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Final/Temporary Regulations Address Treatment of Certain Interests in Corporations as Stock or Indebtedness

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On October 13, 2016, the United States Treasury and the IRS released final and temporary regulations under section 385 of the Internal Revenue Code (the "385 Regulations") that (i) establish threshold documentation requirements that ordinarily must be satisfied in order for certain related-party interests in a corporation to be treated as indebtedness for U.S. federal income tax purposes; and (ii) treat as stock certain related-party interests that otherwise would be treated as indebtedness for U.S. federal income tax purposes.[1]

Although the 385 Regulations were released on October 13, 2016, they are expected to have a published date of **October 21, 2016**, for determining when the various effective dates described below begin to apply to taxpayers.

Background

The 385 Regulations follow the issuance of, and *are significantly narrower in scope* than, the proposed regulations issued on April 4, 2016, under section 385 (the "Proposed Regulations") that would have (i) authorized the IRS to treat certain related-party interests as part stock and part debt for federal tax purposes; (ii) established contemporaneous documentation requirements that must be satisfied for certain related-party debt to be respected for federal tax purposes; and (iii) treated certain related-party debt as stock for all purposes of the Code when issued in connection with certain distributions and acquisitions.[2] For a discussion of the Proposed Regulations, see United States Tax Alert dated April 6, 2016.

Scope: Debt Issued by Domestic Corporations to Related Parties

[1] TD 9790.
[2] REG 108060-16, 81 Fed. Reg. 20912.

The 385 Regulations apply to debt instruments issued by a domestic corporation to certain related persons. More specifically, the 385 Regulations apply to debt instruments that are: (i) issued by a "covered member," which is currently defined to mean a domestic corporation, or a disregarded entity of a covered member; and (ii) held by a member of the domestic corporation's "expanded group," which generally includes all corporations connected to a common parent that owns, directly or indirectly, 80% of the vote or value of each such corporation.

- Exclusion of foreign issuers – The term "covered member" is not currently defined to include foreign issuers (including CFCs) and the 385 Regulations reserve on all aspects of their application to foreign issuers (including CFCs); however, the preamble to the 385 Regulations (the "Preamble") indicates that any guidance that may subsequently be issued with respect to foreign issuers will apply prospectively only.
- Exclusion of S corporations and non-controlled RICs and REITs – S corporations and non-controlled regulated investment companies (RICs) and real estate investment trusts (REITs) are exempt from all aspects of the 385 Regulations.
- Exclusion of debt instruments held by a consolidated group member – Debt instruments between members of the same consolidated group are generally outside the scope of the 385 Regulations.

Observations: The 385 Regulations target the inbound financing of a foreign-parented multinational group's domestic subsidiaries, but do not currently address the financing of such group's U.S. branch operations. Further, the 385 Regulations can be expected to have limited application to U.S.-parented multinational groups, particularly where the group's domestic corporations join in filing a consolidated return.

Bifurcation Rule Eliminated

Unlike the Proposed Regulations, the 385 Regulations do not include a general bifurcation rule, which would have allowed the IRS to treat a single instrument as part debt and part equity.

Documentation Rules

Treasury Regulation §1.385-2 (the "Documentation Rules") imposes contemporaneous documentation requirements on certain related-party debt instruments as a prerequisite to treating such instruments as debt. The rules generally require written documentation of the following four indebtedness factors (the "Indebtedness Factors"): (i) the issuer's unconditional obligation to pay a sum certain, (ii) the holder's rights as a creditor, (iii) the issuer's ability to repay the obligation, and (iv) the issuer's and holder's actions evidencing a debtor-creditor relationship, such as payments of interest or principal and actions taken on default. With respect to credit facilities, revolvers, omnibus, master and cash pooling arrangements, the Documentation Rules provide special rules to satisfy Indebtedness Factors (i) through (iii).

As compared to the Proposed Regulations, the 385 Regulations incorporate the following significant changes:

- Extension of period required for timely preparation – The 385 Regulations eliminate the Proposed Regulations' 30-day timely preparation requirement, and instead treat documentation and financial analysis as timely prepared if it is prepared by the time that the issuer's federal income tax return is filed (taking into account all applicable extensions).

- Rebuttable presumption based on compliance with documentation requirements – The 385 Regulations provide that, if an expanded group is otherwise generally compliant with the documentation requirements, then a rebuttable presumption, rather than the per se recharacterization as stock, applies in the event of a documentation failure with respect to a purported debt instrument.

- Relaxed credit analysis – The 385 Regulations provide that an annual credit analysis may be used to support an issuer's ability to repay multiple debt instruments, rather than requiring separate credit analyses for each debt issuance. An annual credit analysis cannot be used, however, after the issuer suffers a "material event," which generally includes, but is not limited to, bankruptcy, insolvency, and disposition of more than 50% of the FMV of its assets. The rules also provide that the analysis of an issuer's ability to repay can assume that the principal amount of a debt instrument will be satisfied with the proceeds of another borrowing by the issuer, provided that such assumption is reasonable.

- Notional cash pooling arrangements are potentially in scope – The 385 Regulations provide that the written documentation requirements for Indebtedness Factors (i) and (ii) that are otherwise applicable to credit facilities, revolvers, omnibus, master and cash pooling arrangements are also applicable to notional cash pooling arrangements, if such arrangements would be treated as debt issued between expanded group members.

- Trade payables may be covered by master agreements – The 385 Regulations clarify that master agreements can be used to satisfy the written documentation requirements for trade payables.

- Treatment of disregarded entities – Unlike the Proposed Regulations, the 385 regulations provide that if a debt instrument issued by a disregarded entity ("DRE") is recharacterized as equity due to failure to satisfy the Documentation Rules, then such debt will be treated as equity in the covered member that owns the issuing DRE. In other words, failing the Documentation Rules will not spring a DRE into a partnership.

- Treatment of debt instruments issued by controlled partnerships –

The 385 Regulations also exclude debt instruments issued by controlled partnerships from the Documentation Rules, unless issued with a principal purpose of avoiding the application of the Documentation Rules.

- Delayed implementation – The 385 Regulations apply only to debt instruments issued on or after January 1, 2018.

The documentation rules apply to taxable years ending on or after the date that is 90 days after the date the 385 Regulations are published in the Federal Register.

Observations: As a general matter, the 385 Regulations are less strict and more administrable than the Proposed Regulations. Similar to the Proposed Regulations, however, it is unclear how a cash pool header that takes on deposits would evidence its ability to repay. Further, while the 385 Regulations do not automatically disregard notional cash pooling arrangements as conduits, the reference to such arrangements suggests that the government will pay more attention to them in the future; accordingly, taxpayers should reconsider the documentation and operation of their notional cash pooling arrangements. Finally, despite the delayed implementation date, taxpayers should consider preparing written documentation of the four indebtedness factors for debt instruments issued prior to January 1, 2018 under general U.S. federal income tax principles.

Debt Recast Rules

Treasury Regulation §1.385-3 and Temporary Treasury Regulation §1.385-3T (together, the "Debt Recast Rules") generally adopt the following operative rules of the Proposed Regulations in targeting debt instruments issued in connection with distributions and certain acquisitions by members of the Expanded Group:

- A "General Rule" that applies if a domestic corporation distributes a debt instrument, or issues a debt instrument as consideration to acquire expanded group stock or issues a debt instrument as boot that is received by an expanded group member in an asset reorganization; and
- A "Funding Rule" that generally recharacterizes certain debt as equity if a domestic corporation distributes property other than debt, acquires stock for property other than debt, or issues boot other than debt in an asset reorganization, if the domestic corporation has issued such debt instrument within a 36-month period before or after one of the foregoing transactions, or the debt was otherwise issued with a principal purpose of funding one of the foregoing transactions.

As compared to the Proposed Regulations, the 385 Regulations incorporate the following significant changes:

- Certain debt instruments excluded – The following debt instruments are excluded from the scope of the Debt Recast Rules: (i) debt instruments issued before April 5, 2016; (ii) debt instruments issued by a regulated financial or insurance company, in each case as defined in the 385 Regulations; (iii) certain debt instruments that are issued by a domestic corporation to, or acquired by, a dealer in securities; and (iv) certain short-term debt instruments that are either issued for property other than money in the ordinary course of business, or have a short term and meet a number of conditions in the 385 Regulations.

- Expanded and Added Exceptions:
  - Subsidiary stock exception – The 385 Regulations retain and broaden the subsidiary stock exception in the Proposed Regulations to cover not only acquisitions of expanded group stock by issuance, but also acquisitions of expanded group stock from other members of the Expanded Group, in each case so long as the acquirer controls the issuer or seller immediately after the acquisition. As with the Proposed Regulations, control means direct or indirect ownership of 50 percent of the combined voting power and value of the corporation.
  - Earnings & profits exception – The earnings and profits exception has been retained and continues to apply by reducing the amount of debt reclassified as stock based on the order in which the prohibited transactions occur. However, the exception has been broadened to include not only current earnings and profits but also earnings and profits that were accumulated by the member in taxable years ending on or after April 5, 2016. The exception provides several limitations and anti-avoidance provisions. Primarily, the amount of earnings and profits available to reduce prohibited transactions engaged in by the domestic corporation is limited to only those earnings and profits that were accumulated by the domestic corporation while it continued to have the same expanded group parent. In addition, there is a "look-through" rule that disregards earnings and profits of lower-tier subsidiaries that are distributed up the chain of ownership if, generally, those earnings and profits were accumulated in taxable years ending before April 5, 2016, or were accumulated while the distributee was a member of a different expanded group.
  - "Net equity" contribution exception – There is a new exception for "net equity" contributions, where contributions of certain types of property to a corporation in exchange for its stock within a specified time frame may be applied to reduce the amount of prohibited transactions undertaken by the transferee corporation. The reduction is applied based on the order in which prohibited transactions have been undertaken by the transferee corporation.
  - Threshold exception – The "cliff effect" of the threshold exception under the Proposed Regulations is removed, so that the first $50 million of debt instruments (measured by reference to adjusted issue price) is exempt from recharacterization, regardless of whether a taxpayer has issued more than $50

million of debt instruments that are subject to recharacterization under the 385 Regulations.

   - Other new exceptions – The 385 Regulations also incorporate a number of new exceptions, such as (i) acquisitions of stock to be used as equity compensation that is delivered to individuals that are employees, directors, and independent contractors as consideration for the provision of services, (ii) deemed distributions or acquisitions resulting from transfer pricing adjustments, (iii) acquisitions of stock by dealers in securities, and (iv) an exception to address the "cascading problem" by exempting acquisitions of expanded group stock resulting from the application of the rules as being treated as giving rise to additional prohibited transactions that could cause the 385 Regulations to apply again.

- Treatment of controlled partnerships – For purposes of the General and Funding Rules, the 385 Regulations adopt an aggregate approach to controlled partnerships. If there is an event that would otherwise result in the treatment of a controlled partnership's debt instrument as equity, in lieu of recharacterizing the debt instrument as stock, the expanded group member that holds the debt instrument is deemed to contribute its receivable from the controlled partnership to the expanded group partner that undertook the distribution or acquisition in exchange for stock in that expanded group partner (but only if the expanded group partner is otherwise a covered member). This is known as the "deemed conduit approach."

- Scrutiny of partnership preferred equity – The Treasury Department and the IRS state in the Preamble that they intend to closely scrutinize, and may challenge under the anti-abuse rule, transactions in which a controlled partnership issues preferred equity to an expanded group member and the Debt Recast Rules would have applied had the preferred equity been denominated as a debt instrument issued by the partnership.

Subject to certain transition rules, the Treas. Reg. §1.385-3 generally applies 90 days after the date on which the regulations are *published* in the Federal Register.

For debt instruments that have been issued after April 4, 2016, but before 90 days after the 385 Regulations are published, and where the 385 Regulations would have applied to recharacterize them as stock during this period, the debt instruments will not be recharacterized as stock until the 91st day after the 385 Regulations have been published. There are additional transition rules that deal with the treatment of certain payments with respect to such debt instruments outstanding during this transition period, as well as a rule that avoids double counting such debt instruments as both within the scope of the General Rule and the Funding Rule.

Finally, the 385 Regulations provide an option to taxpayers to elect to apply the Proposed Regulations in lieu of the 385 Regulations for specific issuers (and members of its expanded group that are domestic corporations) during the period from April 4, 2016, through October 13, 2016. The option is solely for the purpose of determining if a debt instrument is treated as stock and must be consistently applied by the taxpayer.

Observation: Because the earnings and profits exception is limited to only those earnings and profits that were accumulated by the domestic corporation while it continued to have the same expanded group parent, taxpayers should consider whether the exception applies to acquisition indebtedness incurred by a domestic target corporation.

Consolidated Group Rules

Like the Proposed Regulations, the 385 Regulations treat members of a consolidated group as one corporation for purposes of applying the Debt Recast Rules. Generally, the Temporary Treasury Regulation §1.385-4T does not apply to issuances of interests and related transactions among members of a consolidated group, because the concerns addressed therein generally are not present when the issuer's deduction for interest expense and the holder's corresponding interest income offset each other in the group's consolidated federal income tax return. Special rules apply, however, when a debt instrument becomes, or ceases to be, a consolidated group debt instrument, or a consolidated group member that is a party to a debt instrument becomes, or ceases to be, a consolidated group member.

Blocker Entities

Although the Preamble to the Proposed Regulations asked for comments on whether to extend the proposed regulations to indebtedness issued by certain “blocker” entities to investment partnerships, the 385 Regulations do not adopt special rules for debt instruments in the context of investment partnerships, including indebtedness issued by certain “blocker” entities. However, Treasury and the IRS noted that they will continue to study these structures and transactions.

State Income Tax Implications

The proposed regulations had required that “all members of a consolidated group (as defined in §1.1502-1(h)) are treated as one corporation” for purposes of applying both the documentation rules and the debt recast rules. The temporary regulations now provide that, for purposes of applying the consolidated group rules and prohibited leveraging rules, “all members of a consolidated group (as defined in §1.1502-1(h)) that file (or that are required to file) consolidated U.S. federal income tax return are treated as one corporation.” For purposes of the documentation rules, the final regulations now exempt from the documentation requirements an intercompany obligation defined in the consolidated return rules as an obligation between members of the consolidated group (Treas. Reg. §1.1502-13(g)(2)(ii)), or an interest issued by one member of a consolidated group and held by another member of the same consolidated group.

According to the Preamble, the change to the language applicable to the prohibited leveraging rules was adopted by the Treasury in response to a commenter's concern that "if a state applies the one-corporation rule based on the composition of the state filing group rather than the federal consolidated group, transactions could be subject to the regulations for state income tax purposes even when the transactions are not subject to the regulations for federal income tax purposes." A comment suggesting all domestic corporations under common control be treated as one corporation, regardless of whether such corporations elected to file a consolidated return, was not adopted. State implications could include:

- Separate entity application of the rules in states with statutory requirements to compute taxable income beginning with *pro forma* separate federal taxable income;
- Differing combined group filing thresholds, including 50 percent ownership requirement, worldwide filings, and inclusion or exclusion of entities with a certain percentage of apportionment factors within or outside the U.S. (80/20 companies); and
- Differing earnings and profits and basis, absent application of the consolidated return regulations.

Companies should consult with their Deloitte tax advisors about the potential implications in specific jurisdictions.