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CORPORATE CLIENT ALERT

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How Do the Final Section 385 Regulations Impact Your Company?

The business community breathed a sigh of relief after Treasury's issuance, on October 13, 2016, of final and temporary debt-equity regulations under section 385 of the Code (the "385 regulations" or the "regulations"). Unlike the regulations proposed in April, the regulations are largely inapplicable to U.S.-parented multinationals. Treasury also narrowed the impact of the regulations on foreign-parented companies with U.S. subsidiaries. The regulations are nonetheless a major development for those companies, and now is the time to consider their effects.

There is a very real possibility that the Trump Administration will withdraw, postpone, or significantly modify the 385 regulations before companies need to make investments to comply with the documentation requirements. For now, though, the regulations are law. Companies ignore the general and funding rules in particular at their peril.

This alert is intended as a starting point for our clients. Because the application of the regulations will depend on each client's specific circumstances, we do not set forth in detail the very extensive and complex rules, or their differences from the proposed regulations. We also do not address any possible state and local tax implications.

If you have questions about this alert or the 385 regulations, please contact a member of our Corporate Tax team: Doug Andre, Larry Axelrod, Jamie Brown, Eric Fox, Hank Gutman, Jeff Moeller, Les Schneider, or Pat Smith.

Background

U.S. corporations can generally deduct the interest they pay, including interest on debt owed to their shareholders. They cannot, however, deduct distributions to shareholders. Therefore, companies often have a U.S. tax incentive to structure investments by their shareholders as debt rather than as equity. The IRS frequently asserts that purported debt instruments issued by corporations to related persons are in substance equity. Historically, debt-equity disputes have been resolved by applying factors developed by the courts to all of the facts relevant to whether there was a true debtor-creditor relationship.

In 1969, Congress enacted section 385, which gives Treasury the authority to issue regulations governing whether an interest in a corporation is treated as debt or as equity for tax purposes. Treasury issued regulations under section 385 in 1980 but quickly withdrew them. Section 385 otherwise lay dormant for 47 years.

In recent years, however, Treasury became increasingly concerned with the practice of "earnings stripping"—reducing the taxable income of U.S. companies by causing them to issue interest-bearing debt to foreign affiliates—especially by large, foreign-parented multinationals. The ability to engage in earnings stripping was a primary driver of a wave, peaking in 2014, of so-called "inversion" transactions in which very large U.S.-based companies inverted from being U.S.-parented to being foreign-parented. Treasury repeatedly tried to persuade Congress to strengthen existing Code provisions addressing inversions and earnings stripping, but those efforts were unsuccessful.

Instead, then, on April 4, 2016, Treasury (creatively) used its authority under section 385 to issue proposed regulations limiting earnings stripping opportunities within multinational groups. On October 13, Treasury issued the final and temporary regulations, which retain the overall structure of the proposed regulations but cut back significantly on their scope.

General Scope and Effective Dates

The 385 regulations generally apply to groups of corporations of which at least one member is a U.S. corporation and that are directly or indirectly owned by a single parent corporation. The regulations do not apply, however, to groups of which a RIC or a REIT is the parent. The regulations use the defined term "expanded group" to refer to groups to which the regulations may apply.

The regulations apply to taxable years ending on or after January 19, 2017. The most significant change from the proposed regulations is that the regulations apply only to debt issued by a *U.S. corporation* to another member of its expanded group (whether U.S. or foreign, but not including another member of its consolidated group). This causes the 385 regulations to have very limited application to U.S.-parented multinationals. They apply to U.S.-parented groups only in

unusual situations such as: (1) where an affiliated group does not elect to file consolidated returns; (2) where an expanded group includes U.S. members that are not members of an affiliated group, and (3) where a foreign subsidiary lends to its U.S. affiliates. Treasury reserved on applying the regulations to debt issued by foreign corporations, and it may revisit the issue.

The regulations do not apply to debt issued by an S-corporation, and they apply only in a limited way to debt issued by a "regulated insurance company" or an "excepted regulated financial company," the latter of which includes banks, registered brokers, registered dealers, and several similar types of "regulated financial company" (and, in general, any direct or indirect subsidiary of such a company).

The regulations have two main components: the documentation requirements in Treas. Reg. § 1.385-2, and the "general" and "funding" rules in Treas. Reg. § 1.385-3.

The Documentation Requirements

Introduction. The documentation requirements address the IRS's difficulties in efficiently assembling relevant evidence to assess on audit whether debt issued within large multinationals should be respected. Treasury also sought, as they put it, "to impose discipline on related parties by requiring timely documentation and financial analysis that is similar to the documentation and analysis created when indebtedness is issued to third parties." Preamble to proposed regulations, 81 F.R. at 20916.

The documentation requirements require an expanded group to prepare certain documentation tending to establish that intercompany debt issued by its U.S. members is in substance debt. The most robust of these requirements is to prepare documentation, by the due date of the issuer's federal income tax return for the taxable year in which a debt instrument is issued, establishing that at the time of issuance there was a "reasonable expectation" that the issuer could make all payments required by the instrument.

If the documentation requirements are not satisfied, then, unless a mitigating exception applies, the debt instrument is treated as stock. If the documentation requirements are satisfied, and if the general and funding rules do not apply, then, as under prior law, a debt instrument is treated as debt or equity based on the application of traditional debt-equity factors (as modified slightly by the regulations) to all of the facts and circumstances.

How big does a corporate group need to be to concern itself with the documentation requirements? The documentation requirements apply to corporate groups with a member the stock of which is publicly-traded or otherwise traded on an "established financial market." They also apply to corporate groups with over $100 million in assets, or whose annual total revenue exceeds $50 million, generally determined as of any date within the 3 years

before a debt instrument becomes an "expanded group interest" ("EGI"). An EGI is generally any debt instrument issued within an expanded group (other than an instrument issued by a partnership, or issued within a consolidated group).

What EGIs are subject to the documentation requirements? With limited exceptions, an EGI is subject to the documentation requirements if it is issued by a U.S. member (or a disregarded entity whose owner is a U.S. member).

When do companies need to be ready to document EGIs? The documentation requirements may apply to debt instruments issued or deemed issued on or after January 1, 2018. Although the documentation required at issuance need be prepared only by the due date of the issuer's federal income tax return, it will generally be easier to comply with the documentation requirements as EGIs are issued rather than preparing documentation for multiple EGIs shortly before the deadline for the issuer's return.

How should companies prepare? Corporate groups should establish procedures for documenting issuances of intercompany debt by U.S. members on or after January 1, 2018. In particular, groups should decide in advance how they will address the requirement to establish a reasonable expectation of repayment, which is not well-defined in the documentation requirements. This includes determining with respect to each U.S. group member whether it will document the reasonable expectation of repayment in advance through an annual credit analysis (and if so up to what amount), or on an EGI-by-EGI basis. Companies should also evaluate whether their cash-management techniques will be subject to the special rules for agreements covering multiple EGIs.

The General and Funding Rules

Introduction. The general and funding rules address Treasury's concern with the introduction of new debt issued by a U.S. corporation to an affiliate where there is no new investment in the issuer. The simplest target is the distribution of a debt instrument (*e.g.*, the issuance of a note from a U.S. subsidiary to its foreign parent for no consideration). Under the ***general rule***, such debt distributed by a U.S. company to another member of its expanded group (other than a member of its consolidated group) is, subject to exclusions and reductions that may apply, treated as stock for almost all U.S. federal income tax purposes. Thus, for example, payments of principal and interest on the debt are treated for U.S. tax purposes as distributions with respect to the issuer's stock. The general rule also applies to two other types of transaction that, according to Treasury, raise similar policy concerns: debt issued in exchange for expanded group stock, and debt issued in exchange for property in an "asset reorganization" (as defined in the regulations) within the corporate group.

The ***funding rule*** backstops the general rule by treating as stock a debt instrument issued within an expanded group in exchange for property, where the debt is treated as funding a distribution, an acquisition of expanded group stock, or an acquisition of property in an asset reorganization (all of which, in Treasury's view, reduce the issuer's capital at little or no tax cost). The "per se funding rule" treats debt as funding such a distribution or acquisition if it is issued during the period beginning 36 months before, and ending 36 months after, the distribution or acquisition. Moreover, the per se funding rule is not a safe harbor—a "principal purpose rule" can apply to debt issued outside of that period.

The final regulations remedy some of the over-breadth of the proposed regulations by including, among other changes, (1) a new exception to the funding rule for short-term loans and cash pooling and similar arrangements; (2) a broadened reduction to the amount of distributions and acquisitions triggering the general and funding rules for, in general, earnings and profits accumulated by an issuer after April 4, 2016, while it is a member of a single expanded group; and, (3) a reduction of the amount of such distributions and acquisitions for "qualified contributions" of property by expanded group members to the issuer.

The consequences of the treatment of a debt instrument as stock are by no means limited to the loss of interest deductions, and they can be unpredictable. For example, deemed dividends and redemptions from a re-characterized note can themselves be treated as distributions for purposes of the funding rule, causing still other debts to be treated as stock. Due in part to such unpredictable results, we are generally advising clients to avoid completely the general and funding rules.

Transition rules. Debt instruments issued, and distributions or acquisitions occurring, on or after April 5, 2016, are taken into account for purposes of the general and funding rules. Under a transition rule, debt issued between April 5, 2016, and January 19, 2017, that would otherwise be treated as stock upon issuance, will be deemed exchanged for stock immediately after January 19, 2017. Payments (other than stated interest) on such debt made prior to January 19, 2017, are treated as distributions for purposes of the funding rule.

How big does a corporate group need to be to concern itself with the general and funding rules? There is no exception to the general and funding rules based on the size of a corporate group. The "threshold exception," however, will effectively exempt small and mid-sized corporate groups that do not use a disproportionate amount of intercompany debt. If the issuance of a debt instrument would not cause an expanded group to have $50 million or more of total intercompany debt of its U.S. members outstanding, the general and funding rules do not apply to any member of that group. If a group has more than $50 million of total intercompany debt of its U.S. members outstanding, then the general and funding rules need to be applied even to determine the extent to which the threshold exception applies.

The threshold exception benefits all corporate groups—even if the $50 million threshold has been exceeded, the first $50 million of debt that would otherwise be treated as stock is not subject to the general and funding rules. Through careful planning around the general and funding rules, even a large corporate group with significant intercompany indebtedness can fully qualify for the threshold exception by minimizing its debt to which the general rule or the funding rule applies.

How does a company know where it stands currently under the general and funding rules? Companies continue to analyze issues arising under the general and funding rules such as: (1) the extent to which intercompany debt issued by U.S. group members on or after April 5, 2016, will be deemed exchanged for stock effective on January 20, 2017 (to avoid this result, such debt could be repaid in advance); (2) the extent to which a group's U.S.-issued intercompany debt potentially treated as stock under the general and funding rules could exceed the threshold exception in the first taxable year in which the rules are effective; and (3) the extent to which, going forward, each U.S. group member can issue debt and make distributions to other members without debt being treated as stock under the funding rule.

As basic building blocks for analyzing those issues, companies should track (or continue to track) the following transactions occurring on or after April 5, 2016, for each U.S. member of an expanded group (and each disregarded entity or "controlled partnership" (as defined in the regulations) in which a U.S. member of the expanded group holds an interest):

- Issuances of debt instruments to another member of the expanded group (other than a member of its consolidated group);
  - This includes deemed issuances of debt, for example due to a significant modification to the terms of an existing debt instrument, as well as increases in the principal amount of a debt instrument.
- Distributions to another member of the expanded group;
- Acquisitions of expanded group stock from another member of the expanded group;
- Acquisitions of property in asset reorganizations within the expanded group**;** and
- Contributions of property from another member of the expanded group (for purposes of the new reduction for qualified contributions).

It may also be necessary to estimate the expanded group earnings account (for purposes of the reduction for expanded group earnings) for each U.S. member of the expanded group.

What is the starting point for considering the impact of the 385 regulations on transactional planning? Companies should in all cases consider the potential implications

under the general rule and the funding rule of any U.S. group member engaging in the any of the first four types of transactions listed above.

Other issues to consider. Companies may also need to consider which of the specified current assets test or the 270-day test each U.S. group member will rely on during its first taxable year ending after January 19, 2017, to qualify short-term debt issued by that member for the exception for short-term funding arrangements.

Companies that use cash pooling or similar arrangements to which a U.S. group member contributes may need to ensure that the arrangement satisfies the requirements to be a "cash-management arrangement" managed by a "qualified cash pool header," so that deposits to the arrangement will qualify for the exception for qualified short-term debt instruments.

A Word About Validity

The 385 regulations, and especially the general and funding rules, are premised on Treasury's aggressive interpretation of its authority under section 385 of the Code to issue debt-equity regulations. Section 385 contemplates that the substance of a particular debt instrument controls its treatment as debt or equity (as it has done for decades), and, in our view, section 385(b) limits the authority granted in section 385(a) to setting forth debt-equity factors (and how to weigh them). In our view, section 385 does not authorize Treasury to issue momentous earnings stripping regulations that (1) are based on policy concerns previously addressed by Congress; (2) treat debt instruments that are *in substance debt* as stock; and (3) use bright-line rules, and not factors, to determine whether an instrument is treated as debt or as stock. For these and other reasons, the 385 regulations are vulnerable to invalidation by a court under the Administrative Procedure Act in that they exceed Treasury's authority to issue regulations under section 385. The timing of this possible invalidation (or possible withdrawal or modification of the regulations by the Trump Administration) is uncertain, and in the meantime companies should generally assume the regulations are valid.

WHO WE ARE

Ivins, Phillips & Barker, Chartered
1700 Pennsylvania Ave. NW, Suite 600
Washington DC, 20006
(202) 393-7600

CORPORATE TAX TEAM
www.ipbtax.com

Douglas M. Andre dandre@ipbtax.com	Lawrence M. Axelrod laxelrod@ipbtax.com	James E. Brown jbrown@ipbtax.com	Eric R. Fox efox@ipbtax.com
Harry L. Gutman hgutman@ipbtax.com	Jeffrey E. Moeller jmoeller@ipbtax.com	Leslie Jay Schneider lschneider@ipbtax.com	Patrick J. Smith psmith@ipbtax.com