



The Final and Temporary Section 385 Regulations

Key Highlights from a U.S. Inbound
Perspective

30 November 2016



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Speakers

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Agenda

- Introduction
 - Significant Changes
 - Effective Dates
 - Key Definitions
- The Final Section 385 Regulations
 - Documentation Rules
 - Recast Rules
 - Consolidated Groups
- Examples

Introduction

Introduction

On October 21, 2016, the Treasury Department and the IRS published final and temporary regulations under section 385 (the “Final 385 Regulations”)

The Final 385 Regulations primarily affect debt issued by U.S. corporations to related parties outside their U.S. consolidated group

The Final Regulations include rules regarding:

- Documentation of related-party debt instruments (the “Documentation Rules”)
- Recharacterization of related-party debt instruments issued in certain transactions (the “Recast Rules”)

Regulation package also includes:

- Temporary regulations addressing the application of the Recast Rules to:
 - Certain types of debt instruments (e.g., short-term and ordinary course instruments) and debt instruments
 - U.S. consolidated groups (the “Consolidated Group Rules”)
- Proposed regulations regarding partners’ share of recourse liabilities

Final Regulations: Significant Changes

The scope of the Final 385 Regulations is significantly narrower than that of the Proposed 385 Regulations issued on April 04, 2016 (the “Proposed Regulations”)

- No “bifurcation” rule
- Do not apply to foreign-issued debt, debt issued by S corporations, and, in almost all instances, debt issued by RICs and REITs
 - Foreign issuer exemption applies even if the issuer has income effectively connected to a U.S. trade or business or attributable to a U.S. permanent establishment
- Documentation Rules’ compliance deadline is the issuer’s timely-filed U.S. tax return
- Transaction Rules do not apply to certain regulated financial and insurance entities
- Expanded exceptions to the Transaction Rules

Effective Dates

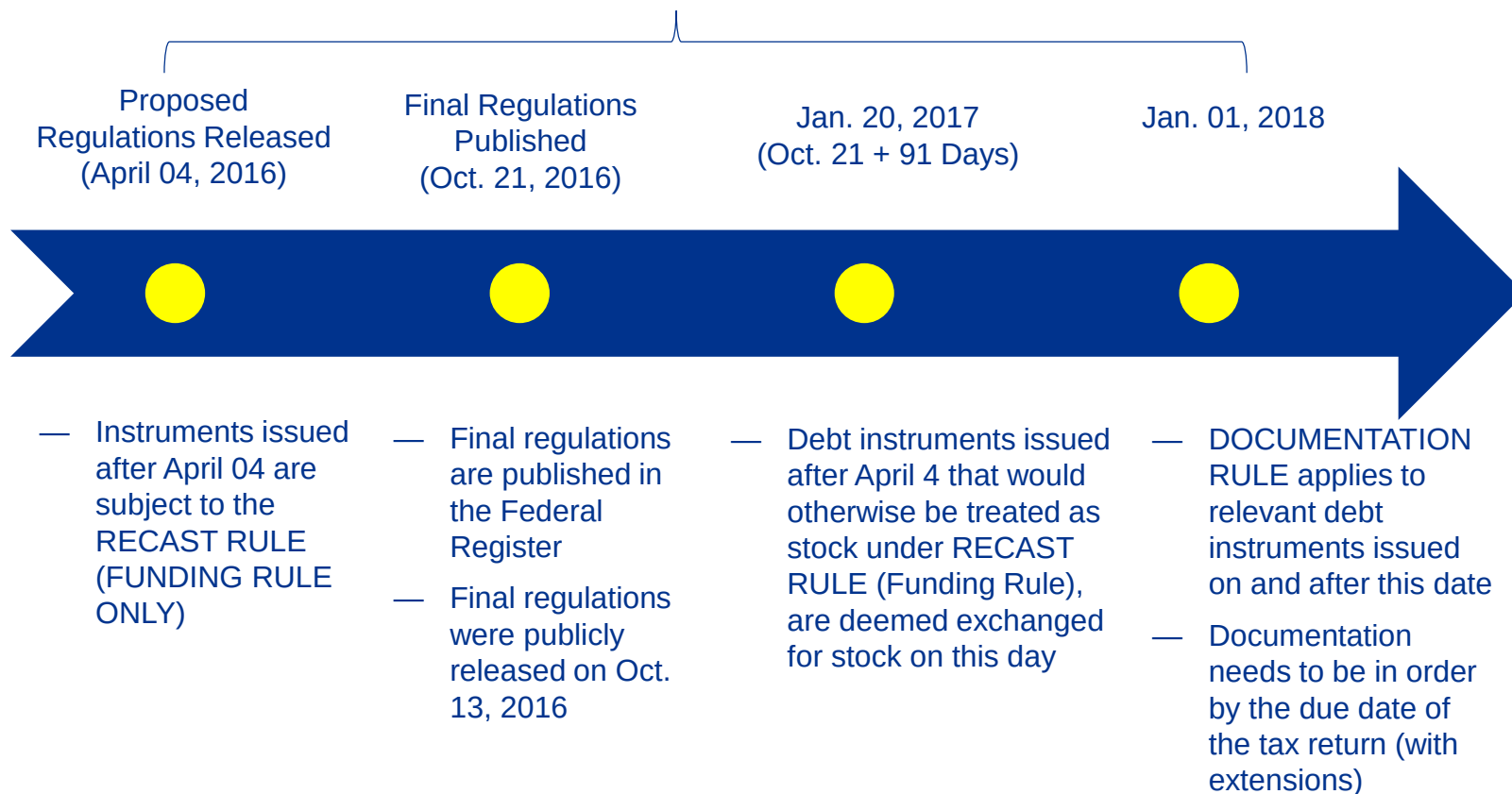
Documentation Rules

- Apply to debt issued on or after January 01, 2018

Recast Rules

- Generally apply to transactions occurring and debt issued on or after April 04, 2016
- Debt instruments treated as stock under the Recast Rules are recharacterized immediately after the General Effective Date (January 20, 2017)
 - For taxable years ending on or after the General Effective Date, debt instruments are not treated as stock prior to the General Effective Date
- Taxpayers can elect to apply Proposed Regulations for all debt instruments issued after April 04, 2016, and before October 13, 2016

Timeline of Effective Dates



NOTE: debt instruments can be deemed to be issued/re-issued as a result of re-financings, significant modifications, and certain other occurrences.

Key Definitions (1/2)

— **“Expanded Group”** (EG)

- Includes foreign corps, RICs, REITs, insurance companies, tax-exempts, DISCs (but not S corps)
- 80% vote or value
- Ownership can be direct or indirect
- Preferred Stock is excluded

— **“Expanded Group Interest”** (EGI) – Relevant to the Documentation Rule

- An “applicable interest”
 - includes interests issued in the legal form of a debt instrument (excludes repo’s)
 - includes intercompany payables/receivables documented as debt in a ledger, accounting system, open account intercompany debt ledger, trade payable, journal entry or similar arrangement if no written legal instrument or arrangement governs the legal treatment of the payables/receivables
- Issuer/holder are members of the same EG (or are DREs with regarded owners that are members of the same EG)
 - The holder can also be a controlled partnership of the same EG

Key Definitions (2/2)

— **“Controlled partnership”**

- Partnership in which EG members directly or indirectly own at least 80% of the interests in partnership capital or profits
- Indirect ownership is determined by “applying the principles” of the rules applicable to EGs

— **“Covered member”**

- A member of an EG that is a U.S. corporation

— **“Covered debt instrument”** (CDI) – Relevant to the Recast Rules

- Debt instrument issued after April 4, 2016 (with certain limited exclusions), and
- Issued by a covered member (other than certain regulated financial or insurance companies)

Documentation Rules

Documentation Rules

What do the Documentation Rules apply to?

- Generally, every kind of debt issuance by certain U.S. companies to non-U.S. affiliates in a “Medium or Large-Sized” expanded group:
 - Intercompany debt of foreign issuers is exempt
 - Not only formal loan agreements -- Documentation Rules apply to ALL “in form” intercompany debt, even if just a trade payable and/or documented as debt in a ledger, accounting system and no legal instrument governs the debt instrument
 - The rules apply separately with respect to each debt instrument

- What is a “Medium or Large-Sized” corporate group?
 - A corporate group that satisfies at least one of the following requirements:
 - A member has publicly traded stock,
 - Aggregate annual revenue is more than \$50 million, or
 - Total assets are more than \$100 million.
 - Determination is made by looking at one or more financial statements of the members of the EG.

Documentation Rules

What do the Documentation Rules require?

- Impose minimum written documentation, financial diligence and behavioral requirements that must be observed with respect to an EGI:
 - Unconditional obligation to pay a determinable sum certain
 - Creditor's rights
 - Reasonable expectation of ability to repay EGI
 - Actions evidencing debtor-creditor relationship
 - Consistency requirement
- Terms and conditions of written loan documentation alone not sufficient to satisfy Documentation Rules requirement → Actual performance of the debtor and note holder also considered
- Maintenance rule:
 - Maintain required documentation/information “for all taxable years that the EGI is outstanding and until the period of limitations expires for any federal tax return with respect to which the treatment of the EGI is relevant”
- Special rules for revolvers, umbrella agreements, cash pool and similar arrangements

Documentation Rules

What support is required to comply with Documentation Rules?

- Written documentation must include evidence of payments of interest and principal (e.g., wire transfer records, bank statements, journal entries, etc.)
 - If there is a default:
 - Documentation evidencing reasonable exercise of the diligence and judgment of a creditor
 - If rights not enforced, documentation supporting decision to refrain from pursuing actions to enforce payment as being consistent with the reasonable exercise of the diligence and judgment of a creditor
- Acceptable documentation can include cash flow projections, financial statements, business forecasts, asset appraisals, the issuer's financial ratios relative to industry averages, and other information regarding the sources of funds
- Market standard safe harbor
 - Documentation of a kind customarily used in comparable third-party transactions respected as debt can satisfy the promise to pay and creditor's rights requirements

Documentation Rules

Initial practical operational considerations

- The establishment of operational measures to avoid inadvertent compliance failures will involve a subjective process
- Suggested initial steps to prepare for the application of the Documentation Rules include the following:
 - Step 1: Compile and maintain a complete inventory of outstanding intragroup loans between U.S. and non-U.S. affiliates
 - Step 2: Begin documenting new loans in accordance with the requirements set forth in the Documentation Rules
 - Step 3: Group Tax and Treasury Departments need to ensure that terms of intragroup loans are abided by in practice

Documentation Rules

What exceptions to the Documentation Rules exist?

— General exceptions:

- Reasonable cause exception
- Ministerial or non-material error exception
- “Highly compliant” exception
 - If a taxpayer demonstrates that it is *highly compliant* with the Documentation Rules, the automatic recharacterization instead becomes a rebuttable presumption

Documentation Rules

What happens if the Documentation Rules are not satisfied and no exception applies?

- The debt instrument at issue will be recharacterized as stock.
- General rules, when an EGI determined to be stock under the Documentation Rules is treated as becoming stock:
 - If an EGI when issued, it is treated as stock at the date of issuance
 - If not an EGI when issued, it is stock as of the date it becomes an EGI
 - If recharacterized due to post-issuance behavior, the EGI becomes treated as stock “as of the time the facts and circumstances regarding the behavior of the issuer or the holder with respect to the EGI cease to evidence a debtor-creditor relationship”

NOTE: Satisfying the Documentation Rules is only a threshold to debt status

- an EGI continues to be subject to general tax principles (common law debt-equity analysis)
- an EGI that passes muster under the Documentation Rules remains subject to recharacterization as stock under the Recast Rules

Documentation Rules

When do the Documentation Rules apply?

- Generally apply to debt issued on or after January 01, 2018
 - Thus, a taxpayer must have documentation in place by the due date (as extended) of its tax return for its TYE 2018 (e.g., September 15, 2019)
 - Taxpayers should use the time to implement systems and controls for compliance
 - Taxpayers should implement “best practices” currently without regard to the effective date

Recast Rules

Recast Rules

What are the Recast Rules?

- The Recast Rules recharacterize as stock related party debt instruments issued in a transaction (or series of transactions) that does not result in new investment in U.S. operations.
- Two primary operating rules:
 - “General Rule”
 - “Funding Rule”

What Do the Recast Rules Apply to?

- The Recast Rules apply to CDIs
 - Debt instruments
 - Issued after April 04, 2016
 - Issued by a covered member (i.e., “U.S. corporations” and “controlled partnerships”)

Recast Rules

What is the “General Rule”?

- The General Rule targets three “suspect transactions” by which a CDI is recharacterized as stock to the extent issued to an EG member:
 - in a distribution (other than an exempt distribution)
 - to acquire stock in an EG member (other than in an exempt exchange)
 - as boot in an intra-EG asset reorganization

Recast Rules

What is a “Funding Transaction”

- The Funding Rule generally applies to recharacterize as stock CDI issued to an EG member in exchange for property that is treated as funding a “defunding” acquisition or distribution outlined above, *to the extent* of the defunding
 - **Per se funding rule:** a CDI is treated as funding an acquisition or distribution (thus recharacterized as stock) *to the extent* the issuer issues the CDI within the *per se* period that applies to the defunding acquisition or distribution
 - The *per se* period begins 36 months before the date of a defunding acquisition or distribution (but not prior to April 04, 2016), and ends 36 months after the date of the defunding acquisition or distribution
 - **Principal purpose funding rule:** a CDI is treated as funding a defunding acquisition or distribution (thus recharacterized as stock) if it is issued outside of the *per se* period with a principal purpose to fund the defunding acquisition or distribution

Recast Rules

Additional Recharacterization Rule

— Anti-avoidance rule

- If an EG member enters into a transaction with a principal purpose of avoiding the purposes of the Recast Rules, a CDI issued or held by that member (or another EG member) may, depending on the facts and circumstances, be treated as stock

Recast Rules

What Exceptions to the Recast Rules Apply?

— Key Exceptions to the Recast Rules

- Threshold exception (\$50 million threshold)
 - No longer a cliff!
- U.S. Expanded Group Earnings and Profits (“E&P”) exception
 - This exception is largely expanded as compared to the Proposed Regulations
 - The exception now applies to the amount of all E&P generated in all tax years ending on/after 05 April, 2016, while in the EG
 - Look-through rule for dividends applies
- Qualified short-term debt instruments exception
 - Short-term funding arrangements
 - Ordinary course loans
 - Interest-free loans
 - Deposits with a qualified cash pool header
- Certain acquisitions of subsidiary stock exception
- Qualified contribution netting exception

Recast Rules

What are the Timing Rules?

- Generally, a CDI that is treated as stock under the Recast Rules is treated as stock when issued
 - A CDI that is treated as funding a post-issuance distribution/acquisition is treated as stock on the date that the distribution/acquisition occurs
- When a CDI is treated as funding a distribution/acquisition because the funded member is a predecessor/successor of another EG member, the CDI is treated as stock on the later of:
 - the date the funded member completes the transaction causing it to be a predecessor/successor
 - the CDI issuance date
 - the date that the distribution/acquisition occurs

Consolidated Group Rules

Consolidated Group Rules

In general

- Temporary regulations apply to members of a consolidated group
 - All members of a consolidated group that file (or that are required to file) a consolidated U.S. federal income tax return are treated as one corporation (the “One Corporation Rule”) only for purposes of the Recast Rules
 - Special rules apply where a CDI ceases to be or becomes a consolidated group debt instrument (“CGDI”)
 - Special rules apply to departing members that remain members of the same EG

What’s new?

- More detail on the One Corporation Rule, including an ordering rule on its timing
- Instruments treated as stock due to the Recast Rules are no longer taken into account for purposes of determining whether the issuer is a member of a U.S. consolidated group
 - As such, the Recast Rules should not cause deconsolidation or disaffiliation

NOTE: Uncertainty remains regarding whether U.S. states will uniformly apply the One Corporation Rule

Consolidated Group Rules

Primary Consequences:

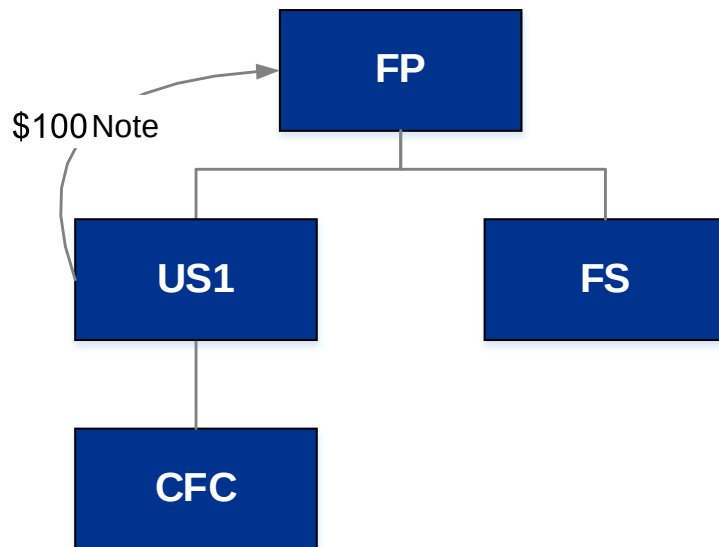
- CDIs between members (i.e., intercompany debt) are disregarded for Recast Rules purposes
- Intra-group distributions and acquisitions are disregarded for Recast Rules purposes
- CDIs issued by any consolidated group member to a non-consolidated EG member generally are treated as issued by the consolidated group for purposes of the Recast Rules
- CDI issued by any consolidated group member can be treated as funding a defunding acquisition or distribution by any other consolidated group member

Examples

Example 1: Recast Rules

Example: Distribution of a Loan Note – Recharacterization Applies

USD: '000s



Transaction

Facts

- As of 30 January 2017, US1 has no related-party indebtedness.
- On 01 February 2017, US1 distributes a self created loan note to FP ("US1 Note").
- US1 has \$0 post-04 April 2016 US earnings and profits.

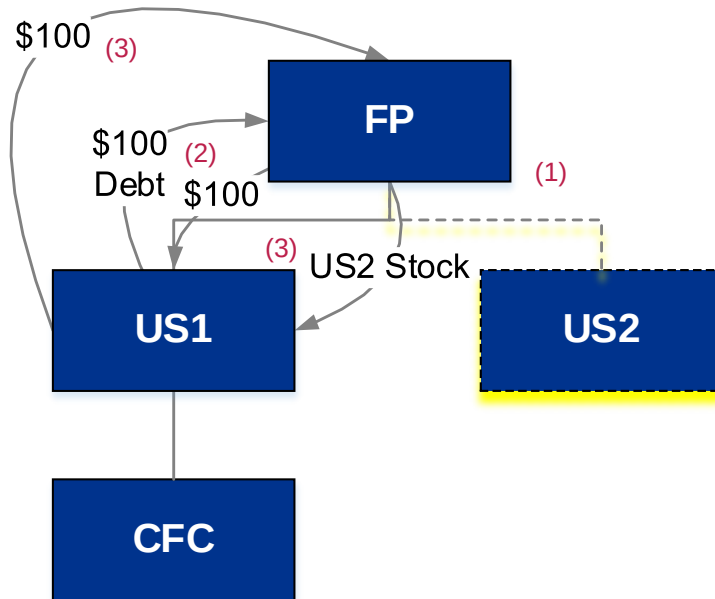
Treatment

- \$50M of US1 Note will be recharacterized as stock of US1.

Example 2: Recast Rules

Example: Stock purchase funded by a debt instrument – Recharacterization Applies

USD: '000s



Transaction

Facts

- On 01 January 2017, FP acquires US2 stock from a third party.
- On 30 June 2017, FP contributes \$100M to US1 in exchange for loan note ("US1 Note").
- On 31 December 2017, US1 purchases 100% of US2 stock in exchange for \$100M cash.
- As of 31 December 2017, US1 has no related-party indebtedness.
- US1 has \$0 post-04 April 2016 US earnings and profits.

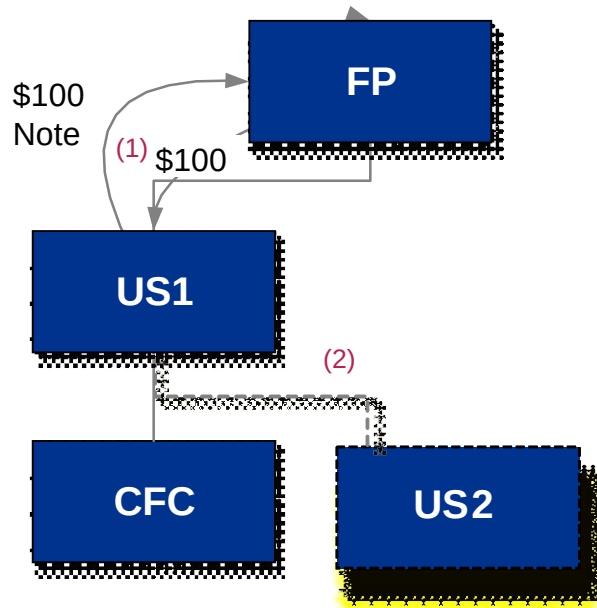
Treatment

- \$50M of US1 Note should be recharacterized as stock of US1.

Example 3: Recast Rules

Example: Stock purchase funded by a debt instrument – Recharacterization Does Not Apply

USD: '000s



Transaction

Facts

- On 01 January 2017, FP transfers \$100M cash to US1 in exchange for a loan note ("US1 Note").
- On 30 June 2017, US1 purchases 100% of US2 stock from a third party for \$100M cash.
- US1 has \$0 post-04 April 2016 US earnings and profits.

Treatment

- The \$100M US1 Note should not be recharacterized as stock as a result of the transaction steps.

Questions?

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