

**Final Regulations under Section 385 - Impact on Inbound Investment into  
the United States**

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# Proposed Regulations - Overview

- On April 4, 2016, regulations were proposed under Section 385.
- Specific concern with "inverted groups and other foreign-parented groups..." that "create interest deductions that reduce U.S. source income without investing any new capital into the U.S. operations."
- Would have recharacterized as equity for all US federal tax purposes certain debt issued between closely-related corporations in specified circumstances.
- The proposed regulations were divided as follows:
  - 1.385-1 – Bifurcation rule
  - 1.385-2 – Documentation requirements
  - 1.385-3 – Per Se Stock Rules
    - General Rule – Recharacterized EGIs issued directly in certain related-party transactions
    - Funding Rule – To prevent taxpayers from circumventing General Rule

# Final and Temporary Regulations

- On October 13, 2016, final and temporary regulations were released
- Substantial changes as compared to proposed regulations
- Scope has been significantly narrowed, several helpful exceptions introduced
- Basic structure of regs (including funding rule) otherwise retained

# Final Regulations

- Continue to treat purported debt as stock for all US federal tax purposes
- Eliminated general bifurcation rule from proposed regs
- Introduced significant exceptions:
  - Non-US issuers (all rules)
  - Ordinary course transactions, such as cash pooling arrangements (per se rule)
  - Post- April 4, 2106 accumulated e&p (per se rule)
  - Certain acquisitions of subsidiary stock (per se rule)
  - Other changes intended to better focus rules on related party financings with potential to erode tax base
- Changes to effective date provisions
- Regs now apply to a much narrower group of taxpayers and instruments than the proposed regs

# Treas. Reg. §1.385-1

## Definitions

- Regs only apply to US issuers
  - Foreign-to-foreign transactions are excluded completely
- Applicable instrument (AI):
  - Any instrument issued or deemed issued which is “in form a debt instrument”
- Expanded Group (EG):
  - Corporations affiliated by 80% vote or value
  - Indirect ownership rules, option attribution rules (if exercise is reasonably certain)
  - S Corps, non-controlled RICs and REITS generally excluded
- Expanded Group Instrument (EGI):
  - A debt instrument issued by US corp and held by a member of issuer's EG (subject to exceptions for consolidated group debt and certain others)

**Treas. Reg. § 1.385-2**  
**Documentation Requirements**

# Treas. Reg. §1.385-2

## Documentation Rules

- Intercompany debt subject to these rules will automatically be treated as equity if the taxpayer fails to create the required documentation
  - Rebuttable presumption for highly compliant taxpayers
  - Reasonable cause exception
  - Ministerial or non-material failure or error discovered by taxpayer
- Must satisfy documentation requirements in timely fashion
  - Under final regs, this means no later than time for filing issuer's US federal income tax return, including extensions
- Where the EGI is issued by a disregarded entity owned by a US member of the EG, deemed stock considered issued by US corporate owner
- Satisfying the documentation requirements does not mean the instrument is debt– IRS may still challenge characterization under applicable debt/equity case law

# Documentation Rules, Cont'd

- Apply only if:
  - The stock of any member of the EG is publicly traded
  - Total assets exceed \$100 million on any “applicable financial statement”

**or**

  - Annual total revenue exceeds \$50 million on any “applicable financial statement”
- Documentation not required for interests between members of a US federal consolidated group (carved out from definition of AI)
- Effective Dates: Documentation rules effective for EGIs issued (or deemed issued) on or after January 1, 2018

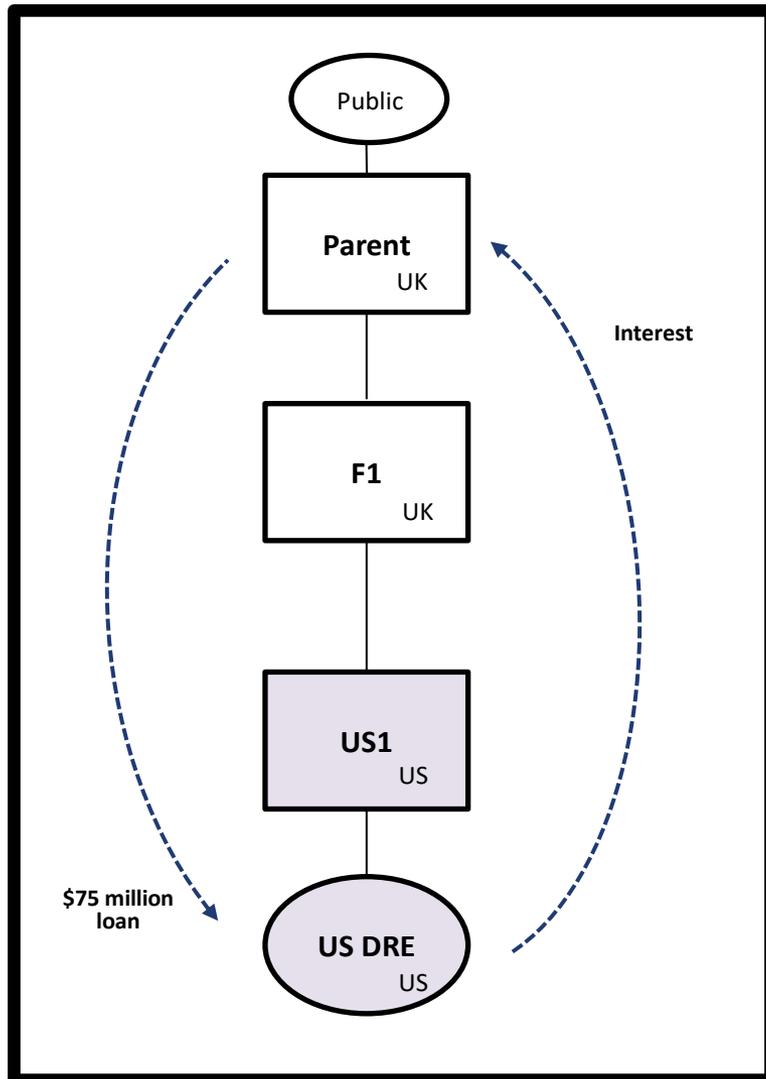
# Treas. Reg. §1.385-2

## Documentation Requirements

### Four Components of Required Documentation:

1. Relevant Agreements: Taxpayer must retain complete and executed copies of all relevant instruments and documents, including promissory note, security agreement, guarantee, subordination agreements
2. Creditor Rights: Creditor must have binding right to enforce, superior to equity holders; Right to accelerate principal payment upon default, especially non-payment of principal or interest
3. Reasonable Expectation of Ability to Repay: Issuer must intend to repay, *and* Issuer must have ability to repay, as of date of issuance; If issuer is disregarded entity, count only assets/income of the disregarded entity if the owner has limited liability; Cash flow projections, financial statements, asset appraisals, debt/equity ratios in relation to industry averages, etc.
4. Evidence of Genuine Debtor-Creditor Relationship: Written evidence of payments of principal and interest must be documented; Bank statements, wire transfer notices, etc.; In case of default, must be evidence of holder exercising reasonable diligence to collect (letters or emails re: collection efforts, negotiations, mitigation efforts, etc.)

# Documentation Rules- Example



- US Group wants to expand
- During 2018, Parent makes \$75 million loan to US DRE; DRE issues Parent note in exchange
- After the loan is made, Parent does not properly maintain documentation as required by 1.385-2
- Neither US1 nor US DRE is aware that Parent is not complying with the documentation requirements
- Upon audit, IRS recharacterizes entire \$75 million loan as equity as of the time Parent failed to comply with the maintenance requirements
- This results in deemed issuance of stock of US1 to Parent (under proposed regulations, could have caused US DRE to become a partnership)
- Withholding tax on "interest" payments

**Treas. Reg. § 1.385-3**  
**Certain Debt Treated as Stock**

# Treas. Reg. §1.385-3

## Per Se Stock Rules

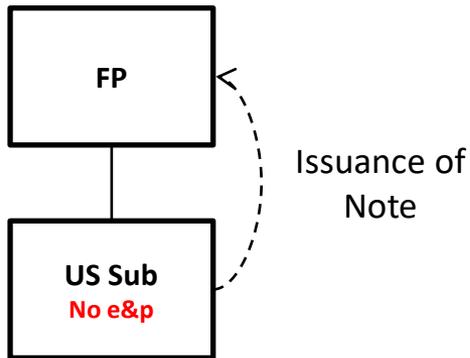
- In addition to the documentation requirements, certain debt instruments will *automatically* be treated as stock (for all purposes of the Code), *even if* proper documentation is maintained
- Two separate rules:
  - general rule, and
  - funding rule
- The Per Se stock rules in the Proposed Regs were heavily criticized
  - Final and temp regs retain the basic spirit of the rules
  - Introduce limitations on who the rules may apply to (but no reasonable cause exception)
  - Now only apply to domestic corps and certain partnerships

# Treas. Reg. §1.385-3

## General Rule

- Issuance of a Note will trigger Per Se Stock Rule if:
  1. Domestic Corp distributes its own note to its non-US parent;
  2. Domestic Corp issues its own note in exchange for stock of its non-US parent (subject to certain “exempt exchange” rules); or
  3. Domestic Corp issues its own note in certain asset reorganizations.
- Exceptions / special rules apply

# Example



- Assume US Sub is not a USRPHC
- Assume US sub has little or no earnings and profits, and issues note to its foreign parent
- No withholding tax on issuance of note, because no e&p to support dividend classification
- Subsequent payments on the note may be treated (in relevant part) as tax-free repayments of principal
- Under the "General Rule" of the -3 final reg, this "debt" is treated as equity for US federal tax purposes
- Thus, later return of principal payments treated as dividends (assuming e&p)

# Treas. Reg. §1.385-3

## Funding Rule

- If a domestic corp issues debt to a member of its EG, the debt is treated as stock if, during a relevant six-year window (3 years prior to issuance and 3 years after issuance), the domestic issuer:
  - (1) Makes a distribution of property (including cash);
  - (2) Acquires stock of an EG member (other than in certain “exempt” exchanges); or
  - (3) Acquires assets from an EG member in certain asset reorganizations involving boot.
- Again various exceptions and special rules apply

# Treas. Reg. §1.385-3

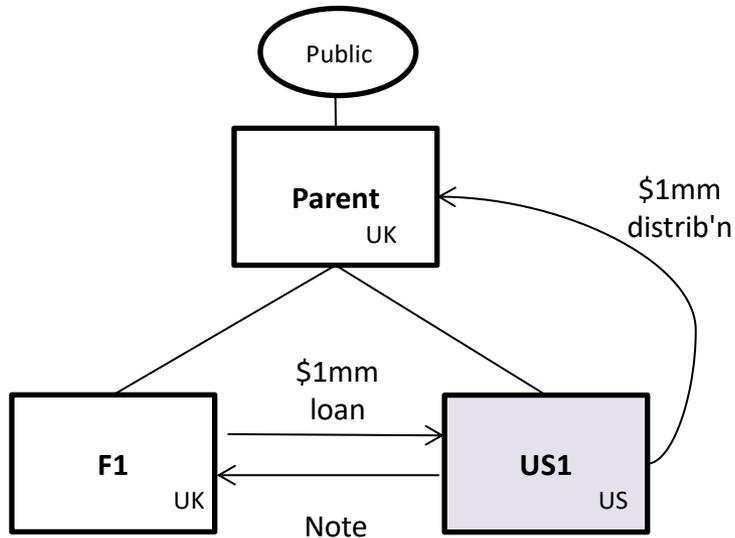
## Funding Rule, Cont'd

- **Per se rule** – *irrebuttable presumption* that the funding rule is treated as violated if debt is issued 36 months before or after an acquisition or distribution (as defined on prior slides)
  - This is not a safe harbor. Outside the 72 month window, the IRS may still apply a facts and circumstances analysis to determine if the funding rule was violated
  - Recharacterization under this rule will begin on January 19, 2017
  - Only for debt issued after April 4, 2016
- **Timing**- Recharacterize debt as stock on *later of* (i) date of issuance of EGI, or (ii) date of relevant acquisition or distribution

# Anti-Abuse Rule (1.385-3(b)(4))

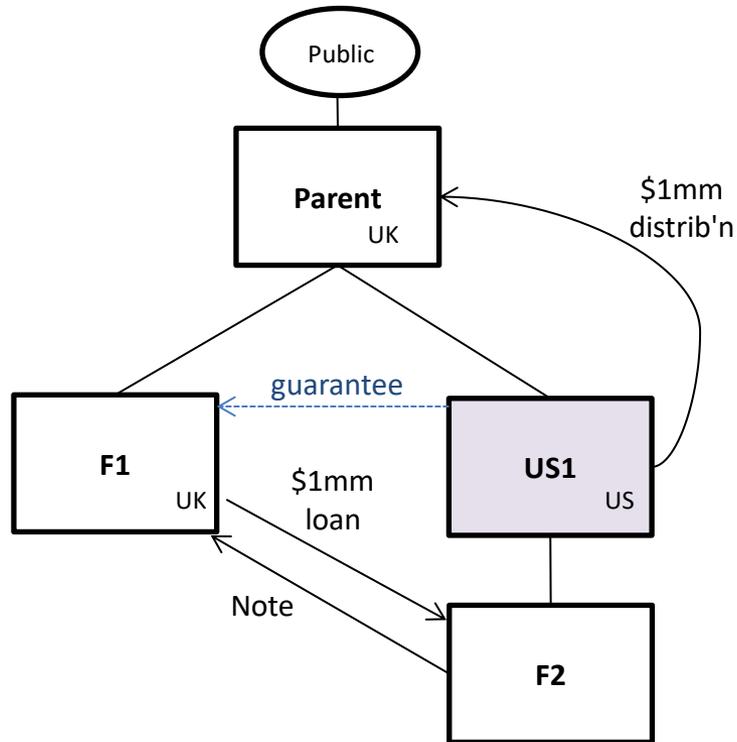
- If an EG member enters into a transaction with a principal purpose of avoiding the purposes of Treas. Reg. sections 1.385-3 or -3T, any interest issued or held by that member or another EG member may be treated as stock
- For example:
  - An EGI issued to an entity that is not taxable as a corporation for U.S. federal tax purposes;
  - An EGI issued in connection with a reorganization or similar transaction; or
  - An EGI issued as part of a plan or series of transactions to expand the applicability of the transition rules.

# Example



- In year 1, US sub makes a \$1mm distribution to UK Parent
- In year 3, F1 loans US1 \$1mm in exchange for a note
- US1 note is treated as stock under the funding rule, as of the date of issuance of note to F1 (later of rule)
- So part of US1 is now owned by F1 for US tax purposes
- "Interest" payments on the note treated as dividends to F1 (assuming e&p)
- Withholding tax applies to such dividends

# Modified Example- Guarantee



- F1 loans F2 \$1mm in exchange for a note
- F2 is thinly capitalized
- US1 guarantees debt of F2
- Plantation Patterns?
- 2 years earlier, US1 made a \$1mm distribution to UK Parent
- Deemed US1 note now subject to funding rule?
- Under funding rule, debt treated as stock
- Part of US1 is thus owned by F1 for US tax purposes
- "Interest" payments on the note treated as dividends to F1

# Funding Rule (only)

## Qualified Short-Term Debt Exceptions

- The Funding Rule will not apply to the following "qualified short-term debt instruments"
  - Certain Cash Pooling Arrangements (response to comments)
  - Interest-Free Loans- Debt that does not provide for stated interest, original issue discount, or imputed interest
  - Ordinary Course Payables- Debt issued in ordinary course of issuer trade or business and expected to be repaid within 120 days
  - Short-term Funding Arrangements
    - 270-day Borrowings- Debt with short-term interest rates and a term of 270 days or less, provided issuer is relying on exception for all lenders
    - Working Capital Borrowings- Debt with short-term interest rates to extent of issuer's current assets other than cash and cash equivalents

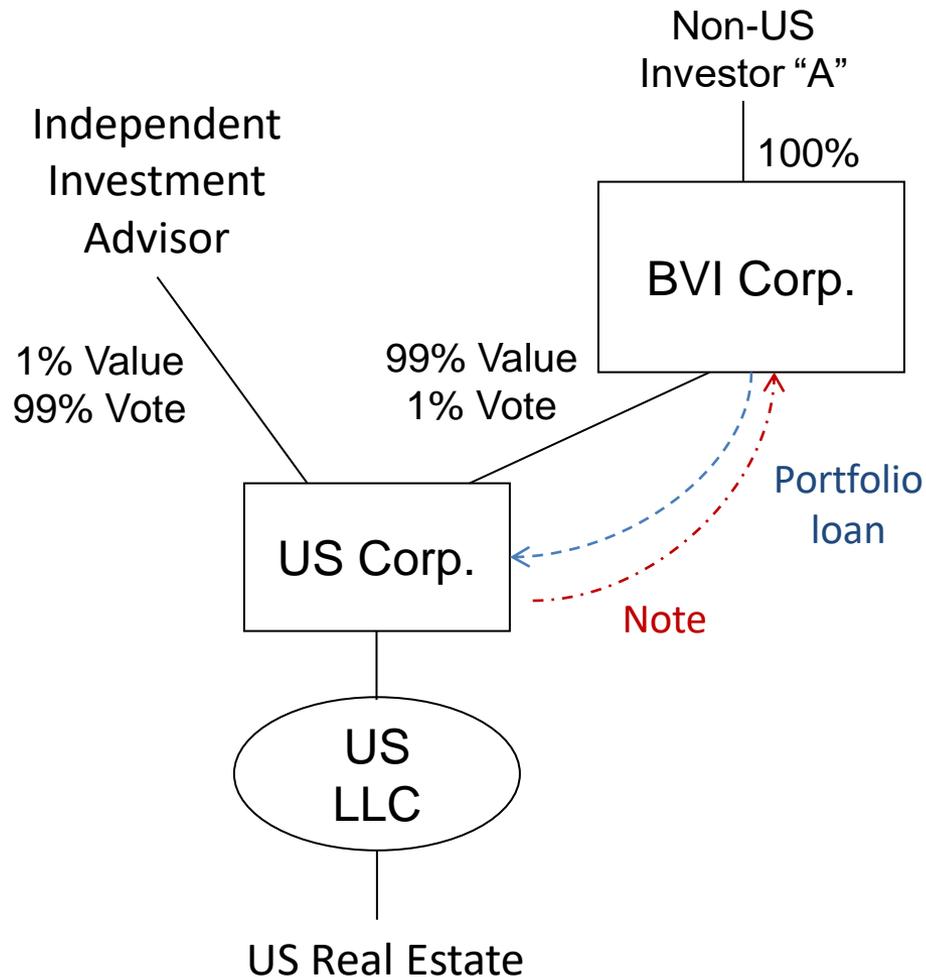
# -3 Exceptions (General Rule and Funding Rule)

- E&P Exception: To the extent a distribution or acquisition does not exceed the post-April 4, 2016 E&P of the member (during the period the member has been a member of the EG)
  - Requires taxpayers to create and trace a new pool of e&p for this purpose
- Qualified Contribution Exception: After applying other exceptions (including the e&p exception above), distributions and acquisitions that would trigger recharacterization are first offset by "qualified contributions," including contributions of property made within 3 years before or after the distribution or acquisition

## -3 Exceptions (General Rule and Funding Rule), Cont'd

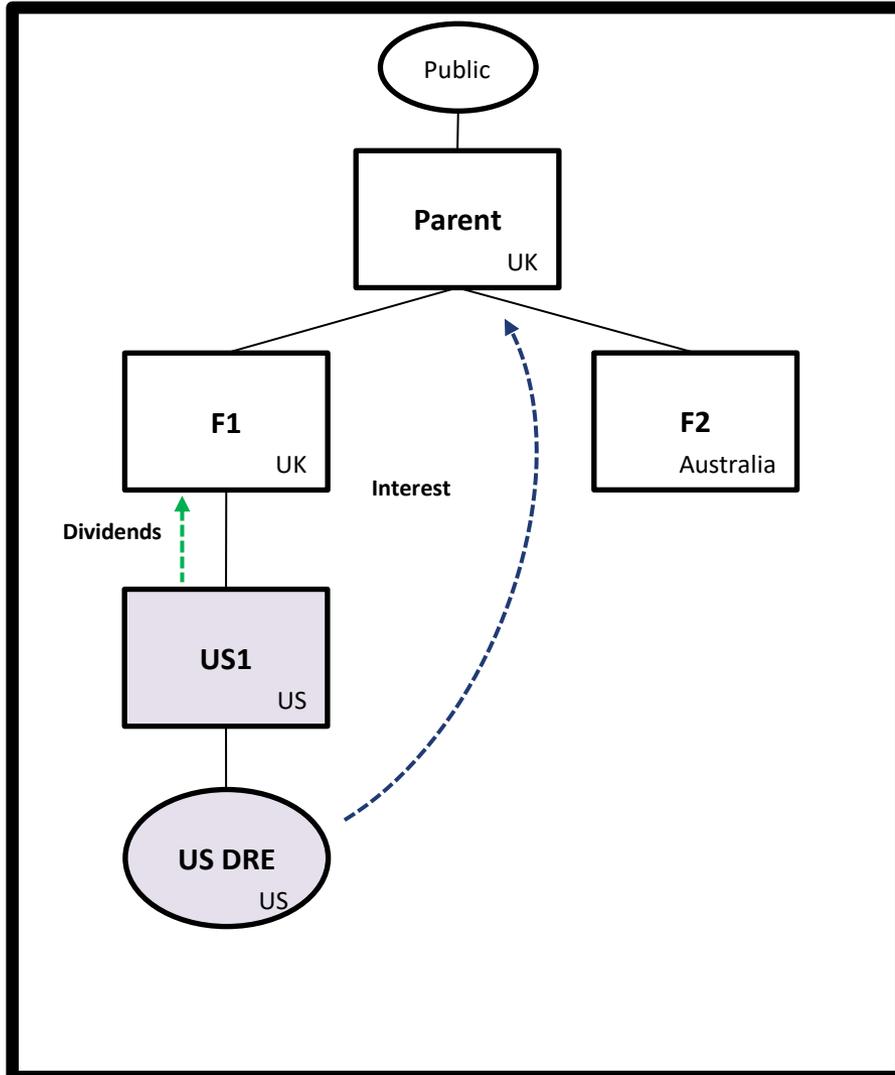
- Threshold Exception: An EGI will not be treated as stock, if and to the extent that, when a debt instrument is issued, the aggregate issue price of all EGIs is not more than \$50 million.
- The \$50 million threshold was a cliff test under the proposed regs, but was revised to exempt the first \$50 million under the final regs.
- No operating rules, so detailed implications unclear
- The threshold exception applies after applying the E&P and contribution exceptions.

# Portfolio Debt Example



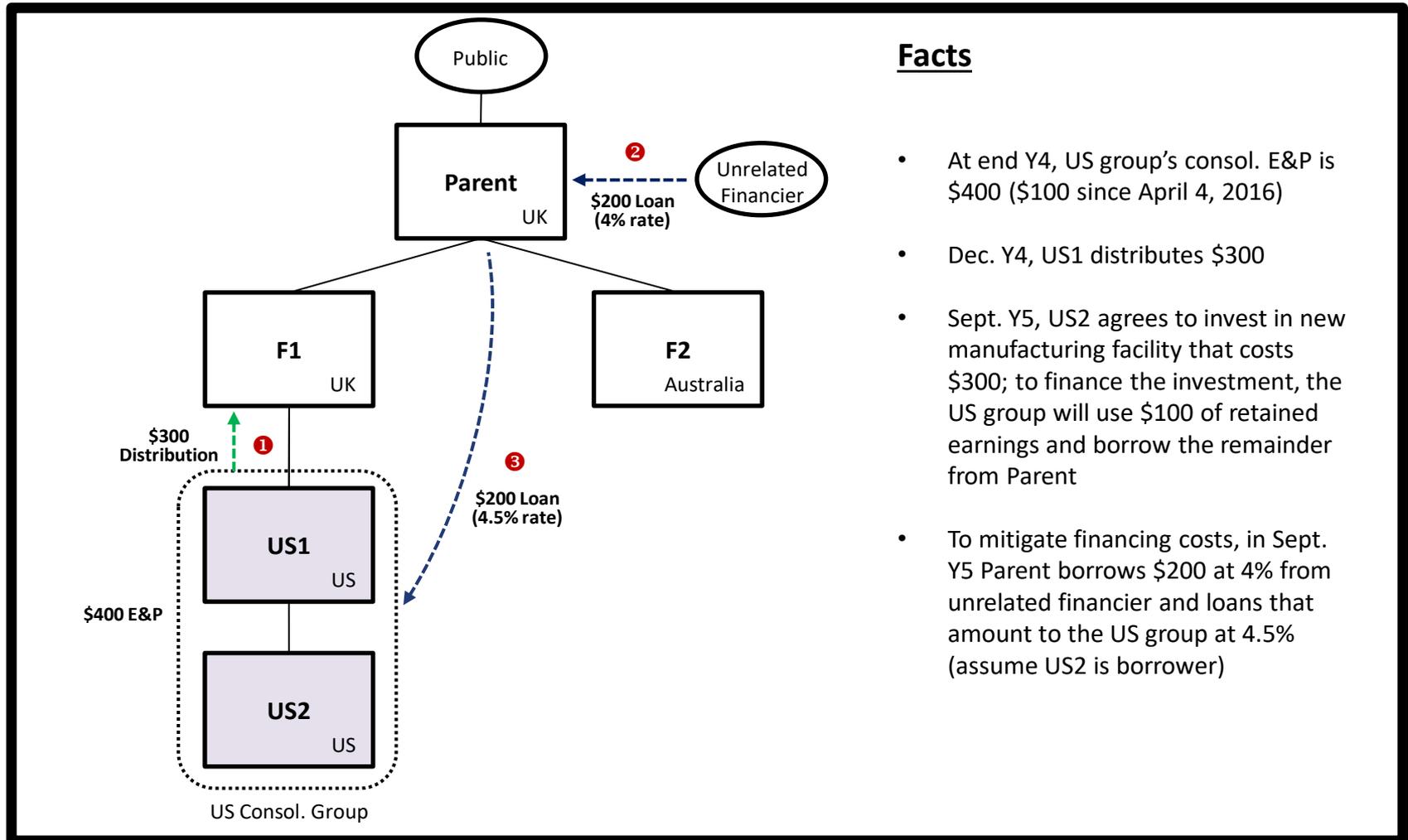
- Assume aggregate issue price of all EGIs exceeds \$50 million before accounting for the portfolio loan
- Portfolio loan from BVI Corp to US Corp will be recharacterized as equity under the Funding Rule if US Corp makes distributions that exceed post-April 4, 2016 e&p, or if the distributions come out of pre-April 4, 2016 e&p

# Facts/ Assumptions



- Non-inverter
- US leverage is consistent with WW ratios, and US borrowing within 163(j) safe harbor
- Parent can borrow at 4%, whereas US group borrowing rate is 5%
- US-UK treaty otherwise applicable
  - Interest – 0% (unless conduit)
  - Dividends – 0%, 5%, 15%
  - LOB
- All entities are calendar year taxpayers

# Funding Rule- Impact on Treaty Rates



## Facts

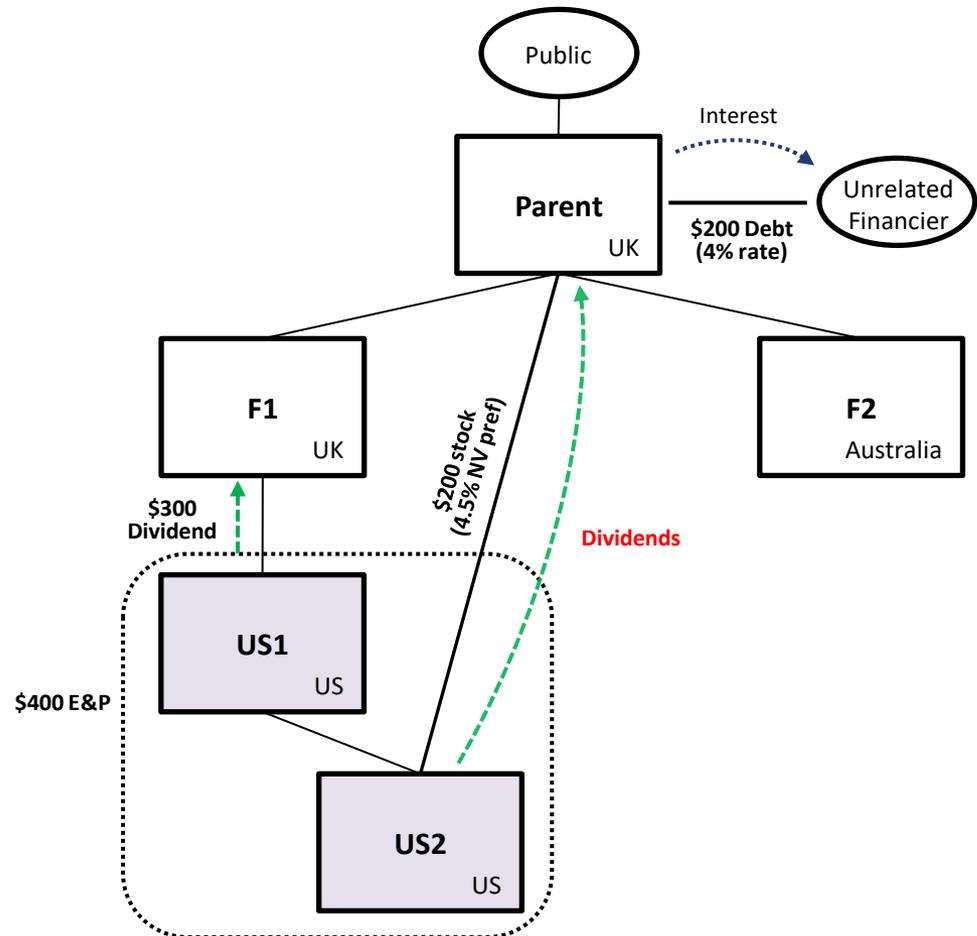
- At end Y4, US group's consol. E&P is \$400 (\$100 since April 4, 2016)
- Dec. Y4, US1 distributes \$300
- Sept. Y5, US2 agrees to invest in new manufacturing facility that costs \$300; to finance the investment, the US group will use \$100 of retained earnings and borrow the remainder from Parent
- To mitigate financing costs, in Sept. Y5 Parent borrows \$200 at 4% from unrelated financier and loans that amount to the US group at 4.5% (assume US2 is borrower)



# Treaty Rates (cont.)

## Section 385 Regulations

- \$300 dividend subject to 0% WH per Art. 10(3)(a) of US-UK treaty
- Because of Y4 \$300 dividend (when only \$100 relevant E&P) \$200 of distribution available to recast US group debt to Parent (funding rule)
- US2 debt is treated as stock for all US tax purposes, as of the issuance date
- US group cannot deduct \$9 finance payment (even though could get \$10 deduction if used 3<sup>rd</sup> party lender)
- US group's \$9 finance payment is no longer subject to 0% WH



# Treaty Rates (cont.)

- **Interest on the US2 debt is subject to 5% withholding**
  - How are treaty partners to respond?
  - How does this fit with BEPS?
  - Treaty non-discrimination issues?