Final Section 385 Rules

A mixed bag for sovereign wealth and pension funds

kpmg.com

KPMG

The good news regarding the final Section 385 rules is that they are significantly less burdensome than the proposed Section 385 rules. However, this does not mean that taxpayers, including pension funds and sovereign wealth funds (SWFs), have cause to celebrate.

The final rules are still extremely complex, are very long (more than 500 pages), and create new compliance obligations.[1]

During a March 2017 Webcast, KPMG LLP tax professionals David Neuenhaus, Stuart Cruikshank, and Greg Featherman discussed the Section 385 rules and their potential impact on SWFs and pension funds. They explored the new rules, explained how they differed from the proposed rules, and offered recommendations on what impacted entities need to do to prepare for and comply with Section 385.

Time of the essence: Generally speaking, there are two parts to the rules. The first part, the "recast" rules, generally apply to debt issued after April 4, 2016 (including debt deemed issued by virtue of a significant modification).[2] The second part, the "documentation" rules, apply to debt issued on or after January 1, 2019.[3] Time is of the essence: pension funds and SWFs need to act now to get their policies and processes in place.[4]

Although there is no reason to believe that the Section 385 rules will actually be repealed as part of the Trump administration's deregulation efforts, a recent Treasury Notice identified the Section 385 regulations as a candidate for possible simplification or repeal.

[1] On April 21, 2017, President Trump signed an executive order requiring an immediate review of all significant tax regulations since the beginning of 2016, and requiring an interim report within 60 days, followed by a report on specific actions to lessen the burden of the regulations identified in that interim report within 150 days. In response to that executive order, a large number of trade groups have written comments requesting the repeal of the Section 385 regulation. On July 7, 2017, Treasury released Notice 2017-38, which specifically identified, among others, the Section 385 regulations as candidates for simplification or repeal.

[2] The recharacterization of a debt under the "recast" rules did not occur until 90 days after the regulations were issued in final form (such date being January 19, 2017). While it is not clear what the result of that process will be, in the absence of further action, the Section 385 regulations will continue to apply.

[3] Originally, the documentation rules were scheduled to apply to debt issued on or after January 1, 2018. However, in Notice 2017-36, the Treasury announced that the application of the documentation rules would be delayed for 12 months, applying to debt issued on or after January 1, 2019.

[4] The proposed Section 385 rules also gave the Treasury the power to bifurcate but, to the relief of potentially effected businesses, this provision was not included in the final Section 385 rules.

Background

From a tax perspective, it is less costly—and typically more beneficial—for a company or individual to finance a transaction with debt rather than by making a capital contribution (i.e., with stock or equity). With debt financing, payment of interest that accrues can be tax deductible. And repayment of principal on debt occurs tax free. On the other hand, with equity, distributions are typically treated as taxable dividends and generally are not deductible.

When financing transactions are made between **related parties**, like a parent corporation and its subsidiaries, the arrangement attracts greater scrutiny. The Treasury Department will take a close look at these transactions and may reclassify the debt as equity, where a true debtor-creditor relationship does not exist.

It is exactly this situation that the final rules to Section 385 focus on. They set out "bright line" rules about when debt instruments are truly debt, and when they may—or must—be reclassified as equity under the so-called recast rules. It also sets out documentation requirements that must be met in order for debt instruments to be treated as debt instead of equity.

Note that even if a debt instrument is not treated as equity under the Section 385 rules, it may still be recharacterized as equity under the historical "facts and circumstances" approach to debt-equity classification.

The consequences: If debt is recast as equity, it may affect repatriation planning, eliminate U.S. interest deductions, and have other significant income tax consequences such as unanticipated withholding taxes, additional shareholder classes, and other unforeseen complexities.

Highlights of Section 385

Before taking a deeper dive into the Section 385 rules, the following highlights should be noted:

- The Section 385 rules generally apply only to debt issued by a U.S. corporation and held by a member of the U.S. corporation's "expanded group."
  - An expanded group is a group of corporations connected through stock ownership (directly or indirectly) with a common parent corporation (other than an S corporation, a RIC, or a REIT), but only if (i) the common parent corporation owns (directly or indirectly) at least 80 percent (by vote or value) of at least one corporation, and (ii) at least 80 percent (by vote or value) of each member of the group is owned (directly or indirectly) by other members of the group.
  - There are also special rules applicable to debt issued by or held by certain partnerships.
- The following examples illustrate the determination of an expanded group.
  - **Example 1:** Fund, a partnership with individuals as owners, owns all of the stock of a U.S. portfolio company. Fund and the U.S. portfolio company are not members of the same expanded group (and therefore loans between Fund and the U.S. portfolio company are not covered by the Section 385 rules).
  - **Example 2:** U.S. blocker, which is owned 100 percent by a foreign corporation, invests in Fund. Debt issued by U.S. blocker to its shareholder is an expanded group debt that is covered by the Section 385 rules.
- Generally, debt issued by certain specific types of issuers is not covered by the new rules. This includes, among others, debt issued by (i) foreign corporations, (ii) S corporations, (iii) certain RICs and REITs, and (iv) certain regulated financial institutions (banks, savings and loan associations, and insurance companies).
- Note that the Section 385 rules contain several antiavoidance rules that can cause debt instruments otherwise not subject to the Section 385 rules to become subject to the Section 385 rules.
- If the Section 385 rules apply to a debt instrument because it is between expanded group members (and no other exceptions apply), there are a number of substantive rules that may apply to recharacterize the debt instrument as equity for U.S. tax purposes. These substantive rules are discussed in greater detail below. Note that the discussion below is high level. The rules are very complex and address a number of fact patterns not specifically addressed below.

Who is covered by Section 385?

Section 385 generally covers transactions made between a parent company and members of an "expanded group." An expanded group is one or more chains of corporations connected through stock ownership of at least 80 percent (by vote or value) with a common corporate parent [Reg. Sec 1.385-1(c) (4)].

Expanded group members can include U.S. corporate blockers (often used for private equity), controlled U.S. portfolio companies, and controlled U.S. operating companies.

SWFs and pension funds often invest in these types of businesses, which is why they need to be aware of the Section 385 rules.

The recast rules – details

When an intercompany debt instrument is issued, but does not appear to create any new economic benefits or generate profits, earnings or investments, Treasury will presume that the debt was issued primarily as a tax avoidance or mitigation strategy. The Section 385 recast rules contain two operative rules to address this concern: the "general rule" and the "funding rule."

Under the general rule, a debt instrument issued by a U.S. corporation to a member of its expanded group is treated as stock of the U.S. corporation if it is issued:

— As part of a distribution,

— To acquire stock in a member of the expanded group, or

— To acquire assets of an expanded group member as a part of a tax-free reorganization.

Under the funding rule, a debt instrument issued by a U.S. corporation (the "funded member") to a member of its expanded group in exchange for property (e.g., cash) is treated as stock of the funded member if it is treated as funding a "funded transaction," which includes the following:

— A distribution of property by the funded member to a member of the expanded group (subject to certain exceptions),

— An acquisition of stock in a member of the expanded group from another member of the expanded group in exchange for property (subject to certain exceptions), or

— An acquisition of assets of an expanded group member in exchange for property as part of a tax-free reorganization.

In general, a debt instrument issued during the 36-month period preceding or following a funded transaction is presumed to be issued to fund such funded transaction. Note, however, that funded transactions occurring before April 5, 2016 are not taken into account.

The following examples illustrate how the recast rules work:

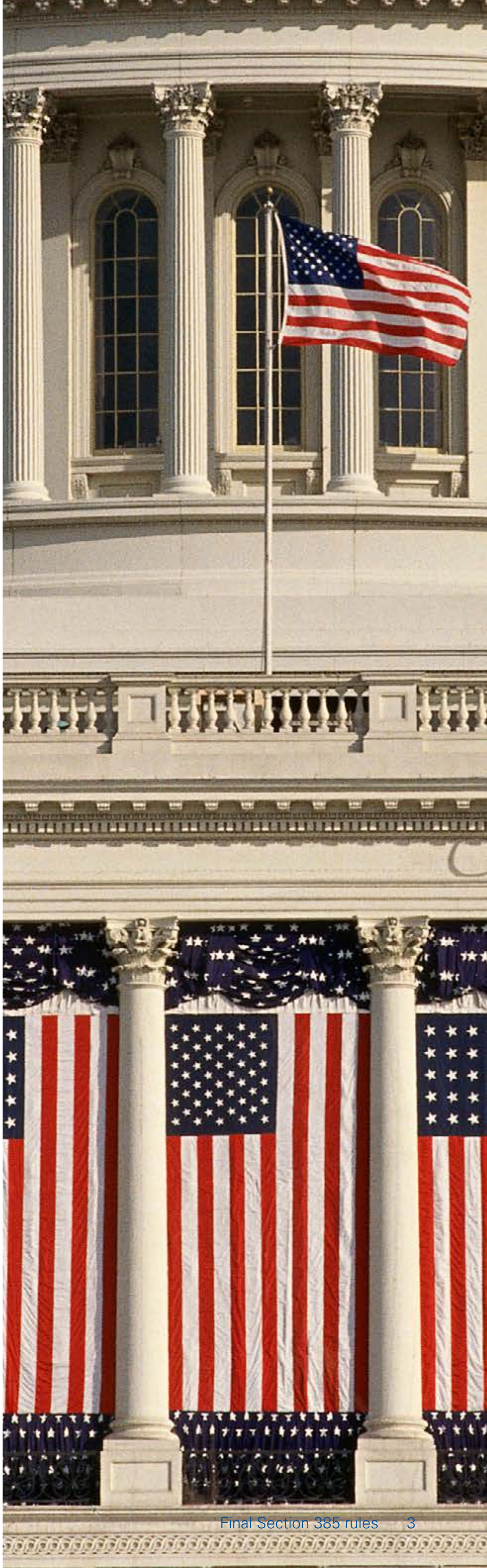
Example 1: A foreign parent company owns two brother-sister U.S. subsidiaries (Sub #1 and Sub #2). If Sub #1 simply distributes a note to the foreign parent, or buys stock in the foreign parent in exchange for a note, the debt instrument (the note) will be treated as equity under the general rule.

Reason: The foreign parent company is not making a new investment in Sub #1; the transaction is primarily made to push debt to Sub #1.

Example 2: Sub #2 is merged into Sub #1, and Sub #1 issues a note to the foreign parent as consideration for the merger. The result is the same; the debt will be treated as equity under the general rule.

Reason: Again, there is no economic benefit or value created by the transaction.

Example 3: This time, Sub #1 receives $1 million from the foreign parent in exchange for the note.



Notable exceptions from the Section 385 rules

— Debts issued by foreign corporations

— Cash-pooling operations of U.S.-based multinational corporations

— "Ordinary course" transactions, including cash pool deposits and borrowing, certain other short-term debt instruments

— Funding for certain acquisitions of controlled company/subsidiary stock

— Distributions from a complete liquidation of a related company or as part of a tax-free reorganization or liquidation

— Distributions or acquisitions made 36 months before or after date of the distributions or acquisitions

— S corporations; REITs and RICs may be covered, but only if they are considered to be "controlled"

— Banks, bank holding companies, certain savings and loan holding companies, regulated insurance companies

— Covered debt instruments of $50 million or less; if over $50 million, only the excess may be treated as stock

Reason: If Sub #1 engages in a funded transaction (e.g., makes a distribution to its parent) less than 36 months before or after the note is issued, it is presumed that the distribution is equity and not debt, and will be recast as equity under the funding rule.

Exceptions to the recast rules: The amount that may be recast is subject to a number of exceptions; a few notable ones include:

— Partial recharacterization: For example, if a parent loaned a subsidiary $1 million, and the subsidiary distributed $600,000 back to the parent within the 36-month period, only $600,000 would be recast as equity. The $400,000 balance could still be eligible for debt treatment.

— Earning and profit reduction: The amount subject to recharacterization under the general rule and the amount of funded transactions are generally reduced by the earnings and profits of the issuer that are earned in taxable years ending on or after April 5, 2016.

— Equity contribution reduction: The amount subject to recharacterization under the general rule and the amount of funded transactions are generally reduced by the value of the stock issued by the issuer in "qualified contributions." This exception benefits many companies that invest in infrastructure or real estate.

— $50 million exception: The first $50 million of debt that would otherwise be recharacterized as equity under the Section 385 recast rules will not be recast as equity. Note that even if the funded transaction exceeds $50 million, e.g., it is $55 million, the first $50 million is exempt from being recast; only the additional $5 million payment can result in recharacterization as equity.

— Open financing arrangement exception: The recast rules generally do not apply to distributions made under short-term or ordinary course transactions, including cash pooling arrangements or revolving accounts.

The documentation rules – details

Proper written documentation must be prepared for a debt instrument issued by a U.S. corporation to a member of an expanded group to be treated as debt for tax purposes. If not, the debt will be recharacterized, or recast, as equity.

The taxpayer must document the following:

— The debtor's unconditional obligation to repay the debt,

— Proof of the creditor's rights,

— Reasonableness of expectation that the debtor has the ability to repay back the loan, and

— Actions that indicate an ongoing debtor-creditor relationship.

As a general rule, the more the related parties treat a debt transaction the way a bank or a third-party lender would treat a loan, the better off they are and the more likely it is that the Treasury will do the same.

For instance, the parties should document the debt with a promissory note, creditor agreement, etc. Also, the borrower should provide the lender with financial statements and other information that shows it has the ability to pay back the debt, including cash flow projections, business forecasts, asset appraisals, and so on.

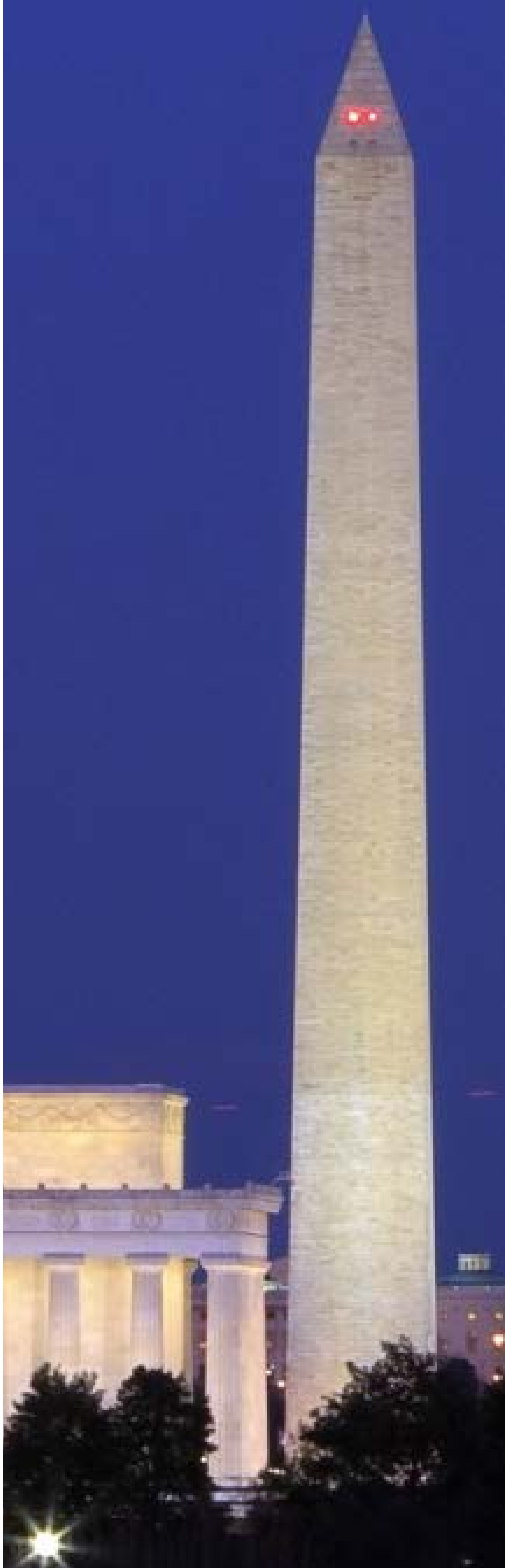
The borrower must also provide financial protections to the lender in the event it does not make good on its obligation (i.e., protecting creditor's rights). And in the event there is a default, the parties should act the way that an unrelated debtor and creditor would. So for example, if an unrelated creditor would require the debtor to renegotiate the loan terms, the parties should do the same—and make sure to document it.

"Small issuer" exception: The Section 385 documentation rules do not apply unless (i) the stock of a member of the expanded group is traded on an established financial market, (ii) total assets of the expanded group exceed $100 million, or (iii) annual total revenue of the expanded group exceeds $50 million.

Good faith exception: As noted above, while the parties technically are required to have all documentation in place by the time they file tax returns for the year the debt was issued, Section 385 includes a good faith exception. As long as the parties are in substantial compliance with the rules and have acted accordingly, Treasury may offer some leeway and not recharacterize the debt as equity.

Special rules for revolving accounts and cash pooling arrangements: The documentation requirements are also relaxed when debt financing is made via an open account, such as a revolving account or cash pooling arrangement. Under these setups, debtors may draw upon the account on an annual (or other) basis, or they may not tap into the account at all for extended periods of time.

In such cases, documentation only has to be updated once a year (e.g., running an annual credit check on the borrower) or when there is a material change in the borrower's creditworthiness. In other words, the documentation does not have to be updated each time funds are borrowed, reducing the administrative burden on the parties.



Eight steps to take now

SWFs and pension funds should take the following eight steps now to prepare for the Section 385 rules:

1. Design and implement a system that identifies expanded groups and each expanded group member. This includes:
   - Controlled U.S. corporate blockers including those used for private equity investments,
   - Controlled U.S. corporate portfolio companies, and
   - Controlled U.S. operating companies (e.g., domestic credit platforms).
2. Establish processes for tracking the balances of any loans issued after April 4, 2016[5] and document the nature of these transactions.
3. Establish a system to track transactions and amounts subject to the recast rules. The system should track debt instruments, distributions (including dividends) issued to expanded group members, acquisitions of stock or assets from expanded group members, mergers, and reorganizations.
   - This system should also allow review of the earnings and profits of expanded group members as well as capital contributions made to them; this may enable a reduction in the amount that potentially can be recast.
4. Review terms of intercompany credit agreements being used for loans made to expanded group members based in the United States.
   - Maintain separate files for each lending arrangement, including ongoing agreements (e.g., revolving and cash pooling arrangements), and periodically review and update them.
5. Ensure that debt instruments issued by U.S. corporations that are part of an expanded group meet the documentation requirements; this includes maintaining files for each intercompany lending arrangement.
6. Review deal models. In reviewing the models, make sure that the benefits—tax and otherwise—of any U.S. inbound loans from a parent or expanded party member are considered.
   - This review should also take into account tax structuring that will allow for access to repatriation of cash.
7. Provide training to all affected parties on the Section 385 rules.
   - Consider what various impacted individuals or departments need to know. For example, what information does the tax group need to understand?
   - Determine who is responsible for owning the review process. For a portfolio company, it might be the owner of accounting records; for a global enterprise, it may need to be more centralized.
8. Modify diligence procedures.

[5] April 4, 2016 was the date the proposed Section 385 rules were issued. Although application of the documentation rules has been deferred to January 1, 2019, the recast rules still apply to debt instruments issued after April 4, 2016. Also, some companies may opt to apply the proposed regulations to debt instruments issued after April 4, 2016 and before October 13, 2016, the date the final rules were issued.

Final thoughts

The final Section 385 rules are long and complicated, and companies are still trying to digest their full impact. But some things are for certain: they appear to be here to stay and actions should be taken now.

Companies would be wise to review their policies and processes and begin documenting intercompany loan instruments. This is a great opportunity to stand, take an inventory of all U.S. inbound loans, and reboot processes for handling them.

How KPMG can help you

KPMG LLP is a leading provider to the financial services industry, serving more than 25 percent of FORTUNE 1000 companies in the United States. And through KPMG International's network of member firms, we serve clients worldwide with more than 2,700 partners and almost 39,000 professionals. We provide audit, tax, and advisory services to a broad range of industry players, including pension funds and SWFs, both domestic and international.

Our professionals have deep knowledge of current tax and other compliance regulations. Their network of industry and governmental contacts and associations helps ensure that we stay on top of potential regulatory changes. In this way, we can help our clients proactively take advantage of change rather than merely react to it.

We offer:

- Deep industry experience: Our professionals have the passion and experience to help you deal with the issues and challenges that impact you today, as well as prepare you for what lies ahead.
- Global strength and capabilities: KPMG International's network of member firms includes professionals located in the world's commercial hubs, enabling us to serve our clients wherever they do business.
- Outstanding team leadership by senior professionals: Our engagement teams, led by senior partners and professionals, work with you to offer practical, customized, and appropriate insight and guidance, and deliver real, tangible results.
- Advanced technology and innovation: We supplement our hands-on approach with industry-leading technology capabilities that help enable you to operate and leverage your resources—people, vendors, legacy platforms, and equipment—more efficiently.

Get in touch with us

For more KPMG insights on the final Section 385 regulations, visit www.kpmg.com/us/385regs, click here to listen to a replay of the Webcast, or contact:

David M. Neuenhaus
Principal, Tax, International M&A
Global Lead, Institutional Investor Group
T: 917-400-9272
E: dneuenhaus@kpmg.com

Stuart Cruikshank
Partner, Tax, International M&A
T: 917-601-3827
E: scruikshank@kpmg.com

Greg W. Featherman
Principal, Tax, International M&A
T: 202-533-5045
E: gfeatherman@kpmg.com

Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates.

kpmg.com/socialmedia