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Section 385 final regulations: Initial reactions

The Treasury Department and IRS late yesterday released final and temporary section 385 regulations (hereinafter the "Final 385 Regulations") addressing the treatment of related party debt for U.S. tax purposes. These regulations had been proposed on April 4, 2016 (the "Proposed 385 Regulations").

- Read text of the final regulations [PDF 1.73 MB]

The final rules offer significant relief for U.S. multinational groups, and offer some, but less significant, relief for foreign multinational groups.

The discussion below contains a high-level summary of the section 385 regulations, including the key changes from the Proposed 385 Regulations, based upon KPMG's initial review of the new rules, and will be supplemented with further analysis in the future.

Structure

As with the Proposed 385 Regulations, the final version contains four separate sections: Treas. Reg. §§ 1.385-1 (providing general definitions and rules); 1.385-2 (the "Documentation Rules"); 1.385-3 (the "Recast Rules"); 1.385-4 (the "U.S. Consolidated Group Rules"). Certain matters within the rules are reserved.

Effective dates

Under the Proposed 385 Regulations, the Documentation Rules were effective for debt issued on or after the date the regulations became final. The Recast Rules were technically applicable to debt issued on or after April 4, 2016, and to "tainted" transactions occurring on or after that same date, subject to a 90-day grace period upon finalization before affected debt instruments are deemed converted into equity.

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The Final 385 Regulations offer significant relief with respect to the final Documentation Rules' effective date in two main ways. First, the final Documentation Rules only apply to debt issued on or after January 1, 2018, and to debt issued after that date pursuant to an "overall arrangement" in effect prior to that date. Second, the documentation requirements now are only required to be completed as of the filing of the tax return (including extensions) for the taxable year in which the "relevant date" occurs, rather than by the "relevant date." Together, these extensions provide companies an additional year of time to better assess their current status, update their systems and develop the necessary procedures to implement the documentation rules.

The effective date for the Recast Rules was largely retained, and thus applies to transactions occurring and debt issued on or after April 4, 2016. There is also a complicated "final transition period" that generally exempts debt from the Recharacterization Rules if it is settled within 90 days of the publication of the Final Regulations (estimated to occur on October 21). Any debt that would have been recast between April 4, 2016 and the end of the final transition period is subject to recast upon the end of the final transition period.

Foreign Issuer Exception

Arguably the proposed 385 Regulations were overbroad in that they contained no U.S. tax "relevancy" filter to their application. Thus, for example, if a U.S. company was considering acquiring the stock of a foreign target that had no U.S. tax connection, the U.S. company would have to evaluate and reconstruct the foreign target group's intercompany transactions through the lens of the Proposed 385 Regulations which necessarily were not considered by the target company at the time.

Treasury and the IRS also had repeatedly noted that they would provide for a "foreign to foreign" or "relevancy" exception, which was expected to exclude at the least debt issued between two foreign entities that did not have U.S. tax relevance. Some commentators also requested treating all of an expanded group's "controlled foreign corporations" as a single corporation for purposes of the 385 rules, in order to minimize the rules' application to transactions that were not directly U.S.-tax relevant.

The Final 385 Regulations broadly exempt all debt issued by foreign corporations, including both controlled foreign corporations ("CFC"s) and non-U.S. controlled foreign corporations. The change is implemented by limiting the current application of the rules to debt issued by a "covered member," meaning a member of the expanded group that is a domestic corporation. The significance of this carveback cannot be overstated, particularly for U.S. multinationals. The restricted definition also exempts debt issued by partnerships from the scope of the Documentation Rules, although debt of a covered member that is held by a controlled partnership is still subject to the rules.

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Cash pooling

Perhaps the most commented-upon and discussed issue for the Proposed 385 Regulations was how they would apply in the context of "cash pooling" arrangements, a modern treasury function used by many multinationals to streamline groups' interaction with external lenders and also to facilitate intercompany financing. Treasury and the IRS have indicated that they did not intend to generally deny multinationals the ability to use cash pooling arrangements, but wanted to ensure that the arrangements could not be used to avoid the substance of the Proposed 385 Regulations.

The general exemption for foreign issuers should provide significant relief in this regard. For domestic issuers, the Final 385 Regulations also provide more detail regarding how to satisfy the four requirements in the Documentation Rules with respect to cash pooling arrangements (discussed further below). More broadly, however, the Final 385 Regulations do not provide a holistic definition of a cash pooling arrangement for U.S. income tax purposes, and do not exempt cash pooling arrangements (including notional cash pooling arrangements) from the Documentation Rules. In the context of the Recast Rules, certain demand deposits made by group members are not subject to recharacterization.

Bifurcation

In a significant change from the Proposed 385 Regulations, Treasury and IRS did not include the much-discussed and ambiguous "Bifurcation" rule in the Final 385 Regulations. The Bifurcation rule would have provided the IRS, upon audit, the authority to determine that an instrument that was treated as debt by the taxpayer should instead be treated as part-debt and part-equity, for example because the issuer could only reasonably be expected to service less than 100% of the debt obligations. Numerous commentators focused on the lack of specificity and guidance around the rule and questioned how it would be applied in practice by revenue agents.

The changed position means that under the Final 385 Regulations, the debt versus equity classification for U.S. tax purposes generally remains an "all-or-nothing" determination. The preamble to the final regulations indicate that Treasury and the IRS continue to study this issue, but because it was not included in the final regulations, the preamble does not discuss the comments received with respect to the Bifurcation rule.

S Corporation status

A significant collateral effect of the Proposed 385 Regulations would have been that if debt issued by an "S Corporation" were recharacterized into equity, the deemed equity could invalidate the S Corporation's "S Election" by being treated as a prohibited second class of stock. The Final 385 Regulations responded to comments requesting relief on this point by excluding S Corporations from the definition of an expanded

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group, thereby fully exempting debt issued by S Corporations from the section 385 rules.

Application to Regulated Financial Institutions, Insurance Companies, RICs and REITs

The Proposed 385 Regulations did not contain an explicit carveout for debt issued by corporations that are subject to regulatory oversight (such as financial institutions and insurance companies) and thus have limited ability to "manipulate" their debt issuances, or that are effectively pass-throughs under special U.S. tax regimes and thus have limited incentive to engage in "earnings stripping."

The Final 385 Regulations exclude RICs and REITs from being members of an expanded group, and thus debt issued by such entities is outside the rules, unless the RIC or REIT is controlled by members of an otherwise existing expanded group.

For regulated entities, the Final 385 Regulations do not provide any exception from the Documentation Rules for debt issued by such companies. The final Recast Rules, however, do not apply to debt issued by qualifying "regulated financial companies" and certain other specified non-financial companies, including insurance companies.

Application to debt issued by DREs and partnerships

The Proposed 385 Regulations treated debt issued by disregarded entities ("DRE"s) and partnerships differently for purposes of the proposed Documentation Rules and Recast Rules. Under Prop. Reg. § 1.385-2, the Documentation Rules were applied at the level of the legal entity issuing the debt—*i.e.,* the DRE or partnership (provided the partnership was considered an Expanded Group member). Debt that failed to satisfy the Documentation Rules and was recast into equity could therefore result in such entities having new members for U.S. tax purposes, with potentially retroactive effect. By contrast, under Prop. Reg. § 1.385-3, the Recast Rules applied an aggregate or "look-through" approach to debt issued by pass-through entities, which was tiered up to the DRE's corporate owner or the partnership's corporate partners, as applicable.

Numerous commentators criticized and questioned the applicability of the Proposed 385 Regulations to debt issued by partnerships because of the statutory language providing that Section 385 operates to determine whether an interest "in a *corporation* is to be treated…as stock or indebtedness…".

In response, the Final 385 Regulations now exclude debt issued by partnerships from the Documentation Rules. This is implemented by applying the Documentation Rules only to debt issued by "covered members," meaning members of the expanded group that are domestic corporations. Debt issued by DREs of covered members is subject to the Documentation Rules, but if such debt is recast it is converted into equity of the DRE's regarded owner (that is, the covered member) and not into debt of the DRE. This change will reduce the uncertainty and burden that would have existed if debt

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"flunking" the Documentation Rules could result in new partners being deemed to exist in partnerships or DREs being deemed to convert into partnerships.

The final Recast Rules continue to generally apply the aggregate model to debt issued by or to a partnership that has partners that are members of an expanded group, with some modifications. The Recast Rules also apply to debt issued by a DRE, but again treat the holder of the recast debt as owning deemed equity in the DRE's regarded owner and not in the DRE.

Significant changes to the documentation rules

1. Clarified Scope and Process

As under the Proposed 385 Regulations, the substantive documentation requirements are: (i) a sum certain; (ii) creditor's rights; (iii) the borrower's ability to repay; and (iv) go-forward compliance with the terms of the debt instrument, such as evidence of timely payments and what enforcement actions were taken if an event of default occurs.

The Proposed 385 Regulations were drafted very broadly, by their literal terms applying to all expanded group debt (once the *de minimis* thresholds were crossed) irrespective of the size, duration or nature of the debt instrument. The only exception in this regard was that the Prop. Reg. § 1.385-3 recast rules contained a limited "ordinary course" exception for some trade payables. In response, numerous commentators requested that the ordinary course exception be broadened in scope and made applicable to the § 1.385-2 documentation rules; and also that some kind of overarching short-term and/or *de minimis* loan exception be provided.

For the Documentation Rules, Treasury and the IRS declined to provide these types of definitional exceptions. Instead, the Final 385 Regulations generally apply to all types of "in-form" debt for U.S. federal income tax purposes, now including specifically debt that is evidenced only through journal entries, in trade accounts, or other accounting system that does not generally form part of a company's long-term liabilities from an accounting perspective and is not corroborated by a separate legal agreement. The rules continue to reserve on the application of the Documentation Rules to debt that is not debt "in form," such as debt arising under a substance-over-form analysis of a "sale and repurchase" or "repo" transaction.

The Final 385 Regulations, however, provide a more feasible overall approach to satisfying the documentation rules. The proposed Documentation Rules raised the possibility that the expanded group would have to produce a new loan document for every accounting entry, even multiple times over the course of the same day for the same entity, and similarly to have to comply with the ability-to-pay analysis in a redundant fashion. The final Documentation Rules provide more detail on how taxpayers can use "umbrella" or "master" credit agreements that can serve as the documentation "platform" from a creditor's rights and sum certain perspective for cash

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pooling, open credit facility, and similar high-volume intercompany financing arrangements.

In this regard, the final rules provide that if a transaction is not evidenced by a separate note or other written documentation, the sum certain and creditor's rights requirements can be met only if material documentation, including enabling documents, are prepared and maintained pursuant to the overall agreement. Enabling documents are defined as including "board of directors' resolutions, credit agreements, omnibus agreements, security agreements, or agreements prepared in connection with the execution of the legal documents governing the EGI as well as any relevant documentation executed with respect to an initial principal balance or increase in the principal balance of the EGI."

Regarding the ability-to-pay analysis, the final rules helpfully permit taxpayers using such an "overall arrangement" to only perform the analysis on an annual basis, unless a specified "material event" occurs (which triggers a new analysis requirement). This annual analysis must contain information establishing that as of the date of the annual credit analysis, taking into account all relevant circumstances (such as other obligations incurred by the issuer or reasonably anticipated to be incurred after the analysis date), "the issuer's financial position supported a reasonable expectation that the issuer would be able to pay interest and principal in respect of the maximum principal amount permitted" under the terms of the agreement.

Between the new exception for foreign issuers (discussed above) and the continued treatment of U.S. consolidated groups as one taxpayer, the universe of debt instruments to which the final Documentation Rules apply is significantly narrower. While still potentially creating a compliance burden for U.S. issuers, these changes should lessen the concern that vast amounts of redundant documentation would be required.

2. Exceptions to Recast Effect

Under the Proposed 385 Regulations, failure to satisfy the Documentation Rules automatically recast the instrument into stock. Commentators noted that this could be inappropriate, especially when the relationship otherwise bore the common law factors supporting debt treatment. The final Documentation Rules adopt these suggestions by permitting taxpayers that are "highly compliant' with the rules to rebut in some cases the presumption that the documentation failure results in equity recharacterization.

The Final 385 Regulations also retain the "reasonable cause" exception for curing a missed documentation requirement.

3. Final Status of Documentation Rules

In summary, the Final 385 Regulations require documentation for all "in form" debt issued by U.S. corporations (that are members of an expanded group) to expanded group members outside of the issuer's U.S. consolidated group.

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The Final 385 Regulations retain the proposed “relevant date” concept of 30 days or 120 days after the debt issuance or creditor event. In a crucial change, however, the substantive documentation now must only be completed by the due date for filing (including extensions) the tax return for the taxable year that the “relevant date” falls within, and thus no longer by the relevant date itself. Thus, the “relevant date” now serves as the marker to associate the event with a particular year’s tax return and is not itself an effective date or applicability date.

This change will provide companies significantly more time to satisfy the Documentation Rules. Furthermore, the delay in effective date for the final Documentation Rules—to debt issued on or after January 1, 2018—provides a helpful transition period for companies to develop the necessary systems and agreements to comply going forward. Thus, for calendar-year taxpayers that file an automatic return extension, their first round of documentation materials will not be technically “due” until late 2019.

Significant changes to the Recast rules

1. No Change to 72-Month *Per Se* Period

Perhaps the most controversial aspect of the Proposed 385 Regulations was the per se “funding rule,” which provided that any debt instrument issued within 36 months before or after a taxpayer’s implementation of a “tainted” transaction (generally, a distribution to shareholders; acquiring an EG member in an asset reorganization with “boot”; and acquiring stock of another EG member in exchange for property) would be recharacterized to the extent of the amount of the transaction. Although styled a “principal purpose” rule, the 36 month before-and-after *per se* periods permitted no exception to the funding rule’s application. Government officials have defended the provision because of the chronic underfunding and resource constraints of the IRS made it impractical to take a more nuanced approach to the issue. A bright-line test can be administered by the IRS without needing to consider the subjective facts and circumstances.

The Final 385 Regulations contain the 72-Month rule and the inability to rebut the presumption of a principal purpose for debt issued within that period. As discussed elsewhere herein, however, the narrower scope of the final rules should reduce the number of loans that must be monitored for purposes of the Recast Rules.

2. Expanded Exceptions to In-Scope Debt

The Proposed 385 Regulations contained an “ordinary course” exception to the Funding Rule for certain intercompany trade payables arising in connection with the purchase of property or the receipt of services. Otherwise, any instrument treated as debt for U.S. tax purposes generally could be caught.

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Helpfully, the Final 385 Regulations contain several new categories loans that are exempt from the Funding Rule, including:

1) Demand deposits placed with the "qualified cash pool header" entity pursuant to a "cash management arrangement";
2) One of two alternative "short-term" funding arrangements, respectively based on the current assets arising from ordinary course transactions and as reported on the issuer's financial statements in the current period or certain loans outstanding for 270 days or fewer;
3) Loans issued for property (other than cash) in the ordinary course of the issuer's trade or business, provided reasonably expected to be repaid within 120 days; and
4) Loans which are interest-free in fact and which are not required to carry interest under the applicable U.S. tax rules—*e.g.*, they do not have OID, are not required to impute interest under sections 483 or 7872, and are exempt from bearing an arm's-length interest rate under section 482.

3. Current Year E&P Exception

Under the proposed regulations, the Recast Rule and Funding Rule in Prop. Reg. § 1.385-3 would not apply to the extent of the corporations' current-year earning and profits ("E&P"). The exception, which was intended to approximate exempting a distribution by companies' of their customary annual profits, was a widely-discussed topic. At times government officials have suggested that a different metric (such as a three-year rolling average for current E&P) might be included instead because of, *e.g.*, the narrow and somewhat elective nature of the current E&P measurement.

The Final 385 Regulations retain and expand the current E&P exception in two significant ways. First, the new exception permits all E&P that accumulate in years ending after the initial proposal to be included in the "buffer" that prevents recharacterization of debt instruments under the Recast Rules. This change is implemented through the new concept of a member's "expanded group earnings account," which includes earnings accumulated by the member in taxable years ending after April 4, 2016 (and importantly, excluding dividends attributable to pre-effective date years' E&P). Second, the new exception permits taxpayers to net "qualified contributions" of non-excluded property into a subsidiary against distributions and stock purchases by the subsidiary, with the effect that only debt equal to the "net reduction" of the subsidiary's capital amount is subject to recharacterization.

Because the Recast and Funding rules were technically retroactive to April 4, 2016, a question of reliance arises for taxpayers that may have expected to use the current year E&P exception in their transactions and planning decisions during the interim period. The final regulations include a transition rule under which taxpayers may choose to apply the proposed versions of §§ 1.385-1, -3 and -4 to debt issued on or after April 4, 2016, and before October 13, 2016, provided that approach is consistent.

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4. Clarification of Potential “Cascading” Recasts

Another thorny aspect of the proposed Funding Rules was that it appeared possible for a single distribution or acquisition transaction to eventually taint numerous intercompany loans. For example, if a dividend by Company A were to recast a loan taken out by Company A as equity, and then repayment of that recast loan created a new dividend-equivalent redemption of the deemed stock, another dividend distribution would arise which could potentially taint other expanded group borrowings by Company A, and so on.

In response to numerous comments to limit and clarify the application of the funding rule on this matter, Treasury helpfully modified the application of the funding rule to somewhat prevent this “cascading” effect. Under the final regulations, once a debt instrument (*e.g.*, Debt A) has been recast into debt under the Funding Rule, the “tainting” transaction no longer can recast other debt instruments even after Debt A is repaid. The government did not agree, however, that a repayment of Debt A that was treated as a dividend-equivalent redemption should also be excluded as a new dividend for purposes of the funding rule, and thus that deemed dividend can still recast other in-scope debt.

Collateral effects upon other Federal Income Tax Provisions

The effect of recasting debt into equity for U.S. tax purposes raises a host of collateral issues for the conversion and repayment of such instruments, including the section 902 foreign tax credit treatment of repayments of recast debt and the status of recast debt for ownership provisions such as in the corporate reorganization and non-recognition rules, “S-Corporation” eligibility, consolidated group ownership rules, and for purposes of U.S. income tax treaties.

A number of these concerns have been significantly ameliorated by the reduced scope of the Final 385 Regulations and their sole application to debt issued by domestic C-corporations. Thus, for example, debt issued by a CFC could not be treated as non-voting stock with adverse section 902 implications; debt issued by foreign entities “above” a domestic corporation in the ownership chain cannot be recast into equity in a way that would muddle Treaty ownership requirements; and debt issued by S Corporations cannot be converted into a second class of stock that threatens the Subchapter S Election’s viability.

For the debt that remains in scope, however, Treasury and the IRS rejected the requests by commentators to carve back the recast effect for purposes of any other provision, except for one relating to affiliated group status. The sole exception is that debt recharacterized under the Recast Rules is, if not described in section 1504(a)(4) (generally, “plain vanilla” preferred that is not treated as stock for purposes of the affiliated group test) and excluded under that provision, then nevertheless not treated as stock for purposes of section 1504(a). This exception will help limit the risk that recast debt would “de-consolidate” the U.S. corporate issuer.

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Conclusion

The proposed rules have been characterized as one of the most significant changes, and potentially burdensome new regimes, in the U.S. international tax system in decades. After much speculation and concern, the final product reflects a significant effort by Treasury and the IRS to limit the scope and burden of the 385 Regulations, particularly for U.S. multinationals. The Final 385 Regulations contain many new terms and concepts that bear further close scrutiny, and they will be addressed in subsequent reports.

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