THE HARRY POTTER REGULATIONS: THE MAGIC OF THE 385 REGULATIONS AND THE SUCCESSOR AND PREDECESSOR RULES

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I. INTRODUCTION

Prior to my first year of law school, my alma mater received a large private donation to construct a new building. The building's opening corresponded with my matriculation, affording my cohorts the perks of beautiful architecture, a gym, a chapel, and the "Harry Potter Room." As you enter, large windows flank both sides. Adjacent to these are

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towering shelves stocked with legally profound titles. Large chandeliers hang from the ceiling. Like Harry Potter himself, visitors and students would enter the Harry Potter Room with looks of awe.[1] My suspicion is that the room was named after Gringott's Wizarding Bank, the primary fiscal and magical lending institution of J.K. Rowling's epic fictional series.[2]

This vision of Gringott's Wizarding Bank, and the mysterious nature of its magical world, mirrors the Treasury Regulations under section 385 (385 Regulations) released in October 2016.[3] The 385 Regulations are vast and complex. Tax practitioners may stumble upon the literature the same way Harry Potter stumbled upon Gringott's, only to become lost in its maze of rules.[4] The focus of this article is on a narrow area of the 385 Regulations; specifically, the successor and predecessor rules located in Treasury Regulations section 1.385-3.[5] These rules have not been as actively written about as the documentation requirements under the 1.385-2 regulations, and for a good reason. Their complications lead to results unintuitive to the everyday taxpayer. Before addressing the specifics of the successor and predecessor rules, it is critical to first understand how the rules were crafted.

II. BACKGROUND ON THE PROPOSED AND FINAL 385 REGULATIONS

A. *Scope of the 385 Regulations*

On October 13, 2016, the U.S. Department of Treasury (Treasury Department) released the final regulations under Internal Revenue Code section 385.[6] In general, section 385 authorized the Secretary of the Treasury to prescribe rules to determine whether an interest in a corporation is treated as debt or equity.[7] However, this is not the first

1. *See The Dedication of Eckstein Hall*, 94 MARQ. L. REV. 451 (2010) (indicating that one of the more notable visitors to enter the room was the late Supreme Court Justice Antonin Scalia, who provided the dedication of Eckstein Hall, Marquette University's law building, upon its opening in 2010).

2. *See* J.K. ROWLING, HARRY POTTER AND THE SORCERER'S STONE 63 (1997).

3. *See* Treas. Reg. § 1.385 (2016).

4. *See* Treatment of Certain Interests in Corporations as Stock or Indebtedness, Final Rule, 81 Fed. Reg. 72858 (Oct. 21, 2016) (to be codified at 26 C.F.R. pt. 1)[hereinafter Final Rule] (illustrating that in the Federal Register the 385 regulations occupy Volume 81, No. 204 pages 72858 through 72984, which equates to 126 pages of regulations).

5. *See* Treas. Reg. § 1.385-3 (2017) (located within the Debt Recast rules of this section)[hereinafter Debt Recast Rules].

6. *See* Press Release, Fact Sheet: Treasury Issues Final Earnings Stripped Regulations, U.S. Department of the Treasury (Oct. 13, 2016) (indicating that § 385 was originally enacted as part of the Tax Reform Act of 1969. The regulation allowed the Treasury Department to create regulations "to determine whether an interest in a corporation is to be treated as stock or indebtedness."); *see also* Tax Reform Act of 1969, Pub. L. No. 91-172, § 415 (1969).

7. *See* Final Rule, *supra* note 4, at 72861.

time the Treasury Department created 385 Regulations,[8] nor the second.[9] Prior to the 385 Regulations, the Treasury Department had hinted its potential release of 385 Regulations, but instead allowed the courts to determine whether an interest was debt or equity.[10] The test was a fact and circumstances question.[11] The Treasury Department has attempted to remove some of the issues surrounding the facts and circumstances tests by creating 385 Regulations.[12] The 385 Regulations accomplish this by setting forth a number of factual examples.[13] In addition to the examples, the 385 Regulations also lay out other rules.[14] Section 1.385-1 creates general provisions for determining the treatment of an interest based on provisions of the Internal Revenue Code and on common law.[15] Section 1.385-2 created the Documentation Rules.[16] The Documentation Rules impose documentation requirements on certain related party debt instruments as a prerequisite to treating those instruments as debt.[17] Section 1.385-3 created the Debt Recast Rules.[18] These rules have the ability to recast debt to equity, under two different categories: the General Rule[19] and the Funding Rule.[20] Section 1.385-3T(f) provides rules on the treatment of debt instruments issued

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8. *SEE* INTERNAL REVENUE SERVICE, INTERNAL REV. WKLY. BULL. 2016-17, *Notice of Proposed Rulemaking Treatment of Certain Interests in Corporations as Stock or Indebtedness* 636, 638 (April 25, 2016)[hereinafter *Notice*] (stating that on March 24, 1980, the Treasury Department published proposed regulations under section 385, which were eventually revised, finalized, and withdrawn prior to becoming effective and became known as the "1980 Final Regulations").

9. *See id.* (indicating that subsequent revisions to the final 385 Regulations were made on January 5, 1982, and eventually withdrawn on July 6, 1983. These regulations are referred to as the "1982 Proposed Regulations").

10. *See id.* at 639 (illustrating the Treasury Department's withdrawal of 385 regulations in the 1980s, and its hint at releasing earnings stripping regulations); *see also, e.g.*, Notice 2014-52, 2014-42 IRB 712.

11. See Fin Hay Realty Co. v. Comm'r, 398 F.2d 694, 696 (3d Cir. 1968) (identifying the following factors: (i) the intent of the parties; (ii) the identity between creditors and shareholders; (iii) the extent of participation in management by the holder of the instrument; (iv) the ability of the corporation to obtain funds from outside sources; (v) the "thinness" of the capital structure in relation to debt; (vi) the risk involved; (vii) the formal indicia of the arrangement; (viii) the relative position of the obligees as to other creditors regarding the payment of interest and principal; (ix) the voting power of the holder of the instrument; (x) the provision of a fixed rate of interest; (xi) a contingency on the obligation to repay; (xii) the source of the interest payments; (xiii) the presence or absence of a fixed maturity date; (xiv) a provision for redemption by the corporation; (xv) a provision for redemption at the option of the holder; and (xvi) the timing of the advance with reference to the organization of the corporation).

12. *See* Final Rule, *supra* note 4 at 72861.

13. *See* Treas. Reg. § 1.385-3(h)(3).

14. *See* Treas. Reg. §§ 1.385-1 to 1.385-4T.

15. *See generally* Treas. Reg. § 1.385-1.

16. *See generally* Treas. Reg. § 1.385-2.

17. *See id.*

18. *See generally* Debt Recast Rules, supra note 5.

19. *See* Treas. Reg. § 1.385-3(b)(2).

20. *See* Treas. Reg. § 1.385-3(b)(3).

by certain partnerships.[21] Section 1.385-4T provides rules that apply to 1.385-3 and 1.385-3T, but only within a consolidated group context.[22]

Given its sweeping scope, it comes as little surprise that both academics and practitioners have questioned whether the Internal Revenue Service has the authority to promulgate the 385 Regulations.[23] The Treasury Department, for its part, received various comments on the topic and addressed them in the Federal Register.[24] Among the comments were arguments that the Proposed 385 Regulations were an invalid exercise of regulatory authority because the 385 Regulations did not authorize the Treasury Department to write rules on excessive interest deductions.[25] Even if Congress did authorize the Treasury Department to promulgate regulations on interest deductibility, taxpayer-friendly legislation already exists; therefore, it would be inappropriate for the Treasury Department to create less taxpayer-friendly rules.[26] The Treasury Department's response is simple — it believes it has authority to determine whether debt should be treated as equity, and as such, the 385 Regulations are both necessary and appropriate.[27] Interestingly, the focus of most taxpayers has been on the

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21. *See* Treas. Reg. § 1.385-3T(f). The partnership rules are beyond the scope of this article, but are perhaps even more complex and controversial than the 385 Regulations that affect corporations. *See, e.g.*, Letter from AICPA to the Department of Treasury and Internal Revenue Service (July 13, 2016) https://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA-Expresses-Concern-over-IRS-Authority-to-Apply-Section-385-to-Partnership-Debt-7-13-16.pdf.

22. *See* Treas. Reg. § 1.385-4T.

23. *See* Andy Grewal, *The Section 385 Debt-Equity Regulations and The Separation of Powers*, YALE J. ON REG. :NOTICE AND COMMENT(July 29, 2016) http://yalejreg.com/nc/the-section-385-debt-equity-regulations-and-the-separation-of-powers/.

24. *See* Final Rule, *supra* note 4, at 72860.

25. Letter from John Engler, President, Bus. Roundtable, to Jacob Lew, Sec'y, (July 7, 2016) http://businessroundtable.org/resources/brt-comment-letter-treasury-department-proposed-385-regulations (noting that while proposals have been made to limit interest deductibility, Congress has refused to pass any new legislation on the topic. Moreover, to the extent that Congress did allow the Treasury Department to promulgate regulations on interest deductibility, those regulations are limited to section 163(j)).

26. *See, e.g.*, Protecting Americans from Tax Hikes Act, 26 U.S.C. § 954 (2015) (The Path Act) (allowing various tax extender provisions to become permanent, including the subpart F look-through rule under § 954(c)(6). Had Congress wanted to increase the tax liabilities of multinational corporations, it could have refused to make § 954(c)(6) permanent instead of creating a new base erosion provision through section 385).

27. This determination seems biased at worst, or conflicted at best. The Treasury Department received comments from taxpayers about rules that it created and promulgated. It would seem that if the taxpayer raised concerns about the Treasury Department's authority, a different agency, or perhaps a neutral arbiter, would be a better candidate to make this judgment. This issue is not unique to the Treasury Department. For example, In August of 2015, the Environmental Protection Agency released 1,560 pages of regulations, which mandated federal limits on power-plant carbon emissions. This triggered a number of lawsuits against the agency, made by individual states, arguing that the EPA exceeded its authority. Unlike the 385 Regulations, the issue of whether or not the EPA has the authority to regulate power-plant carbon emission was eventually heard by the US Court of Appeals for the District of Columbia Circuit Court. Regardless of the outcome, having an independent judicial system decide if the EPA has authority to regulate the issue makes more sense than the Treasury Department deciding if it has authority to regulate

onerous Documentation Rules set forth in section 1.385-2, not the complexities of the Debt Recast rules in section 1.385-3.[28] This stems from the fact that the documentation requirement would likely create a *prima facie* case of increased responsibilities for both corporate treasury departments and corporate tax departments.[29] In contrast, the Debt Recast Rules only initially appear to increase the burden on corporate tax departments.[30]

It can be argued that the Final 385 Regulations are a significant improvement, and less burdensome, from the Proposed 385 Regulations.[31] One of these improvements allows for large exemptions from the 385 Regulations if the taxpayer's covered debt instrument is below a certain size.[32] Taking into considerations the improvements from the Proposed 385 Regulations to the Final 385 Regulations, the Treasury Department still underestimates the burden these regulations place on the taxpayer.[33]

B. The Documentation Rules: Treasury Regulation § 1.385-2

From a corporate perspective, the Documentation Rules have spurred an immediate concern for tax departments and treasury centers.[34] The Documentation Rules impose documentation requirements on certain related party debt instruments as a

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excessive interest deductions. Whether or not the Tax Court or another court, would be best positioned to decide the issue is open for another article to explore. *See* Carbon Pollution Emission Guidelines for Existing Stationary Sources: Electric Utility Generating Units, 80 Fed. Reg. 64661 (Oct. 23, 2015) (to be codified at 40 C.F.R. pt. 60).

28. *See* Final Rule, *supra* note 4, at 72864 (explaining that the public's comments on the 385 Regulations were not only split into the Documentation Rules and the Recast Rules, but also focused on definitional aspects of the regulations, like "expanded affiliated group" or "modified controlled partnership").

29. *See* Treas. Reg. § 1.385-2(c)(4) – (5).

30. As will be discussed later in this article, this assumption is wrong. Both corporate treasury and tax departments will need to work together to track intercompany transactions that could recast debt to equity, which create distributions between entities that otherwise do not exist for financial or legal purposes, but do exist for tax purposes.

31. *See, e.g.*, Final Rule, *supra* note 4, at 72862, 72869 (summarizing two rules in the proposed regulations, but not included in the final 385 Regulations, that were particularly burdensome to the taxpayers: (1) the Bifurcation Rule that would have allowed the Treasury Department to bifurcate a single debt instrument into both debt and equity and (2) the Foreign Issuer Rule, which would have included foreign issuers, i.e. Controlled Foreign Corporations, that issue debt in the 385 Regulations.)

32. *See* Treas. Reg. § 1.385-3(c)(4) (creating an exception for taxpayers to exclude the first $50 million of indebtedness that otherwise would be re-characterized under the Debt Recast Rules).

33. *See* James J. Tobin, *Proposed 385 Regulations Go Way Too Far*, BLOOMBERG, INT'L TAX (August 16, 2016), https://www.bna.com/proposed-385-regulations-n73014446402/.

34. The Documentation Rules are easier to understand than the Recast Rules. In addition, the Documentation Rules have strict deadlines that require taxpayers to collect and explain intercompany transactions, regardless if any new transactions are undertaken. *See* Treas. Reg. § 1.385-2.

prerequisite to treat those instruments as debt.[35] The requirement is based on four "indebtedness factors," including: (1) the issuer's unconditional obligation to pay a certain sum, (2) the holder's rights as a creditor, (3) the issuer's ability to repay the obligation, and (4) the issuer's and holder's actions evidencing a debtor-creditor relationship, such as payments of interest or principal and actions taken on default.[36] Compliance with this section does not establish that an interest is considered debt, it only serves to satisfy the minimum documentation for the determination to be made under general tax principles.[37] This has the potential to add even more confusion for tax and treasury departments because if the indebtedness factors are not satisfied for tax purposes, the debt may be recast as equity. However, for treasury purposes, the same debt would be considered debt.[38]

C. *The Debt Recast Rules: Treasury Regulations §§ 1.385-3 and 1.385-3T*

In general, Treasury Regulations 1.385-3 and 1.385-3T are, together, known as the "Debt Recast Rules."[39] These rules target debt instruments issued in connection with certain distributions and acquisitions by members of a corporation's expanded group. [40] The Debt Recast Rules operate under two mechanisms: the General Rule[41] and the

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35. *See, e.g.*, Final Rule, *supra* note 4, at 72859 (2016) (summarizing improvements from the taxpayers' perspectives, relating to the Documentation Rules, by comparing the proposed 385 Regulations to the final 385 Regulations. Two of the more pressing improvements were: (1) under the final 385 Regulations, documentation is considered "timely" if it is prepared by the time the issuers U.S. federal income tax return is due. Under the proposed 385 Regulations, corporations were required to prepare documentation contemporaneously with the issuance of debt. (2) The final 385 Regulations apply only to debt instruments issued on or before January 1, 2018, while the proposed 385 Regulations would have applied as of the effective date of the final 385 Regulations).

36. Treas. Reg. § 1.385-2(c)(2).

37. *See* § 1.385-2(a)(2).

38. In addition to complexities related to the Federal Income Tax consequences of the 385 Regulations, there will be unknown consequences for state tax returns. *Compare* Treas. Reg. § 1.385-2 (d)(2)(ii)(A) (exempting intercompany obligations between members of a consolidated group, pursuant to the Documentation Rules) *with* Mike Porter, Michael Paxton, Elil Shunmugavel Arasu, and J. Snowden Rives, *State Conformity to Federal Provisions: Exploring the Variances,* STATE TAX NOTES 145 (July 10, 2017) (explaining that states that do not fully conform to the consolidated return rules require that income be calculated as though a consolidated return was never filed. The effect is that states may apply the 385 Regulations to distributions between members of the same consolidated group that would otherwise be exempt from a Federal U.S. Income Tax perspective).

39. *See* Deloitte, *Final/Temporary Regulations Address Treatment of Certain Interests in Corporations as Stock or Indebtedness*, U.S. TAX ALERT 1, 4 (October 14, 2016), https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-united-states-14-october-2016.pdf.

40. *See* Treas. Reg. § 1.385-3(c)(3)(i)(C) (limiting distributions as to "Expanded Group Earnings," which are defined as earnings accumulated after April 4, 2016, and while the entity was a member of the same expanded group).

41. § 1.385-3(b)(2).

Funding Rule.[42] The General Rule applies if a domestic corporation distributes a debt instrument, or issues a debt instrument as consideration to acquire expanded group stock, or issues a debt instrument to an expanded group member as boot in an asset reorganization. [43] The Funding Rule re-characterizes certain debt as equity if a domestic corporation: distributes property,[44] acquires expanded group stock for property, [45] issues boot to an expanded group member in an asset reorganization, [46] or if the domestic corporation has issued the debt instrument within a 36-month period before or after one of the foregoing transactions or the debt was otherwise issued with a principal purpose of funding one of the foregoing transactions. [47] If, for some reason, both the General Rule and Funding Rule apply to the same transaction, a Coordination Rule allows only the General Rule to apply. [48] The focus of this article is on the successor and predecessor rules located within the Funding Rule.

III. UNDERSTANDING THE GENERAL RULE AND THE FUNDING RULE

A. *The Statutes*

The Funding Rule is a backstop to the General Rule.[49] That is, the Funding Rule is designed to treat debt instruments as equity in circumstances where taxpayers are attempting to circumvent the General Rule by having other expanded group members execute transactions.[50] Thus, to understand the Funding Rule, one must first start with the General Rule.

The General Rule states:[51]

> General Rule. Except as otherwise provided in paragraphs (c) and (e) of this section, a covered debt instrument is treated as stock to the extent the covered debt instrument is issued by a covered member to a member of the covered member's expanded group in one or more of the following transactions: 1) in a distribution; 2) in exchange for expanded group stock, other than in an exempt exchange; or 3) in exchange for property in an asset reorganization, but only to the extent that, pursuant to the plan of reorganization, a shareholder in the transferor corporation that is

42. § 1.385-3(b)(3).
43. *See* § 1.385-3(b)(2).
44. *See* § 1.385-3(b)(3)(i)(A).
45. *See* § 1.385-3(b)(3)(i)(B).
46. *See* Treas. Reg. § 1.385-3(b)(3)(i)(C).
47. *See* § 1.385-3(b)(3)(iii)(A).
48. *See* § 1.385-3(b)(5).
49. *See* Final Rule, *supra* note 4, at 72889.
50. *See id.*
51. Treas. Reg. § 1.385-3(b)(2).

> a member of the issuer's expanded group immediately before the reorganization receives the covered debt instrument with respect to its stock in the transferor corporation.

The Funding Rule states:[52]

> In general. Except as otherwise provided in paragraphs (c) and (e) of this section, a covered debt instrument that is not a qualified short-term debt instrument (as defined in paragraph (b)(3)(vii) of this section) is treated as stock to the extent that it is both issued by a covered member to a member of the covered member's expanded group in exchange for property and, pursuant to paragraph (b)(3)(iii) or (b)(3)(iv) of this section, treated as funding a distribution or acquisition described in one or more paragraphs (b)(3)(i)(A) through (C) of this section. A covered member that makes a distribution or acquisition described in paragraphs (b)(3)(i)(A) through (C) is referred to as a "funded member," regardless of when it issues a covered debt instrument in exchange for property.

The sub-paragraphs of Funding Rule state:[53]

> (A) A distribution of property by the funded member to a member of the funded member's expanded group, other than in an exempt distribution; (B) An acquisition of expanded group stock, other than an exempt exchange, by the funded member from a member of the funded member's expanded group in exchange of property other than expanded group stock; or (C) An acquisition of property by the funded member in an asset reorganization but only to the extent that, pursuant to the plan of reorganization, a shareholder in the transferor corporation that is a member of the funded member's expanded group immediately before the reorganization receives other property or money within the meaning of section 356 with respect to its stock in the transferor corporation.

B. The General Rule

To understand how the Funding Rule works, first examine how the mechanics of the General Rule operate through Treasury Regulation 1.385-3(h)(3).

Example 1 assumed facts state:[54]

> i) FP is a foreign corporation that owns 100% of the stock of USS1, a covered member, 100% of the stock of USS2, a covered member, and 100% of the stock of FS, a foreign corporation; ii) USS1 owns 100% of the stock of DS, a covered member, and CFC, which is a

52. § 1.385-3(b)(3)(i).
53. § 1.385-3(b)(3)(i)(A)-(C).
54. § 1.385-3(h)(1).

> controlled foreign corporation within the meaning of section 957; iii) At the beginning of Year 1, FP is the common parent of an expanded group comprised solely of FP, USS1, USS2, FS, DS, and CFC (the FP expanded group); iv) The FP expanded group has more than $50 million of covered debt instruments described in paragraph (c)(4) of this section at all times; v) No issuer of a covered debt instrument has a positive expanded group earnings account within the meaning of paragraph (c)(3)(i)(B) of this section or has received qualified contributions within the meaning of (c)(3)(ii) of this section; vi) All notes are covered debt instruments (as defined in (g)(3)) and are not qualified short-term debt instruments (as defined by (b)(3)(vii)); vii) Each entity has its taxable year as the calendar year; viii) PRS is a partnership for federal income tax purposes; ix) No corporation is a member of a consolidated group; x) No domestic corporation is a United States real property holding corporation within the meaning of section 897(c)(2); xi) Each note is issued with adequate stated interest (as defined in section 1274(c)(2)); and xii) Each transaction occurs after January 19, 2017.

Facts specific to Example 1 state: [55]

> On Date A in Year 1, FS lends $100x to USS1 in exchange for USS1 Note A. On Date B in Year 2, USS1 issues USS1 Note B, which has a value of $100x, to FP in a distribution.

The analysis of the Treasury Department states:[56]

> USS1 Note B is a covered debt instrument[57] that is issued by USS1[58] to FP, a member of the expanded group[59] of which USS1 is a member, in a distribution. Accordingly, USS1 Note B is treated as stock under paragraph (b)(2)(i)[60] of this section. Under

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55. § 1.385-3(h)(3), Example 1.

56. *Id.*

57. *See* Treas. Reg. § 1.385-3(g)(3)(i) (defining "covered debt instrument" as "a debt instrument issued after April 4, 2016 that is not a qualified dealer debt instrument (as defined in paragraph (g)(3)(ii) of this section) or an excluded statutory or regulatory debt instrument (as defined in paragraph (g)(3)(iii) of this section), and that is issued by a covered member that is not an excepted regulated financial company (as defined in paragraph (g)(3)(iv) of this section) or a regulated insurance company (as defined in paragraph (g)(3)(v) of this section").

58. *See* § 1.385-1(c)(2) (defining a "covered member" as a "member of an expanded group that is a domestic corporation").

59. *See* § 1.385-1(c)(4)(i). (defining "expanded group" as one or more chains of corporations (other than corporations described in section 1504(b)(8)) connected through stock ownership with a common parent corporation not described in section 1504(b)(6) or (b)(8) (an expanded group parent), but only if Treas. Reg. § 1.385-1(c)(4)(i)(A)-(B) apply).

60. *See* § 1.385-3(b)(2)(i) (treating covered debt instrument as stock, under the General Rule, to the extent the covered debt instrument is issued by a covered member to a member of the covered member's expanded group in a distribution).

paragraph (d)(1)(i)[61] of this section, USS1 Note B is treated as stock when it is issued by USS1 to FP on Date B in Year 2. Accordingly, USS1 is treated as distributing USS1 stock to its shareholder FP in a distribution that is subject to section 305. Under paragraph (b)(5)[62] of this section, because the distribution of USS1 Note B is described in paragraph (b)(2)(i)[63] of this section, the distribution of USS1 Note B is not treated as a distribution of property described in paragraph (b)(3)(i)(A)[64] of this section. Accordingly, USS1 Note A is not treated as funding the distribution of USS1 Note B for purposes of paragraph (b)(3)(i)(A) of this section.

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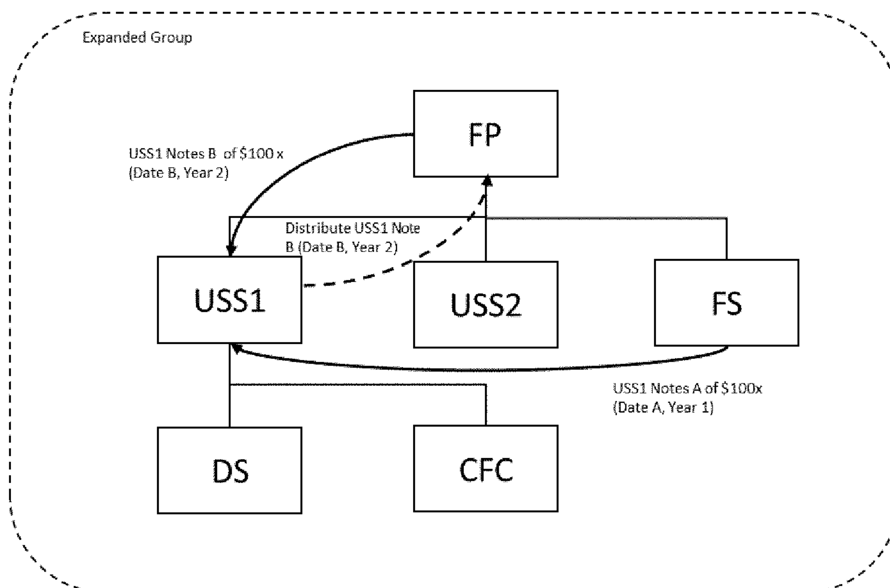
61. *See* § 1.385-3(d)(1)(i) ("Except as otherwise provided in this paragraph (d)(1), when paragraph (b) of this section applies to treat a covered debt instrument as stock, the covered debt instrument is treated as stock when the covered debt instrument is issued.").

62. It is worth noting that this Coordination Rule ensures that the same transaction does not fall within both the General Rule and Funding Rule. Instead, if both rules apply then the transaction is classified under the General Rule. *See* § 1.385-3(b)(5) (stating that "for purposes of this section, a distribution or acquisition described in paragraph (b)(2) of this section is not also described in paragraph (b)(3)(i) of this section.").

63. *See* Treas. Reg. § 1.385-3(b)(2)(i) (stating, under the General Rule, that "a covered debt instrument is treated as stock to the extent the covered debt instrument is issued by a covered member to a member of the covered member's expanded group. . . in a distribution.").

64. *Compare* § 1.385-3(b)(3)(i). (noting, under the Funding Rule, that "except as otherwise provided in paragraphs (c) and (e) of this section, a covered debt instrument that is not a qualified short-term debt instrument (as defined in paragraph (b)(3)(vii) of this section) is treated as stock to the extent that it is both issued by a covered member to a member of the covered member's expanded group in exchange for property and, pursuant to paragraph (b)(3)(iii) or (b)(3)(iv) of this section, treated as funding a distribution or acquisition described in one or more paragraphs (b)(3)(i)(A) through (C) of this section. A covered member that makes a distribution or acquisition described in paragraphs (b)(3)(i)(A) through (C) is referred to as a 'funded member,' regardless of when it issues a covered debt instrument in exchange for property") *with* § 1.385-3(b)(3)(i)(A) ("A distribution of property by the funded member to a member of the funded member's expanded group, other than in an exempt distribution.").

TREASURY REGULATION 1.385-3(h)(3) EXAMPLE #1



The logic behind 1.385-3(h)(3) Example #1 is straightforward. Ignore the first note (Note A that was issued by FS to USS1), and focus on Note B. In essence, the Treasury Department is concerned that USS1 is issuing debt at the US level, and absent the 385 Regulations, USS1 would be able to take a deduction for the interest payment made to its parent (FP).[65] From the Treasury Department's perspective, this appears to be a clear example of stripping away the US tax base by allowing USS1 to take interest deductions, while simultaneously allowing FP to report interest income from USS1.[66] Furthermore, from the Treasury Department's perspective, if FP is in a low tax jurisdiction, then recasting the debt as equity under the 385 Regulations prevents the taxpayer from shifting its income to low tax destinations and its expenses to high tax jurisdictions.[67]

C. *The Funding Rule*

The purpose of the Funding Rule is to prevent companies from issuing intercompany loans that would otherwise be targeted by the General Rule, but circumvent the General Rule by issuing the debt through another "funded member" of the domestic corporation's

65. *See* Final Rule, *supra* note 4, at 72941.
66. *See* Final Rule, *supra* note 4, at 72941.
67. *See* Final Rule, *supra* note 4, at 72941.

expanded group.[68] Example #4 in the 385 Regulations demonstrates the mechanics of the Funding Rule. [69]

Facts specific to Example #4 are as follows:[70]

> On Date A in Year 1, FP lends $200x to DS in exchange for DS Note A. On Date B in Year 1, DS distributes $400x of cash to USS1 in a distribution.

The Treasury Department's analysis is the following:[71]

> Under paragraph (b)(3)(iii)(A)[72] of this section, DS Note A is treated as funding the distribution by DS to USS1 because DS Note A is issued to a member of the FP expanded group[73] during the per se period[74] with respect to DS's distribution to USS1. Accordingly, under paragraphs (b)(3)(i)(A)[75] and (d)(1)(ii)[76] of this section, DS Note A is treated as stock on Date B in Year 1.

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68. *See* Final Rule, *supra* note 4, at 72859.

69. *Compare* Treas. Reg. § 1.385-3(h)(3) Example 1, *with* § 1.385-3(h)(3) Example 4 (illustrating unique transaction facts are unique to, but identical background facts, i.e. ownership structure).

70. Treas. Reg. § 1.385-3(h)(3) Example 4.

71. *Id.*

72. Treas. Reg. § 1.385-3(b)(3)(iii)(A) (applying the Per Se Funding Rule when "a covered debt instrument is treated as funding a distribution or acquisition described in paragraphs (b)(3)(i)(A) through (C) of this section if the covered debt instrument is issued by a funded member during the period beginning 36 months before the date of the distribution or acquisition, and ending 36 months after the date of the distribution or acquisition.").

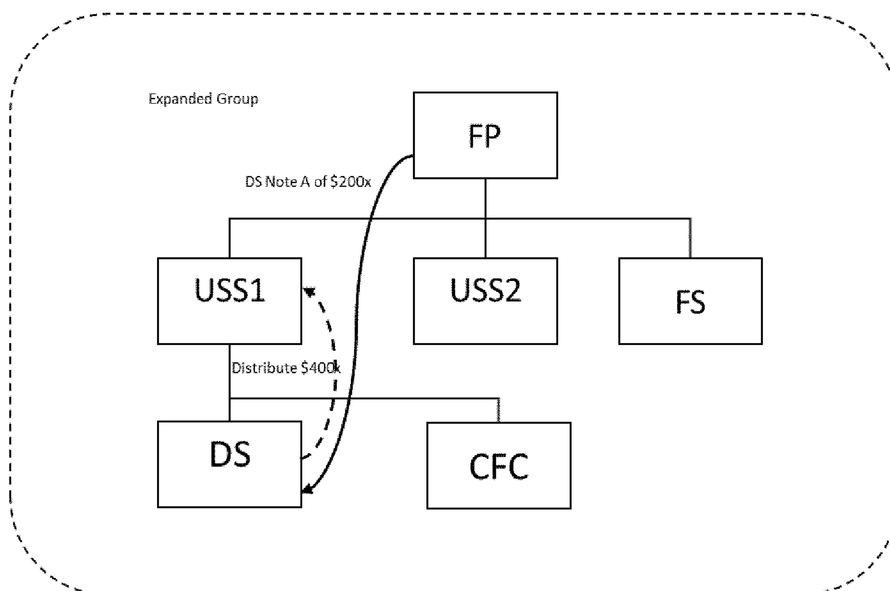
73. *See* Treas. Reg. § 1.385-1(c)(4)(i). The term expanded group means one or more chains of corporations (other than corporations described in section 1504(b)(8)) connected through stock ownership with a common parent corporation not described in section 1504(b)(6) or (b)(8) (an expanded group parent), but only if Treas. Reg. § 1.385-1(c)(4)(i)(A)-(B) applies.

74. *See* § 1.385-3(b)(3)(iii) (applying the 36-month, per se period because both Note A and Note B were issued in Year 1).

75. § 1.385-3(b)(3)(i)("A covered member that makes a distribution or acquisition described in paragraphs (b)(3)(i)(A) through (C) is referred to as a 'funded member,' regardless of when it issues a covered debt instrument in exchange for property."). *See* § 1.385-3(b)(3)(i)(A) (including "a distribution of property by the funded member to a member of the funded member's expanded group, other than in an exempt distribution.")

76. § 1.385-3(d)(1)(ii) (explaining the timing of when Note A is treated as stock. In general (d)(1)(i) would apply to the transaction and state that Note A is treated as stock on Date A. However, (d)(1)(ii) is an exception, stating, "Exception when a covered debt instrument is treated as funding a distribution or acquisition that occurs after the issuance of the covered debt instrument. When paragraph (b)(3)(iii) of this section applies to treat a covered debt instrument as funding a distribution or acquisition described in (b)(3)(i)(A) through (C) of this section that occurs after the covered debt instrument is issued, the covered debt instrument is deemed to be exchanged for stock on the date that the distribution or acquisition occurs.").

TREASURY REGULATION 1.385-3(h)(3) EXAMPLE #4



The overall goal of the Funding Rule is the same as the General Rule.[77] The Treasury Department is attempting to prevent debt from being added to a US entity without a commensurate increase in the amount of capital invested in the US entity's operations.[78] By creating "funded members," the Funding Rule is able to achieve this.

After the 385 Proposed Regulations were published, the Treasury Department solicited comments.[79] One of the comments addressed the exact situation that was highlighted in Example #4.[80] The taxpayer's argument stated that the Funding Rule should only address circular transactions that are economically equivalent to the General Rule by requiring the lender to be the recipient of the proceeds of the distribution or acquisition.[81] The Treasury Department rejected this concern and noted that in addition to the lack of capital increase as being a main driver for including the Funding Rule, there is insufficient non-tax significance between commonly controlled corporations.[82] As such, the proceeds of the distribution could be transferred to other entities in

77. *See* § 1.385-3(h)(3) (identifying the Funding Rule's similarity to the General Rule in its attempt to prevent U.S. entities from adding debt without adding an equal amount of capital).

78. *Accord* 26 U.S.C. § 163(j)(2015)(preventing attempts of corporate taxpayers from eroding their tax base through interest deductions).

79. *See generally* Final Rule, *supra* note 4.

80. *See* Final Rule, *supra* note 4, at 72892.

81. *See* Final Rule, *supra* note 4, at 72892.

82. *See* Final Rule, *supra* note 4, at 72892.

the expanded group.[83] In short, the Treasury Department declined to adopt the taxpayer's advice of removing the Funding Rule.[84] The result is that once a foreign entity loans a domestic entity money (within the expanded group) and that domestic entity makes a distribution, the original loan will be recast as equity.

It is not difficult to see why the Treasury Department was reluctant to remove the Funding Rule in lieu of only the General Rule. Money is fungible. Without a Funding Rule, it would be too easy to add one more step to a transaction, and avoid the General Rule. Example #4 (referenced above) proves this point when FP loaned DS money and then DS distributed money to USS1. Without a Funding Rule, this transaction is not covered by the General Rule and thus a US entity would increase its debt without any proportional increase in capital. With a Funding Rule, however, because FP loaned money to DS and then DS distributed money to USS1, the original loan is still recast as equity even though the distribution was made from DS to USS1 and back to FP.

IV. SUCCESSOR AND PREDECESSOR RULES

A. *Purpose, Consequence, and Costs of the Successor and Predecessor Rule*

The 385 Regulations extend the Funding Rule to include predecessors and successors.[85] The purpose of the successor and predecessor rules appears to prevent taxpayers from tainting one entity with a covered debt instrument, and thereafter removing the taint of the covered debt instrument by merging that entity into another entity, or perhaps even liquidating the entity entirely.[86] The problem with the successor and predecessor rules is that they apply in the reverse situation as well. Assume the following: USS1 makes a distribution of $10x to an expanded group member in year 1. USS2, also an expanded group member that is not consolidated with USS1, borrows $10x from an expanded group member in year 2. In year 3, USS1 merges into USS2 in an asset reorganization.[87] Under these facts, it does not appear the taxpayer is attempting to dissolve the entity that was subject to the covered debt instrument initially (USS2). However, because USS1 made

83. *See* Final Rule, *supra* note 4, at 72892.

84. *See* Final Rule, *supra* note 4, at 72892.

85. *See* Treas. Reg. § 1.385-3(g)(20) & (24) (defining successor and predecessor are terms of art).

86. § 1.385-3(h)(3), Example 9.

87. *Accord* Final Rule, *supra* note 4, at 72896 (providing the same example, except instead of the merger occurring in year 3, the merger occurred in year 10, and therefore fell outside the per se 72-month funding rule. In the modified example above, the merger occurred within the 72-month per se funding rule).

a distribution and then subsequently merged into USS2, the original debt instrument is recast to equity.

The result above is even more burdensome once the taxpayer layers in the per-se Funding Rule, which states that:

> A covered debt instrument that is otherwise issued by a funded member within the per se period of a distribution or acquisition made by a predecessor or successor is not treated as issued during the per se period with respect to the distribution or acquisition unless both: i) the covered debt instrument is issued by the funded member during the period beginning 36 months before the date of the transaction in which the predecessor or successor becomes the predecessor or successor and ending 36 months after the date of the transaction and, ii) the distribution or acquisition is made by the predecessor or successor during the same 72-month period.[88]

From a cost perspective, this is a substantial burden to place on the taxpayer. Nonetheless, it is the Treasury Department's position that the benefits of the 385 Regulations for tax revenues outweigh the costs.[89] I disagree with the Treasury Department's position. The per-se funding rule will require corporate tax departments to expend considerable resources tracking: distributions, which entities are considered predecessors and successors on both a historical basis and on a looking-forward basis, which entities are considered part of the same expanded group, and inter-company loans.[90]

B. *Magical Outcomes*

As alluded to at the beginning of this article, the 385 Regulations can provide for some *magical* outcomes for the unprepared corporate tax department. Two examples highlight these outcomes. First, Example #9 as set forth in the regulations.[91] Second, the application of the successor and predecessor rules when subsidiaries of tainted entities, not tainted entities themselves, undergo transactions that fall within the rules.[92]

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88. Final Rule, *supra* note 4, at 72896.

89. *See* Final Rule, *supra* note 4, at 72862 (estimating the average cost to taxpayers, on an ongoing basis, as approximately $8,900 per year, and that revenue generated from the regulations would reduce tax avoidance by 6 to 7 times).

90. *See* Letter from John Engler, *supra* note 25 (estimating the total number of employee hours to sustain policies and procedures of section 385 is estimated at 9,660, or about 4.8 full-time employees and the total annual cost to sustain the policies and procedures of section 385 is estimated at $1,245,000, which does not include an estimate of more than $3,000,000 in start-up costs).

91. *See* Treas. Reg. § 1.385-3(h)(3), Example 9.

92. *See* § 1.385-3(g)(24)(ii) (creating a subsidiary stock exception, under the final 385 Regulations, so that taxpayers electing the Final 385 Regulations would not need to worry about subsidiary entities becoming predecessors or successors upon engaging in reorganizations.

C. *Treasury Regulation 1.385-3(b)(3)(h) Example #9*

The background facts are consistent with the background facts stated in Example #1.[93]

Facts specific to Example #9 state:[94]

> On Date A in Year 1, FP lends $200x to USS2 in exchange for USS2 Note. In a transaction that is treated as independent from the transaction on Date A in Year 1, on Date B in Year 2, USS2 transfers a portion of its assets to DS2, a newly formed domestic corporation, in exchange for all of the stock of DS2 and DS2 Note. Immediately afterwards, USS2 distributes all of the DS2 stock and DS2 Note to FP with respect to FP's USS2 stock in a transaction that qualifies under section 355. USS2's transfer of a portion of its assets to DS2 qualifies as a reorganization described in section 368(a)(1)(D). The DS2 stock has a value of $150x and DS2 Note has a value of $50x. The DS2 stock is not nonqualified preferred stock as defined in section 351(g)(2). Absent the application of this section, DS2 Note would be treated by FP as other property within the meaning of section 356. Furthermore, on Date C in Year 3, DS2 distributes $200x of cash to FP and, subsequently, on Date D in Year 3, USS2 distributes $100x of cash to FP.

The Treasury Department's analysis states:[95]

> USS2 is a predecessor of DS2 under paragraph (g)(20)(i)(B) and DS2 is a successor to USS2 under paragraph (g)(24)(i)(B) of this section because USS2 is distributing the corporation and DS2 is the controlled corporation in a distribution to which section 355 applies. Accordingly, under paragraph (b)(3)(v) of this section, a distribution by DS2 is treated as a distribution by USS2. Under paragraphs (b)(3)(iii)(A) and (b)(3)(v)(B) of this section, USS2 Note is treated as funding the distribution by DS2 to FP because USS2 Note was issued during the per se period with respect to DS2's $200x cash distribution, and because both the issuance of USS2 Note and the distribution by DS2 occur during the per se period with respect to the section 355 distribution. Accordingly, under paragraphs (b)(3)(i)(A) and (d)(1)(ii) of this section, USS2 Note is treated as stock beginning on Date C in Year 3. Because the entire amount of USS2 Note is treated as funding DS2's $200x distribution to FP, under paragraph (b)(3)(c)(iii)(C) of this section, USS2 Note is not treated as funding the subsequent distribution by USS2 on Date D in Year 3.

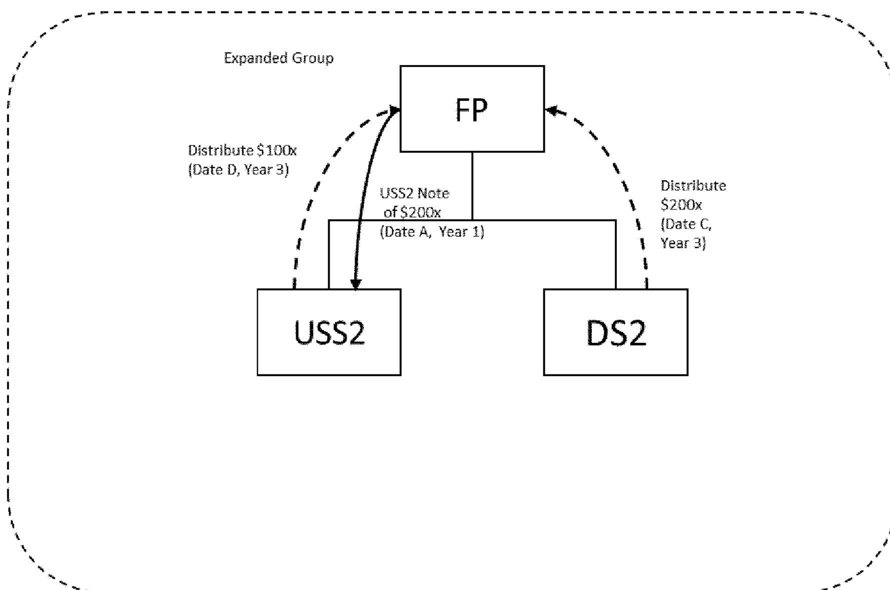
However, taxpayers are eligible to elect into the Proposed 385 Regulations, and if this were to occur, those taxpayers would be not be eligible for the subsidiary carve out exception located in this section).

93. *Accord* § 1.385-3(h)(1)(i)-(xii).

94. Treas. Reg. § 1.385-3(h)(3), Example 9.

95. *Id.*

TREASURY REGULATION 1.385-3(h)(3) EXAMPLE #9



The successor and predecessor rules, as applied in the Treasury Department's analysis above, place a substantial burden on the taxpayer to properly identify: predecessor and successor entities, all members that are considered expanded group members, all transactions within a 72-month time period, and all potential recast transactions.[96] While creating burdensome regulations is not a new phenomenon of the Treasury Department, creating regulations that fundamentally change both the nature of the transaction (debt to equity), as well as the actual entities that engage in the transaction (see above where the distribution by DS2 is treated as made by USS2), is unprecedented.[97] The combination of these two changes could cause results that non-tax experts in the corporate treasury or finance departments find no less magical than when Harry Potter wandered into Gringott's Wizarding Bank.[98]

To further highlight the power of the successor and predecessor rules, consider if the taxpayer had performed its due diligence on the 385 Regulations and had prepared for the possibility that DS2's loan may be recast as equity. Moreover, assume that the taxpayer ensured that DS2 has sufficient earnings and profits and basis. Under this level of preparation, it is reasonable to believe that taxpayers would have prepared earnings and profits studies and basis studies on DS2. As such,

96. *See id.*

97. *See id.*

98. *See* Rowling, *supra* note 2, at 74.

the taxpayer could sufficiently predict the tax consequences to FP's taxable income.[99] However, had the taxpayer not properly foreseen that the IRS would recast the debt to equity and reassign the equity distribution to USS2, USS2 may have zero earnings and profits and zero basis, and therefore could trigger a substantial and unplanned capital gain at FP's level. Furthermore, this analysis could be applied in any 36-month window from the date of the distribution. Thus, multiple years may pass between corporate restructurings, and when a successor entity makes a distribution, it will be attributed to a different predecessor entity. From a risk perspective, corporate treasury departments may need to hedge against this possibility. From a corporate tax accounting perspective, not only will reserves need to be created for the risk associated with debt recasts, but substantial foreign currency issues could arise too.[100] How corporate internal controls will address the risk is an open question.[101]

D. More Magic: The Successor and Predecessor Rules Under the Proposed 385 Regulations

In the event the taxpayer elects the Proposed 385 Regulations, the successor and predecessor rules provide for even larger traps for the taxpayers. Take for example, transactions involving subsidiaries.[102] Assume a Foreign Parent (FP) owns 100% of two corporations that are brother-sister entities. One of these subsidiaries is a US company (US Co) and the other is a foreign company (Foreign Co). US Co owns 100% of two CFC1 and CFC2, which are also brother-sister entities. CFC2 owns 100% of CFC3. In year one, Foreign Co lends US Co $200x in exchange for US Co Note. Later in Year 1, CFC1 acquires CFC3 from CFC2 in exchange for cash. In Year 5, CFC1 liquidates.

The analysis under the Proposed 385 Regulations is the following: the loan made from US Co to Foreign Co., and then the purchase of CFC3 by CFC1 from CFC2, all occurred during the 36-month per se period. As a result, the US Note is recast from debt to equity. This is because US Co. is considered a funded member and CFC1 is a predecessor of US Co.

99. *See* 26 I.R.C. § 301 (2014) (considering a distribution as a dividend to the extent the payer has sufficient earnings and profits).

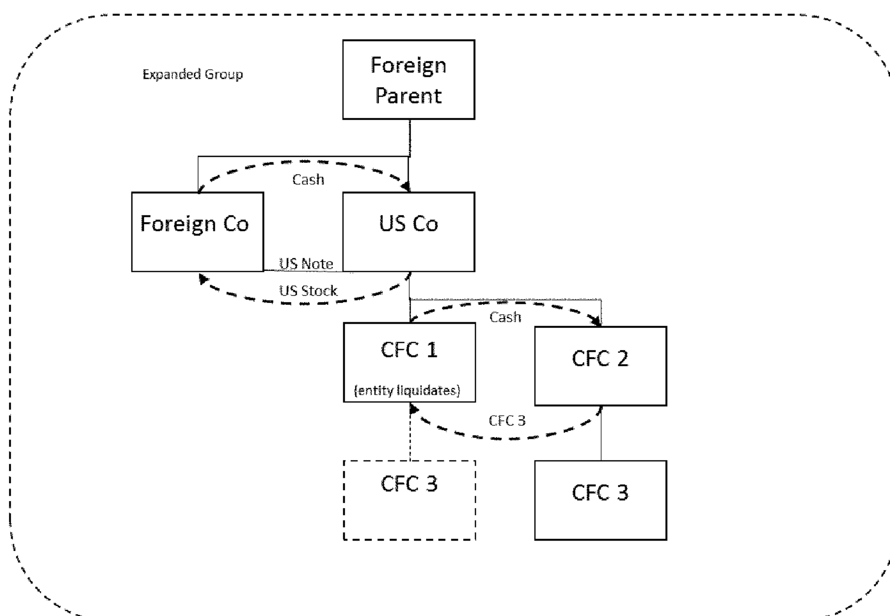
100. *See* Jennifer Spang & Kassie Bauman, *Financial Statement Implications of IRC Section 385*, PWC 2 (Nov. 3, 2016) https://www.pwc.com/us/en/cfodirect/assets/pdf/in-depth/section-385-accounting-intercompany-debt.pdf (noting that significant client risk could be present in ASC 830-20-35-3(b), relating to foreign currencies).

101. *See id.* (stating that companies will need to develop processes and controls to ensure that their accounting for the tax and foreign currency consequences of intercompany loans reflects the impact of the new regulations).

102. *See* Treas. Reg. § 1.385-3(c)(2) (creating a specific exception for subsidiary stock acquisitions, which did not exist under the Proposed 385 Regulations).

CFC1 has acquired expanded group stock,[103] which generally triggers the Funding Rule. Similar to the Treasury Department's Example #9 described above, this provides for an unprecedented result. That is, a transaction that does not involve either Foreign Co or US Co, but instead involves only the subsidiaries of US Co, has the ability to recast a US loan made to a foreign entity. The logic behind the Treasury Department's rule appears to be that money is fungible. And even though loans from US entities to foreign entities do not appear to run afoul of the 385 Regulations, if a foreign subsidiary of an US Co engages in any transaction that triggers the Funding Rule, the US Co will immediately need to recast any debt as equity.

SUCESSOR AND PREDECESSOR RULES UNDER THE PROPOSED 385 REGULATIONS: SUBSIDIARY STOCK EXAMPLE



In addition to the concerns of treasury and finance departments who may not be fully aware of the scope of the 385 Regulations, there are also open questions about how debt, which is recast as equity, should be treated for other parts of the Internal Revenue Code. For

103. *See* § 1.385(b)(3). The purchase of CFC3 by CFC1 qualifies as a section 304 transaction. The tax fiction behind section 304 is that CFC2 is deemed to have made a section 351 contribution of CFC3 to CFC1, in exchange for CFC1 stock. CFC1 then redeems that stock by way of a distribution from CFC1 to CFC2. The distribution is considered a dividend to the extent that CFC1 has accumulated earnings and profits and then to the extent that CFC3 has accumulated earnings and profits. To the extent that earnings and profits are exhausted at both entities, the distribution is considered a return of capital and then capital gain. While the section 304 transaction may be considered a distribution from CFC1, the loan cash moving from CFC1 to CFC2 triggers the Funding Rule first.

example, typically when one entity makes an equity contribution to another entity, any cash that US persons or corporations have access to outside the US may need to be reported under the Foreign Account Tax Compliance Act (FATCA) rules.[104] It is also possible that this equity contribution would create deemed bank accounts in foreign jurisdictions that would require persons or corporations with bank balances, or signature authority over such equity, to report those amounts on Foreign Bank Account Reportings (FBARs).[105] In short, the full power of recasting debt to equity between companies that otherwise did not engage in any transaction that would be considered equity for finance purposes, is unknown. Only after years of audits and appeals will taxpayers understand the far-reaching consequences of the 385 Regulations.

V. RECOMMENDATIONS

A. *Follow the Treasury Department's Prior Practice and Withdraw the 385 Regulations*

As noted earlier in this article, the Treasury Department has a history of passing 385 Regulations, and subsequently withdrawing them.[106] The Treasury Department should follow its own precedent and withdraw both the Proposed 385 Regulations and the Final 385 Regulations. A withdrawal of only the Final 385 Regulations would create substantial disparities between taxpayers that elected to apply the Proposed 385 Regulations and not the Final 385 Regulations. A withdrawal of both sets of regulations would eliminate this disparity.

B. *Allow BEPS and Section 163(j) to Focus on Base Erosion*

The Internal Revenue Service already has tools at its disposal to prevent taxpayers from eroding their tax base.[107] Moreover, there is considerably less debate about whether the Treasury Department has

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104. *See generally* 26 U.S.C. §§ 1471 – 1474; *see also* Tara Ferris, *Revised Timeline and Other Guidance Regarding the Implementation of FATCA*, Notice 2013-43, INTERNAL REVENUE SERVICE (last visited Nov. 28 2017) https://www.irs.gov/pub/irs-drop/n-13-43.pdf. (explaining that law requires all foreign financial institutions to enter into disclosure compliance agreements with the U.S. Treasury Department, and all nonfinancial foreign entities, that are not excepted under the regulations, must report or certify their ownership or be subject to the same 30 percent withholding).

105. *See* Foreign Bank Account Reporting, 75 Fed. Reg. 8844, 8845 (Feb. 26, 2010) (to be codified at 31 C.F.R. 103.24) (requiring U.S. persons and corporations with a financial interest or signature authority over foreign financial accounts with an aggregate balance that exceeds $10,000 or more at any time during a calendar year to file a Finance Crimes Enforcement Network (FinCEN) Report. FinCEN is a separate organization within the Department of Treasury and is in charge of collecting FBAR filings).

106. *See Notice, supra* note 8, at 638

107. *See*, e.g., 26 I.R.C. § 163(j).

the authority to promulgate regulations under section 163(j).[108] In addition to the current tools provided in section 163(j), the Treasury Department will rely on future tools to prevent base erosion, specifically, Base Erosion Profit Shifting (BEPS).[109] While BEPS will require time to reach full enforcement in the US, its general framework has been laid out over the course of years, allowing taxpayers to process and prepare for its changes.[110] And, unlike the 385 Regulations, the complexity of BEPS will not trap willing and prepared taxpayers.

C. *Executive Order 13789*

On April 2, 2017, President Trump issued Executive Order 13789.[111] This Executive Order required the Secretary of Treasury to review all tax regulations issued after January 1, 2017 and determine if any regulations should be mitigated in order to reduce the burden imposed on taxpayers.[112] The Treasury Department responded to the Executive Order with Notice 2017-38, which set forth a number of regulations that the Treasury Department agreed could be reviewed as being too burdensome.[113] The 385 Regulations were included in the notice.[114] This should be the final administrative action that allows the Treasury Department to follow its own precedent and withdraw the Proposed and Final 385 Regulations.

VI. CONCLUSION

Congress has been concerned about the corporate tax base for quite some time.[115] The Treasury Department has issued, not one,[116] but

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108. *See* Tobin, *supra* note 33.

109. BEPS is an agreement between Organization for Economic Development and Cooperation (OECD) countries that requires complying countries to report country-by-country profit allocations. *See Country-by-Country Reporting,* OECD http://www.oecd.org/tax/automatic-exchange/about-automatic-exchange/country-by-country-reporting.htm (last visited Dec. 18, 2017).

110. *See* Klaus von Brock and Jurjan Wouda Kuipers, *How BEPS Fits in with the EU's Tax Agenda*, INT'L TAX REV. 44, 45 (explaining that since BEPS is a non-binding agreement between countries, it requires each country to adopt its principles, with the exception of the EU countries, where changes within the EU will occur as the countries agree to enforce its provision).

111. *See* Exec. Order No. 13789, 82 Fed. Reg. 191317 (April 21, 2017).

112. *See id.*

113. *See Implementation of Executive Order 13789 (Identifying and Reducing Tax Regulatory Burdens)*, Notice 2017-38, INTERNAL REVENUE SERVICE https://www.irs.gov/pub/irs-drop/n-17-38.pdf. (last visited Nov. 28, 2017)

114. *See id.*

115. *See, e.g.*, Report to the Congress, *Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, DEPT. OF TREAS. 3–5 (Nov. 2007) https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Earnings-Stripping-Transfer-Pricing-2007.pdf.

116. *See* 8 Prior Prop. Treas. Reg. §§ 1.385-1 to -12, 45 Fed. Reg. 18959 (Mar. 24, 1980); *See also* T.D. 7747 (Dec. 29, 1980), 1981-1 C.B. 141, as modified by T.D. 7774 (Apr. 29, 1981), 1981-1

two[117] different sets of 385 Regulations prior to issuing the Final 385 Regulations in 2016. The Final 385 Regulations promulgated in 2016 are the Treasury Department's third attempt at creating 385 Regulations. These rules extend beyond traditional section 481 adjustments.[118] Moreover, the 385 Regulations have the ability to: a) create equity where none previously existed (i.e. recast debt to equity), and b) create equity between companies that had no direct involvement in the transaction.

Merriam-Webster's Dictionary defines "magic" as: the art of producing illusions by sleight of hand.[119] While no one would confuse the Treasury Department's capabilities with Harry Potter's, the 385 Regulations have accomplished sleight through regulations. The 1.385-2 documentation requirements may seem burdensome, but are relatively self-explanatory. However, while Treasury Regulation 1.385-2 distracts the taxpayer with one hand, Treasury Regulation 1.385-3 will perform the magic of creating new equity relationships where none exist, between entities that do not suspect it, and for lengths of time that are unprecedented. The Treasury Department did not intend for the 385 Regulations to be as magical as Gringott's Wizarding Bank. The best way to remove the magic is to withdraw the regulations.

C.B. 168, T.D. 7801 (Dec. 30, 1981), 1982-1 C.B. 60, and T.D. 7822 (June 29, 1982), 1982-2 C.B. 84, and withdrawn by T.D. 7920 (Nov. 2, 1983), 1983-2 C.B. 69.

117. *See* Prior Prop. Treas. Reg. §§ 1.385-1 to -10; *see also* 47 Fed. Reg. 163, 164 (1982); 48 Fed. Reg. 31054 (1983).

118. *See* 26 I.R.C. § 481 (utilized by the Internal Revenue Service to adjust taxable income in situations where the Internal Revenue Service believes a deduction is not warranted or gross income was not fully inclusive of the economics of a transaction).

119. *See "Magic"*, MERRIAM-WEBSTER https://www.merriam-webster.com/dictionary/magic (last visited Dec. 18, 2017).