DEFENDING AMERICA'S SMALL AND FAMILY-OWNED BUSINESSES

July 7, 2016

VIA ELECTRONIC SUBMISSION

CC:PA:LPD:PR (REG-108060-15)
Room 5205
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Comments to Proposed Regulations on Treatment of Certain Interests in Corporations as Stock or Indebtedness (REG-108060-15)

Dear Madam or Sir:

The S Corporation Association respectfully submits the following comments to REG-108060-15, Proposed Regulations on the Treatment of Certain Interests in Corporations as Stock or Indebtedness, 81 Fed. Reg. 20912 (April 8, 2016) (the "Proposed Regulations").

The Proposed Regulations authorize the Internal Revenue Service (the "IRS") to treat certain related party indebtedness as stock, in whole or in part, for federal income tax purposes. Since the release of the Proposed Regulations, the broader business community has raised numerous concerns regarding their scope, including the statutory authority under which they were drafted, the opaque process by which they were developed and released, and the additional costs and uncertainty they will impose on a broad range of traditional business loans and cash sharing arrangements. Described as a response to corporate inversions and base erosion practices, the proposed rule instead pulls in a broad array of businesses that have nothing to do with either.

We share these concerns and recommend that the Proposed Regulations be withdrawn and recrafted. As currently drafted, the Proposed Regulations would affect domestic businesses of all sizes – there *is no de minimis threshold* for the "bifurcation" rule that would allow the IRS to recharacterize debt as part equity. *See* Prop. Treas. Reg. Section 1.385-1(d). Without significant revision, we believe these Proposed Regulations are overly broad and will have a material and negative impact on business investment and hiring in the United States. These negative effects are wholly unnecessary and could be avoided.

At a minimum, the S Corporation Association shares the fundamental concerns raised regarding the accelerated time periods for comment and review, and strongly encourages the Treasury Department and IRS to extend both time periods. The sweep of the Proposed Regulations is extremely broad, and the likelihood of serious unintended consequences is high unless the professionals in both the business sector and the government take the necessary time to formulate them carefully.

In addition to these broad concerns, the S Corporation Association has identified a number of specific issues related to S corporations that are raised by the Proposed Regulations. These concerns are outlined below, as is our proposal on how to best address them in a targeted manner.

Purpose of the Proposed Regulations

The preamble to the Proposed Regulations contains a detailed discussion of the purpose of the Proposed Regulations:

> These Proposed Regulations under section 385 address whether an interest in a related corporation is treated as stock or indebtedness, or as in part stock or in part indebtedness, for purposes of the Code. While these Proposed Regulations are motivated in part by the enhanced incentives for related parties to engage in transactions that result in excessive indebtedness in the cross-border context, federal income tax liability can also be reduced or eliminated with excessive indebtedness between domestic related parties. Thus, the proposed rules apply to purported indebtedness issued to certain related parties, without regard to whether the parties are domestic or foreign.[1]

Put another way, the purpose of the Proposed Regulations is to target debt used to reduce the tax liabilities of corporate taxpayers and related parties (the "expanded group" and "modified expanded group" as defined in Prop. Treas. Reg. Section 1.385-1(b)). In keeping with this goal, the Proposed Regulations apply to a broad array of financial arrangements that are both international and domestic in nature. Also in keeping with this goal, the Proposed Regulations exclude structures that do not give rise to the use of debt to reduce a group's overall tax liabilities.

Specifically, they do not apply to interests between members of a consolidated group. Prop. Treas. Reg. Sections 1.385-1(e), -4(a). As the preamble to the Proposed Regulations states:

> Nonetheless, the Treasury Department and the IRS also have determined that the Proposed Regulations should not apply to issuances of interests and related transactions among members of a consolidated group because the concerns addressed in the Proposed Regulations generally are not present when the issuer's deduction for interest expense and the holder's corresponding interest income offset on the group's consolidated federal income tax return.[2]

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[1] 81 Fed. Reg. at 20914.

[2] *Id.*

For purposes of the Proposed Regulations, therefore, all members of a consolidated group are treated as one corporation. Prop. Treas. Reg. Sections 1.385-1(e), -4(a). Accordingly, the Proposed Regulations do not apply to a consolidated group debt instrument (i.e., a debt instrument that is issued by one member of a consolidated group to another member of the consolidated group).

This treatment makes sense in light of several facts: (i) all income and expense items of members of a consolidated group joining in a consolidated return are taxed on Form 1120, and (ii) intercompany transactions including indebtedness between members of the consolidated group are eliminated such that the indebtedness between consolidated group members is ignored for federal income tax purposes.

Because S corporations cannot be members of a consolidated group, this exception in the Proposed Regulations is not applicable to S corporations. *See* Internal Revenue Code Section 1504(b)(8). As discussed in greater detail below, however, the considerations that led to the Proposed Regulations' exception for consolidated groups also apply to S corporations.

<u>Considerations Underlying Consolidated Group Exception Apply in the S Corporation Context</u>

The consolidated group exception was promulgated because "the concerns addressed in the Proposed Regulations [regarding tax base erosion] are generally are not present when the issuer's deduction for interest expense and the holder's corresponding interest income offset on the group's consolidated federal income tax return."[3] In other words, because all income and loss are taxed on Form 1120 to the same taxpayer and because intercompany indebtedness between members of the Form 1120 consolidated return group is eliminated and ignored for federal income tax purposes, there is no tax arbitrage potential for the reduction of federal income tax liability that the Proposed Regulations need to address.

The Proposed Regulations do apply to related party indebtedness between members of an "expanded group" and a "modified expanded group," which can include S corporations. *See* Prop. Treas. Reg. Section 1.385-1(b)(3)(i)(A) (defining "expanded group" as a consolidated group under Internal Revenue Code Section 1504(a), without regard to the exception for S corporations in Internal Revenue Code Section 1504(b)(8)). As a result, indebtedness between related S corporations satisfying certain common ownership requirements, as well as indebtedness between a single S corporation and other related individuals, corporations and other entities, may be subject to the Proposed Regulations.

Application in the S corporation context, however, is inappropriate as the rules relating to S corporations likewise eliminate the possibility of tax arbitrage, making the income reported on Form 1120S analogous to the income reported by a consolidated group on Form 1120 for federal income tax purposes. Therefore, S corporations should be exempted, the same as consolidated group members.

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[3] *Id.*

In particular, all S corporation shareholders must be U.S. resident taxpayers (i.e., U.S. citizens, residents, certain trusts and certain exempt organizations) who are subject to current taxation here in the United States on all of their worldwide income reported on Form 1120S (via Form K-1s). In addition, because S corporation shareholders are only eligible for the Internal Revenue Code Section 901 direct foreign tax credit, but not the Internal Revenue Code Section 902 indirect foreign tax credit, S corporations must structure their global operations in either branch or disregarded entity (i.e., "check the box") form, with the result of all worldwide income being reported on each of their Form 1120Ss (and included on a current basis via Form K-1 on the U.S. returns of their shareholders), in order to secure the Internal Revenue Code Section 901 direct foreign tax credit and avoid double taxation of their foreign operations income in both the source country and the United States.

As a result, indebtedness between the member entities reported on Form 1120S (i.e., the S corporation and its qualified subchapter S subsidiaries, foreign branches and foreign disregarded entities) is ignored for federal income tax purposes, similar to indebtedness between members of a consolidated group, because both the interest income and corresponding interest deduction are included on a current basis on the Form 1120S and proportionately reported on the individual tax returns of the S corporation's U.S. shareholders (which must be on a pro rata basis under the single class of stock rules applicable to S corporations) via Form K-1.

Similarly, S corporations will enter into international joint ventures in the form of foreign partnerships to ensure that their S corporation shareholders receive the Internal Revenue Code Section 901 direct foreign tax credit, with the S corporation's partnership share of both interest income and corresponding interest deductions similarly included on the Form 1120S and reported on the individual tax returns of the S corporation's U.S. shareholders.[4] Therefore, given the structure and operative rules that apply to S corporations, the same lack of potential tax arbitrage that exists in the consolidated return context also exists for S corporations, such that S corporations should be exempt also.

Other Policy Considerations Support the Exclusion of S Corporations (Including Qualified Subchapter S Subsidiaries) From the Proposed Regulations

Unlike C corporations, the distinction between nondeductible dividends and deductible interest has virtually no significance for S corporations. Any income distributed to the shareholders of an S corporation in the form of dividends has already been taxed to them, and will not be taxed again upon distribution. Admittedly, income paid out in the form of interest will be deductible, but it will also be fully taxable to the recipient. Thus, all income in the S corporation context is taxed once, and only once, and there is no substantial tax motivation to recharacterize profits distributions (i.e., dividends) as interest in order to achieve deductibility at the corporate level. It was primarily this concern, which does not apply in the S corporation context, that gave rise to the enactment of Section 385 of the Internal Revenue Code to begin with.

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[4] It should be noted that S corporations rarely structure international operations using controlled foreign corporations given their inability to take advantage of the Internal Revenue Code Section 902 indirect foreign tax credit.

Under the Proposed Regulations, S corporations are actually treated less favorably than partnerships, which also have virtually no incentive to recharacterize distributions as interest, inasmuch as there is only one level of tax for partnerships also. Significantly and appropriately, the Proposed Regulations do not include within the definition of "expanded group" any group that consists solely of partnerships.[5] However, as currently drafted, the Proposed Regulations' definition of "expanded group" would include a group that consists solely of S corporations.

Both S corporations and partnerships should not be included, because their income is passed through and taxed to the individual owners, and therefore do not present the same opportunities for abuse that Section 385 of the Internal Revenue Code was designed to circumscribe for C corporations. If anything, S corporations present even less of a tax avoidance risk, because the single class of stock and eligible shareholder rules effectively preclude the use of complicated corporate structures and income allocations, and foster a simple, transparent means for taxing closely-held business entities.

<u>Importance of an Exception for S Corporations</u>

The importance of providing S corporations with an exception from the Proposed Regulations is compounded by the fact that S corporations are subject to the single class of stock requirement, as well as the limitations on eligible shareholders. Internal Revenue Code Sections 1361(b)(1)(B),(D).

As a result, if S corporations were subject to the Proposed Regulations, recharacterization of related party indebtedness as stock would result in the loss of S corporation status in nearly all circumstances. The requirement that qualified subchapter S subsidiaries be 100% owned by the S corporation parent would similarly result in "Q-Sub" disqualification in the vast majority of circumstances. Internal Revenue Code Section 1361(b)(3)(B)(i).

The loss of S corporation and/or "Q-Sub" status, in turn, would result in costs far in excess of the increased taxation resulting from any recharacterization of debt as equity, including the payment of IRS and professional fees necessary to seek restoration of S corporation status, the need to change how the business is financed in order to avoid future disqualifying events, and back taxes and penalties related to the disqualification if the corporation is unable to "cure" the loss of S corporation status with IRS consent.

This challenge is significant. According to the IRS Data Book, there are 4.5 million S corporations and, in our experience, their use of related party indebtedness is widespread. As noted above, it is not necessary for a business to be either large or international to be subject to the Proposed Regulations. In the domestic context, a common business structure is for an S

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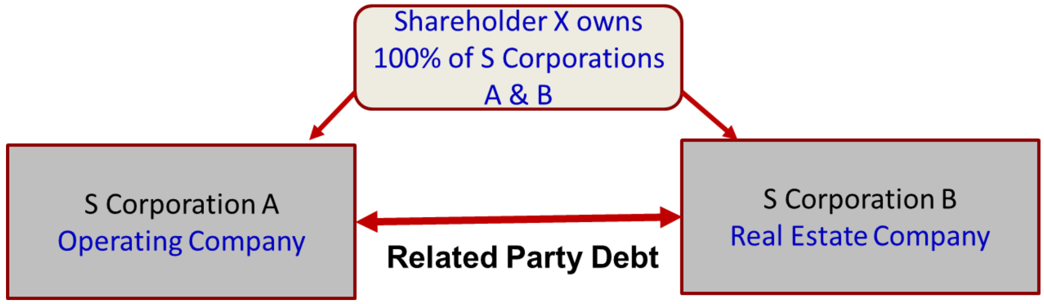
[5] Subsidiary partnerships (i.e., those that are owned by corporate "parents" within an expanded group) are taken into account for purposes of the Proposed Regulations. Prop. Treas. Reg. Section 1.385-1(b)(1). However, since S corporations cannot have corporations (or for that matter, partnerships) as shareholders, S corporations, by definition, cannot be subsidiaries within an expanded group and would not be covered by these provisions in any event. Internal Revenue Code Section 1361(b)(1)(B).

corporation shareholder to own the stock of two separate S corporations in order to insulate valuable real estate assets from potentially unforeseen business liabilities.

In these "brother-sister" company arrangements, there may be related party indebtedness between the two companies for cash management purposes.



The structure illustrated above is widely used and would be subject to the Proposed Regulations under the so-called bifurcation rule. *See* Prop. Treas. Reg. Section 1.385-1(d).

Requested Guidance

The exception from the Proposed Regulations for consolidated groups recognizes the lack of opportunity for related party indebtedness to result in tax arbitrage because such indebtedness is effectively eliminated by means of the consolidated return as it includes both interest expense and the corresponding interest income. Similarly, the lack of potential tax arbitrage exists in the S corporation context because the structure and operative rules that apply to S corporations also ensure that interest expense and the corresponding interest income with respect to related party indebtedness (both in the domestic and international context) are included in the returns of the U.S. shareholders of an S corporation.

Therefore, the S Corporation Association respectfully requests that S corporations be removed from the definitions of "expanded groups" and "modified expanded groups" by amending Prop. Treas. Reg. Section 1.385-1(b)(3) to read as follows:

(3) Expanded group--(i) In general. The term expanded group means an affiliated group as defined in section 1504(a), determined:

> *(A) Without regard to paragraphs (1) through (7) of section 1504(b);*
> *(B) By substituting "directly or indirectly" for "directly" in section 1504(a)(1)(B)(i); and*
> *(C) By substituting "or" for "and" in section 1504(a)(2)(A).*
>
> > *(ii) Indirect stock ownership. For purposes of this paragraph (b)(3), indirect stock ownership is determined by applying the rules of section 304(c)(3).*

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Thank you for the opportunity to comment on the Proposed Regulations. We would welcome the opportunity to meet with the Treasury Department and the IRS to discuss these comments in greater detail or to answer any questions that you may have.

Respectfully submitted,

Brian Reardon
President, S Corporation Association