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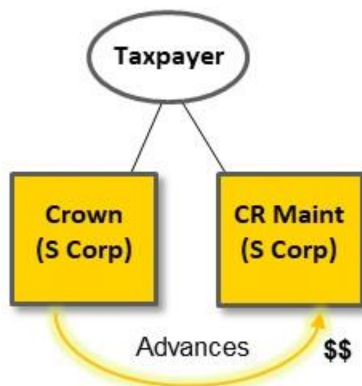
Technical Developments and Musings

Informal advances not governed by Section 385(c). Section 385(c) generally provides that an issuer's "characterization" of an instrument as debt or equity is generally binding on an issuer and holder (but not necessarily on the IRS). But characterization requires an "instrument," as underscored by a recent Tax Court memorandum decision, *Est. of Fry v. Comm'r*, TC Memo 2024-8, which concluded that §385(c) did not prevent a taxpayer from asserting that informal advances between two S corporations were more properly characterized as equity, despite taxpayer reporting of the advances as indebtedness on relevant tax returns. The simplified facts, depicted here, involved advances from one S corporation (Crown) to another S corporation (CR Maintenance), each wholly owned by the same individual taxpayer. The court agreed with the taxpayer that §385(c) was inapplicable because "there was no formal issuance of any instrument evidencing the creation of an interest in stock or equity." The court then analyzed 11 common law debt-equity factors, concluding that the advances "more likely than not" did not constitute "true indebtedness," while expressing doubt whether §385 or its regulations even applied to S corporations. A footnote goes even further, noting that §385(c) "has never been applied to bind any taxpayer, much less an S corporation, to the initial characterization of an interest as equity or debt, and despite its enactment in 1992, this section has been cited by a court on only one other occasion and merely in passing." The Tax Court then concluded that the advances should be recharacterized as constructive, or deemed, distributions of property by Crown to the sole shareholder, followed by deemed contributions by the taxpayer to CR Maintenance, which may enable the taxpayer to absorb more flow-through losses of CR Maintenance.



IRS comfortable with ruling on broader range of transactions. In its annual revenue procedures addressing private letter rulings, the corporate division of the office of IRS Associate Chief Counsel has expanded transaction types for which a PLR may be sought. Although PLRs are often sought for §355 divisive transactions, "comfort letter" rulings for more commonplace transactions such as the tax effects of corporate organizations under §351, acquisitive reorganizations under §368 or corporate liquidations under §332 have historically been on an IRS "no-rule" list. However, Rev. Proc. 2024-1 and Rev. Proc. 2024-3 have removed these transactions and others from the no-rule list. Notably, IRS apparently will also consider ruling on issues under §355(e) involving plans to acquire distributing or controlled corporations.

"Determination" excuses taxpayer mistake of law. Beyond PLRs, the annual revenue procedure also notes that other IRS offices may issue written "determinations" to taxpayers where the determination can be made based upon "clearly established rules" representing the IRS position. Determination letter 202352022 is an example: in it, the IRS Large Business and International division invoked its authority under Reg. §1.1502-75(b) in advising a consolidated group that it could include a property and casualty insurance company in a previously-filed consolidated return, even though the company was not included on Form 1122 for the first-year tax return due to a mistaken view of the law regarding such companies.