TAX ALERT

Final and Temporary Proposed Section 385 Regulations

Summary

On October 13, 2016 final and temporary regulations under Section 385 were released which address related party financing instruments. These are expected to be officially published today. The regulations were much-anticipated and contain numerous changes from their original proposed form, addressing numerous comments and concerns raised by practitioners. The initially proposed regulations, released April 4, 2016, were intended to address earnings stripping and the use of cross border debt to reduce U.S. income tax. But, it is important to note that the proposed regulations were not limited to these transactions and could also have an impact on related party debt transactions structured exclusively in the U.S. or solely outside of the U.S.

The proposed regulations caused alarm and concern for multinational and domestic enterprises which use cash pooling and related party financing as typical business practices and contained rules detailing:

- The ability of the IRS to recharacterize a financing instrument as in part indebtedness and in part stock (bifurcation rule - Proposed Reg. Section 1.385-1(d)).
- Documentation requirements which must be maintained and prepared within 30 days of a related party debt instrument being issued, otherwise the debt would be re-characterized as stock, absent reasonable cause relief. (Proposed Reg. Section 1.385-2).
- Rules which could recharacterize related party debt instruments as stock in connection with certain corporate transactions (transaction recharacterization – Proposed Reg. Section 1.385-3(b)(2)) as well as recharacterization of principal purpose debt (funding recharacterization – Proposed Reg. Section 1.385-3(b)(3)).

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(cont.)

What Has Changed?

While the essence of the proposed regulations has not gone away, the 518 pages of final and temporary regulations under Section 385 contain many changes. To highlight a few changes the final and temporary regulations clarify the following significant areas:

- The regulations in final form exclude foreign issuers of debt.
- The controversial general bifurcation rule has been removed.
- Documentation requirements have been delayed and apply only to debt instruments issued on or after January 1, 2018.
- Up to $50 million of indebtedness is exempt from recharacterization (the proposed regulations included a “cliff effect”, applying the regulations to all indebtedness if the taxpayer had over $50 million in debt).
- The final regulations provide additional and expanded exceptions to recharacterization, including: equity compensation, certain subsidiary acquisitions, and an expanded earnings and profits (E&P) exception.

What Does this Mean to Me?

The good news is that many taxpayers will find that they are now exempt from the documentation and recharacterization rules of the final and temporary regulations. Now is the time to determine the effects of the recharacterization rules and documentation requirements, if they apply to you, and review available remediation with your GBQ tax advisor. The final and temporary regulations are complex and the impact varies based on the facts and circumstances of each taxpayer.

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