American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

July 13, 2016

The Honorable Jacob Lew
Secretary
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

RE: Lack of Statutory Authority to Include Partnerships in Proposed Regulations Regarding the Treatment of Certain Interests in Corporations as Stock or Indebtedness

Dear Messrs. Lew, Koskinen, and Wilkins:

The American Institute of CPAs (AICPA) offers the following comments on the proposed regulations under section 385[1] of the Internal Revenue Code (IRC or "Code") related to certain interests in corporations as stock or indebtedness (REG-108060-15). Specifically, this letter addresses our concern that the United States Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) do not have the authority to extend the application of section 385 to partnership equity or debt instruments issued by partnerships.

The AICPA previously submitted comments, in a letter dated July 7, 2016,[2] regarding our substantive recommendations and concerns related to the technical aspects of the proposed regulations.

Analysis

The language in section 385 relates directly to Treasury's authority to prescribe regulations to determine whether an interest in a corporation is considered debt or equity for federal income tax purposes. Section 385(a) states, "[t]he 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 (or as in part stock and in part indebtedness)" (emphasis added).

[1] All section references in this letter are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder.
[2] AICPA Comments on Section 385 Proposed Regulations submitted July 7, 2016..

It does not appear that any regulations issued under this authority apply to partnerships. In fact, the Preamble to the proposed regulations states as 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" (emphasis added). Further, in the legislative history underlying the enactment of section 385, the United States Senate ("Senate") report states, "[a]lthough the problem of distinguishing debt from equity is a long-standing one in the tax laws, it has become even more significant in recent years because of the increased level of corporate merger activities and ***the increasing use of debt for corporate acquisition purposes***." In addition, the Senate report describes section 385 in the section of the report under "corporate mergers, etc." (IV.K). The Senate report related to this change makes no mention of partnerships.[3]

The Senate report also states:

> "*General reasons for change*.— … In view of the increasing use of debt for corporate acquisition purposes and the fact that the substitution of debt for equity is most easily accomplished in this situation, the committee also agrees with the House that it is appropriate to take action in this bill to provide rules for resolving, ***in a limited context,*** the ambiguities and uncertainties which have long existed in our tax law in distinguishing between a debt interest and an equity interest ***in a corporation***. …
>
> "In view of the uncertainties and difficulties which the distinction between debt and equity has produced in numerous situations other than those involving corporate acquisitions, the committee further believes that it would be desirable to provide rules for distinguishing debt from equity in the variety of contexts in which this problem can arise. The differing circumstances which characterize these situations, however, would make it difficult for the committee to provide comprehensive and specific statutory rules of universal and equal applicability. In view of this, the committee believes it is appropriate to specifically authorize the Secretary of the Treasury to prescribe the appropriate rules for distinguishing debt from equity in these different situations."
>
> *"Explanation of provision*.—For the above reasons, the committee has added a provision to the House bill which gives the Secretary of the Treasury or his delegate specific statutory authority to promulgate regulatory guidelines, to the extent necessary or appropriate, for determining whether a ***corporate*** obligation constitutes stock or indebtedness. The provision specifies that these guidelines are to set forth factors to be taken into account in determining, with respect to a

[3] S. Rep. No. 91-552, at 137 (1969) (emphasis added).

> particular factual situation, whether a debtor-creditor relationship exists or whether a ***corporation-shareholder*** relationship exists."[4]

It is clear that the primary concern of Congress in enacting section 385 was leveraged corporate acquisitions; partnerships are not mentioned or implied as a source of concern.

Nonetheless, as currently drafted, the proposed regulations provide for the recharacterization of certain debt instruments issued by partnerships.[5] The Preamble also states as information about the purpose of the proposed regulations that "federal income tax liability can also be reduced or eliminated with excessive ***indebtedness*** between domestic related parties" (emphasis added). This stated purpose is consistent with the legislative history indicating congressional concern about the use of debt instruments which have equity characteristics, thereby justifying the disallowance of the interest expense on these debt instruments. Similar to its silence regarding partnerships, the legislative history does not express concern about the use of equity interests as a policy reason underlying the enactment of section 385. Thus, an expansion of the proposed regulations to partnership equity interests or debt instruments issued by partnerships represents a broadening of scope beyond both the authority granted by the Code and the intent of Congress in enacting section 385.

The AICPA is the world's largest member association representing the accounting profession, with more than 412,000 members in 144 countries and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

* * * * *

We appreciate your consideration of these comments and welcome the opportunity to discuss this issue further. Please feel free to contact me at (801) 523-1051 or tlewis@sisna.com; or Noel Brock, Chair, AICPA Partnership Taxation Technical Resource Panel, at (619) 300-1207 or noel@noelpbrock.com; or Jonathan Horn, Senior Technical Manager – AICPA Tax Policy & Advocacy, at (202) 434-9204 or jhorn@aicpa.org.

Respectfully submitted,

Troy K. Lewis, CPA, CGMA
Chair, AICPA Tax Executive Committee

---

[4] *Id.* at 138 (emphasis added).
[5] Prop. Reg. § 1.385-3(d)(5).

cc: The Honorable Mark Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
Mr. Thomas West, Tax Legislative Counsel, Department of the Treasury
Ms. Ossie Borosh, Senior Counsel, Office of Tax Legislative Counsel, Department of the Treasury
Mr. Curt Wilson, Associate Chief Counsel (Passthroughs and Special Industries), Internal Revenue Service
Ms. Donna Marie Young, Deputy Associate Chief Counsel (Passthroughs and Special Industries), Internal Revenue Service