UNDERSTANDING THE NEWLY ISSUED PROPOSED REGULATIONS UNDER § 385 (Issued on April 4, 2016)

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Intercompany debt treated as stock in certain transactions

Prop. Treas. Reg. §§ 1.385-3 and -4

Summary

- The proposed regulations appear to be overreaching because they cast a wide net with the definition of an “expanded group”
- They can affect inbound and outbound
- With the look back of 36 months taxpayers can be whipsawed
- They add a new dimension to due-diligence on mergers and acquisitions
- They will require more direct banking and less intercompany / internal banking arrangements
- They will require structures to be readdressed
- There will be a greater need to review the use of “check the box” planning
- [update on where the service on particular comment points – e.g. cash pooling]

Consequences

- If Prop. Treas. Reg. § 1.385-3 applies to an instrument, that instrument would be **treated as stock** rather than debt **for all purposes** of the Code. **Examples** include:
- If a note is distributed, it would be treated as stock to which Section 305 (not Section 301) applies.
- If stock is acquired for a note in what would otherwise constitute a Section 304(a)(1) transaction, the transaction would be treated as a stock-for-stock acquisition (Section 304 would not apply).
- A triangular 'B' reorganization in which S acquires P stock from P in exchange for a note would not be subject to Treas. Reg. § 1.367(b)-10, because S would be treated as acquiring P stock with S stock (not property).
- The recharacterized debt could be Section 351(g), nonqualified preferred stock, Section 306 stock, or fast-pay preferred stock.

Consequences (continued)

Loss of Section 902 credits on cross-chain deemed dividends

- When a cross-chain loan is recharacterized as equity, the repayment of the principal amount will generally be a redemption of equity under Section 302(d), resulting in a cross-chain dividend.
- Because the recipient of the deemed dividend will generally not hold a 10% voting interest in the payor, no Section 902 credits will accompany the dividend.
- The taxes in the Section 902 pool associated with the dividend earnings would be removed from the pool and lost.

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General rules

Overview

- On April 4, 2016, Treasury and the IRS released proposed regulations under Section 385 (the Proposed Regulations) to address whether a purported debt instrument is treated as stock or debt (in whole or part) for US federal income tax purposes.
- The Proposed Regulations are packaged with new Section 7874 temporary regulations addressing cross-border merger activity viewed as 'inversions,' but their scope is not limited to inverted companies.
- The announced purpose is to limit inverted companies' 'earnings-stripping,' using cross-border debt to reduce US income taxes on US affiliates' earnings.
- The impact of the Proposed Regulations would be far broader, however, potentially recharacterizing related party debt as equity in a wide variety of circumstances where no tax planning is involved.
- The Proposed Regulations would have a profound adverse impact on the day-to-day internal funding and treasury operations of both US- and foreign-based multinationals.
- The Proposed Regulations could apply retroactively to related party debt issued on or after April 4, 2016.

Expanded Group defined

- The Proposed Regulations potentially recharacterize as equity debt issued between members of an 'expanded group.'
  - The term 'expanded group' is defined in Prop. Treas. Reg. § 1.385-1 by reference to the term 'affiliated group' in Section 1504(a), with certain modifications. An expanded group includes:
    - foreign and tax-exempt corporations
    - corporations held indirectly (*e.g.*, through partnerships)
    - corporations connected by ownership of 80% vote or value, rather than vote and value.
    - The Proposed Regulations also adopt the Section 304(c)(3) attribution rules, which are quite broad, for purposes of determining indirect ownership.
  - A general exception is provided for debt between corporations within a consolidated group.

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Expanded Group - continued

- Treatment of certain instruments as partly debt and partly stock
  - Prop. Treas. Reg. § 1.385-1(d)(1) provides that the IRS may treat expanded group debt as part debt and part stock if the IRS's analysis supports a reasonable expectation that, as of the issuance of the debt instrument, only a portion of the principal amount will be repaid.
  - The elimination of the 'all-or-nothing' characterization of a purported debt instrument applies to instruments issued on or after the date the regulations are finalized. Such bifurcation will only occur, however, if the instrument has met the documentation and information requirements discussed below (set forth in Prop. Treas. Reg. § 1.385-2), if applicable, and the substance of the instrument is regarded.
  - For this purpose, the expanded group is modified to use a 50% vote or value threshold, rather than 80%.

Expanded Group - continued

- The bifurcation rule of prop. reg. section 1.385-1(d) would enable the government to divide some purported debt instruments issued among related parties in a modified expanded group into part debt and part stock. While most of the provisions in the section 385 regs apply to an expanded group (using an 80 percent direct or indirect relatedness standard), the bifurcation rule applies to a modified expanded group (using a 50 percent direct or indirect relatedness standard) and doesn't have a de minimis exception. The definition of expanded group relies on section 1504(a), section 304(c)(3), and the section 318 attribution rules.

- Thus, the proposed regs as currently drafted don't pick up brother-sister corporations owned by a single entity or individual. However, they were intended to and the Treasury is rethinking the definition.

- Treasury has invited comments on this issue and how to address it.

Targeted transactions
Related party debt treated as equity

The Proposed Regulations identify two types of transactions at issue:

- Debt issued to a related party in distribution or as consideration in certain transactions (the **General Rule**).
- Debt issued with a principal purpose of funding transactions described in the General Rule (the **Funding Rule**).

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Related party debt treated as equity

Impact on Partnerships

- When the proposed 385 regs interact with the partnership rules of subchapter K there are likely to be some unintended consequences, some of which could be particularly harsh. For example, if a disregarded entity is found to have failed the documentation requirements for a debt instrument it issued many years ago, under the proposed regs it could be treated as issuing equity to the debt holder and suddenly no longer a single-member disregarded entity but a deemed partnership that's failed to file partnership returns.

- Query whether the Treasury will attempt to put in place some type of coordination rule, or if they will “let the chips fall where they may”.

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Targeted transactions
Specified Transactions

Specified transactions:

- Expanded group debt is treated as stock if it is issued in any of the following situations:
- in a distribution to acquire expanded group stock, other than to acquire stock of an acquiring corporation in an asset reorganization to acquire property in an asset reorganization, to the extent a shareholder that is a member of the issuer's expanded group immediately before the reorganization receives the debt instrument with respect to its stock in the transferor corporation.

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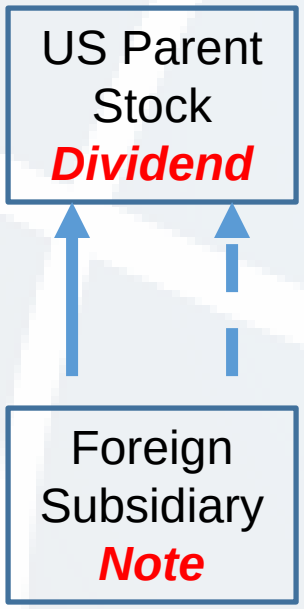
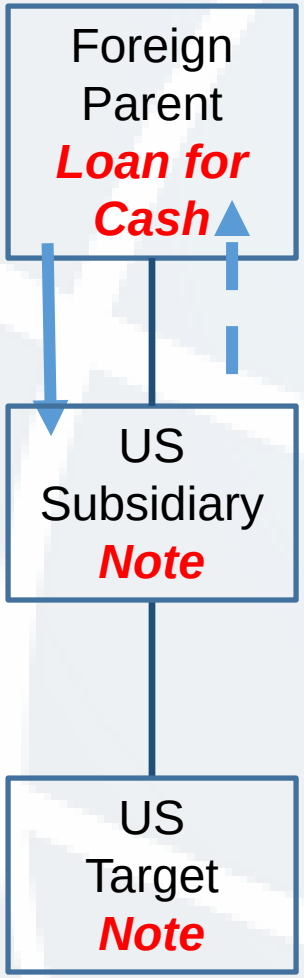
Outbound example
Note distribution



- ***Facts:*** Foreign Sub has no E&P. Foreign Sub distributes a note to US Parent as a return of basis.
- ***Debt Instrument***: Recharacterized as a **stock** distribution under the General Rule.
- ***Analysis***: Interest and principal payments should be recharacterized as distributions with respect to stock; **not deductible**; potentially subject to **dividend treatment** when interest/principal is paid.

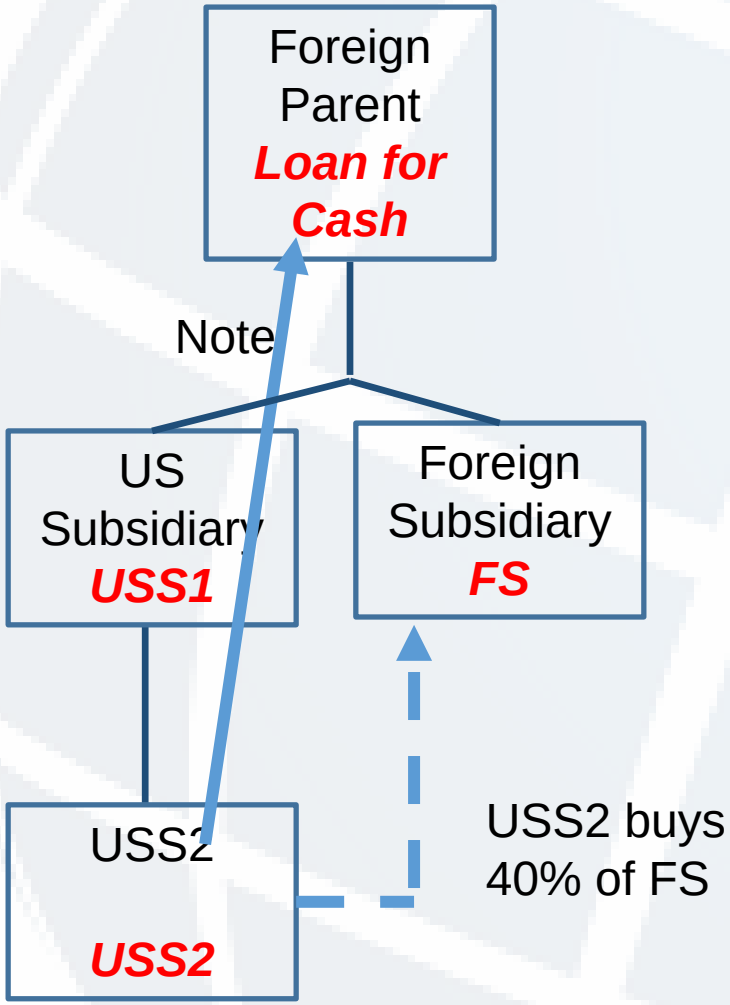
Inbound example
Third party acquisition



- ***Facts:*** Foreign Parent forms US Sub. Foreign Parent lends cash to US Sub in exchange for debt. US Sub acquires shares in US target for cash.
- ***Debt Instrument***: Instrument characterized as **debt** provided the documentation and debt capacity requirements are met.
- ***Analysis***: There is no recharacterization as there was an acquisition of third party shares. However, to the extent US Sub makes a cash distribution, acquires related group shares, or completes an asset reorganization, the debt may be recast as stock at a later point.

Example

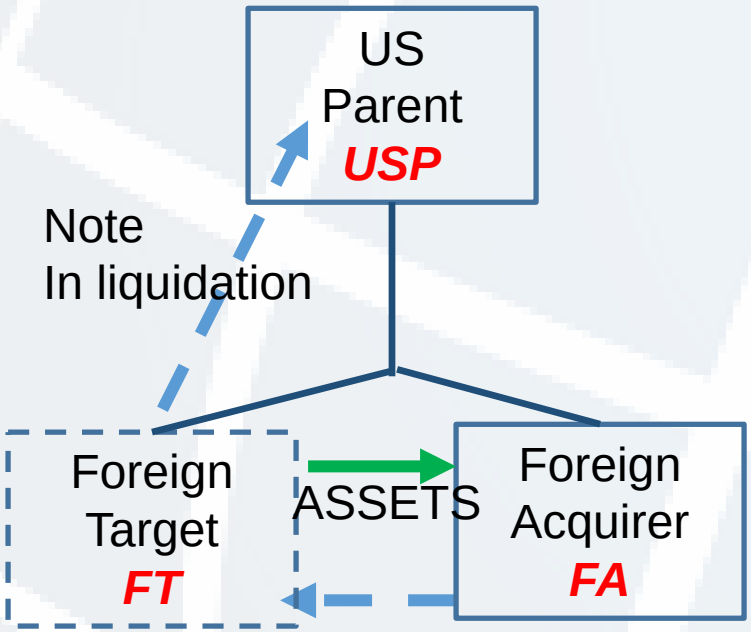
Exchange for expanded group stock



- ***Facts:*** USS2 acquires 40% of FS stock from FP in exchange for USS2 Note.
- ***Debt Instrument***: USS2 Note is ***treated as stock*** when it is issued.
- Same analysis applies if FS issues new shares to USS2 because USS2 owns less than 50%.
- Query whether the Proposed Regulations might result in a ***deconsolidation*** of USS1 and USS2 if FP owns more than 20% of USS2 as result of the debt recharacterization. Consider whether the debt meets the requirements of Section 1504(a)(4).

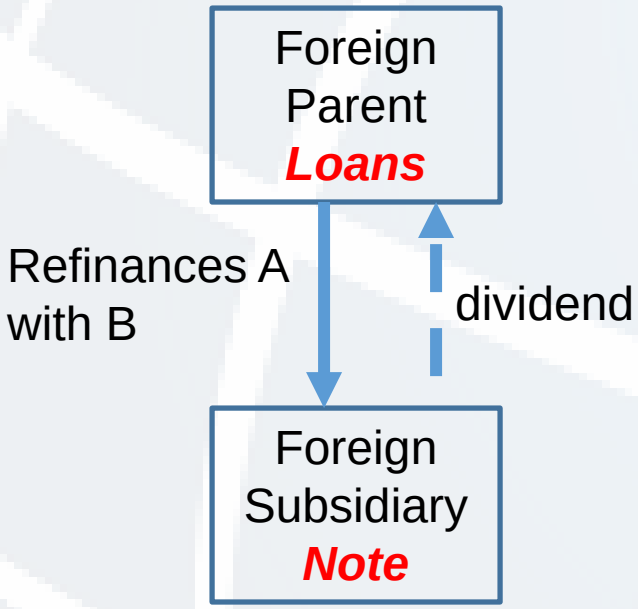
Example

Exchange for property in an asset reorganization



- ***Facts***: FA issues a note to FT in exchange for all of FT's assets and FT subsequently liquidates, distributing the FA note to USP.
- ***Debt Instrument***: FA Note is ***treated as stock*** when it is issued.
- ***Analysis***: The transaction should qualify as a reorganization under Section 368(a)(1)(D), and the General Rule would apply to treat the FA Note as ***stock***.
- Under law in effect prior to the Proposed Regulations, distribution of FA Note was boot, subject to 'boot within gain' rule. Under the Proposed Regulations, consider whether FA Note is boot (i.e., non-qualified preferred stock).

Example
Refinance of debt



- ***Facts:*** Foreign Parent has a loan receivable (Note A) from US Sub that was issued prior to 04/04/16. Note A matures on 12/31/16. US Sub refinances Note A for a new note, Note B, on 12/31/16.
- ***Debt Instrument***: The Proposed Regulations do not apply to Note A as it was issued prior to 04/04/16.
- ***Analysis***: Note B is likely treated as new debt issued on or after 04/04/16 thus it is subject to the Proposed Regulations. The transactions of US Sub must be monitored to determine if Note B becomes subject to the Funding Rule (discussed shortly).

Intercompany debt treated as stock in certain transactions
Funding Transactions

Expanded group debt is also treated as stock if it is issued with a **principal purpose** of funding a distribution or acquisition described above.

Therefore a related party borrowing to fund any of the following is equity: a distribution a purchase of equity in an affiliate, or payment of boot in an asset reorganization.

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Funding Transactions (continued)

There is a **per se rule** that a 'principal purpose' exists if the funding transaction and the relevant distribution or acquisition occur **within 36 months** of one another.

Exceptions exist for:

- ordinary course transactions
- certain distributions having § § 354 or 355 nonrecognition treatment
- acquisitions of subsidiary stock by issuance (if the subsidiary is more than 50% owned for the following 36 months).

Funding rule can be triggered by distributions and acquisitions made by predecessor or successor corporations.

Now need to "lock down" US groups for 36 months.

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Exceptions

- Prop. Treas. Reg. § 385-3 **does not apply** to the extent of the issuer's **current year earnings and profits (E&P)**.

- Prop. Treas. Reg. § 1.385-3 **does not apply** if the expanded group has total expanded group debt of **$50 million or less**.
  - This exception has a 'cliff effect': if the expanded group has **more than $50 million** of total expanded group debt, then Prop. Treas. Reg. § 1.385-3 applies to **all** expanded group debt, not just the excess over $50 million.

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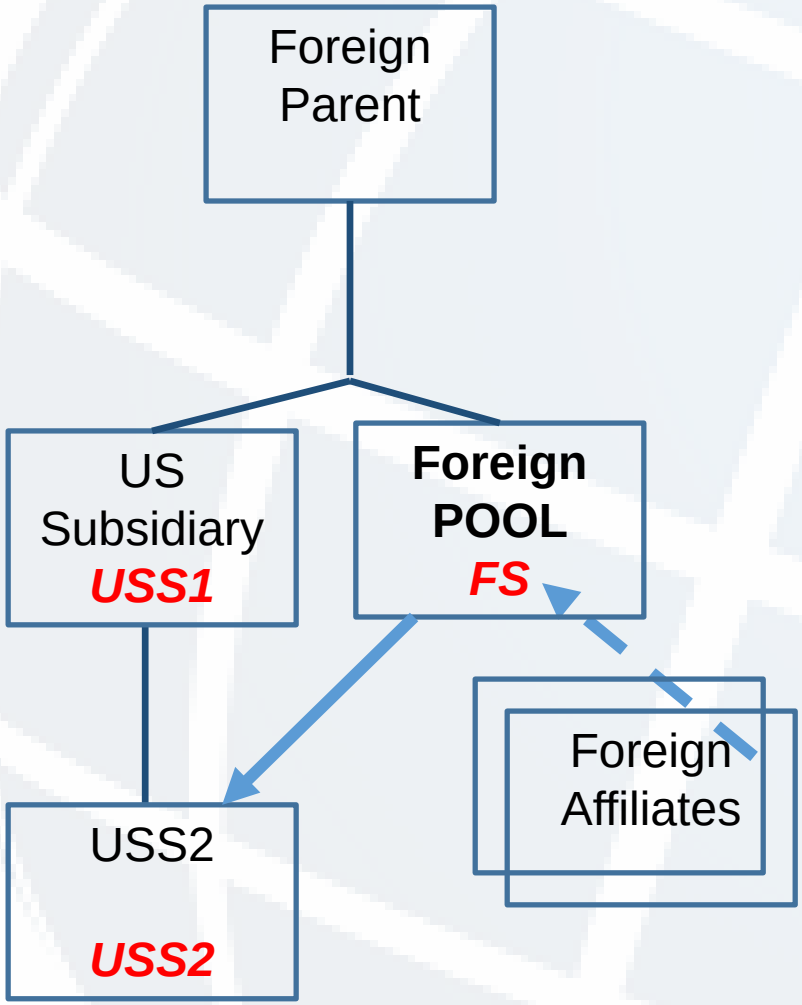
Anti-Abuse rules

- An interest that is not a debt instrument subject to Prop. Treas. Reg. § 1.385-3 (*e.g.*, debt issued to an unrelated person) is treated as stock if issued with a **principal purpose of avoiding** the application of Prop. Treas. Reg. § 1.385-3.

- Prop. Treas. Reg. § 1.385-3 does not apply to the extent a person enters into a transaction that otherwise would be subject to that provision with **a principal purpose of reducing** the US federal income tax liability of any expanded group member by disregarding the treatment of the debt instrument that would occur without application of Prop. Treas. Reg. § 1.385-3.
  - Thus, taxpayers may not affirmatively apply these rules where it would be advantageous to do so.

Example

Inbound Group Cash Pooling



Inbound cash pooling arrangements

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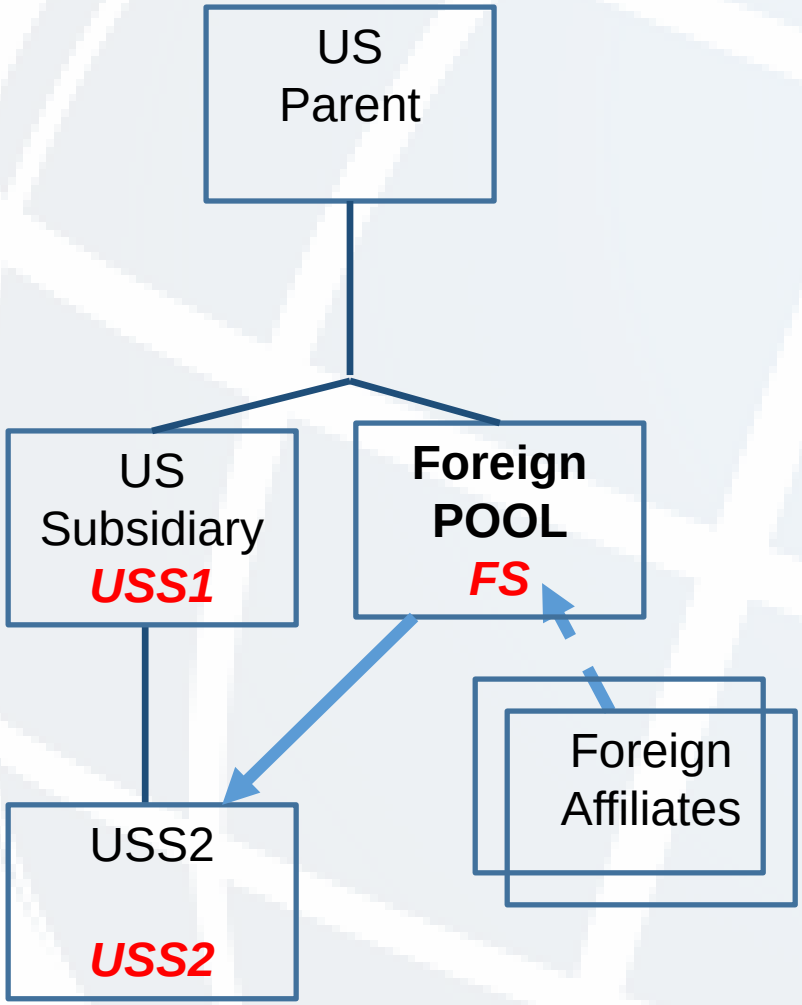
Consider:

1. If FS3 enters into a prohibited transaction described in Prop. Treas. Reg. § 1.385-3(b)(3)(ii) within 3 years of the borrowing, then FS3's borrowing is recharacterized as stock.
2. Would a distribution or acquisition by FS3 described in Prop. Treas. Reg. § 1.385-3(b)(3)(ii) within 3 years of the borrowing convert USP's or FDE's deposit into stock?
3. Consider whether a recharacterization of the deposits as equity could result in a further recharacterization of the USS2 and CFC borrowings as equity?
4. Could the fast-pay stock rules apply in the event CFC's debt were recharacterized?
5. Consider potential withholding taxes and deconsolidation with respect to US2's recharacterized debt.

Example

Outbound Group Cash Pooling



Outbound cash pooling arrangements

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2. Would a distribution or acquisition by FS3 described in Prop. Treas. Reg. § 1.385-3(b)(3)(ii) within 3 years of the borrowing convert USP's or FDE's deposit into stock?
3. Consider whether a recharacterization of the deposits as equity could result in a further recharacterization of the USS2 and CFC borrowings as equity?
4. Likely to lose any deemed paid credits under 902.

Portfolio Interest Exemption

- The Funding Rule appears to have relatively broad potential application to many common inbound financing structures. As noted above, the Funding Rule does not contain an exception for a distribution made by the borrower to the lender.

- As a result, many routine lending transactions could be recast as equity. Payments on such transactions, which were otherwise free of US tax, would be subject to withholding tax at a 30% (or lower treaty rate if one applies) if even a single dollar of recast dividends is distributed to the lender within the six year period set forth under the proposed regs.

- Under the Funding Rule, even a small distribution on an otherwise widely used and accepted structure, will turn the tax consequences on their head. Consider the following example:

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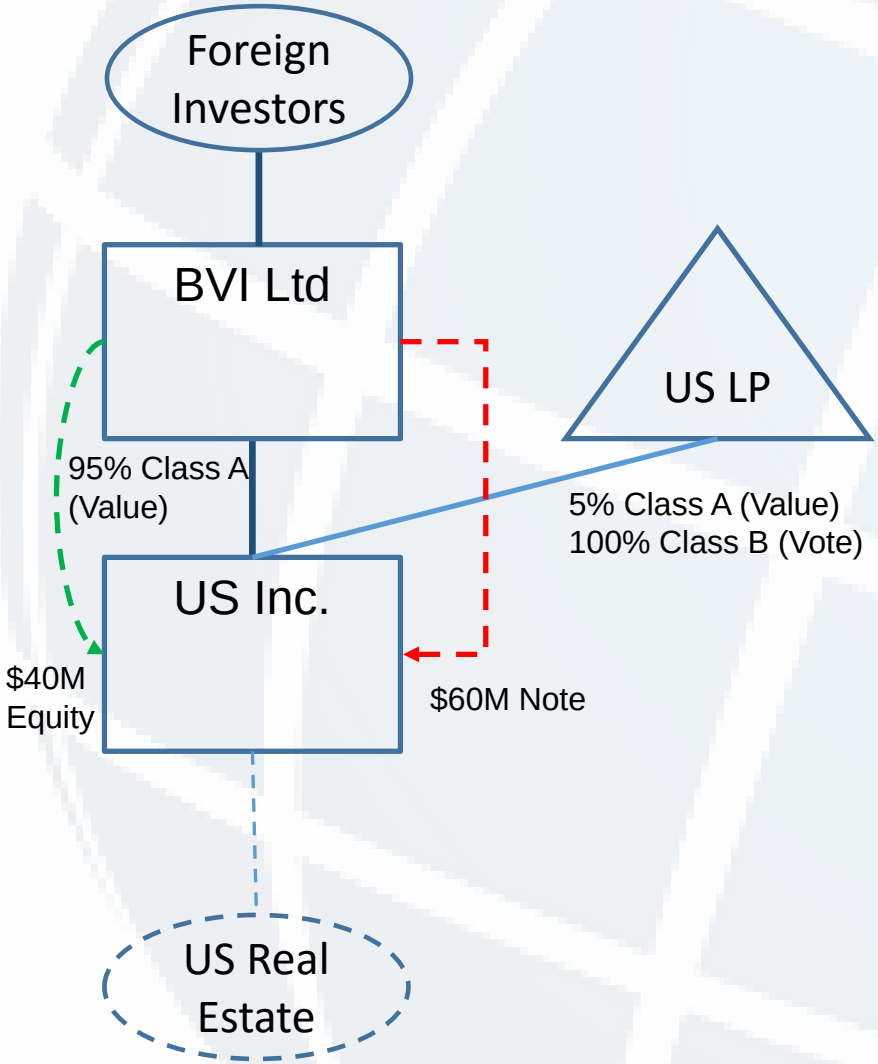
Example
Portfolio Interest Exemption



Consider:

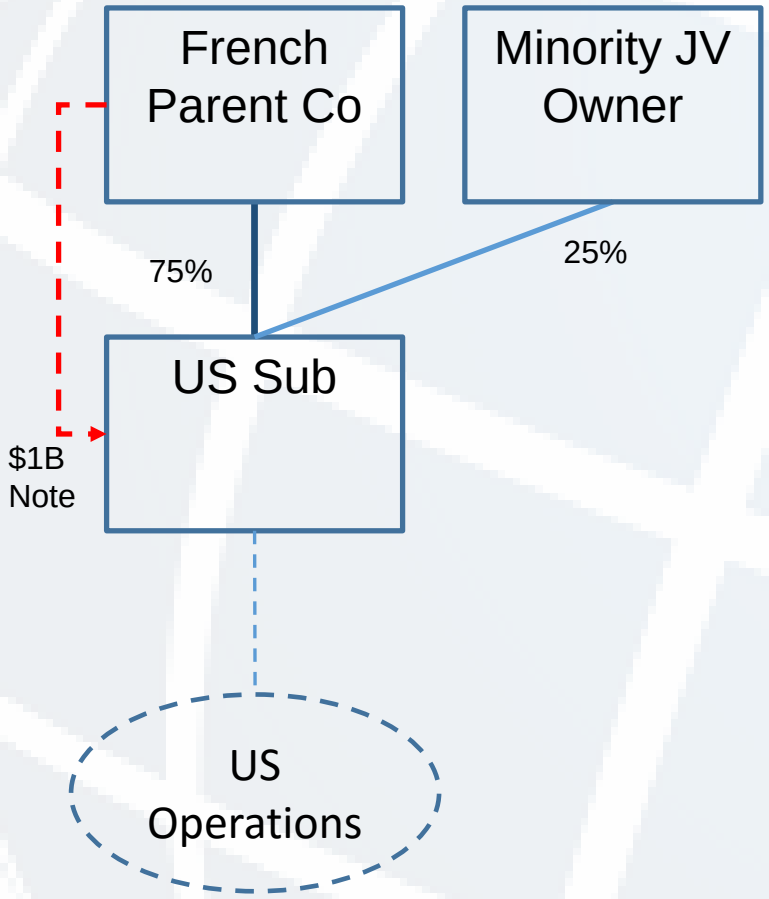
1. Foreign investors from a non-treaty country (BVI) wish to invest an aggregate of $100M in a US real estate fund.
2. Investors set up a BVI Ltd as a feeder entity and capitalize BVI Ltd with $100M. BVI Ltd forms a US blocker ("US Inc"). US Inc has two classes of stock: Class A with high vote/low value and Class B with low vote/high value
3. BVI Ltd receives 95 percent of the Class A shares of US Inc (and 95 percent of the value of US Inc), but none of the Class B shares. The remaining 5 percent of the Class A shares by value, along with all of the Class B shares of US Inc, are owned by a Delaware LP (taxed as a partnership), which serves as the GP to the US real estate investment fund.
4. BVI Ltd then leverages its investment in US Inc, by using 40 percent of its cash (i.e., $40M) to capitalize US Inc with equity, and lending the remaining $60M, to US Inc in exchange for a note with a market rate of interest.
5. Assuming the other portfolio interest exemption requirements are met, since BVI Ltd owns no voting shares in US Inc, interest payments on the debt should be exempt from withholding tax under 881(c) and deductible by US Inc (163(j) safe harbor of 1.5:1 is met).

Treaty Implications

- How will the proposed regs effect the US Bi-Lateral Tax Treaties with respect to withholding tax on instruments purported to be debt in the lender's home country, but now treated as equity under the proposed regs?
- Debt/Equity mismatches will likely create nightmare scenarios for taxpayers seeking relief from double taxation under Competent Authority and MAP Procedures.
- Will the US APA program have the ability to rule that an instrument is debt or equity for transfer pricing purposes?
- Will the US recharacterization rules run afoul of the OECD Hybrid Debt BEPS Rules?
- Withholding Tax Miss-match (French Treaty example)

Example

Treaty Miss-Match on WHT



Consider:

1. French Parent Company with 75% owned Subsidiary funds JV with debt and equity.

2. Under US-France Tax Treaty: WHT on interest is 0%; WHT on dividend on 80% or greater owned sub is 0%, on 75% owned sub its 5%.

3. France treats note as debt – tax on interest income, no tax on repatriation of principal.

4. US treats note as equity – 5% WHT on "interest" and 5% WHT on "principal".

5. Assuming a US$ 1B Loan (think Airbus), the WHT could be significant.

6. Why would France give an FTC on the WHT when it treats the note as debt and should have 0% WHT.

7. Could it be equity in France?; if so the dividend would be subject to French 95% participation exemption.

8. Go to Competent Authority – how do you resolve this so the taxpayer is not whipsawed?

Effective Date

- Prop. Reg. § 1.385-3 applies to debt **instruments issued** or deemed issued **on or after April 4, 2016.**

- Debt instruments issued or deemed issued on or after April 4, 2016, but before the Proposed Regulations are finalized, will be treated as debt until 90 days after the finalization date, at which time they will be deemed exchanged for the issuer's stock.

- Dividends paid, or equity acquisitions made on or after April 4, 2016, could result in recharacterization of debt issued in the following 36 months.

- ***It is therefore imperative that taxpayers consider the potential impact of the Proposed Regulations today as they engage in related party financings, dividend planning, and stock restructurings.***

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Substantiation / Documentation

Substantiation of related party debt

In general

- Prop. Reg. § 1.385-2 provides documentation requirements for expanded group debt, identifying the nature of the documentation needed to substantiate debt treatment:
  - requires (a) contemporaneous documentation and (b) maintenance documentation as necessary condition to debt characterization
  - if these requirements are satisfied, the purported debt is analyzed as debt or stock (in whole or in part) under general US federal tax law principles, taking into account the documentation provided and other facts and circumstances
  - if these requirements are not satisfied, the purported debt is treated as stock (reasonable cause exception provided).
- The substantiation requirements apply only to instruments:
  - issued in form as debt
  - instruments issued and held by members of an expanded group (expanded group instruments or EGIs), and large taxpayer groups (*e.g.*, stock of any expanded group member that is publicly traded).

Substantiation / Documentation (cont)

General documentation requirements

The following written documentation requirements must be maintained for all tax years the debt is outstanding:

- Form / agreement: An unconditional and legally binding obligation to pay a sum certain on demand or at one or more fixed dates.
- Form / agreement: Indicating the holder has creditor's rights, superior to shareholders (common and preferred) in case of dissolution.
- Commercial / underwriting: Demonstrating a reasonable expectation of issuer's ability to repay the debt, such as cash flow projections, financial statements, business forecasts, asset appraisals, relevant financial ratios or information on sources of funds (timing: **no later than 30 calendar days after** the instrument first becomes expanded group debt and related ability to pay).
- Commercial / maintenance: Evidence of timely interest and principal payments or, in case of failure to make required payments or an event of default, the holder's reasonable exercise of a creditor's diligence and judgment (timing: **no later than 120 calendar days after** (i) the due date of each payment or (ii) the date of each default or acceleration event).

Substantiation / Documentation
Revolvers / Cash Pooling

Revolvers/cash pools documentation

- With respect to revolvers and cash pools, all material documentation relevant to expanded group debt must be documented; prepared, maintained, and provided as follows:
- documentation of debt as part of a revolving credit agreement, including all relevant enabling documents (*e.g.*, board of directors' resolutions, credit agreements, omnibus agreements, security agreements, etc.)
- documentation of debt pursuant to a cash pooling arrangement or internal banking service, including those governing the ongoing operations of the arrangement or service (such as any agreements with entities that are not members of the expanded group).

New Rule Book

The New Rules to Follow:

- Use notional pooling in place of actual sweep pooling to eliminating the creation of intercompany distributions.
- Use check the box to make intercompany fund flows “disappear”
- Consider making intercompany loans voting to avoid losing 902 credits if they are converted into equity
- Get the documentation right.
- Inbound: keep US out of sweep pooling: distributions could be recharacterized as dividends and subject to withholding tax.
- Once equity, its equity “for all purposes”. agreements with entities that are not members of the expanded group).
- Coordination of loan documentation rules with transfer pricing rules

Final Thoughts

Some things to keep an eye on:

- Treasury has stated over and over its intention to finalize the proposed 385 regs by September.
- The last time Treasury tried to write rules under section 385, it was unsuccessful (final regulations issued in 1981 (T.D. 7747, 1981-1 C.B. 141) were withdrawn in 1983 (T.D. 7920, 1983-2 C.B. 69) before they went into effect).
- Multiple groups and sources have questioned the validity of the regulations and whether the Treasury has “overstepped” its authority.
- Treasury is under pressure from business groups, taxpayers and even Congress to extend the comment period of the proposed regs by at least 90 days.
- Many government officials have empathized with the problems that the proposed rules cause for cash pooling in multinational groups. The Treasury has asked for help in drafting appropriate rules that don't ”throw out the baby with the bathwater”.