Tax & Investment in the US

Second quarter 2016

Key tax developments for global companies operating in the US

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Proposed Section 385 Regulations: Impact on US inbounds

The US Treasury Department April 4 released proposed regulations under Section 385 intended to address 'earnings stripping.' The Proposed Regulations – applicable for all 'foreign'-owned groups (with limited exceptions) - cite Section 385 as authority to target "transactions that increase related-party debt that does not finance new investment in the United States," according to the Treasury fact sheet. The Proposed Regulations were packaged with new Section 7874 temporary regulations addressing cross-border merger activity viewed as 'inversions,' but are much broader in their scope. The Proposed Regulations would apply to instruments issued on or after April 4, 2016 (as discussed below).

The Proposed Regulations, which go beyond anything that was anticipated, potentially apply to all related-party debt issued going forward. PwC's US Inbound Tax Leader, Joel Walters, called these regulations "the most significant tax development for US inbound companies in the last 10 years."

Key rules

The key operating rules in the Proposed Regulations provide as follows:

- characterize as equity (i) notes distributed to a related shareholder, (ii) notes issued to acquire equity of a related entity, and (iii) notes distributed to a related entity as boot in an asset reorganization. The rules also generally characterize certain loans to related entities as an equity investment if such a loan is issued within a 72-month period centered on the date that the issuer of the loan (i) distributes a dividend, (ii) acquires equity in a related entity, or (iii) distributes boot in an asset reorganization
- provide a new contemporaneous documentation requirement for related-party debt. Taxpayers would be required to document both the commercial terms of the lending and an analysis of the creditworthiness of the borrower within 30 days of the lending. Taxpayers also would be required to document events after the loan - such as payments of principal and interest and events of default and similar events - within 120 days of the event. If these contemporaneous documentation requirements are not satisfied, the financing generally would be characterized as equity
- provide that the IRS on exam (but not taxpayers) could bifurcate a single financial instrument issued between related parties into a combination of debt and equity.

As noted, the Proposed Regulations were issued as part of a larger regulation package targeting redomiciliations. However, it is important to note that these rules would apply broadly and thus would not be limited to redomiciled companies or 'foreign' transactions. The Proposed Regulations also attempt to impede many cross-border transactions, based on the regulatory authority under Section 385, by recharacterizing financing transactions as equity (or in part debt and in party equity).

Impact and issues

The Proposed Regulations, as drafted, would dramatically impact typical international treasury management practices, such as cash pooling and related-party financing. This would burden multinationals competing in the global marketplace if they were effectively prevented from engaging in modern treasury management techniques designed to minimize external borrowings and manage internal liquidity.

The standards to be applied and the limits on the IRS Commissioner's discretion to bifurcate debt instruments are not clear. Complex issues could arise on examination when, after debt has been outstanding for several years and the principal has been partially paid, the IRS asserts, with the benefit of hindsight, that a given portion of the debt was equity.

The contemporaneous documentation requirements set forth in Prop. Treas. Reg. Sec. 1.385-2 - which if not satisfied generally would result in the recharacterization of debt as equity for all US federal income tax purposes - will impose significant compliance burdens on taxpayers. It is not clear what this contemporaneous documentation requirement would achieve, given that a taxpayer always has had the burden of proof and always has had to present evidence to establish that a related-party financing qualifies as debt.

Observations

There will certainly be debate over the authority for and administrability of the Proposed Regulations. The Treasury has interpreted this authority under Section 385 broadly to address various transactions that have been targeted by Administration legislative proposals, including basis return planning, 'Cash D reorganizations,' triangular reorganizations, and earnings stripping. Although Treasury has had broad regulatory authority under Section 385 since 1969, it has been over 30 years since Treasury's last effort to promulgate regulations.

The broad regulatory authority is not unlimited. It requires Treasury to write regulations distinguishing between debt and equity based on a series of factors that reflect principles of long-standing common law. Rather than adopting the factors specified in Section 385 in a coherent set of regulations, the Proposed Regulations would treat debt that is clearly debt under common law principles as equity based solely on the common ownership of the issuer and holder.

Effective date concerns

The proposed application of final regulations to debt issued on or after April 4, 2016, presents immediate concerns to inbound taxpayers. Any debt subject to recharacterization under the Proposed Regulations issued on or after April 4, 2016, would be deemed to convert into stock on the date 90 days after the regulations are issued in final form. Among the effects of such a deemed conversion would be the recognition of 'foreign' currency gains with respect to the debt.

Taxpayers need to be mindful that the payment of dividends, the purchase of stock in affiliates, and the issuance of boot in asset reorganizations taking place while the regulations are still in proposed form could result in debt issued on or after April 4, 2016, being recharacterized as stock if final regulations are issued retaining that effective date. Inbound taxpayers should immediately analyze the potential impact these rules rules would have on their routine business transactions and treasury management functions carried on currently and, more specifically, around related-party financing, dividend planning, and stock restructuring.

Further analysis

Read PwC's *Tax Insights* on the Proposed Regulations. Additionally, explore PwC's analysis of the impact on cash management operations.

Proposed Section 385 Regulations: state tax impact

The application of the Proposed Regulations may have significant impact from the state income tax perspective for a wide range of transactions. Since not all states conform to the Internal Revenue Code and the corresponding Treasury Regulations, the Proposed Regulations likely would produce unintended consequences and significant uncertainty when applied in a state tax context, especially as to debt-versus-equity characterization of intercompany debt, an issue on which many states already have been aggressively challenging taxpayers.

For example, the Proposed Regulations include an exception for indebtedness between members of a consolidated group, treating the group as one taxpayer and not subject to the 'general rule', 'funding rule', or documentation requirements. However, numerous states require separate company reporting as they do not conform to the federal consolidated return regulations. States may impose documentation requirements on taxpayers within federal consolidated groups even though such taxpayers may not need to satisfy these requirements for federal income tax purposes. Consequently, consolidated groups that include entities with filing requirements in such states will need to consider that, while the requirements need not be satisfied for federal purposes, there may be a need to meet documentation requirements for debt between related parties for state purposes.

Additionally, not all unitary or combined state filings include the same members as the federal consolidated group. This again may require documentation of indebtedness that is irrelevant for federal tax purposes.

Intercompany indebtedness and treasury practices such as related-party financing and cash pooling are common among consolidated groups. Taxpayers need to consider what documentation policies to implement within their consolidated groups, as it is unclear at this point whether and how states will conform to the Proposed Regulations.

Finally, taxpayers need to consider whether state departments of revenue may use the federal 'anti-abuse' rule in the Proposed Regulations in absence of specific state anti-abuse authority. In light of the restrictions against affirmatively using the Proposed Regulations to reduce federal income tax, one needs to consider a taxpayer's ability to use the Proposed Regulations to reduce state income or franchise tax.

Read more on the Proposed 385 Regulations' impact on US state tax.

IRS focus on 'foreign' travelers in the United States

US subsidiaries of 'foreign' parent companies often serve as host for employees of 'foreign' affiliates. Several years ago, the IRS performed a study that found that employers generally were not tracking their employees' travel into the United States. Since then, PwC has noticed an increase in IRS requests from our US inbound clients for employee lists and descriptions of activities performed in the United States during Form 1042 examinations.

While most companies maintain proper tracking and payroll documentation for travelers in the United States over six months, there may be insufficient tracking of employees in the United States for under six months. The IRS has been raising questions during examinations focused on short-term travelers, including request for information regarding the location of the cost centre for these employees as well as the performance of management functions. This leads to the IRS questioning potential management fees as appropriately charged and paid to the 'foreign' parent entity that employs these individuals. The IRS seeks to determine the time non-US employees spend in the United States to measure the income earned in the United States. The number of days in the United States can assist the IRS in determining the portion of payments that is US source and paid to the 'foreign' parent or non-US employees.

Once the IRS begins asking questions in this area, taxpayers generally are allowed only 30-45 days to respond. The requests are IDRs (information document requests) and often are extensive and time-consuming, making it difficult for an organization to provide all requested information in the allotted time. US inbounds that have 'foreign' affiliate employees traveling to the United States should evaluate this issue by reviewing their existing policies and procedures and gathering available data that demonstrates compliance with the reporting and withholding obligations associated with making these payments.

If you have any questions or would like to discuss this issue further with PwC, please contact Candace Ewell at candace.b.ewell@us.pwc.com.

PwC's 2016 CFO Insourcing Survey

Together with the Organization for International Investment (OFII), PwC recently released the results of their *2016 CFO Insourcing Survey* (Survey). The Survey compiles responses from 100 US CFOs of US inbound companies, highlighting key issues facing their businesses, including US federal and state taxes. Some of the key points taken from the Survey include:

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- CFO confidence levels remain high, and the United States still is viewed as a top location for growth and new investment. 56% of the CFOs surveyed expect to increase investment in the United States, and 43% expect to increase employment over the next 12 months.
- This intent to expand investment is driven by the US consumer market, access to capital markets, skilled workforce, and infrastructure, according to the CFOs.
- However, there are a number of cautions in the data. In the last survey in 2014, 64% of the CFOs planned to increase investment and 51 percent planned to increase employment in the United States. Also, emerging markets appear to be faltering, with only 33 percent of CFOs choosing China as a top destination for investment, dropping from 49 percent in 2014. Confidence in other emerged economies has fallen as well.
- Thus, to some extent the data can be viewed as suggesting that the United States remains a strong investment location due to some key attributes of the market, but that it is failing to take advantage of softer confidence in the rest of the world.
- The top three ways the CFOs believe the United States can attract more global investment are modernizing the tax system, improving the regulatory system, and finalizing bilateral and regional trade agreements.
- Finally, a majority of CFOs believe they face discriminatory tax policies in the United States at the federal and state level from state and local level of governments pursuing policies that undermine internatonal norms and provisions of US tax treaties, to the growing concern of anti-foreign rhetoric in public policy discourse.

It should be noted that this Survey was conducted before the Section 385 Proposed Regulations were released.

As part of the Survey release, PwC co-hosted with OFII a high-profile event, which was live streamed globally, at the Bipartisan Policy Center. Abha Bhattarai of the Washington Post moderated a panel consisting of Lars Green (Senior VP, Novo Nordisk), Jim McCrery (former Ranking Member of the House Committee on Ways and Means), Nancy McLernon (President and CEO of OFII), and Joel Walters (PwC's US Inbound Tax Leader) to discuss the results and explore the competitiveness of the United States in the global economy.

To see more of the results from the Survey, accesse: CFO Insourcing Survey 2016. For more coverage on the release event, read here.

Why does global investment in the USA matter?

PwC's Scott McCandless discusses how global companies can engage with US policy makers with Nancy McLernon, President and CEO of the Organization of International Investment (OFII). Watch their discussion here: Tax and investment in the US: unique opportunities and challenges [video].

Let's talk

For a deeper discussion, please contact:

Joel Walters

US Inbound Tax Leader

(646) 471-7881

joel.walters@pwc.com

Bernard Moens

International Tax Services

(202) 414-4302

bernard.moens@pwc.com

Todd Roberts

State and Local Tax

(720) 938-9191

todd.roberts@pwc.com

Candace Ewell

Information Reporting

(202) 312-7694

candace.b.ewell@pwc.com