
The Final and Temporary (and Proposed) Section 385 Regulations

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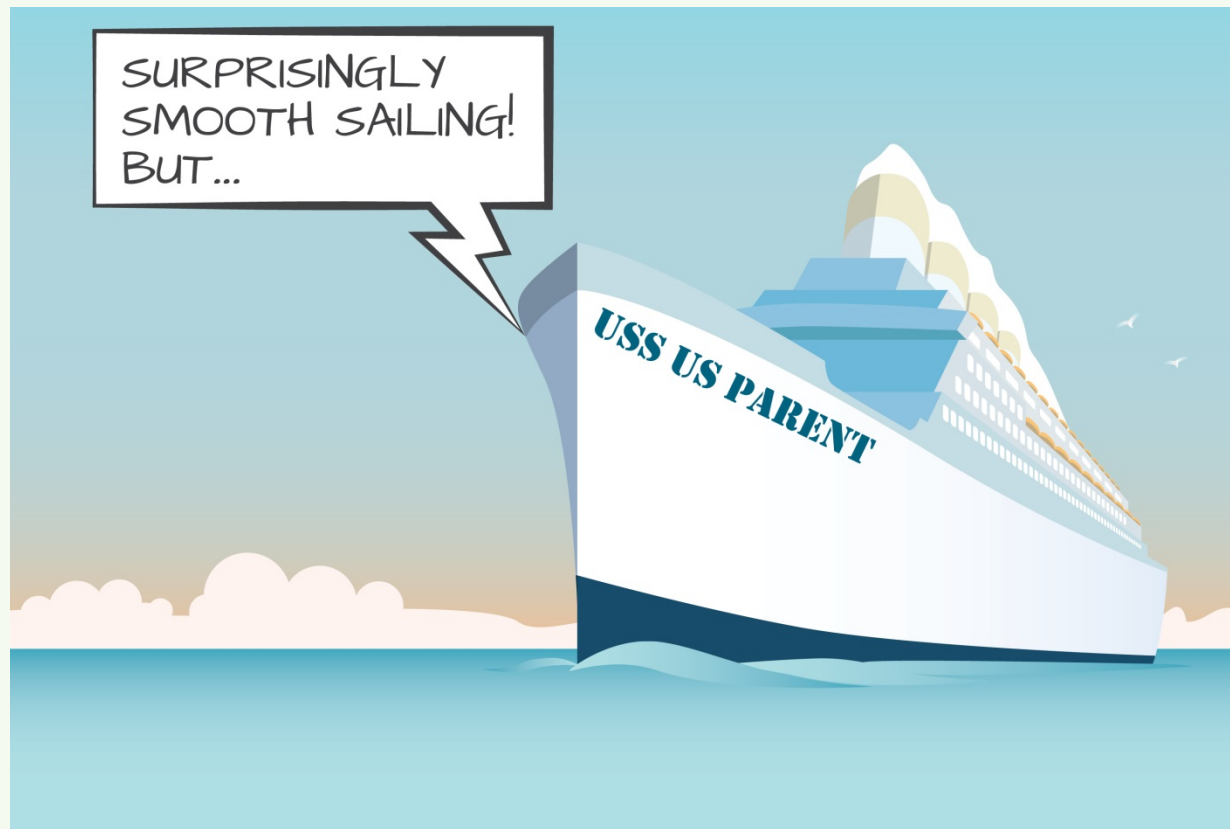
Introduction

- On October 13, 2016, the IRS and Treasury issued final and temporary regulations under section 385 that prescribe documentation rules that must be met for certain related party instruments to be respected as debt and that automatically reclassify certain related party loans as stock in certain cases
 - These final and temporary regulations largely retain the basic structure of the rules proposed in April 2016, but with a significantly reduced scope

- Topics Covered
 - Scope of the rules generally
 - Documentation Rules
 - Per Se Stock Rules
 - Cash pools
 - Banks and insurance companies
 - Partnership and DRE “deeming” rules
 - Q&A

Headlines: US-Parented Multinationals

- Most intercompany loans entered into by members of US-parented multinational groups are likely exempt from the final and temporary rules, but these rules could still apply in certain cases



Headlines: Non US-Parented Multinationals

- Intercompany loans issued by US members of non US-parented multinational groups to other Expanded Group members (not in the same US consolidated group) are generally subject to these rules
- Non US-parented multinational groups that have US subsidiaries in separate chains will be most affected



So... Who's In and Who's Out?

GENERAL APPLICATION OF THE SECTION 385 RULES

Issuer (generally)	In Documentation?	In Per Se Stock?	Neither
Non-US Issuers	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
US Issuers (to non-consolidated group members)	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
US Issuers (to consolidated group members)	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
RIC (non-controlled) Issuers	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
REIT (non-controlled) Issuers	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
S-Corps	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
US Regulated Financial Group Issuers	<input checked="" type="checkbox"/> *	<input type="checkbox"/>	<input type="checkbox"/>
US Regulated Insurance Company Issuers	<input checked="" type="checkbox"/> *	<input type="checkbox"/>	<input type="checkbox"/>

Effective Dates/Transition Rules

■ Documentation Rules

- Intercompany obligations covered by these rules will be treated as stock if the taxpayer fails to create the required documentation
- Rules apply to intercompany obligations issued on or after January 1, 2018
 - Documentation does not need to be completed until the due date (with extensions) of the tax return for the taxable year that includes the “relevant date” (usually the issue date)

■ Per Se Stock Rules

- Intercompany obligations covered by these rules will be treated as stock if issued in certain types of transactions or issued within 36 months before or after certain types of transactions
- Recharacterization of debt as stock starts on January 19, 2017 but only with respect to debt issued and transactions entered into after April 4, 2016

More Guidance to Come...?

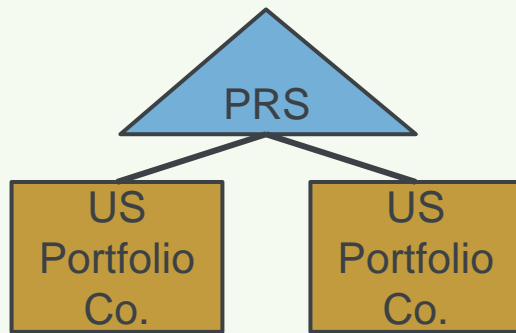
- “Reserved” topics still under study for potential future (prospective only) guidance:
 - Application to non-US issuers of intercompany loans
 - Application to US branches of non-US issuers
 - Treatment of brother-sister groups with common non-corporate owners and group expansion through downward attribution
 - Application of Documentation Rules to obligations not in form debt
 - Rules prohibiting affirmative use of the Documentation and Per Se Stock Rules

Documentation Rules

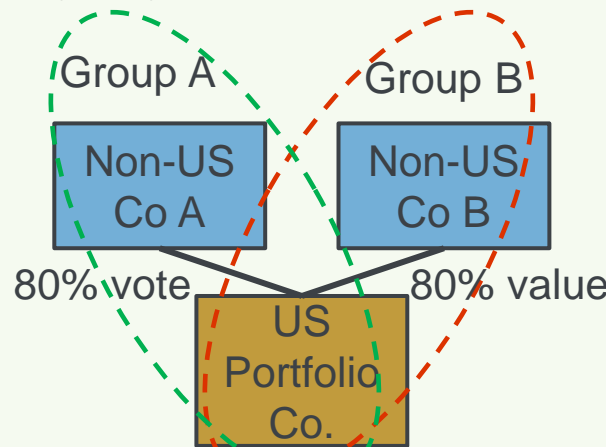
Documentation Rules

SCOPE

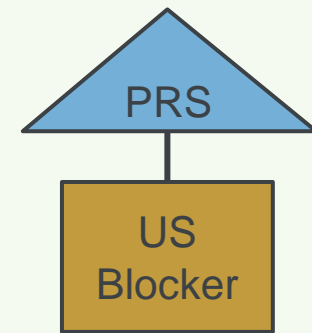
- Generally apply to debt instruments issued by a domestic corporation to members of its **Expanded Group**
 - What is an **Expanded Group**?
 - Generally, corporations affiliated by 80% of vote or value
 - Section 318(a) attribution rules for indirect stock ownership apply, with modifications
 - Treasury has reserved on the use of downward attribution and therefore the inclusion of brother-sister groups with non-corporate owners
 - Option attribution rules apply only if options are reasonably certain to be exercised



Not an Expanded Group (yet)



Two Expanded Groups



Not an Expanded Group (yet)

Documentation Rules

- Members of an Expanded Group must prepare and maintain documentation relating to any **Expanded Group Interest (“EGI”)**
 - **EGI:** A debt instrument (in form) issued by a domestic corporation and held by a member of the corporation’s Expanded Group, subject to exceptions for consolidated group debt and certain other exceptions
- Consequence of failure: Debt is treated as stock for all US federal income tax purposes, *except*:
 - Taxpayers with high volumes of EGIs who are “highly compliant” may rebut the presumption
 - Reasonable cause
 - Ministerial or non-material failure or error discovered by taxpayer
- An EGI issued by a disregarded entity (“**DRE**”) that is owned by a domestic member of an Expanded Group is treated as stock issued by the corporate owner of the DRE
- Satisfaction of the Documentation Rules does not ensure debt treatment; still need to pass traditional debt/equity analysis to be respected as debt

Documentation Rules

TIMELY PREPARATION

- Required Documentation:
 - Unconditional and legally binding obligation to pay a sum certain
 - Rights of a creditor
 - e.g., rights to trigger event of default or acceleration and a superior right to shareholders to share assets upon dissolution
 - Reasonable expectation of repayment
 - e.g., cash flow projections, financial statements, business forecasts, asset appraisals, debt-equity ratios
 - Debtor-creditor relationship
 - e.g., wire transfer record of payments made, bank statement, evidence of creditor's reasonable exercise of the diligence of a creditor
- Deadline: Due date for filing issuer's federal income tax return (with extensions) for the year that includes the relevant date of required documentation



Documentation Rules

MASTER AGREEMENTS

- Master agreements are generally subject to the Documentation Rules
 - Single credit analysis may be prepared and used on an annual basis for EGIs issued by a member up to an overall amount of indebtedness set forth in an annual credit analysis

- Upon the occurrence of a “Material Event,” additional documentation must be prepared analyzing the updated circumstances of the issuer
 - Material Event includes bankruptcy, material change in the line of business and a disposition of 50% or more by value of the issuer’s assets
 - Additional documentation must be completed by the time for filing the issuer’s federal income tax return for the year in which the Material Event occurred

Documentation Rules

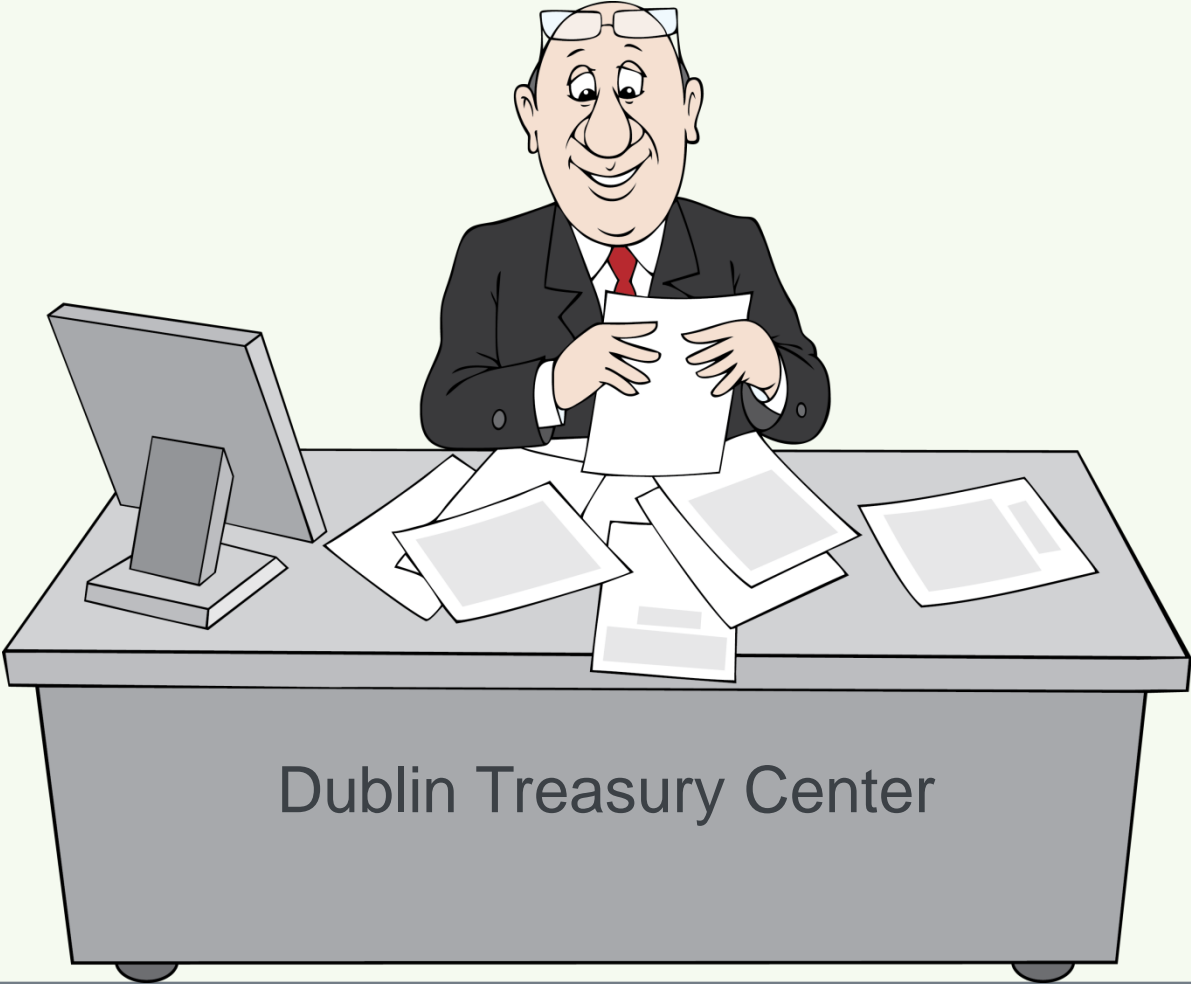
EXEMPTIONS AND SAFE HARBORS

- Limited Safe Harbors:
 - Market Standard Documentation Safe Harbor
 - EGIs with terms required by regulators
 - “Excepted regulated financial company”
 - “Regulated Insurance Company”

- Special Rules and Exemptions:
 - Cash pooling (more later)
 - General threshold limitation
 - Any instrument specifically treated as debt for federal income tax purposes under the provisions of the Code or regulations

Documentation Rules

2016



Documentation Rules

2019



Per Se Stock Rules

Per Se Stock Rules

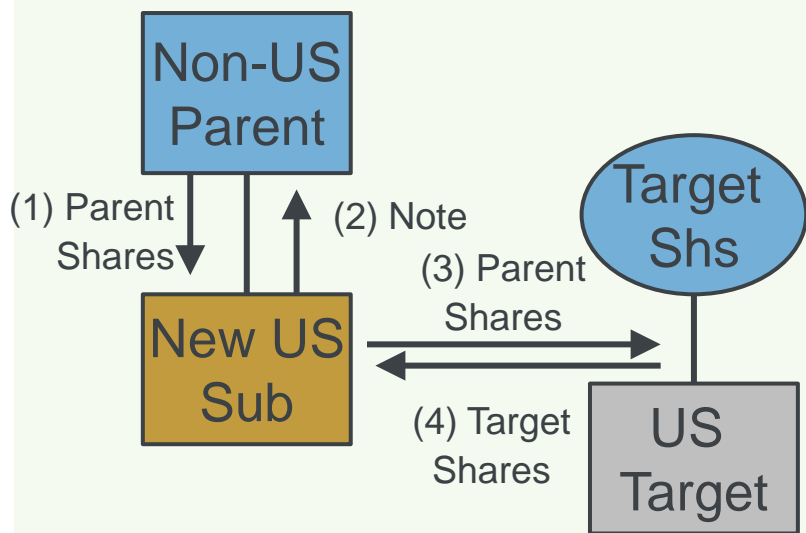
IN GENERAL

- Under the Per Se Stock Rules, a debt instrument will (unless an exception applies) automatically be treated as stock if it was issued by a domestic corporation to a member of its Expanded Group and either:
 - The debt instrument was issued in certain types of transactions (a “**General Rule Transaction**”), or
 - The domestic corporation that issued the debt engages in certain types of transactions during the 3-year period following the debt issuance or previously did so during the 3-year period preceding the debt issuance (a “**Funding Rule Transaction**”)

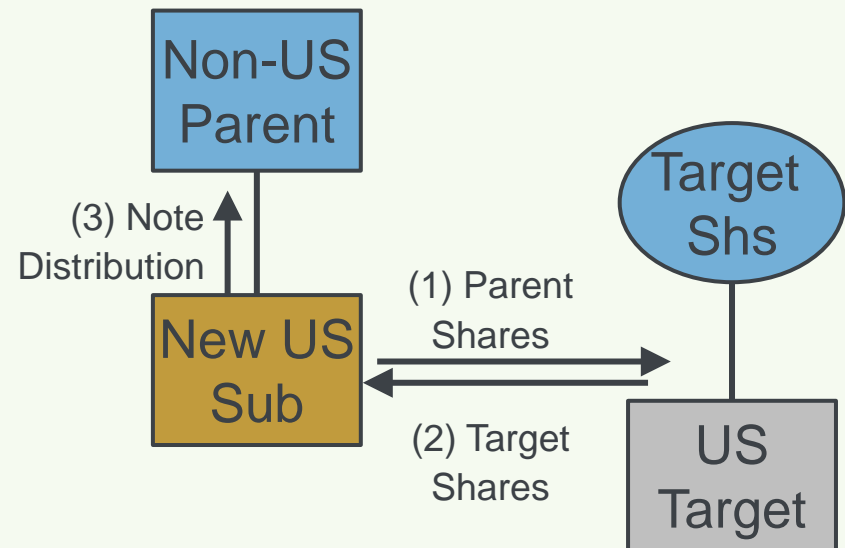
- No reasonable cause or similar exception
 - But the rules are subject to various exceptions

- Per Se Stock Rules were heavily criticized – IRS and Treasury response (so far):
 - Retain basic approach of the proposed regulations
 - Limit who the rules apply to (only domestic corporations and certain partnerships)

Two Types of Earnings Stripping in Inversion Transactions



- New US Sub acquires Non-US Parent shares (in part) for a note
- US Sub uses the Non-US Parent shares as acquisition currency to acquire shares of a US target



- New US Sub uses Non-US Parent shares as acquisition currency to acquire shares of a US target
- New US Sub distributes a note to Non-US Parent

Per Se Stock Rules

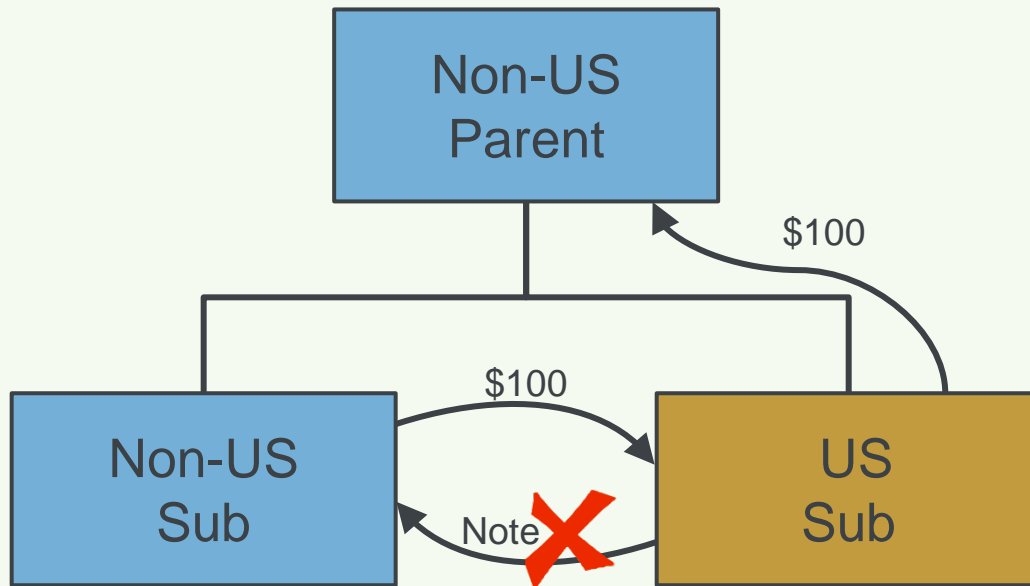
- While the Per Se Stock Rules are generally limited to domestic corporations, they are not limited to transactions that give rise to earnings stripping concerns (or inversion transactions)
- Examples of General Rule Transactions—the issuance itself of a note generally triggers the Per Se Stock Rules in cases where a:
 - Domestic corporation distributes its own note to its non-US parent
 - Domestic corporation issues its own note in exchange for stock of its non-US parent (subject to an “exempt exchange” rule)
 - Domestic corporation issues its own note in certain asset reorganizations
- Various exceptions and special rules

Per Se Stock Rules

- Examples of Funding Rule Transactions:
 - If a domestic corporation issues debt to a member of its Expanded Group, the debt is generally treated as stock if (during the 3-year period prior to the issuance or the 3-year period after the issuance) the domestic issuer:
 - Makes a distribution of cash or property
 - Acquires Expanded Group stock
 - Acquires assets from a member of its Expanded Group in an asset reorganization with boot
 - Various exceptions and special rules

Per Se Stock Rules

FUNDING RULE: "FUNDED" CASH DISTRIBUTION



- Non-US Sub lends US Sub \$100 in exchange for a note
- 2 ½ years earlier US Sub made a \$100 distribution to Non-US Parent
- **US Sub Note treated as stock**

Per Se Stock Rules

EXCEPTIONS FOR CERTAIN TYPES OF DEBT AND CERTAIN TRANSACTIONS

- **Cash Pooling Exceptions:** (more later)
 - Qualified short-term debt instruments
 - Cash pool deposits
- **Ordinary Course Exception:** Debt issued in ordinary course of issuer's trade or business and reasonably expected to be repaid in 120 days
- **Subsidiary Stock Acquisitions:** Acquisitions of Expanded Group stock from a direct or indirect subsidiary where the acquirer does not relinquish control pursuant to a pre-existing plan
- **Compensatory Equity:** Acquisitions of Expanded Group stock that is delivered to employees, directors or independent contractors in consideration for services rendered to the Expanded Group
- **Dealer in Securities:** Certain acquisitions of Expanded Group debt by a dealer in securities in its ordinary course of dealing

Per Se Stock Rules

E&P AND QUALIFIED CONTRIBUTION EXCEPTIONS

- **E&P Exception:** Distributions and acquisitions to the extent of a member's post-April 4, 2016 E&P are exempted from the general and funding rules
 - E&P exception no longer limited to current E&P, as was the case under proposed regulations
 - Special rule for consolidated E&P

- **Qualified Contribution Exception:** Distributions and acquisitions that would otherwise cause a recharacterization of debt are first offset by “qualified contributions”
 - Qualified contributions generally include any contribution of property (other than Expanded Group stock, related party debt and certain other excluded property) made within 3 years before or after the distribution or acquisition

Per Se Stock Rules

OTHER SPECIAL RULES

- **Ordering Rules:**
 - As to General Rule Transactions and Funding Rule Transactions
 - As to payments on debt partially treated as stock
- **Principal Purpose Rule:** For transactions beyond 6-year window for Funding Rule Transactions
- **Straddle Rules:** For transactions that straddle different Expanded Groups
- **Significant Modification Rules:** How various types of significant modifications implicate funding rule
- **Some Others:**
 - Predecessor and Successor Rules
 - Transition Rules
 - Anti-Abuse Rule

Cash Pools

SPECIAL DOCUMENTATION RULES

- **Documentation Rules:** Required documentation for cash pools (including notional cash pools) must be prepared in connection with:
 - Date of execution of legal documents governing overall cash pool;
 - Date of any amendment to documents that increases maximum principal amount or adds an additional borrower; and
 - Each anniversary date of execution of the legal documents during the life of legal documents
 - Absent a material event, a single annual credit analysis may be used

Cash Pools

EXCEPTION FROM FUNDING RULE PORTION OF PER SE STOCK RULES

- **Short-Term Funding Arrangement:** Debt instruments meeting one of two tests (an issuer cannot apply both tests in any one taxable year):
 - **Specified current assets test:** (1) interest rate on the debt is less than or equal to an arm's length rate and (2) issuer's balance of Expanded Group debt that qualifies for certain exceptions does not exceed issuer's "short-term financing needs" (generally, issuer's current assets other than cash and cash equivalents)
 - **270-day test:** (1) the debt has a term of no more than 270 days (or is an advance under a revolver), and (2) issuer is not a net borrower from the lender for more than 270 days in a taxable year or from any other member of the Expanded Group for more than 270 days in a taxable year
- **Qualified Cash Pool Header:** Deposits with a "qualified cash pool header" are exempt from Per Se Stock Rules. Generally defined as:
 - An Expanded Group member, a controlled partnership or a qualified business unit owned by another Expanded Group member that
 - Has as its principal purpose managing a cash-management arrangement for participating Expanded Group members and that maintains deposits in excess of loans to participating members

Banks and Insurance Companies

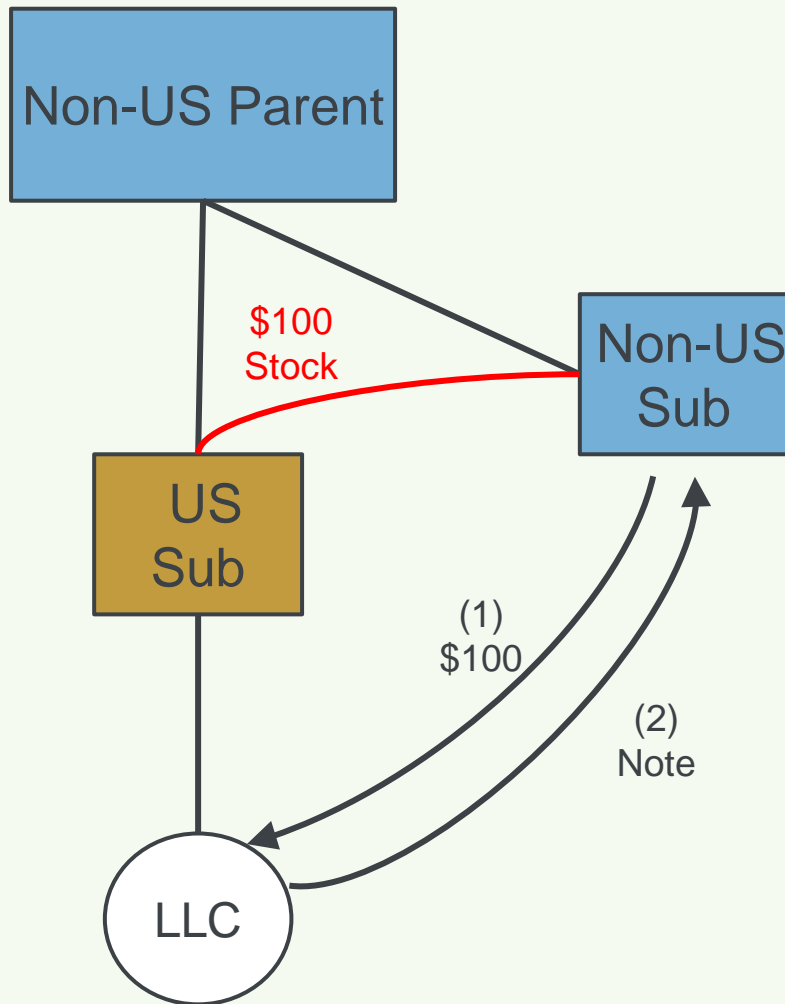
- Exception from Per Se Stock Rules (but not Documentation Rules) for:
 - “Regulated Financial Companies” and their subsidiaries
 - Regulated Financial Company includes banks, bank holding companies, US intermediate holding companies of a non-US banking organization, US-registered broker-dealers and swaps dealers
 - Certain merchant banking and other subsidiaries not exempt
 - “Regulated Insurance Companies”
 - Licensed by a state to sell insurance, reinsurance or annuities to non-related persons, and regularly issuing such products
 - Only the regulated entity is exempt, not subsidiaries
- Simplified Documentation Rules for Regulatory Debt:
 - Regulated financial companies – debt with terms required to satisfy regulatory capital or similar rules governing resolution or orderly liquidation (including “total loss absorbing capacity” requirements)
 - Regulated insurance companies – debt if insurance regulator must approve payments (e.g., surplus notes)
 - Observations

Partnership and DRE Deeming Rules

Special Rule for Controlled Partnerships

- **Controlled Partnership**
 - Generally means a partnership if at least 80% of the capital or profits are owned (directly or indirectly) by members of an Expanded Group
- **Acquisitions of Property by a Controlled Partnership from a member of the Expanded Group**
 - Treated as acquisition of property by the Expanded Group partners
 - Based on liquidation value percentage
 - Special rules when an Expanded Group member becomes a partner
- **Debt issued by a Controlled Partnership to a member of the Expanded Group**
 - Domestic corporate partner that is a member of the Expanded Group is treated as the issuer with respect to its share of the debt
 - A very complicated set of additional rules prescribe how to apply the Per Se Stock Rules to the portion of debt treated as issued by that domestic corporate partner
 - Share based on issuance percentage (anticipated share of interest deductions)

DRE “Deeming” Rules



- Non-US Sub lends \$100 to LLC, a wholly owned sub of US Sub, in exchange for a note (1 and 2)
- If the Note is later recharacterized, for example, for failure to comply with the Documentation Rules, Non-US Sub would be treated as owning \$100 of stock in US Sub

Some Thoughts on What Taxpayers Should Do

- Identify debt instruments potentially subject to the Documentation and/or Per Se Stock Rules
- Develop a procedure for complying with the Documentation Rules
- Determine which debt instruments qualify for an exception and/or make adjustments to ensure qualification
- Before any debt instrument is issued or created, determine whether the issuer:
 - Has (during the preceding 3 years) engaged in a Funding Rule Transaction, or
 - May (during the next 3 years) engage in one



Q&A