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News & Types: Client Advisories

New Proposed Related Party Debt Regulations

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Practices: Corporate, Finance & Acquisitions

On April 4, 2016, the U.S. Treasury Department and the Internal Revenue Service ("IRS") issued proposed regulations under Internal Revenue Code Section 385. The Proposed Regulations were issued as part of the regulations that were issued targeting inversions. Included in the Proposed Regulations, however, are important provisions that are directed at debt transactions among related parties that go beyond inversions and will apply to many common cross-border debt transactions, both inbound and outbound, as well as other ordinary related party debt transactions, both domestic and international.

The Proposed Regulations:

- Require that contemporaneous written documentation be prepared and maintained by large taxpayer groups that satisfy the requirements set forth in the Proposed Regulation (i.e., documentation that an unrelated third party would require). If the documentation requirements are not satisfied, the indebtedness will be treated as equity unless the taxpayer can establish reasonable cause for the failure. Although the documentation is necessary, it is not dispositive of whether the instrument is to be treated as debt.
- Subject to certain exceptions, permit the IRS to characterize as equity for federal income tax purposes certain related party debt issued in connection with specific transactions, regardless of the satisfaction of the documentation requirements.

The Proposed Regulations generally apply to debt instruments issued by members of the same "expanded group". An expanded group is group of corporations connected, directly or indirectly, by 80% ownership (vote or value). Although similar to a group of affiliated corporations that file a consolidated U.S. tax return, an expanded group includes entities that are not part of the consolidated group such as foreign corporations. The Proposed Regulations do not apply, however, to instruments issued and held by members of the same U.S. consolidated group. The U.S. consolidated group, that is part of an expanded group is considered a single entity for purposes of the Proposed Regulations. However, special rules apply if the instrument or entity leave or become part of the consolidated group.

In those circumstances in which debt is recharacterized, the Proposed Regulations will result in, among other things, recasting deductible interest payments as non-deductible dividends that, if cross-border, may be subject to withholding at a higher rate. Similarly, principal payments may be treated as dividends subject to withholding. In addition, because the Proposed Regulations results in the treatment of certain instruments as stock for all federal income tax purposes, there may be other consequences in the case of certain structured transactions. Finally, there may be state tax implications.

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The Proposed Regulations are intended to be effective with respect to financial instruments issued on or after April 4, 2016 but only with effect from the date that is 90 days after the regulations become final.

The Proposed Regulations are complex and the effect of the Proposed Regulations, if finalized in their current form, will be significant. The Proposed Regulations will no doubt be subject to extensive comment and criticism. However, it is believed that the U.S. Treasury will likely make every effort to finalize the Proposed Regulations quickly in light of the change in the administration.

Although there is no certainty that the Proposed Regulations will be finalized in their current form, in view of the broad scope of the Proposed Regulations and the fact that the Proposed Regulations will be effective with respect to financial instruments issued on or after April 4, 2016, clients with or considering related party debt should consult with qualified tax professionals to assess the impact of the Proposed Regulations on current and contemplated transactions.

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