US Treasury's proposed §385 regulations under extreme scrutiny on Capitol Hill, in corporate tax departments: top points

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As part of its ongoing effort to try to curb inversion transactions, the Treasury Department has issued proposed regulations under section 385. Section 385(a) authorizes the Treasury Department to issue regulations that may be necessary or appropriate to determine whether an interest in a corporation is treated as stock or indebtedness for US federal income tax purposes.

The new proposed regulations, issued April 4, 2016, are extremely broad and affect a vast range of transactions between related parties, whether domestic or foreign. The preamble states that the proposed regulations were motivated in part by policy concerns relating to transactions that result in excessive debt between related parties in a cross-border context.

However, the proposed regulations go far beyond the stated purpose of targeting inversions and earnings stripping and may potentially recharacterize as equity routine intercompany debt transactions that arise in the domestic and intercompany context.

The new proposed regulations can be briefly summarized as follows:

Bifurcation rules (Prop Reg. 1.385-1)

- Apply prospectively
- The Commissioner, on exam, may treat certain related party debt as part debt and part stock. This is a significant departure from the "all or nothing" approach to debt-equity testing at the time of the issuance of the instrument.

Documentation rules (Prop. Reg. 1.385-2)

The documentation rules describe extensive contemporaneous documentation that is necessary (but not sufficient) for treatment of related party instruments as debt.

- Apply prospectively
- Parties to related party debt instruments must maintain contemporaneous documentation evidencing the following:

(1) *Binding obligation to repay*: issuer has an unconditional and legally binding obligation to pay a sum

certain

(2) *Creditor's rights to enforce terms* : holder has traditional creditor's rights to enforce obligation (*e.g.,* ability to trigger default or acceleration, preferred right to share in assets upon issuer's dissolution before shareholders)

(3) *Reasonable expectation of repayment*: documents necessary to establish this (*e.g.*, cash flow projections, financial statements and forecasts, appraisals, debt-to-equity ratio) and

(4) *Genuine debtor-creditor relationship*: timely evidence of payments of principal or interest (or, in the event of default or failure to pay, a holder's reasonable exercise of diligence and judgment of a creditor).

Per se stock rules (Prop. Reg. 1. 385-3 and -4)

Subject to certain limited exceptions, the per se stock rules treat related party debt as stock if it is issued in certain enumerated transactions, even though it would otherwise be characterized as debt under existing case law.

- Apply to related party debt issued on or after April 4 (and which is still in effect 90 days after the Section 385 proposed regulations are published as final)
- Apply to related-party debt issued:

    (1) In a distribution (including a "straight" spinoff)

    (2) In exchange for stock of an affiliate

    (3) As boot in an asset reorganization or

    (4) By an affiliate in exchange for property, where issued with a "principal purpose" of funding one of the transactions described in (1) – (3) (the funding rule)

    There is a non-rebuttable presumption of "principal purpose" when the debt instrument is issued within 36 months before or after such transaction described in (1) – (3).

- 1.385-4 contains rules for applying -3 to a consolidated group when an instrument ceases to be or becomes a consolidated group debt instrument

There are serious concerns relating to the impact of the proposed regulations on routine intercompany transactions, such as cash pooling and integrated hedging. Taxpayers are also concerned about the potential for a "spaghetti-bowl" organization chart resulting from the recharacterization of part (or all) of intercompany loans as equity, and the resulting uncertainty with respect to common transactions such as dividend distributions (and deemed dividend inclusions), reorganization/sale transactions, and foreign tax credit planning. The rules are written so broadly that there are numerous ways for taxpayers to unwittingly trigger their application through normal, day-to-day transactions. Commentators have also pointed out that these proposed regulations significantly increase US tax compliance and monitoring costs, and are therefore anti-competitive to US-based multinationals.

Take steps now

The Treasury has expressed its intent to finalize the proposed regulations by September 5, 2016. Given these public statements, taxpayers that are potentially affected by these proposed regulations should take steps now to ensure that they are prepared to comply. Such steps include inventorying all debt instruments that may be potentially affected (including debt entered into pursuant to cash pooling arrangements), establishing standards for compliance with the requirements of the Documentation Rules, establishing monitoring systems to track transactions that would implicate the Funding Rule, and establishing systems to track a "significant modification" of otherwise grandfathered debt instruments.

We are available to guide you on the potential application of these proposed rules to your organization and assist in your related due diligence and development of tracking and monitoring systems, and eager to help you communicate your concerns to Congress. Learn more by contacting either of the authors.

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