ALSTON&BIRD

WWW.ALSTON.COM

International Tax ADVISORY ■

OCTOBER 17, 2016

Treasury Issues Final & Temporary Section 385 Regulations

On October 13, the Treasury released highly anticipated final and temporary regulations (T.D. 9790) under Section 385, which authorizes the Treasury to devise regulations to determine when an interest in a corporation is treated for federal tax purposes as debt, stock, or part debt and part stock. In early April, the Treasury had issued proposed regulations, which generally were not well-received by taxpayers and practitioners. Some questioned the Treasury's authority to issue rules that included per se grounds for recharacterizing purported debt, rather than employing the factor-based approach in the Code. Others complained of overbreadth, citing the proposed rules' potential coverage of routine transactions like cash-pooling arrangements.

Incorporating a number of the many comments to the proposed regulations, the final and temporary regulations reflect modifications that, in general, reduce the scope of and delay the application of the regulations. The regulations also shelve a number of big issues pending further study (such as application to foreign issuers) and eliminate the controversial bifurcation provision proposed in April.

Proposed Regulations

First hinted at in inversion-related guidance, the proposed regulations under Section 385 sought to attack earnings-stripping structures that increased related-party debt, creating tax benefits without financing new U.S. investment. The proposed regulations included provisions that would categorically recharacterize purported debt as equity, prescribe documentation requirements to substantiate related-party debt treatment, and permit the IRS to bifurcate purported related-party debt on audit. The proposed regulations applied only to debt issued by a corporation or controlled partnership to members of an "expanded group" (EG)—generally, entities related by at least 80 percent ownership by vote or value. Notably, the proposed regulations would have covered both foreign and domestic parties and were generally effective for debt issued on or after April 4, 2016. (See our prior coverage of the proposed rules here and here.)

Proposed Section 1.385-3 would treat an EG interest (EGI) as stock under three alternative rules: the general rule, the funding rule and the anti-abuse rule. The general rule would treat an EGI as stock to the extent issued by a corporation to a member of the corporation's EG in a distribution, in a nonexempt exchange for EG stock or in exchange for property in certain asset reorganizations. The funding rule would treat as stock an EGI issued with the principal purpose of funding

a transaction described in the general rule. The anti-abuse rule would recharacterize debt issued with the principal purpose of avoiding the regulations.

The rules of proposed Section 1.385-2 required covered taxpayers to prepare and maintain documentation evincing certain characteristics of third-party debt: the borrower's unconditional and binding obligation to pay, the creditor's rights, a reasonable expectation of repayment at the time of issuance and conduct consistent with an arm's-length debtor-creditor relationship. The documentation rules were not dispositive but would merely inform a facts-and-circumstances analysis.

Proposed Section 1.385-1(d) allowed the IRS to bifurcate related-party instruments and treat them as part debt and part stock. For purposes of this rule, a lower 50 percent threshold for relatedness applies. The Treasury makes clear that the proposed regulations do not affect the IRS's authority to disregard an interest as stock or debt, treat a purported debt interest as debt or equity of another entity, or otherwise treat an instrument according to its substance. These provisions would not be effective until the regulations become final.

Changes in Final & Temporary Regulations

To the dismay of many, the operative provisions of Section 1.385-3 (and -3T)—i.e., the rules providing for recharacterization of related-party debt as stock in certain factual circumstances—have not changed substantially from the proposed rules. But "to achieve a better balance between minimizing the burdens imposed on taxpayers and fulfilling the important policy objectives," the final regulations introduce and expand carve outs and relax applicability and transition rules even for the targeted "corporate 1%." The Treasury also eliminated the bifurcation rule from the proposed regulations.

The final and temporary Section 385 regulations do not apply to foreign issuers, S corporations or noncontrolled RICs and REITs—even apart from entities excluded under the revenue- and asset-based thresholds. Debt issued by regulated financial groups and certain regulated insurance entities is excluded from the rules of Section 1.385-3, as are certain cash management and other "short-term" debt arrangements (based on a specified current assets test or 270-day test)—although the documentation rules still generally apply. The regulations ease the "cliff effect" of the proposed rules' $50 million exception by allowing all taxpayers to exclude the first $50 million of debt that would be recharacterized. The rules also narrow the funding rule to limit "cascading" recharacterization, expand the earnings and profits (E&P) exception beyond a current year's E&P, exclude acquisitions of compensatory stock and allow certain capital contributions to be netted first against transactions that could otherwise result in recharacterization.

For debt that would be recharacterized as stock under Section 1.385-3, the regulations clarify the consequences of such treatment. The holder is deemed to exchange the debt for stock, realizing an amount equal to its adjusted basis in the debt. The issuer is considered to retire the debt at its adjusted issue price as of the deemed exchange date, and that value is also assigned to the stock deemed issued for purposes of Section 108(e)(8). To the extent Section 988 applies to the deemed stock-for-debt exchange, the parties may also have to recognize foreign currency gain or loss.

Considerable relief is embedded in the regulations' procedural and timing-related provisions. Debt instruments issued before April 5, 2016, are not covered by the final regulations, and for purposes of the funding rule, distributions and acquisitions (and similar transactions) before that date are grandfathered. The documentation rules do not apply to instruments issued before January 1, 2018. Section 1.385-2 also extends the time for taxpayers to prepare timely documentation from 30 days post-issuance to the date the issuer files its return and adds a rebuttable presumption rule in case of failures by an EG that has otherwise been substantially compliant with the documentation rules. Most importantly, the transition rule delays recharacterization under Sections 1.385-3 and 1.385-3T until 90 days after the regulations' publication in the *Federal Register*, to the extent a covered instrument is held by a member of the issuer's EG immediately after that date. A transition funding rule applies to prevent avoidance transactions during the transition period by treating as distributions for purposes of the funding rule any payments, other than stated interest,

on an instrument that occur between April 5 and the date 90 days after publication. The regulations are scheduled to be published on October 21, 2016, which would make the end of the 90-day transition period January 19, 2017.

Conclusion

Noting that many taxpayers are completely exempt from the regulations, the Treasury dismisses concerns that the regulations (as proposed or finalized) exceed its rule-making authority under the Code. The preamble concludes that the rules are "necessary and appropriate" in the context of transactions between "highly-related parties" that would generate tax benefits yet have little nontax significance. Undoubtedly, there will be opportunities to see whether the courts will agree with the Treasury's view on the matter. But affected taxpayers should take some solace in the mostly taxpayer-friendly refinements and carve outs to the heavy-handed proposed rules.

In any case, the newly minted regulations are probably not the government's last word in the debt-equity characterization area. The Treasury specifically requests comments for future guidance on a number of reserved issues, such as application of the rules to foreign issuers, brother-sister groups with common noncorporate owners and debt not in form. The preamble also seeks input on whether a working capital-based measure for the short-term debt exceptions may be preferable to the specified current asset-based test in the final rules. The Treasury is also continuing study on disallowing affirmative use of Sections 1.385-2 and 1.385-3, a general bifurcation rule, debt issued to a third party but guaranteed by another group member and the safe harbor interest rate provisions under the Section 482 regulations.

For more information, contact Edward Tanenbaum at 212.210.9425 or Heather Ripley at 212.210.9549.

If you would like to receive future *International Tax Advisories* electronically, please forward your contact information to **InternationalTax.Advisory@alston.com**. Be sure to put "**subscribe**" in the subject line.

Click **here** for Alston & Bird's Tax Blog.

If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

Sam K. Kaywood, Jr.
Co-Chair
404.881.7481
sam.kaywood@alston.com

Edward Tanenbaum
Co-Chair
212.210.9425
edward.tanenbaum@alston.com

George B. Abney
404.881.7980
george.abney@alston.com

John F. Baron
704.444.1434
john.baron@alston.com

Henry J. Birnkrant
202.239.3319
henry.birnkrant@alston.com

James E. Croker, Jr.
202.239.3309
jim.croker@alston.com

Jasper L. Cummings, Jr.
919.862.2302
jack.cummings@alston.com

Scott Harty
404.881.7867
scott.harty@alston.com

Brian D. Harvel
404.881.4491
brian.harvel@alston.com

L. Andrew Immerman
404.881.7532
andy.immerman@alston.com

Stefanie Kavanagh
202.239.3914
stefanie.kavanagh@alston.com

Brian E. Lebowitz
202.239.3394
brian.lebowitz@alston.com

Clay A. Littlefield
704.444.1440
clay.littlefield@alston.com

Ashley B. Menser
919.862.2209
ashley.menser@alston.com

Matthew P. Moseley
202.239.3828
matthew.moseley@alston.com

Daniel M. Reach
704.444.1272
danny.reach@alston.com

Heather Ripley
212.210.9549
heather.ripley@alston.com

ALSTON&BIRD

WWW.ALSTON.COM