subsidiary to another and loans from a foreign parent to a U.S. subsidiary are also affected. In the case of a brother-sister loan which bears an interest rate which is not reasonable, foreign tax credit questions discussed above are likely to be applicable in one form or another. In addition, there may be adverse effects on Subpart F income computations as well as an adverse effect on certain Section 351 transactions; both of these problems are discussed below in § 32.03[2][a] devoted to Subchapter C problems.[75]

[g] *Loan to U.S. Subsidiary—Withholding Tax*

In the case of a U.S. borrower, the principal issue is whether U.S. tax is imposed on the original issue discount. The answer appears to be in the affirmative if the instrument has a maturity in excess of six months, since the regulations indicate that the original issue discount they create is covered by Section 1232[76] and such discount on debt with a greater than six months maturity is subject to withholding at a 30 percent rate[77] if not reduced by a treaty. In addition, if a purported loan is treated as preferred stock, the loan "repayment" will be treated as a dividend subject to U.S. withholding tax.

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[75] The Subpart F issue is discussed at § 32.03[2][a][i]; the Section 351 issue is discussed in the text at § 32.03[2][a][ii].

[76] Reg. § 1.385–2(c)(2).

[77] I.R.C. §§ 871(a)(1)(C), 881(a)(3), 1441 and 1442.

[2] Conversion of Debt to Preferred Stock

[a] *Subchapter C Problems*

[i] *Brother-Sister Company Loan—Dividend Treatment When Loan is Repaid—Subpart F Consequences and Foreign Tax Credit Dilution*

If a loan from one first-tier foreign subsidiary of a U.S. parent to another is treated as preferred stock, repayment of the loan is a redemption subject to the rules of Section 302. Since the Supreme Court has ruled that the attribution rules of Section 318 are applicable to Section 302 redemptions,[78] such a transaction will be treated as a dividend with possible Subpart F and unfavorable foreign tax credit consequences due to treating what the parties considered repayment of a loan as a dividend. For Subpart F purposes, dividend treatment might not only produce taxable income to the parent in the amount of the loan but might cause other untaxed Subpart F income to become taxable by pushing the recipient's Subpart F income over 10 percent of gross income or by causing non-Subpart F income to become taxable by pushing the recipient's Subpart F income over 70 percent of gross income. Under the Subpart F provisions, there is, in effect, a de minimus rule which excuses Subpart F income from taxation if it is less than 10 percent of gross income[79] and there is a penalty rule which treats all gross income as Subpart F income if actual Subpart F income exceeds 70 percent of gross income.[80]

Foreign tax credits are subject to significant dilution because the recipient's earnings and profits are increased by the loan repayment without any increase in foreign tax.[81] Of course, the foreign taxing authorities in both the country of the lender and the borrower might attempt to follow U.S. law with the former imposing its income tax on the dividend and the latter a withholding tax.

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[78] United States v. Davis, 397 U.S. 301 (1970).

[79] I.R.C. § 954(b)(3)(A).

[80] I.R.C. § 954(b)(3)(B).

[81] See § 32.03[1][c].

Depending on the tax rates, the Section 385 regulations could in that case increase the overall tax burden of the related companies with none of the increase accruing to the benefit of the United States.

[ii] *Brother-Sister Company Loan—Section 351*

A second Subchapter C problem involving brother-sister company loans results from the requirements for tax-free treatment under Section 351. If a U.S. parent contributes property to a foreign subsidiary which has borrowed funds from a second foreign subsidiary of the parent in a manner which leads the purported loan to be treated as preferred stock, the contribution to capital transaction will not be tax free because the parent will fail to satisfy the control requirement of Section 351 which requires 80 percent ownership of the voting power of all of the transferee's voting stock together with 80 percent of all other classes of stock.[82]

[iii] *Section 367(a) Transactions*

The Section 385 regulations also present a problem in the Sections 351–367 area with a possible effect on Section 453 installment sales treatment as well. A U.S. corporation sells machinery and equipment to a wholly owned foreign subsidiary and accepts notes in return which do not qualify as trade accounts receivable. It should further be assumed that the sale takes place in the first month of the taxable year, the interest rate is reasonable and the purchaser does not have excessive debt. Due to a reversal of fortunes, the subsidiary becomes unable to pay the interest late in the taxable year and the seller is determined not to have exercised the ordinary diligence of an independent creditor. In this situation the regulations prescribe that the debt is converted to preferred stock as of the first day of the taxable year.[83] Accordingly, what was intended to be a sale is converted to a contribution to capital

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[82] I.R.C. §§ 351(a) and 368(c).

[83] Reg. § 1.385–6(k)(1) and (3).

by a U.S. corporation to a foreign corporation for which the taxpayer did not seek a ruling under Section 367 within the required 183-day period.[84] While the gain recognized is the same in both instances, the transferee obtains only a carryover basis under Section 351[85] rather than a basis equal to cost.[86] Its depreciation deductions are therefore reduced with a resulting increase in earnings and profits and a corresponding reduction in the transferor's foreign tax credits.[87]

If the sale were a qualified installment sale, the taxation of the gain would be accelerated to the year of transfer. Perhaps most significant, all payments required to be made by the transferee would be treated as dividends rather than as purchase price so there would be no recovery of the transferor's basis. Furthermore, while theoretically, the transferor could avoid dividend consequences (assuming it was aware of them prior to payment) by cancelling the transferee's obligation to pay, frequently these issues will not arise until an audit which occurs long after all payments have been received. In such case, there appears to be no mechanism for undoing the transaction to conform it to the structure which the Service has imposed. In other words, the transferor cannot return the "purchase price" and treat the "sale" as a contribution to capital without receipt of a dividend.

[b] *Difficulty in Acting in the Manner of an Independent Creditor*

One of the assumptions made to develop the above problem was the failure of the U.S. parent to exercise the ordinary diligence of an independent creditor. This is not a fanciful assumption. In Europe particularly, directors may be subject to criminal penalties for failure to maintain a corporation's solvency, and concern over reputation of foreign nationals who are affiliated with insolvent corporations frequently precludes a U.S. parent from suing its

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[84] I.R.C. § 367(a).

[85] I.R.C. § 362(a).

[86] I.R.C. § 1012.

[87] See N. 62. The opposite result is obtained in this situation.

debtor subsidiary in situations where independent creditors would be likely to do so.

An anomaly here is that independent creditors are frequently persuaded not to sue in exchange for the parent's guarantee that their claims will be honored. Since the parent cannot guarantee payment to itself, it may be barred from justifying failure to bring suit under the Section 385 regulations yet prevented from bringing suit by overwhelming practical considerations.

Given the fact that trade accounts payable are excluded from coverage by the Section 385 regulations, foreign subsidiaries in financial straits should pay debts owed to a U.S. parent other than trade payables first to avoid converting into preferred stock those debts covered by the regulations. Whether trade payables will be converted to ordinary debt if they remain unpaid for an inordinate length of time (such payables become interest bearing under the Section 482 regulations after six months[88] is not clear. If there is a conversion, there is the further question of whether the debt is treated as exchanged for property or for existing debt.

[c] *Loan to Second-Tier Foreign Subsidiary—Possible Loss of Foreign Tax Credits*

As has been seen above, one of the most significant aspects of the Section 385 regulations is their effect on the earnings and profits calculations of dividend paying subsidiaries which tends to dilute foreign tax credits. In the case of loans to second-tier foreign subsidiaries, these credits can be eliminated entirely. Under Section 902 a U.S. taxpayer is entitled to a deemed paid foreign tax credit with respect to dividends received directly from foreign corporations in which it owns directly a 10 percent or greater voting interest.[89] If a domestic company makes a loan to a second-tier foreign subsidiary in which it owns no voting stock and the loan is treated as preferred stock, the dividends paid to the domestic company in the form of interest will carry no foreign tax

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[88] Reg. § 1.482–2(a)(3).

[89] I.R.C. § 902(a).

credits.[90] Furthermore, the credits which relate to the earnings deemed distributed will be lost permanently because a distribution by the second-tier subsidiary through the first tier can be only of those earnings remaining after subtracting those deemed paid on the preferred stock.

[d] *Conversion of Interest to Dividends—Withholding Tax*

In situations where interest payments are converted to dividends under the Section 385 regulations, the corollary of a problem discussed above arises. If the foreign country involved taxes dividends at a lower rate than interest, the dividend recipient would be entitled to a tax refund if U.S. law were applied. If the refund is not claimed, the taxpayer may jeopardize its foreign tax credit to the extent of the potential refund; yet, if it is claimed, the "borrower" may find its interest deduction in jeopardy.[91] Once again, foreign tax authorities may inquire into loan transactions between corporations within their jurisdiction and corporations within the United States to determine whether interest deductions can be disallowed by following U.S. law. Even if the deduction were not disallowed, foreign authorities might attempt to impose their withholding tax on dividends if it happened to be higher than their withholding tax on interest.

[e] *DISCs*

In the DISC area, conversion of debt to preferred stock would disqualify the DISC due to the one class of stock restriction.[92] Due to this drastic result, the DISC regulations override Section 385 if certain tests are met.[93]

[f] *Worthless Stock Loss*

One unintended benefit of the Service's determination to con-

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[90] Rev. Rul. 74–459, 1974–2 C.B. 207.

[91] See § 32.03[1][c].

[92] I.R.C. § 992(a)(1)(C).

[93] Reg. § 1.992–1(d)(2).

vert certain debts to preferred stock is that worthless stock deductions may become available where they otherwise would not exist. Under pre-existing law, when shareholder debt was treated as equity, the loan was regarded as a contribution to capital; i.e., the shareholder's basis in the common stock owned was increased.[94] As a result, any payment made by an insolvent corporation with respect to the debt was treated as a partial distribution with respect to common stock, thereby precluding an ordinary loss for worthlessness.[95] If however, the debt is converted to preferred stock and there are not sufficient assets to satisfy the preferred's liquidation preference, there is one case, with which the Service does not agree, that justifies a worthless stock loss for the common stock.[96]

[g] *Conversion of Debt to Equity—Recapitalization*

Under the Section 385 regulations, a conversion of debt to preferred stock at some date after the debt is issued is treated as a tax-free recapitalization.[97] Presumably this is not the type of transaction which must be reported to the Service under Section 367(b), especially since the taxpayer may not realize that the exchange has occurred until an audit takes place well after the filing deadline[98] has expired, but no exception has been provided. This is an important point, since the penalty for failing to file may be the conversion of a tax-free transaction into a taxable one.[99]

[3] Problems Based on Dealing in Foreign Currency

In the realm of foreign currency, the regulations present two

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[94] See, e.g., Waterman Steamship Corp. v. United States, 203 F. Supp. 915 (S.D. Ala. 1962).

[95] Such losses are authorized under I.R.C. § 165(g)(3) which requires that stock be totally worthless as a prerequisite to converting what would otherwise be a capital loss to an ordinary loss.

[96] Spaulding Bakeries Inc. v. Comm'r, 27 T.C. 684 (1957), *nonacq.* 1957–2 C.B. 8, *aff'd* 252 F.2d 693 (2d Cir. 1958).

[97] Reg. § 1.385–4(c)(1)(ii).

[98] Reg. § 7.367(b)–1(a) and (c).

[99] Reg. § 7.367(b)–1(b) and (c)(3).

problems. First, they are not clear as to whether foreign currency is to be treated as money or as property. Second, fluctuations in foreign currency exchange rates may result in the elimination of safe havens. If a company maintains its books in the currency of country *A* but has liabilities in the currency of country *B*, an increase in the value of currency *B* against currency *A* could result in the debtor's debt-equity ratio exceeding any of the magic numbers which afford security under the regulations.

§ 32.04 SUMMARY

The Section 385 regulations are particularly troublesome when applied to foreign transactions since they require that debt transactions be constantly monitored by individuals with tax expertise. In addition they are filled with traps and predicaments for the wary as well as the unwary. From a policy standpoint, the bias in favor of converting interest payments and loan repayments to dividends seems unwise, since the effect is likely to be an increase in taxes paid to foreign jurisdictions with little or no corresponding benefit to the U.S. Treasury. When the final regulations applicable to international transactions are issued, the Treasury should keep this point keenly in mind.