Executive summary

On 13 October 2016, the US Treasury Department (the Treasury) and the Internal Revenue Service (the IRS) released final and temporary regulations under Internal Revenue Code Section 385 (TD 9790, the Final Regulations), which follow the release of extremely controversial proposed regulations by just six months (REG-108060-15, the Proposed Regulations). In response to comments, the Final Regulations significantly narrow the scope of the Proposed Regulations.

For background on the proposed regulations, which were released on 4 April 2016, see EY Global Tax Alert, New Section 385 regulations would treat certain related-party corporate interests as stock, rather than debt, for federal tax purposes, dated 7 April 2016.

Although the Final Regulations retain much of the general approach of the Proposed Regulations, they also contain numerous and significant modifications, detailed further below. Like the Proposed Regulations, the Final Regulations target instruments issued to a member of the issuer’s “expanded group” that would otherwise constitute indebtedness for US federal tax purposes under common law principles (a debt instrument). Like the Proposed Regulations, the Final Regulations:
Establish extensive documentation requirements that must be satisfied for a debt instrument to constitute indebtedness for US federal tax purposes (the Documentation Rule, which is found in Reg. Section 1.385-2).

Recharacterize a debt instrument issued after 4 April 2016, as stock if the instrument is: (i) issued in one of a number of specified transactions (herein referenced as tainted transactions), or (ii) funds a tainted transaction (the Recharacterization Rule, which is found in Reg. Section 1.385-3T).

Notable changes in the Final Regulations include:

- **Limited to US borrowers.** In what is likely the most significant change, the Final Regulations apply only to instruments issued by domestic corporations (and certain partnerships and disregarded entities with domestic corporate owners) (a covered member). This change has the effect of excluding, for example, foreign-to-foreign and US-to-foreign (outbound) loans from the scope of the documentation and transaction rules, and should alleviate many of the concerns created by the Proposed Regulations for US-based multinationals. Foreign-based multinationals and certain other groups in which foreign or other non-consolidated expanded group members hold covered debt instruments, however, are likely to be significantly affected by the Final Regulations. In addition, the Treasury and the IRS reiterated their belief that the Documentation Rule distills “best documentation practices under case law,” which may preclude additional IRS scrutiny of related-party debt instruments not literally subject to those rules under the Final Regulations.

- **Removal of the general bifurcation rule.** The Final Regulations remove the general “bifurcation” rule contained in the Proposed Regulations that would have allowed the IRS to bifurcate an instrument into part debt, part equity, based upon an analysis of the relevant facts and circumstances. Instead, Treasury will continue to study this issue.

- **Changes to expanded group definition.** Although the Final Regulations continue to apply to debt issued by a covered member within an “expanded group” or “EG,” several significant changes were made to what constitutes an EG. First, S corporations and non-controlled regulated investment companies (RICs) and real estate investment trusts (REITs) are excluded from an expanded group. Second, the determination of “indirect” ownership is now made by reference to modified attribution rules that, among other things, do not incorporate so-called downward attribution. This has the effect of preventing brother-sister groups with non-corporate ownership from being treated as an expanded group.

- **Delayed documentation requirement.** The Documentation Rule applies only to debt instruments issued on or after 1 January 2018, and the documentation is not required to be completed until the due date of the issuer’s return, including extensions, for the tax year that includes the “relevant date” (in many cases, the date of the instrument’s issuance).

- **Other significant Documentation Rule changes.** The Final Regulations also provide additional clarity to the Documentation Rule, and important exceptions, described more fully below and highlighted here. First, the Final Regulations provide more details regarding the application of the rules to revolving credit agreements, omnibus, umbrella, master, cash pool, and similar agreements. Second, the Final Regulations generally allow a single, annual credit analysis for all the instruments issued by a particular member. Third, the Final Regulations provide further clarity that payments satisfying the Documentation Rule may include the proper netting of payables and receivables, as well as payments evidenced by journal entry. Lastly, the Final Regulations provide that taxpayers that are “highly compliant” with the Documentation Rule may rebut the presumption that an undocumented debt is nevertheless debt under common law factors.

- **Exclusion of short-term debt from the Recharacterization Rule.** Several categories of short-term debt instruments are excluded from the scope of the Recharacterization Rules: short-term funding arrangements, ordinary course loans, interest-free loans and deposits with qualified cash pool header.

- **Earnings and profits and other significant exceptions.** The application of the Recharacterization Rule is reduced or eliminated under newly expanded exceptions, including: (i) exceptions based upon earnings and profits of the issuer accumulated in tax years ending on or after 5 April 2016, and (ii) certain capital contributions to the issuer. In addition, the Recharacterization Rule no longer applies in a wide variety of settings, including: (i) acquisitions of expanded group stock as part of certain compensatory arrangements, (ii) deemed distributions from a Section 482 adjustment, (iii) stock acquisitions made by dealers in securities, and (iv) acquisitions of stock from controlled subsidiaries (by issuance or by purchase).
US state and local income tax effects. The Treasury acknowledged the US state and local income tax implications posed by the Proposed Regulations and correspondingly modified the consolidated group exception for purposes of both the Documentation Rule and the Recharacterization Rule. While these changes appear to respond to these same US state and local income tax concerns, it does not appear that the Treasury has alleviated the potential that the new rules may apply much more broadly for US state and local income tax purposes.

Detailed discussion

This section contains a more detailed summary of the provisions in the Final Regulations.

Reg. Section 1.385-1 (the expanded group and covered members)

Reg. Section 1.385-1 contains three major changes as compared to Prop. Reg. Section 1.385-1. First, in one of the most significant changes to the Proposed Regulations, Reg. Section 1.385-1 limits the present scope of the Final Regulations to debt instruments issued by a domestic corporation. Reg. Section 1.385-1(c)(2) achieves this result by introducing the new fundamental concept of a “covered member,” defined as a member of an expanded group that is a domestic corporation. Both the Documentation Rule and the Recharacterization Rule apply only to a debt instrument issued by a covered member. Consistent with the Proposed Regulations, the Final Regulations generally do not apply to a debt instrument within a consolidated group of domestic corporations. Consequently, the Final Regulations’ effect is limited to debt instruments issued by a domestic corporation and held by an unconsolidated affiliate. The Final Regulations’ effect on domestic-parented multinationals is therefore substantially reduced. It should be noted that the Treasury and the IRS have reserved on the Final Regulations’ application to foreign corporation issuers and requested additional comments on this issue, which leaves open the possibility that future guidance could expand the scope of the Section 385 regulations to include foreign corporation issuers.

Second, Reg. Section 1.385-1 no longer contains the “bifurcation rule” of the Proposed Regulations (Prop. Reg. Section 1.385-1(d)). Under that rule, the Commissioner was empowered to bifurcate (as part debt, part stock) certain debt instruments held within a “modified” expanded group. The bifurcation rule would have represented a departure from the approach that has prevailed under the common law (namely, classification of an instrument wholly as debt or as equity). Instead, Reg. Section 1.385-1(e) reserves on the bifurcation rule while the Treasury and the IRS study the issue.

Third, the definition of “expanded group” generally tracks that in the Proposed Regulations, but has been modified in two respects. Like the Proposed Regulations, the definition of expanded group starts with the definition of “affiliated group” in Section 1504(a), which generally includes corporations under common ownership of 80% of the vote and value of their outstanding stock, subject to certain exceptions in Section 1504(b). The Proposed Regulations and the Final Regulations expand this definition by: (i) finding the requisite connection among members based upon voting power or value, and (ii) eliminating many of the exceptions in Section 1504(b). In contrast to the Proposed Regulations, the Final Regulations provide that a RIC or a REIT cannot constitute the parent of an expanded group, and an S corporation is excluded from membership therein altogether. In addition, while “indirect” ownership continues to be based upon the constructive attribution rules of Section 318(a), the Treasury and the IRS have reserved upon the application of Section 318(a)(1) (attribution among certain family members) and (a)(3) (attribution to entities from owners and beneficiaries). As a result, two corporations (or chains of corporations) owned by a common non-corporate entity (e.g., a partnership) are not presently members of the same expanded group. For example, an investment partnership’s ownership of multiple corporations (including “blocker” corporations that do not own greater than 80% of the underlying corporate investment) will not cause such corporations to be treated as members of a single expanded group.

Reg. Section 1.385-2 (the Documentation Rule)

The Final Regulations contain the same general documentation requirements as the Proposed Regulations, although, as previously noted, they will apply to a smaller universe of related-party instruments. Reg. Section 1.385-2 provides minimum documentation requirements necessary for substantiating the treatment of certain expanded group instruments (EGIs) of covered members (Covered EGIs) as debt for US federal tax purposes. The stated purposes of the rules are: (1) to provide guidance
regarding the documentation and other information that must be prepared, maintained and provided by the taxpayer to support debt treatment; and (2) to establish certain operating rules, presumptions and factors in the determination of whether a particular instrument will be treated as debt for US federal tax purposes. As the preamble acknowledges, the Documentation Rule is “consistent with best documentation practices under case law, but many taxpayers do not currently follow best documentation practices.” In that regard, the Documentation Rule represents an elevation of the importance of documentation and is intended to aid in IRS audits and to prevent taxpayers from characterizing intercompany debt with the benefit of hindsight.

Consistent with the Proposed Regulations, an EGI is subject to the Documentation Rule if: (1) the stock of any member of the expanded group is publicly traded; (2) all or any portion of the expanded group's financial results are reported on financial statements with total assets exceeding $100 million; or (3) the expanded group's financial results are reported on financial statements that reflect annual total revenue that exceeds $50 million.

Compliance with the Documentation Rule does not ensure that an EGI will be treated as debt but merely enables the taxpayer to move forward in its determination under general debt-versus-equity US federal tax principles established under both common law as described in Reg. Section 1.385-1(b) and the new rules in Reg. Sections 1.385-3, 1.385-3T and 1.385-4. If a taxpayer is unable to satisfy the requirements of the Documentation Rule, however, the EGI generally is treated as stock for all US federal tax purposes, unless the taxpayer meets an exception from per se stock treatment under Reg. Section 1.385-2(b)(2).

The central provisions of Reg. Section 1.385-2 are the requirements concerning the documentation and other information that must be prepared and maintained with respect to an EGI to evidence the so-called indebtedness factors (i.e., (i) an unconditional obligation to pay a sum certain, (ii) creditor’s rights, (iii) reasonable expectation of repayment, and (iv) actions evidencing an ongoing debtor-creditor relationship). The Treasury and the IRS consider the indebtedness factors to be substantive evidence of the intent to characterize an EGI as debt for US federal tax purposes. Under Reg. Section 1.385-2, the indebtedness factors are significant factors taken into account in making a debt-versus-equity determination. Other relevant factors are taken into account as lesser factors, with the relative weight of each lesser factor based on facts and circumstances.

The preamble to the Final Regulations notes that the Treasury and the IRS generally declined to adopt commenters’ requests for exclusions from the Documentation Rule for several categories of transactions believed not to raise earnings-stripping concerns. Therefore, ordinary course transactions, cash pooling and similar arrangements, trade payables, and working capital debt financing, for example, are subject to the Documentation Rule to the extent they constitute Covered EGIs, even though such transactions may be excluded from the Recharacterization Rule.

As noted, the provisions of Reg. Section 1.385-2 generally follow the framework of Prop. Reg. Section 1.385-2, with the following significant clarifications and revisions:

- **Exemptions for EGIs issued by certain entities.** As noted, in a major change from the Proposed Regulations, the Final Regulations exclude any EGI issued by a foreign corporation. The Treasury and the IRS have requested comments on the application of the Final Regulations in the future to foreign corporation issuers. Also as noted, the Final Regulations exclude instruments issued by S corporations, and generally exclude interests issued by REITs, RICs and controlled partnerships.

- **Delayed implementation period.** Another significant change is a substantial delay in the effective date for the Documentation Rule. Reg. Section 1.385-2 applies only to an EGI that is issued or deemed issued on or after 1 January 2018. Consequently, an EGI issued or deemed issued before 1 January 2018, will not be subject to the rules of Reg. Section 1.385-2.
Extended deadline for timely preparation. The Final Regulations also replace the proposed 30-day (and 120-day) timely preparation requirements with a requirement to prepare documentation and financial analysis by the time that the issuer’s federal income tax return is filed (taking into account all applicable extensions).

Consequences of noncompliance. The Final Regulations make several clarifications and revisions regarding the consequences of noncompliance with the Documentation Rule:

- Exceptions to per se stock characterization. In addition to the reasonable cause exception in the Proposed Regulations, the Final Regulations provide two new exceptions to per se stock characterization for EGIs that fail to satisfy the requirements of the Documentation Rule. First, Reg. Section 1.385-2(b)(2)(i) provides a rebuttable presumption when an expanded group objectively demonstrates, based on a complicated formula, a high degree of compliance with Reg. Section 1.385-2. Second, Reg. Section 1.385-2(b)(2)(iii) provides an exception when the taxpayer timely discovers and remedies a ministerial or non-material failure or error.

- Application to interests issued by disregarded entities. If an interest issued by a disregarded entity is characterized as equity because of noncompliance with the Documentation Rule, the Final Regulations deem the regarded corporate owner of the disregarded entity (and not the disregarded entity itself as under the Proposed Regulations) to issue stock to the formal holder of the interest in the disregarded entity. As the preamble to the Final Regulations acknowledges, this provision ensures that a disregarded entity would not be treated as a partnership as a result of noncompliance with the Documentation Rule.

Authorization of master agreements. The Final Regulations clarify the ability of expanded group members to satisfy the requirements of the Documentation Rule for EGIs issued under revolving credit agreements, cash pooling arrangements and other similar arrangements by establishing overall legal documents governing the arrangement. If an EGI is issued under such an arrangement, the reasonable-expectation-of-repayment documentation requirement must be met at least annually. Taxpayers should note that the Documentation Rule also may now apply to notional pooling arrangements to the extent a notional cash pool provider operates as an intermediary. This will require taxpayers to undertake a separate analysis of any notional pools with US participants.

Clarification of rules applicable to certain regulated entities. The Final Regulations clarify the application of the Documentation Rule to certain interests issued by regulated financial services entities and insurance companies that are required by regulators to include particular terms.

Affirmative use reservation. The Proposed Regulations prohibited taxpayers from affirmatively using the Documentation Rule - by non-compliance - to convert debt instruments into stock. The Final Regulations are now reserved on this point in Reg. Section 1.385-2, while the Treasury and the IRS further consider the issues.

Noteworthy changes to the indebtedness factors. The Final Regulations also contain certain other noteworthy clarifications and revisions to the indebtedness factors in response to requests from commenters, including:

- Use of third-party standards to meet certain documentation requirements. The Final Regulations provide a market-standard safe harbor under which documentation customarily used in comparable third-party transactions may be used to satisfy the indebtedness factors related to creditor’s rights and an unconditional obligation to pay a sum certain. Thus, for example, documentation similar to that used by a taxpayer for third-party trade payables will generally satisfy the requirements of the Documentation Rule for trade payables with members of the expanded group.

- Use of refinancing assumptions in credit analyses. The Final Regulations provide that credit analyses required under the reasonable expectation of repayment documentation requirement may assume that the principal amount of an EGI 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.

- Single, annual credit analysis for multiple EGIs issued by the same issuer. The Final Regulations assist in implementing compliance with the Documentation Rule by providing a new rule that a single credit analysis may be prepared on an annual basis and used for all
interests issued by an issuer, up to an overall amount of indebtedness set forth in the annual credit analysis, absent a “material event” of an issuer as defined in Reg. Section 1.385-2(d)(5).

Evidence from third-party lenders. In addition, the Final Regulations include a new provision whereby evidence that a third-party lender would have made a loan to the issuer with the same or substantially similar terms as the EGI may be included as documentation of the reasonable expectation of repayment factor. The extent of this new provision is not described in the preamble and is not clear.

Reg. Section 1.385-3 and Reg. Section 1.385-3T (the Recharacterization Rule)
The Recharacterization Rule in the Final Regulations retains the same general framework as the Proposed Regulations, but its application is narrowed considerably. Specifically, Reg. Section 1.385-3 and Reg. Section 1.385-3T operate to recast a debt instrument into stock if: (i) a member of the expanded group issues the instrument in a tainted transaction to another member of the expanded group; or (ii) the instrument is deemed to fund the tainted transaction. The preamble to the Final Regulations and Reg. Section 1.385-3(a) indicate that the Recharacterization Rule is intended to target debt instruments issued to highly related persons that do not finance new investment in operations of the issuer.

As noted previously, one of the most significant changes reflected in the Final Regulations is that Reg. Section 1.385-3 and Reg. Section 1.385-3T apply only to a “covered debt instrument,” which does not include a debt instrument issued by a foreign corporation. In addition, the Final Regulations narrow the scope of the Proposed Regulations by generally expanding the exceptions, as further described below.

Retention of Proposed Regulations general framework
As noted, the Final Regulations preserve the general framework of the Recharacterization Rule set forth in the Proposed Regulations. The Recharacterization Rule operates in two parts: the General Rule and the Funding Rule.

General Rule
The Final Regulations identify three types of tainted transactions subject to the Recharacterization Rule:

› Distributions of covered debt instruments in exchange for stock of an expanded group member (e.g., in connection with an exchange governed by Section 304)
› Certain issuances of covered debt instruments as consideration in an exchange under an internal asset reorganization of an expanded group member (the latter two transactions referred to as “acquisitions”).

The Treasury and the IRS indicated that the foregoing transactions present the opportunity to replace equity with tax-favored debt with no significant non-tax effect. However, the General Rule is now subject to numerous exceptions, which are summarized below.

Funding Rule
The Treasury and the IRS believe that the policy concerns implicated by the tainted transactions described in the General Rule also arise when a corporation issues a debt instrument to a related party with a principal purpose of funding a tainted transaction. Accordingly, to backstop the General Rule, Reg. 1.385-3 includes both a Funding Rule and an anti-abuse rule.

The Funding Rule is intended to prevent taxpayers from achieving in multiple steps what the General Rule prevents taxpayers from achieving in one step. The Final Regulations therefore retain the “per se funding rule,” which establishes a mechanical rule whereby a covered debt instrument (which is not a “qualified short-term debt instrument”) issued by the funded member during the period beginning 36 months before the funded member makes a distribution or acquisition and ending 36 months after the distribution or acquisition is treated as stock. As with the General Rule, the Funding Rule is now subject to numerous exceptions, which are summarized below.

Anti-abuse rule
The Final Regulations also retained the anti-abuse rule under which a covered debt instrument is treated as stock if it is issued with a principal purpose of avoiding the application of the Funding Rule. Whether a covered debt instrument is subject to this anti-abuse rule is based on all the facts and circumstances.

In addition, the preamble to the Final Regulations states that the IRS intends to closely scrutinize, and may challenge under the anti-abuse rule, transactions in which a controlled partnership issues preferred equity to an expanded group member and the rules of Reg. Section 1.385-3T(f) would have applied had the preferred equity been denominated as a debt instrument issued by the partnership.
Like the Documentation Rule, the Proposed Regulations prohibited taxpayers from affirmatively using the Recharacterization Rule to convert debt instruments into stock. The Final Regulations reserve on this point while the Treasury and the IRS study the issue.

Added and expanded exceptions
While the Final Regulations retained the basic framework of the Proposed Regulations, several exceptions were added to or expanded in the Final Regulations. In particular, the Final Regulations:

- **Exclude instruments issued by foreign borrowers.** As discussed previously, the Recharacterization Rule applies only to debt instruments issued by “covered members,” which are expanded group members that are domestic corporations. As a result, the Final Regulations do not apply to debt instruments issued by foreign borrowers.

- **Exclude instruments issued by certain financial institutions.** The Recharacterization Rule generally does not apply to debt instruments issued by certain regulated financial entities, insurance companies and some of their subsidiaries, all of which are generally subject to regulatory capital or leverage requirements.

- **Exclude certain qualified short-term debt instruments from the Funding Rule.** Certain cash pooling and cash management arrangements, as well as certain advances that finance short-term liquidity needs and ordinary-course transactions, are excluded from the application of the Funding Rule and referenced in the Final Regulations as “qualified short-term debt instruments.” These include:
  - **Ordinary-course loans.** Covered debt instruments that are expected to be repaid within 120 days and are issued as consideration for the acquisition of property (other than money) in the ordinary course of the issuer’s trade or business are excluded from the Recharacterization Rule. In response to uncertainty raised by comments, the preamble to the Final Regulations indicates that debt instruments issued for services or the use of property are not generally subject to the Recharacterization Rule because they are not issued for property.
  - **Interest-free loans.** Covered debt instruments that do not provide for interest to be charged and for which interest is not otherwise required to be charged or imputed under generally applicable US federal income tax principles are excluded from the Recharacterization Rule.
  - **Short-term funding arrangements.** Other covered debt instruments issued in the same tax year by a covered member, which instruments are not otherwise excluded, may be excluded under one of two alternative tests; the “specified current assets test” or the “270-day test.” A covered member may only apply one of the two alternative tests to covered debt instruments issued in the same tax year that are not otherwise excluded.

The specified current asset test is satisfied if: (i) the interest rate charged does not exceed an arm’s-length interest rate that would be charged on a comparable debt instrument of the issuer with a term not exceeding the longer of 90 days or the issuer’s normal operating cycle; and (ii) the total amount of the issuer’s covered debt instruments satisfying one of the qualified short-term debt instrument exceptions does not exceed the maximum amount of “specified” current assets on the covered member’s balance sheet at the time each covered debt instrument is issued.

The 270-day test is satisfied with regard to a covered debt instrument if: (i) the term of the instrument is 270 days or less for an advance under a revolving credit agreement, or similar arrangement, with an interest rate charged that does not exceed an arm’s-length standard, (ii) the net borrowing of the covered member with a particular lender is not more than 270 total or consecutive days, ignoring covered debt instruments otherwise excluded as ordinary course or interest-free, and (iii) the net borrowing of a covered member in aggregate, with members of the issuer’s same expanded group, is not more than 270 total days (but not consecutive), ignoring covered debt instruments otherwise excluded as ordinary course or interest-free. The 270-day test does provide relief for an inadvertent error based on the facts and circumstances.

- **Deposits with a qualified cash pool header.** Covered debt instruments that are demand deposits with a qualified cash pool header and issued under a cash-management arrangement are excluded from the Recharacterization Rule. A “qualified cash pool header” can be an expanded group member, a controlled partnership, or a qualified business unit with a principle purpose of managing a cash-management arrangement (provided books and records are kept reflecting the deposits as cash or cash equivalents, invested through deposits, or the acquisition of portfolio securities of an unrelated person).
Expand the earnings and profits exception. The Final Regulations expand the earnings and profits exception in the Proposed Regulations. The Proposed Regulations exempted debt instruments issued in General Rule or Funding Rule transactions to the extent of the issuer’s current earnings and profits. The Final Regulations exempt debt instruments issued in such transactions to the extent of earnings and profits accumulated in tax years ended on or after 5 April 2016, and derived while the entity was a member of the same expanded group. The exception establishes an “expanded group earnings account.” A distribution or an acquisition that would otherwise be subject to the Recharacterization Rule is excluded to the extent of the balance in the expanded group earnings account. The expanded group earnings account is reduced based on the order in which the distributions or acquisitions occur, regardless of whether a transaction would otherwise be subject to the General Rule or the Funding Rule. The exception also includes provisions to prevent reuse of earnings and profits. The Treasury and the IRS indicated that facilitating the exception through a building account eliminates the “use it or lose it” characteristic of the exception in the Proposed Regulations.

Introduce a new exception for qualified contributions. The Final Regulations exempt debt instruments issued in General Rule or Funding Rule transactions by “netting” certain contributions of property against distributions and transactions with similar economic effect (i.e., acquisitions). This exception reduces the amount of a taxpayer’s distributions that might otherwise cause an equal amount of the taxpayer’s debt to be recharacterized. This has the effect of treating distributions and acquisitions as funded by new equity contributions before related-party borrowings and ensuring that companies that have not seen a reduction in net equity are not subject to the rules.

Similar to the earnings and profits exception, the qualified contributions exception also establishes an account that is equal to the issuer’s total “qualified contributions.” A distribution or an acquisition that would otherwise be subject to the Recharacterization Rule is excluded to the extent of a positive balance in the qualified contributions account. The qualified contributions account is reduced based on the order in which the distributions or acquisitions occur, regardless of whether a transaction would otherwise be subject to the General Rule or the Funding Rule. Unlike the expanded group earnings account, however, the qualified contributions account is not perpetual. It is a rolling account capturing no more than six years of activity. Further, the qualified contributions exception applies only after the application of the earnings and profits exception.

Total qualified contributions are increased by the aggregate fair market value of stock issued in exchange for property, other than excluded property, during the qualified period. Excluded property includes a list of property (e.g., expanded group stock) and an anti-abuse rule meant to prevent artificial increases to qualified contributions. The qualified period begins the later of: (i) 36 months before the date of the distribution or acquisition, or (ii) the first day the covered member is in the same expanded group. The qualified period ends the earlier of: (i) 36 months after the date of the distribution or acquisition, (ii) the first day the covered member is in the expanded group (with the same expanded group parent), or (iii) the last day of the first tax year that a covered member departs the expanded group.

Expand the exception for acquisition of subsidiary stock. This exception was expanded to include the acquisition of outstanding and newly issued subsidiary stock, whether directly with a covered debt instrument or funded with a covered debt instrument, provided certain control requirements are met. The per se 36-month holding period was replaced with a rebuttable presumption test.

Introduce an exception for compensatory stock acquisitions. Acquisitions of expanded group stock that is delivered to employees, directors or independent contractors in consideration for services are excluded from the Funding Rule.

Limit the potential for “cascading” recharacterizations due to the Funding Rule. Exceptions have been added to exclude from the Funding Rule certain distributions and acquisitions which include (i) deemed acquisitions resulting from the application of Section 385 and (ii) distributions or acquisitions deemed to occur under Reg. Section 1.482-1(g). As further discussed below, there were updates limiting the Funding Rule’s application to successors and predecessors of certain liquidations and divisive transactions.

Include predecessors and successors limitations. In general, the predecessor or successor of a funded member is also subject to the Funding Rule as though it were the funded member. A predecessor means: (i) a distributor or transferor in a tax-free liquidation or reorganization (i.e. a
Section 381 transaction); or (ii) the distributing corporation in a tax-free divisive transaction described in Section 355. A successor means: (i) an acquirer in a transaction described as a tax-free liquidation or reorganization (i.e., a Section 381 transaction), (ii) the controlled corporation in a tax-free divisive transaction described in Section 355, or (iii) a seller in an acquisition that would qualify for the acquisition-of-subsidiary-stock exception (e.g., a tax-free Section 351 contribution) to the extent of: (A) the value of expanded group stock acquired for property, (B) while ignoring distributions or acquisitions by the seller to or from the acquirer, and (C) reduced to the extent a covered debt instrument is sheltered by the earnings and profits and/or qualifying contributions exceptions.

A distributing corporation in a tax-free divisive transaction described in Section 355, however, is not a predecessor when it ceases to be a member of the same expanded group as the controlled corporation. Likewise, a controlled corporation in a tax-free divisive transaction described in Section 355 is not a successor when it ceases to be a member of the same expanded group as the distributing corporation. Further, a seller in a transaction that would otherwise qualify for the acquisition-of-subsidiary stock exception but for the successor rules is not a successor when it ceases to be a member of the same expanded group as the acquirer.

> Eliminate the cliff effect of the $50 million threshold exception. The Recharacterization Rule applies to the extent covered debt instruments exceed $50 million. The rule in the Proposed Regulations applied if covered debt instruments exceeded $50 million, which created a “cliff effect.”

> Tack the original issue date for significant modifications of debt instruments. For any debt deemed to be reissued as a result of a significant modification under Reg. Section 1.1001-3, other than a change in the co-obligor or a material deferrals of payments, the debt instrument is treated as issued on the original issue date in applying the Funding Rule.

> Introduce a new exception for statutory debt instruments. The Recharacterization Rule does not apply to certain “statutory debt instruments” that are deemed to be indebtedness, regardless of common law principles, under various sections of the Internal Revenue Code. These instruments include production payments described in Section 636, regular interests in a REMIC described in Section 860G, debt instruments deemed to arise due to transfer pricing adjustments under Section 482 and certain other interests.

The exclusion of foreign corporate issuers together with other added and expanded exceptions meaningfully reduces the effect of the Recharacterization Rule. Nevertheless, the core methodology of the Recharacterization Rule remains and will require due consideration in a multitude of transactions.

Controlled partnerships

The Final Regulations (in Reg. Section 1.385-3T) continue to apply an aggregate approach to controlled partnerships. However, there are a few noteworthy changes in approach from the Proposed Regulations:

> An expanded group partner’s share of a controlled partnership’s assets is determined under a liquidation value percentage approach and not by reference to the partner’s share of partnership profits.

> An expanded group partner continues to be treated as the issuer with respect to such partner’s share of a debt instrument issued by a controlled partnership to an expanded group member, and such partner’s proportionate share of such debt instrument is based on such partner’s anticipated allocations of the partnership’s interest expense.

> In lieu of recharacterizing a partnership debt instrument as stock of the expanded group partners, the Final Regulations adopt a “deemed conduit approach,” under which the expanded group member that holds the debt instrument is deemed to contribute its receivable to the expanded group partner or partners that made, or were treated as making under the aggregate approach, the distribution or acquisition that gave rise to the potential recharacterization of the debt instrument (which transfer is otherwise ignored for purposes of Section 752 liability allocations).

Effective date and transition rules

The Recharacterization Rule generally applies to tax years ending on or after 19 January 2017, which is 90 days after the Final Regulations are expected to be published in the Federal Register (21 October 2016). The Recharacterization Rule, however, applies to debt instruments issued on or after 5 April 2016. Transition rules provide that covered debt instruments issued after 4 April 2016, and before 19 January 2017, will be recharacterized as stock on 19 January 2017, subject to an anti-abuse rule.
Reg. Section 1.385-4T (application to consolidated groups)

The final portion of the 13 October package is a set of temporary regulations under Reg. Section 1.385-4T, which provide special rules involving application of the Recharacterization Rule to consolidated return groups. Since these regulations are only temporary regulations, companion proposed regulations have been issued as well (the temporary regulations under Reg. Section 1.385-4T will expire in three years).

The temporary regulations set forth a strong single-entity approach to a consolidated group in the context of the Recharacterization Rule. Most notably, the temporary regulations provide that, for purposes of the Recharacterization Rule, all members of a consolidated group that file or that are required to file a consolidated return are treated as one corporation. Thus, special rules are provided concerning the treatment of a debt instrument that ceases to be, or becomes, a “consolidated group debt instrument” (i.e., a covered debt instrument issued by a member of a consolidated group and held by a member of the same consolidated group, a term that is often co-extensive with “intercompany obligation”). Other manifestations of this single-entity approach are illustrated by the treatment of a partnership wholly owned by members of a consolidated group; in that case, the regulations provide that a covered debt instrument between a consolidated group member and the controlled partnership is treated as a consolidated group debt instrument. Regarding an “expanded group earnings account” for a consolidated group, there is only one account per consolidated group, namely the earnings and profits of the common parent, as determined under Reg. Section 1.1502-33.

Other special consolidated return rules address the consequences of members leaving or joining the group. Thus, a portion of the expanded group earnings account is allocated to a departing member that leaves the group in the case of a distribution under Section 355, in proportion to the earnings and profits of the consolidated group and the earnings and profits of the departing member immediately after the transaction. The temporary regulations also confirm the independent operation of Reg. Section 1.1502-13(g), which provides its own rules addressing the applicable mechanics when an intercompany obligation becomes a non-intercompany obligation. Thus, when an intercompany obligation is distributed outside the consolidated group, to a member of the expanded group, Reg. Section 1.1502-13(g) first operates to treat the obligation as deemed satisfied and reissued, and then the rules of Reg. Section 1.385-4T(c)(1) operate, as necessary, to treat the obligation as exchanged for stock immediately after the obligation is transferred outside the consolidated group.

Note that, if warranted, a future Alert will explore in more detail other special rules of Reg. Section 1.385-4T.

US state and local income tax considerations

To date, no US state or local (collectively, “state”) taxing authority has issued any official guidance on how it intends to apply these debt-equity rules, neither while in proposed form nor now that they are finalized. It is still possible that many states will choose conformity with the US federal income tax treatment based on automatic ties to federal taxable income and/or ease of administering their tax systems (when conforming to other areas of the Internal Revenue Code). However, states may also attempt, and may have the ability under technical interpretations of the Final Regulations, to apply these new rules based on differences between the US federal and state filing groups or selectively to affiliated debt arrangements that they find troubling. Further monitoring of the state responses to the Final Regulations will be required, particularly since many states may need to issue interpretive or implementing regulations.

Background surrounding Proposed Regulations

A key state income tax issue involving the Proposed Regulations was whether US states would strictly conform to the “consolidated group exception” found in Prop. Reg. Section 1.381-1(e), which read as follows: “Treatment of consolidated groups. For purposes of the regulations under [Section 385, all members of a consolidated group (as defined in [Reg. Section] 1.1502-1(h)) are treated as one corporation.” The consolidated group exception applied for purposes of all of the proposed regulations, and the IRS described the consolidated group exception as the “one-corporation” approach. EY’s US State Income Tax practice had concluded, and some state tax officials had suggested, that the consolidated group exception may not have applied for income tax purposes in certain states since most states do not follow the US federal consolidated return regulations at all, and even in states that have combined reporting and follow the federal consolidated return regulations, the state income tax filing group sometimes does not match the US federal consolidated group. Practically, this would have meant that intercompany debt relationships and related transactions that were not subject to the debt-equity rules
for US federal income tax purposes due to the consolidated group exception might still have had to comply with the requirements for income tax purposes in some states.

Elimination of bifurcation rule

For state income tax purposes, Treasury's elimination of the bifurcation rule from the Final Regulations may be one of the most beneficial changes from the Proposed Regulations. As mentioned in EY Tax Alert, Proposed IRC Section 385 debt/equity regulations have state income tax implications, dated 6 May 2016, armed with the independent ability to reclassify debt in seemingly different proportions from the IRS, taxpayers could have faced great uncertainty as to how instruments could be classified for state income tax purposes. Elimination of the bifurcation rule is a welcome improvement for state income tax purposes.

Changes to Documentation Rule

The Final Regulations eliminated the broadly applied consolidated group exception contained in Prop. Reg. Section 1.381-1(e). However, the same potential state disconnect issues appear to exist both in the Documentation Rule and in the Recharacterization Rule, as described below.

Although the consolidated group exception no longer applies to the Documentation Rule, the Final Regulations exclude from the crucial term “applicable interest” (defined in Reg. Section 1.385-2(d)(X)(ii)(A) and which is a foundational element for whether an instrument is an EGI) “... an intercompany obligation as defined in [Reg. Section] 1.1502-13(qX2)(i) or an interest issued by a member of a consolidated group and held by another member of the same consolidated group, but only for the period during which both parties are members of the same consolidated group.” This means that intercompany debt between members of the same US federal consolidated group continues to fall outside the scope of the Documentation Rule for US federal income tax purposes. But, for state income tax purposes, certain states, whether requiring separate or combined filing methodologies, may not recognize that the definitional exclusion applies to “applicable instruments.”

Changes to Recharacterization Rule

The consolidated group exception, which broadly applied under the Proposed Regulations, has been modified and now applies only to the Recharacterization Rule as set forth in Reg. Section 1.385-4T (which, as described earlier, governs the treatment of US consolidated groups for purposes of the Recharacterization Rule). Specifically, Reg. Section 1.385-4T(b)(1) provides that, for purposes of applying the consolidated group rules and Recharacterization Rule, “all members of a consolidated group (as defined in [Reg. Section] 1.1502-1(h)) that file (or that are required to file) a consolidated US federal income tax return are treated as one corporation” (added language emphasized). The Treasury made clear in the preamble that this modification responds to a specific request by a commenter of the state income tax implications of the Proposed Regulations. According to Treasury, “[t]he comment suggested that this concern could be mitigated in states that adhere to the literal language of the [S]ection 385 regulations by modifying [Prop. Reg. Section] 1.385-1(e) to provide that ‘all members of a consolidated group (as defined in [Reg. Section] 1.1502-1(h)) that file (or that are required to file) consolidated US federal income tax returns are treated as one corporation.’ The temporary regulations adopt this recommendation.”

Despite the Treasury's acknowledgement of the state income tax implications and its changes to the consolidated group exception as it applies to the Recharacterization Rule, there exists the possibility of great uncertainty as to how states will treat intercompany debt that is not subject to the Recharacterization Rule for US federal income tax purposes but could be subject to the rules for state income tax purposes, particularly in states that don't align with the US federal consolidated filing group and/or don't follow the US federal consolidated return regulations.

Implications

These much-anticipated regulations are now fait accompli. Most corporate taxpayers are likely grateful that they are not as far-reaching, in final or temporary form, as they were in proposed form. Nevertheless, this is a significant regulatory package, perhaps illustrated simply by the fact that the filing version of TD 9790 exceeds 500 pages, over 70% of which is devoted to describing Treasury’s rationale for changes that were either made or not made. For that reason, the changes discussed in this Alert represent only that portion of the changes we believe most significant and most likely to affect a broad range of taxpayers.

The changes to the Proposed Regulations significantly narrowed the universe of debt instruments subject to the Documentation Rule and the Recharacterization Rule. For now, at least for US federal tax purposes, the Documentation Rule and the Recharacterization Rule will apply only to debt issued by US corporations to expanded group members that
are not part of the same US federal consolidated group. However, the US state and local income tax implications of these rules will need to be considered.

Regarding the Documentation Rule, because of the delayed effective date and extended documentation preparation deadlines, taxpayers will have until the filing date of their US federal tax return for the tax year that includes 1 January 2018, to complete the Documentation Rule for the first time. For example, a calendar-year corporate taxpayer that timely files an extension would have until 16 September 2019, to complete all of the requisite documentation for debt instruments issued in calendar 2018. Notwithstanding this extended period, the compliance burden for covered issuers remains substantial. Term loans, demand loans, cash pools (now including at least certain notional pools), trade payables and open accounts remain subject to the Documentation Rule. As acknowledged in the preamble, this will require affected taxpayers to incur substantial investments of time and money associated with initial startup and infrastructure investment, as well as ongoing compliance with the regulations. In addition, the Treasury and the IRS reiterated their belief that the Documentation Rule distills the "best documentation practices under case law," which may presage additional IRS scrutiny of related-party debt instruments not literally subject to those rules under the Final Regulations. Therefore, taxpayers should take steps now to ensure that their intercompany financing, payables, and cash management processes and procedures will enable full compliance with the Documentation Rule.

Regarding the Recharacterization Rule, because of the generally taxpayer-favorable changes in the Final Regulations, the Recharacterization Rule will apply to fewer issuers, fewer transactions and fewer debt instruments. The Final Regulations will, however, significantly affect groups, such as foreign-based multinationals with a substantial US presence, in which domestic corporations issue debt instruments to expanded group members that are foreign or otherwise do not file a consolidated federal income tax return with the issuer. While, as noted earlier, there are numerous exceptions to the Recharacterization Rule under Reg. Section 1.385-3, the onus will be on taxpayers to "prove out" that any particular distribution or acquisition within an expanded group qualifies for the particular claimed exception (e.g., that a covered member has sufficient expanded group earnings or qualified contributions, or that a debt instrument in question is a qualified short-term debt instrument). Because of these regulations, it will become even more important for corporate groups to keep track of M&A activity, debt issuances, earnings and profits, and distribution and contribution history of members of an expanded group. Finally, due to the tremendous reach and the complexity of the Final Regulations, the Recharacterization Rule will undoubtedly apply in unanticipated circumstances, so taxpayers are advised to consider the Recharacterization Rule - and the Final Regulations generally - in connection with all transactions involving debt instruments held by expanded group members, especially when corporations join an expanded group (bringing their acquisition and distribution history with them) and when the expanded group is headed by a non-US common parent. Taxpayers should take steps now both to inventory their debt instruments to determine whether any would be subject to the Recharacterization Rule and to put in place safeguards to ensure missteps do not occur.

What should taxpayers do now?
Now that the Final Regulations have been published, taxpayers should take the following actions:

- Inventory affected debt instruments and assess instruments subject to the Recharacterization Rule.
- Remediate affected instruments while establishing policies and procedures to track and comply with the Recharacterization Rule.
- Determine and, as appropriate, institute systems and procedures to comply with the Documentation Rule. For entities that are not subject to the Documentation Rule (e.g., foreign corporations), consider whether existing systems and procedures are sufficient given the Treasury's and IRS's belief that the Documentation Rule distills the "best documentation practices under case law."
- Analyze the potential US state and local income tax effects of both the Recharacterization Rule and the Documentation Rule to instruments issued solely within US federal consolidated groups.
- Assess alternative strategies (legal entity, lending and pooling structures) with planned transactions. While outside the scope of this Alert, taxpayers will need to ensure that their strategies also align with other broad-based government initiatives, such as BEPS and UK anti-hybrid rules.
- Drive multi-functional involvement (Tax, Treasury, Accounting, IT, M&A and Operations) to coordinate procedures in complying with the new requirements.
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