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Legal Update
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Treasury and the IRS Introduce Significant Changes in the Final Section 385 Regulations on Intercompany Debt

On October 13, 2016, the US Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") issued final and temporary regulations (the "Final Regulations") under section 385 of the Internal Revenue Code (the "Code"), as the follow-up to the proposed regulations (the "Proposed Regulations") issued on April 4. Prior to issuing the Final Regulations, Treasury and the IRS received extensive public comment and feedback and submitted the rules to the Office of Management and Budget for review.

As previously reported, the Proposed Regulations had the potential to produce far-reaching effects on US and foreign companies, overturning the long-standing treatment of certain intercompany debt arrangements and subjecting them to the risk of an equity recharacterization for US tax purposes. (For commentary on the Proposed Regulations see our legal update "Treasury's New Anti-Inversion Regulations: Do They Go Too Far?")

Unsurprisingly, the Proposed Regulations resulted in numerous and substantial comments from taxpayers and the tax community, many of which were critical of the Proposed Regulations. These Final Regulations generally maintain the overall theme of the Proposed Regulations (namely, the Documentation Rule and the Recharacterization Rules, as described below). However, the Final Regulations provide some welcome limitations to the scope of those rules as well as certain exceptions and clarifications that mitigate some of the concerns identified with the Proposed Regulations, notably, as discussed in greater detail below:

- Exclusion of foreign borrowers;
- Removal of the bifurcation rule;
- Exceptions for cash-pooling and certain short-term debt instruments from the Funding Rule;
- Expansion of the earnings and profits exception to the Recharacterization Rules;
- Exclusion of regulated financial and insurance institutions from the Recharacterization Rules;
- Extended period to prepare the required loan documentation;
- Introduction of grace periods and longer transition periods in the effective date provisions.

Most of these changes were introduced in response to comments received from taxpayers and the tax community, including Mayer Brown. Despite these improvements, the Final Regulations still contain problematic features and leave open questions that may result in future challenges by taxpayers, including challenges questioning the validity of all or part of the Final Regulations.

This legal update provides a summary of the most signficant changes included in the Final Regulations.

Scope of Treasury's Authority

Commentators raised a concern that the Proposed Regulations exceeded the scope of Treasury's authority. Code section 385(a) authorizes the Secretary to prescribe regulations "as may be necessary or appropriate" to determine if an interest in a corporation is debt or equity (or partially debt and partially equity), while Code section 385(b) provides that any regulations issued under section 385 "shall set forth factors which are to be taken into account" in determining if in a "particular factual situation" a debtor-creditor or a corporation-shareholder relation exists.

Commentators focused on the Proposed Regulation's (like the Final Regulation's) failure to set forth factors for a case-by-case analysis of particular factual situations. To the contrary, the regulations set out a series of rules that result in recharacterization of certain debt instruments as equity. In response, the preamble to the Final Regulations cites the "necessary or appropriate" language of Code section 385(a) to justify Treasury's position that, so long as it views a rule as appropriate, it is authorized to promulgate that rule. In addressing Code section 385(b), the preamble states that "[s]ection 385(b) authorizes the Secretary to 'set forth factors'" for determining debt or equity treatment. But the preamble fails to mention that Code section 385(b) is not permissive, it is mandatory: "regulations prescribed under this section *shall* set forth factors . . . ." And although the preamble notes that some of the recharacterization rules refer to factors encountered in the traditional common law debt/equity test, it does not indicate how elevating some of them to outcome-determinative "super factors" satisfies Treasury's obligation to set forth "factors" under Code section 385(b). Whether taxpayers will challenge the rules based on the scope of the IRS's authority or on other grounds remains an outstanding issue.

Background

The Proposed Regulations introduced three rules relating to the tax characterization of debt issued between related parties: (1) the Bifurcation Rule (not included in the Final Regulations, as explained below); (2) the Documentation Rule; and (3) the Recharacterization Rule.

The Proposed Regulation's "Documentation Rule" prescribes the type of documentation and information that must be prepared and maintained to avoid recharacterization of a debt instrument issued to a related party as equity for US tax purposes. In general, the Documentation Rule requires that the taxpayer's documentation: (1) establishes that the issuer has an unconditional and legally binding obligation to pay a sum certain; (2) establishes that the holder has creditor rights; (3) contains financial information establishing reasonable expectation that the issuer intended to and is able to repay the debt; and (4) evidences post-issuance actions consistent with a debtor-creditor relationship.

The "Recharacterization Rules" include the so-called "General Rule" and "Funding Rule" (the latter with its "*per se* rule").

Under the General Rule, a debt instrument is generally treated as stock to the extent it is issued to a member of the issuer's "expanded group" (as defined in the Final Regulations) (i) in a distribution, (ii) in exchange for expanded group stock, or (iii) in exchange for property in an asset reorganization to the extent that a shareholder who is a member of the expanded group receives the debt instrument with respect to its stock in the transferor corporation.

Under the Funding Rule, a debt instrument is generally treated as stock to the extent its issuer (the "funded member") issues the instrument to a member of its "expanded group" in exchange for property with a principal purpose of funding one of the transactions described in the General

Rule. Importantly, the Funding Rule also includes a *per se* rule under which a debt instrument will be deemed to have been issued with such a principal purpose if it is issued by the funded member during the period beginning 36 months before the date the funded member makes a distribution or acquisition described in the General Rule, and ending 36 months after the date of the distribution or acquisition.

Summary of Significant Changes Included in the Final Regulations

1. HIGHLIGHTS

- **Regulations do not apply to foreign borrowers:** Under the Proposed Regulations, the Documentation and Recharacterization Rules applied equally to debt instruments issued by domestic or foreign corporations.

  Several commentators requested that the regulations not apply to debt instruments issued by foreign borrowers given that such instruments do not present earnings stripping concerns and their recharacterization as stock could potentially result in collateral consequences (e.g., detriment to the taxpayer's foreign tax credit position). In response to these comments, the Final Regulations do not apply to foreign borrowers (regardless of whether the holder of the debt instrument is US or foreign, and whether the issuer is a controlled foreign corporation). Specifically, the Final Regulations are made applicable to "covered members," defined as domestic corporations. This limitation will likely serve to significantly limit the scope of transactions subject to the Final Regulations.

  The preamble states that potential application of the Final Regulations to foreign issuers is subject to further study, clarifying that, if the regulations are ultimately made applicable to foreign issuers, such application would only be effective as of the date of issuance of such future guidance.

- **Elimination of the Bifurcation Rule:** The statutory language of Code section 385 contemplates the possibility of bifurcating the character of a debt instrument as part debt and part stock. The Final Regulations, however, do not include the rule from the Proposed Regulations that allowed the IRS to characterize an instrument as in part indebtedness and in part stock (even though such partial recharacterizations may well occur as a result of the General Rule or the Funding Rule). Treasury and the IRS plan to continue to study this issue.

- **New short-term debt exception and cash-pooling**: Numerous commentators identified significant problems in applying the Proposed Regulations to cash-pooling and other ordinary course short-term lending arrangements. The Final Regulations provide an exception from the Funding Rule for qualified short-term debt instruments. Under the umbrella of this exception, Treasury and the IRS intend to provide relief for cash pooling or revolving credit agreements, as well as ordinary course short-term lending outside of a cash- management arrangement.

  To this end, a temporary regulation provides that a debt instrument will be excluded from the Funding Rule as a qualified short-term debt instrument if it meets any one of the following criteria:

  1) *Cash-Pooling Exception*: demand deposits with a "qualified cash pool header" pursuant to a "cash-management arrangement." The temporary regulation defines what qualifies as a "cash pool header" and as a "cash-management arrangement."
  2) *Short-Term Funding – Specified Current Assets Test*: instruments for which the rate of interest is less than or equal to an arm's length interest rate that would be charged with respect to a comparable short-term debt (longer of 90 days or issuer's normal operating cycle) of the issuer and, after the

instrument is issued, the issuer's outstanding balance under covered instruments issued to members of the group that benefit from one of the qualified short-term debt exceptions (other than the cash-pooling exception) does not exceed the amount expected to be necessary to finance the issuer's short-term financing needs during its normal operating cycle;

3) *Short-Term Funding – 270 Day Test:* the instrument has a term of 270 days or less; bears a rate of interest that is less than or equal to an arm's length interest rate that would be charged with respect to a debt of the issuer of comparable term; the issuer is a net borrower from the lender for no more than 270 days during the taxable year of the issuer; and the issuer is a net borrower under all debt instruments issued to members of the group that would otherwise benefit from this exception for 270 or fewer days during the year;
4) *Ordinary Course Loan Exception:* the instrument is issued as consideration for the acquisition of property other than money in the ordinary course of the issuer's trade or business and it is reasonably expected to be repaid within 120 days; or
5) *Interest-Free Loan Exception:* the instrument does not provide for interest and interest is not required to be imputed on the instrument under the Code and regulations.

- **The earnings and profits exception:** The Proposed Regulations provided that, for purposes of applying the General Rule or the Funding Rule, the aggregate amount of any distributions or acquisitions would be reduced by an amount equal to the member's current year earnings and profits ("E&P"). Although Treasury and the IRS believed that this exception would accommodate many ordinary course distributions and acquisitions, most commentators disagreed, pointing out several difficulties presented by an exception based on current E&P.

  The Final Regulations significantly expand this exception to include all E&P accumulated in taxable years ending after April 4, 2016, so long as the E&P were accumulated while the corporation was a member of the expanded group (so as to prevent "incentives for acquisitions of earnings-rich corporations"). The expansion of the E&P exception will likely be a welcome development for many taxpayers. Note, however, that a corporation with a post April 4, 2016 accumulated deficit will not benefit from the exception as a result of positive current E&P for the year of a distribution or acquisition (i.e., no "nimble E&P exception").

- **Debt instruments issued by certain banks and insurance companies:** Despite taxpayer requests that regulated entities be exempted from the Documentation Rule, Treasury and the IRS declined to include such a blanket exemption in the Final Regulations. However, the Final Regulations provide some relief to certain instruments issued by an excepted regulated financial company or a regulated insurance company (as defined therein). Those instruments will be deemed to comply with the Documentation Rule to the extent they contain terms required by a regulator in order for the instrument to satisfy regulatory capital or similar requirements.

  The Final Regulations limit the scope of the General Rule and the Funding Rule by generally exempting debt instruments issued by certain financial and insurance companies regulated by US authorities. This exemption is justified, among other reasons, because the supervision and regulation to which these entities are subject significantly restricts their ability to engage in the types of transactions the Final Regulations intend to police.

- **Timely preparation of documentation:** Generally, the Proposed Regulations required that documentation satisfying the first three requirements of the Documentation Rule (unconditional obligation to pay, creditor's rights and expectation of repayment) be prepared no later than 30 days after the date of issuance, while documentation satisfying the fourth requirement (actions consistent with debtor-creditor relationship) be prepared 120 days after the relevant action.

Several commentators observed that the 30-day and 120-day windows were unreasonably burdensome and did not correspond to business practices. In response to these comments, Treasury and the IRS have allowed taxpayers additional time to prepare the required documentation. As such, under the Final Regulations, the required documentation must be prepared by the due date of the issuer's federal income tax return (taking into account all applicable extensions) for the tax year including the relevant date (generally, the date of issuance or the date of post-issuance action, for the fourth requirement). This change appears to create parity between these rules and the due date for transfer pricing documentation.

- **Effective dates**: The Final Regulations introduce changes to the effective dates for both the Documentation Rule and the Recharacterization Rules.

  Documentation Rule. Under the Proposed Regulations, the Documentation Rule was applicable to instruments issued or deemed issued on or after the date of issuance of the final regulations. The Final Regulations, however, delay the implementation of the Documentation Rule providing that it will not apply to instruments issued or deemed issued before January 1, 2018. Delaying the effective date until 2018 provides taxpayers with a more generous grace period in which to adopt or adapt internal documentation policies and practices to comply with the new rules. In addition, because the time period for preparing documentation has also been extended (as described below), for calendar-year taxpayers that file an extension, the documentation materials will not be due until September 2019.

  Recharacterization Rules. The Final Regulations grandfather instruments issued, and distributions or acquisitions made, before April 5, 2016. In addition, the Final Regulations expand the transition period contemplated by the Proposed Regulations. Under the Final Regulations, any instrument that would be recharacterized as stock within the 90-day period following the publication of the Final Regulations will generally not be treated as stock during that period and will instead only be deemed exchanged for stock immediately after the 90th day. This extended grace period gives taxpayers a bit more time to analyze and settle, as needed, any related party debt that may be recharacterized under the Final Regulations.

  It should be noted that, even though the Final Regulations are generally more beneficial to taxpayers than the Proposed Regulations, taxpayers are entitled to consistently apply the Proposed Regulations to all debt instruments issued between April 4, and October 13, 2016.

2. OTHER SIGNIFICANT CHANGES

2.1 General

- **Regulations do not apply to S Corporations, and controlling RICs and REITS:** The Final Regulations exempt "S corporations" from being members of an expanded group. Similarly, the Final Regulations also exempt regulated investment companies ("RICs") and real estate investment trusts ("REITs") that would otherwise be the parent of an expanded group. However, the Final Regulations continue to treat a RIC or REIT that is controlled by members of the expanded group as a member of the expanded group.

- **Changes to attribution rules in the definition of "expanded group":** The Documentation and Recharacterization Rules apply to debt instruments issued between highly-related parties, more specifically, between members of the same "expanded group." The Final Regulations reserve on the application of the downward attribution rules of Code section 318(a)(3) in defining an expanded group. Notably, this may limit the possible application of the Final Regulations to corporations that are not highly related (e.g., as a result of the downward attribution rule from partners to partnerships).

2.2. Changes to the Documentation Rule

- **The "high degree of compliance" presumption:** Under the Proposed Regulations, any failure to satisfy the documentation requirements would have resulted in an automatic recharacterization of the instrument as stock (a *per se* stock characterization). The Final Regulations mitigate somewhat the risk of this *per se* recharacterization through the introduction of a rebuttable presumption if the expanded group demonstrates a "high degree of compliance" with the Documentation Rule.

  The determination of whether a group demonstrates a "high degree of compliance" is based on the percentages and relative sizes of the group's debt instruments that comply with the Documentation Rule and those that do not.

  When a taxpayer establishes a "high degree of compliance," it can rebut the recharacterization presumption for a particular debt instrument with evidence that the issuer intended to create indebtedness for tax purposes and that there are sufficient factors present to afford such treatment to the instrument. Whether such strict rules are reasonable is a matter for additional consideration.

  In addition, the Final Regulations provide relief for minor ministerial or clerical errors in the documentation, and include a "market standard" safe harbor that treats the Documentation Rule as satisfied by the documentation customarily used in third-party transactions.

- **Debt issued by disregarded entities and partnerships:** The Proposed Regulations provided that debt instruments issued by a disregarded entity that failed to comply with the Documentation Rule would be recharacterized as equity in the issuing legal entity, potentially creating a springing partnership as a result of such entity having a new member. To avoid significant collateral consequences that would result from this change in entity characterization, the Final Regulations provide that, in such cases, the holder of the instrument will be deemed to hold stock issued by the corporate owner of the disregarded entity.

  In addition, the Final Regulations provide that the Documentation Rule will generally not apply to debt instruments issued by controlled partnerships.

- **Credit analyses required for master agreements**: Treasury and the IRS specifically addressed compliance with the third requirement of the Documentation Rule (i.e., expectation of repayment) in the case of instruments governed by a master agreement or similar arrangement. The Final Regulations state that a single credit analysis may be prepared and used on an annual basis for each issuer, unless the issuer has undergone a material change during the year, in which case a new credit analysis will be required.

  The Final Regulations do not exempt cash pooling arrangements from the Documentation Rule.

- **Refinancing as a possibility in the credit analysis**: Importantly, the Final Regulations provide that the credit analysis required for the third factor of the Documentation Rule may assume that the principal amount of the instrument may be satisfied with the proceeds of another borrowing by the issuer to the extent that such borrowing could occur on similar terms with a third party.

2.3. Changes to the Recharacterization Rules

- **No change to the 72-month *per se* period**: Notwithstanding the numerous comments requesting that the controversial 72-month period be shortened or changed from a *per se* rule to a presumption, Treasury and the IRS retained the rule as an irrebuttable presumption (i.e., a *per se* rule).
- **Reductions for qualified contributions**: In addition to the expansion of the earnings and profits exception, the Final Regulations introduce a new avenue for relief from the General Rule and Funding Rule. The Final Regulations provide that distributions or acquisitions shall be reduced by the aggregate fair market value of the stock issued (or, presumably, deemed issued under a so-called "meaningless gesture" transaction) by the corporation in one or more "qualified contributions." A "qualified contribution" is generally any contribution of property (other than certain excluded property) in exchange for stock during the period beginning 36 months before the date of the distribution or acquisition, and ending 36 months after the date of the distribution or acquisition (but not later than the last day of the first taxable year in which an instrument would be recharacterized absent this rule).
- **The threshold exception no longer functions as a cliff**: The Proposed Regulations did not apply the Recharacterization Rules where the aggregate issue price of all expanded group debt instruments that would otherwise be treated as stock under the Recharacterization Rules did not exceed $50 million. That exception, however, functioned as a cliff: once the $50 million threshold was surpassed, all debt instruments were subject to recharacterization. Under the Final Regulations, instead, only the amount of debt instruments in excess of $50 million is subject to recharacterization.
- **Instrument recharacterized for all US tax purposes other than to trigger deconsolidation**: Various taxpayers had suggested that the Recharacterization Rules should result only in disallowance of interest deductions associated with recharacterized instruments, and that the instrument should otherwise continue to be treated as debt for all other US federal tax purposes. Treasury and the IRS rejected this proposal and, as such, the Final Regulations provide that an instrument recharacterized under the Recharacterization Rules will generally be treated as stock for US federal tax purposes (and, accordingly, the recharacterization can have multiple implications beyond the mere disallowance of the deduction for the purported interest payments). The Final Regulations carve out one exception to this general principle— a recharacterized instrument will not be treated as stock for purposes of the ownership requirements of Code section 1504(a), preventing deconsolidation of the issuing member as a result of an equity recharacterization.
- **Cascading recharacterizations:** Commentators requested relief with respect to two scenarios where the Recharacterization Rules created the potential for cascading recharacterizations: (1) payments made by the issuer with respect to a recharacterized instrument could be treated as a distribution for purposes of the Funding Rule; and (2) the lender in a recharacterized instrument could be treated as acquiring stock of a related party (the issuer) for purposes of the Funding Rule (creating a risk of recharacterization of instruments issued by the lender). Treasury and the IRS determined no relief was warranted for the first scenario. On the

second scenario, the Final Regulations provide that a recharacterized loan should generally not result in the lender being deemed to have acquired stock of a related party for purposes of the Funding Rule.

- **Exceptions for compensatory stock and stock acquisitions by dealers in securities**: In a change that will likely be much welcomed by certain taxpayers, the Final Regulations carve out from the General Rule and the Funding Rule purchases of expanded group stock that is to be delivered to individuals in consideration for services rendered as an employee, director or independent contractor.

  The Final Regulations also include an exception from the General Rule and the Funding Rule for the acquisition of expanded group stock by a dealer in securities assuming certain conditions are met.

2.4. New Rules for Treatment of Consolidated Groups

The Final Regulations include additional rules in 1.385-4 addressing various issues resulting from the interaction of the rules with the consolidated return regulations (the general rule still being that the Documentation Rule and the Recharacterization Rules do not apply to debt instruments issued between corporations that are members of the same US federal consolidated group).

Takeaway

In more than 500 pages, Treasury and the IRS addressed in the Final Regulations comments received and attempted to provide some necessary relief with respect to various concerns raised by the Proposed Regulations. Whether the narrower scope of the Final Regulations will placate taxpayer concerns as to the IRS's authority to promulgate these rules remains to be seen.

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