

### Reg. Section 1.385-1

#### General provisions

(a) Overview of section 385 regulations. This section and §§1.385-2 through 1.385-4T (collectively, the section 385 regulations) provide rules under section 385 to determine the treatment of an interest in a corporation as stock or indebtedness (or as in part stock and in part indebtedness) in particular factual situations. Paragraph (b) of this section provides the general rule for determining the treatment of an interest based on provisions of the Internal Revenue Code and on common law, including the factors prescribed under common law. Paragraphs (c), (d), and (e) of this section provide definitions and rules of general application for purposes of the section 385 regulations. Section 1.385-2 provides additional guidance regarding the application of certain factors in determining the federal tax treatment of an interest in a corporation that is held by a member of the corporation's expanded group. Section 1.385-3 sets forth additional factors that, when present, control the determination of whether an interest in a corporation that is held by a member of the corporation's expanded group is treated (in whole or in part) as stock or indebtedness. Section 1.385-3T(f) provides rules on the treatment of debt instruments issued by certain partnerships. Section 1.385-4T provides rules regarding the application of the factors set forth in §1.385-3 and the rules in §1.385-3T to transactions described in those sections as they relate to consolidated groups.

(b) General rule. Except as otherwise provided in the Internal Revenue Code and the regulations thereunder, including the section 385 regulations, whether an interest in a corporation is treated for purposes of the Internal Revenue Code as stock or indebtedness (or as in part stock and in part indebtedness) is determined based on common law, including the factors prescribed under such common law.

(c) Definitions. The definitions in this paragraph (c) apply for purposes of the section 385 regulations. For additional definitions that apply for purposes of their respective sections, see §§1.385-2(d) , 1.385-3(g) , and 1.385-4T(e) .

(1) Controlled partnership. The term controlled partnership means, with respect to an expanded group, a partnership with respect to which at least 80 percent of the interests in partnership capital or profits are owned, directly or indirectly, by one or more members of the expanded group. For purposes of identifying a controlled partnership, indirect ownership of a partnership interest is determined by applying the principles of paragraph (c)(4)(iii) of this section. Such determination is separate from the determination of the status of a corporation as a member of an expanded group. An unincorporated organization described in §1.761-2 that elects to be excluded from all of subchapter K of chapter 1 of the Internal Revenue Code is not a controlled partnership.

(2) Covered member. The term covered member means a member of an expanded group that is-

(i) A domestic corporation; and

(ii) [Reserved]

(3) Disregarded entity. The term disregarded entity means a business entity (as defined in §301.7701-2(a) of this chapter) that is disregarded as an entity separate from its owner for federal income tax purposes under §§301.7701-1 through 301.7701-3 of this chapter.

(4) Expanded group.

(i) In general. 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-

(A) The expanded group parent owns directly or indirectly stock meeting the requirements of section 1504(a)(2) (modified by substituting "or" for "and" in section 1504(a)(2)(A)) in at least one of the other corporations; and

(B) Stock meeting the requirements of section 1504(a)(2) (modified by substituting "or" for "and" in section 1504(a)(2)(A)) in each of the other corporations (except the expanded group parent) is owned directly or indirectly by one or more of the other corporations.

(ii) Definition of stock. For purposes of paragraph (c)(4)(i) of this section, the term stock has the same meaning as "stock" in section 1504 (without regard to §1.1504-4) and all shares of stock within a single class are considered to have the same value. Thus, control premiums and minority and blockage discounts within a single class are not taken into account.

(iii) Indirect stock ownership. For purposes of paragraph (c)(4)(i) of this section, indirect stock ownership is determined by applying the constructive ownership rules of section 318(a) with the following modifications:

(A) Section 318(a)(1) and (a)(3) do not apply except as set forth in paragraph (c)(4)(v) of this section;

(B) Section 318(a)(2)(C) applies by substituting "5 percent" for "50 percent;" and

(C) Section 318(a)(4) only applies to options (as defined in §1.1504-4(d) ) that are reasonably certain to be exercised as described in §1.1504-4(g) .

(iv) Member of an expanded group or expanded group member. The expanded group parent and each of the other corporations described in paragraphs (c)(4)(i)(A) and (c)(4)(i)(B) of this section is a member of an expanded group (also referred to as an expanded group member). For purposes of the section 385 regulations, a corporation is a member of an expanded group if it is described in this paragraph (c)(4)(iv) of this section immediately before the relevant time for determining membership (for example, immediately before the issuance of an EGI (as defined in §1.385-2(d)(3)) or a debt instrument (as defined in §1.385-3(g)(4)) or immediately before a distribution or acquisition that may be subject to §1.385-3(b)(2) or (3)).

(v) Brother-sister groups with non-corporate owners. [Reserved]

(vi) Special rule for indirect ownership through options for certain members of consolidated groups. In the case of an option of which a member of a consolidated group, other than the common parent, is the issuing corporation (as defined in §1.1504-4(c)(1)), section 318(a)(4) only applies (for purposes of applying paragraph (c)(4)(iii)(C) of this section) to the option if the option is treated as stock or as exercised under §1.1504-4(b) for purposes of determining whether a corporation is a member of an affiliated group.

(vii) Examples. The following examples illustrate the rules of this paragraph (c)(4). Except as otherwise stated, for purposes of the examples in this paragraph (c)(4)(vii), all persons described are corporations that have a single class of stock outstanding and file separate federal tax returns and are not described in section 1504(b)(6) or (b)(8). In addition, the stock of each publicly traded corporation is widely held such that no person directly or indirectly owns stock in the publicly traded corporation meeting the requirements of section 1504(a)(2) (as modified by this paragraph (c)(4)).

Example (1). Two different expanded group parents.

(i) Facts. P has two classes of common stock outstanding: Class A and Class B. X, a publicly traded corporation, directly owns all shares of P's Class A common stock, which is high-vote common stock representing 85% of the vote and 15% of the value of the stock of P. Y, a publicly traded corporation, directly owns all shares of P's Class B common stock, which is low-vote common stock representing 15% of the vote and 85% of the value of the stock of P. P directly owns 100% of the stock of S1.

(ii) Analysis. X owns directly 85% of the vote of the stock of P, which is stock meeting the requirements of section 1504(a)(2) (as modified by paragraph (c)(4)(i)(A) of this section). Therefore, X is an expanded group parent described in paragraph (c)(4)(i) of this section with respect to P. Y owns 85% of the value of the stock of P, which is stock meeting the requirements of section 1504(a)(2) (as modified by paragraph (c)(4)(i)(A) of this section). Therefore, Y is also an expanded group parent described in paragraph (c)(4)(i) of this section with respect

to P. P owns directly 100% of the voting power and value of the stock of S1, which is stock meeting the requirements of section 1504(a)(2) (as modified by paragraph (c)(4)(i)(B) of this section). Therefore, X, P, and S1 constitute an expanded group as defined in paragraph (c)(4)(i) of this section. Additionally, Y, P, and S1 constitute an expanded group as defined in paragraph (c)(4) of this section. X and Y are not members of the same expanded group under paragraph (c)(4) of this section because X does not directly or indirectly own any of the stock of Y and Y does not directly or indirectly own any of the stock of X, such that X and Y do not comprise a chain of corporations described in paragraph (c)(4)(i) of this section.

Example (2). Inclusion of a REIT within an expanded group.

(i) Facts. All of the stock of P is publicly traded. In addition to other assets representing 85% of the value of its total assets, P directly owns all of the stock of S1. S1 owns 99% of the stock of S2. The remaining 1% of the stock of S2 is owned by 100 unrelated individuals. In addition to other assets representing 85% of the value of its total assets, S2 owns all of the stock of S3, which has elected to be treated as a taxable REIT subsidiary of S2 under section 856(l)(1). Both P and S2 are real estate investment trusts described in section 1504(b)(6).

(ii) Analysis. P directly owns 100% of the stock of S1. However, under paragraph (c)(4)(i) of this section, P cannot be the expanded group parent because P is a real estate investment trust described in section 1504(b)(6). Because no other corporation owns stock in P meeting the requirements described in paragraph (c)(4)(i) of this section, P is not an expanded group member. S1 directly owns 99% of the stock of S2, which is stock meeting the requirements of section 1504(a)(2) (as modified by paragraph (c)(4)(i)(A) of this section). Although S2 is a corporation described in section 1504(b)(6), a corporation described in section 1504(b)(6) may be a member of an expanded group described under paragraph (c)(4)(i) of this section provided the corporation is not the expanded group parent. In this case, S1 is the expanded group parent. S2 directly owns 100% of the stock of S3, which is stock meeting the requirements of section 1504(a)(2) (as modified by paragraph (c)(4)(i)(B) of this section). Therefore, S1, S2, and S3 constitute an expanded group as defined in paragraph (c)(4) of this section.

Example (3). Attribution of hook stock.

(i) Facts. P, a publicly traded corporation, directly owns 50% of the stock of S1. S1 directly owns 100% of the stock of S2. S2 directly owns the remaining 50% of the stock of S1.

(ii) Analysis.

(A) P directly owns 50% of the stock of S1. Under paragraph (c)(4)(iii) of this section (which applies section 318(a)(2) with modifications), P constructively owns 50% of the stock of S2 because P directly owns 50% of the stock of S1, which directly owns 100% of S2. Under section 318(a)(5)(A), stock constructively owned by P by reason of the application of section 318(a)(2) is, for purposes of section 318(a)(2), considered as actually owned by P.

(B) S2 directly owns 50% of the stock of S1. Thus, under paragraph (c)(4)(iii) of this section, P is treated as constructively owning an

additional 25% of the stock of S1. For purposes of determining the expanded group, P's ownership must be recalculated treating the additional 25% of S1 stock as actually owned. Under the second application of section 318(a)(2)(C) as modified by paragraph (c)(4)(iii) of this section, P constructively owns an additional 12.5% of the stock of S1 as follows:  $25\% \text{ (P's new attributed ownership of S1)} \times 100\% \text{ (S1's ownership of S2)} \times 50\% \text{ (S2's ownership of S1)} = 12.5\%$ . After two iterations, P's ownership in S1 is 87.5% (50% direct ownership + 25% first order constructive ownership + 12.5% second order constructive ownership) and thus S1 is a member of the expanded group that includes P and S2. Subsequent iterative calculations of P's ownership, treating constructive ownership as actual ownership, would demonstrate that P owns, directly and indirectly, 100% of the stock of S1. P, S1, and S2 therefore constitute an expanded group as defined in paragraph (c)(4) of this section and P is the expanded group parent.

Example (4). Attribution of hook stock when an intermediary has multiple owners.

(i) Facts. The facts are the same as in Example 3, except that P directly owns only 25% of the stock of S1. X, a corporation unrelated to P, also directly owns 25% of the stock of S1.

(ii) Analysis.

(A) P and X each directly owns 25% of the stock of S1. Under paragraph (c)(4)(iii) of this section, P and X each constructively owns 25% of the stock of S2 because P and X each directly owns 25% of the stock of S1, which directly owns 100% of the stock of S2. Under section 318(a)(5)(A), stock constructively owned by P or X by reason of the application of section 318(a)(2) is, for purposes of section 318(a)(2), considered as actually owned by P or X, respectively.

(B) S2 directly owns 50% of the stock of S1. Thus, under paragraph (c)(4)(iii) of this section, P and X each is treated as constructively owning an additional 12.5% of the stock of S1. Under a second application of section 318(a)(2)(C) as modified by paragraph (c)(4)(iii) of this section, P and X each constructively owns an additional 6.25% of the stock of S1 as follows:  $12.5\% \text{ (each of P's and X's new attributed ownership of S1)} \times 100\% \text{ (S1's ownership of S2)} \times 50\% \text{ (S2's ownership of S1)} = 6.25\%$ . After two iterations, each of P's and X's ownership in S1 is 43.75% (25% direct ownership + 12.5% first order constructive ownership + 6.25% second order constructive ownership). Subsequent iterative calculations of each of P's and X's ownership, treating constructive ownership as actual ownership, would demonstrate that P and X each owns, directly and indirectly, 50% of the stock of S1.

(C) S1 and S2 constitute an expanded group as defined under paragraph (c)(4)(i) of this section because S1 directly owns 100% of the stock of S2. S1 is the expanded group parent of the expanded group and neither P nor X are a member of the expanded group that includes S1 and S2.

(5) Regarded owner. The term regarded owner means a person (which cannot be a disregarded entity) that is the single owner (within the meaning of §301.7701-2(c)(2)(i) of this chapter) of a disregarded entity.

(d) Treatment of deemed exchanges.

(1) Debt instrument deemed to be exchanged for stock.

(i) In general. If a debt instrument (as defined in §1.385-3(g)(4)) or an EGI (as defined in §1.385-2(d)(3)) is deemed to be exchanged under the section 385 regulations, in whole or in part, for stock, the holder is treated for all federal tax purposes as having realized an amount equal to the holder's adjusted basis in that portion of the debt instrument or EGI as of the date of the deemed exchange (and as having basis in the stock deemed to be received equal to that amount), and, except as provided in paragraph (d)(1)(iv)(B) of this section, the issuer is treated for all federal tax purposes as having retired that portion of the debt instrument or EGI for an amount equal to its adjusted issue price as of the date of the deemed exchange. In addition, neither party accounts for any accrued but unpaid qualified stated interest on the debt instrument or EGI or any foreign exchange gain or loss with respect to that accrued but unpaid qualified stated interest (if any) as of the deemed exchange. This paragraph (d)(1)(i) does not affect the rules that otherwise apply to the debt instrument or EGI prior to the date of the deemed exchange (for example, this paragraph (d)(1)(i) does not affect the issuer's deduction of accrued but unpaid qualified stated interest otherwise deductible prior to the date of the deemed exchange). Moreover, the stock issued in the deemed exchange is not treated as a payment of accrued but unpaid original issue discount or qualified stated interest on the debt instrument or EGI for federal tax purposes.

(ii) Section 988. Notwithstanding the first sentence of paragraph (d)(1)(i) of this section, the rules of §1.988-2(b)(13) apply to require the holder and the issuer of a debt instrument or an EGI that is deemed to be exchanged under the section 385 regulations, in whole or in part, for stock to recognize any exchange gain or loss, other than any exchange gain or loss with respect to accrued but unpaid qualified stated interest that is not taken into account under paragraph (d)(1)(i) of this section at the time of the deemed exchange. For purposes of this paragraph (d)(1)(ii), in applying §1.988-2(b)(13) the exchange gain or loss under section 988 is treated as the total gain or loss on the exchange.

(iii) Section 108(e)(8). For purposes of section 108(e)(8), if the issuer of a debt instrument or EGI is treated as having retired all or a portion of the debt instrument or EGI in exchange for stock under paragraph (d)(1)(i) of this section, the stock is treated as having a fair market value equal to the adjusted issue price of that portion of the debt instrument or EGI as of the date of the deemed exchange.

(iv) Issuer of stock deemed exchanged for debt. For purposes of applying paragraph (d)(1)(i) of this section-

(A) A debt instrument that is issued by a disregarded entity is deemed to be exchanged for stock of the regarded owner under §§1.385-2(e)(4) and 1.385-3T(d)(4);

(B) A debt instrument that is issued by a partnership that becomes a deemed transferred receivable, in whole or in part, is deemed to be exchanged by the holder for deemed partner stock under §1.385-3T(f)(4) and the partnership is therefore not treated for any federal tax purpose as having retired any portion of the debt instrument; and

(C) A debt instrument that is issued in any situation not described in paragraph (d)(1)(iv)(A) or (B) of this section is deemed to be exchanged for stock of the issuer of the debt instrument.

(2) Stock deemed to be exchanged for newly-issued debt instrument.

(i) EGIs. If an EGI treated as stock under §1.385-2(e)(1) ceases to be an EGI and is deemed to be exchanged pursuant to §1.385-2(e)(2), in whole or in part, for a newly-issued debt instrument, the issue price of the newly-issued debt instrument is determined under either section 1273(b)(4) or 1274, as applicable.

(ii) Debt instruments recharacterized under §1.385-3. If a debt instrument treated as stock under §1.385-3(b) is deemed to be exchanged under §1.385-3(d)(2), in whole or in part, for a newly-issued debt instrument, the issue price of the newly-issued debt instrument is determined under either section 1273(b)(4) or 1274, as applicable.

(e) Indebtedness in part. [Reserved]

(f) Applicability date. This section applies to taxable years ending on or after January 19, 2017.