TAX ALERT

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 on October 21, 2016. 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 bifurcate a financing instrument as in part indebtedness and in part stock, using a seemingly opaque lens (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 would treat expanded group 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 purposes debt (funding recharacterization – Proposed Reg. Section 1.385-3(b)(3).

Proposed Section 385 Regulations (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, S Corporations and certain other entities such as REITs.
- 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.
- All taxpayers can exclude the first $50 million of indebtedness that would otherwise be recharacterized (the proposed regulations had a "cliff effect" for the proposed $50 million threshold, applying the regulations to all debt instruments if above $50 million in total).
- The final regulations provide additional exceptions to recharacterization for equity compensation, distributions and acquisitions to the extent of accumulated earnings & profits (E&P) in taxable years after April 4, 2016 and while they were a member of the same expanded group and certain acquisitions from a subsidiary.

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. The final and temporary regulations are written to focus on new related-party debt which is introduced in a transaction that creates significant tax benefits but very little non-tax effects.

Now is the time to review available remediation with your GBQ tax advisor and determine the effect of the recharacterization rules and documentation requirements, if they apply to you. The final and temporary regulations are complex and the impact varies based on the facts and circumstances of each taxpayer.

Material discussed is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual circumstances. To ensure compliance with Treasury Department regulations, we wish to inform you that any tax advice that may be contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or applicable state or local tax or (ii) promoting, marketing or recommending to another party any tax-related penalties under the Internal Revenue Code or applicable state or local tax law provisions or (iii) promoting, marketing or recommending to another party any tax-related matters addressed herein.