
Impact of the proposed Section 385 regulations on companies investing in the United States

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In brief

The deductibility of interest on related-party debt for US federal income tax purposes is a vital tax issue for foreign businesses investing in the United States (US inbound companies) because it impacts cost of capital and return on investment.

Proposed US Treasury regulations under Section 385, issued April 4, 2016, aim to characterize broad categories of related-party financing as equity. Under the proposed rules, US inbound companies may find bona fide internal debt instruments characterized as equity – which could result in a higher US tax burden, a higher cost of capital, and a lower return on the investment into the United States. The proposed regulations generally would apply to financial instruments issued on or after April 4, 2016 (with effect from the date 90 days after final regulations are issued).

The proposed regulations will impact not only the tax liability of US inbound companies, but also their cash management and financing strategies. Many modern treasury practices that companies use for internal financing, such as cash pooling, debt revolvers, and intercompany loans, will be negatively impacted by the regulations, if finalized as proposed, and may result in a decision to resort to more costly external financing, and, thereby, increase the cost of investing in the United States.

The proposed regulations reflect Treasury's concern that corporate re-domiciliation and the use of internal financing to create potentially 'excessive' interest deductions can erode the US tax base. On the same day the proposed Section 385 regulations were issued, Treasury also issued temporary regulations under Section 7874, intended to make it more difficult for companies to re-domicile. While Treasury's primary target might have been large multinationals, the breadth of the proposed regulations under Section 385 will affect businesses of all sizes, whether public or private.

In detail

Proposed regulations under Section 385

Background

Section 385 creates statutory guidelines for the issuance of

Treasury regulations to determine whether an interest in a corporation should be treated as debt or equity. While that provision does not specifically create any limitations on interest deductibility for related-party debt, Section 163(j), a long-

existing provision, does. This limitation applies to 'excess interest expense' incurred by US companies with a debt-to-equity ratio of 1.5 or greater. Excess interest expense is defined as interest expense exceeding 50% of the company's Adjusted Taxable Income (ATI).

Excess interest expense that is disallowed can be carried forward for use in subsequent tax years, without limitation. To the extent the interest expense is below the limitation, this 'excess limitation' can be carried forward three years and included with that year's ATI to increase the limitation. The proposed regulations under Section 385 do not replace or modify Section 163(j), but rather add an additional layer of regulation for the instrument to be treated as debt, prior to application of the Section 163(j) limitation to the resulting interest expense.

Applicability of proposed rules

The proposed regulations are limited to indebtedness between members of an 'expanded group' or 'modified expanded group' — both are defined as an affiliated group under Section 1504(a) with certain modifications. These modifications include (1) foreign and tax-exempt corporations in the expanded group; (2) corporations held indirectly in the expanded group; (3) corporations connected by ownership of 80% (in some cases 50%) vote or value; and (4) partnerships that are 80% (in some cases 50%) owned by vote or value by another member in an expanded group.

One important exception from the proposed regulations is that they do not apply to indebtedness between members of a consolidated group.

Observations: The proposed regulations use a variety of attribution rules in defining an expanded and modified group. Treasury officials have commented that modifications to these rules may be required. As currently written, the proposed regulations will not include brother-sister corporations that are owned by a single entity or individual. Treasury officials have stated that this was an

oversight that will be addressed in the final regulations.

There is also concern that the proposed regulations will create unintended burdens for certain partnerships. For example, disregarded entities that fail the documentation rule (discussed below) will have a debt instrument recast as an equity contribution to the debtor, resulting in the disregarded entity being a deemed partnership. Many entities, investing as 1% partners, in a partnership that is part of an expanded group may find themselves also part of the larger expanded group. At the same time, Treasury officials have commented that they do not want taxpayers using partnerships to avoid the application of the proposed regulations.

Operational rules

The proposed regulations consist of three main parts. First, the regulations adopt a bifurcation rule allowing Treasury to treat indebtedness between members of an expanded group as part debt and part equity. Under existing rules, debt is treated either wholly as debt or wholly as equity. The IRS's ability to treat one debt instrument as two different interests adds both complexity and uncertainty to taxpayers' financial operations and tax liability within the United States.

Second, the proposed regulations create a documentation rule requiring the taxpayer to generate detailed documentation with respect to each internal debt instrument. This rule essentially requires the taxpayer to show evidence that the related-party debt instrument contains characteristics of a third-party debt instrument -- such as an unconditional obligation to repay -- with the holder of the note having the rights of a creditor and the issuer of

the note having the ability to repay the debt. Not only must this documentation be generated for each debt instrument, but it must also be maintained by the taxpayer for each year in which the debt is outstanding and until the statute of limitations expires for any tax return affected by the debt. The documentation requirements also apply to cash pools and debt revolvers, two commonly used internal financing mechanisms.

If these documentation requirements are not met, the debt is treated as equity unless the taxpayer can establish that the failure is due to reasonable cause. These documentation requirements only apply to expanded groups with (1) one member whose stock is publicly traded; (2) more than \$100 million of total assets as reported on a non-tax audited financial statement; or (3) more than \$50 million of total annual revenue as reported on a non-tax audited financial statement.

Observation: The documentation rule likely will affect many privately owned US inbound companies because it establishes relatively low thresholds of total assets and total revenues. The proposed regulations will certainly result in increased operating and financing costs for US inbounds due to the documentation rule. Companies that wish to keep bona fide lending in-house will be required to generate and maintain proper documentation for each debt instrument. The cost of generating and maintaining the documentation could be significant because taxpayers will need to determine how the statute of limitations affects their record maintenance. Documentation for a note with a seven-year term, for example, must be kept at least another three years past the due date of the seventh year's tax return filing deadline.

Third, the proposed regulations generally treat debt instruments issued by expanded groups as stock for all US tax purposes where the debt instrument is issued in, or funds, certain transactions. The two rules comprising this part are referred to as the general rule and the funding rule.

General rule

This rule would define and treat as stock all debt instruments issued by a corporation to a member of its expanded group (1) in a distribution in which a subsidiary distributes a note to its parent; (2) in exchange for expanded group stock other than in an exempt exchange; and (3) as consideration in an asset reorganization, but only to the extent that a shareholder that is a member of the issuer's expanded group immediately before the reorganization receives the debt instrument with respect to its stock in the transferor corporation.

Funding rule

This rule would generally treat as stock any debt that was issued with a principal purpose to fund any of the transactions described in the general rule. While the proposed regulations state that all of the facts and circumstances must be weighed to determine whether a debt was issued with such principal purpose, there is an irrebuttable presumption that a debt instrument issued in the period three years before or three years after (the 72-month period) the acquisition or distribution occurred was issued with a principal purpose to fund one of the transactions.

Observation: S corporations are commonly used entities in the privately owned arena, and the operation of the proposed regulations may terminate their S corporation status. S corporations may only have one class of stock and can be owned only by certain entities. If the proposed regulations recast a loan to an S corporation as equity and the loan originates from a non-qualified

shareholder, such as a corporation or partnership, the S corporation's status may be terminated because it has a nonqualified owner. Alternatively, the equity created by the proposed regulations may be considered a second class of S corporation stock, also potentially resulting in the termination of the S corporation status. Depending on the nature of the investment in the S corporation operations and the underlying fact pattern, these rules may come into play.

Exceptions

There are exceptions to the general rule and the funding rules. First, the aggregate amount of any distributions or acquisitions, described in the general or funding rule, are reduced by an amount equal to the current year E&P of the distributing or acquiring corporation. Second, a debt instrument will not be treated as stock if, when the debt instrument is issued, the aggregate issue price of all expanded group debt instruments does not exceed \$50 million. Once this threshold has been reached, all the debt instruments of the expanded group that otherwise would have been treated as stock but for the threshold exception are treated as stock.

The third exception applies only to the funding rule. It states that an acquisition of expanded group stock will not be treated as an acquisition for purposes of the rule if both (1) the acquisition results from a transfer of property by a funded member to an issuer in exchange for stock of the issuer and (2) for the 36-month period following the issuance, the transferor holds, directly or indirectly, more than 50% of the vote and value of the stock of the issuer.

Observations: In their most basic operation, the proposed regulations could recast a loan from a foreign parent to its US subsidiary as equity for all US federal tax purposes. The interest payments that the subsidiary pays to the parent would be deemed not as interest but rather as dividends.

While many US treaties exempt interest income from US taxable income, not all of them exempt dividend income. Other consequences of debt being treated as equity include debt payments between partners and their partnerships being recast as guaranteed payments, taxable contributions, taxable reorganizations, lost foreign tax credits, and subpart F income.

These same results also could occur in a cash pool. Due to the operation of many cash pools, these results could replicate throughout a multinational company, tainting entities that did not take part in the recast transaction. In a typical cash pool, affiliates maintain separate accounts in which they can deposit excess cash into or use as an overdraft to borrow from the pool. Another entity acts as the cash pool's leader and all cash from the entities' accounts are swept into the leader's account and all overdrafts are covered via transfers from the leader. If an affiliate borrower makes a distribution or a stock acquisition within the expanded group, the proposed funding rule dictates that the amount borrowed from the cash pool is an equity interest owned by the leader. Other affiliates that have deposited money into the cash pool and then subsequently withdrawn those deposits also might be snared by the funding rule and have those withdrawals considered distributions. In larger companies that have country, regional, or global cash pools, a country cash pool leader affected by the funding rule, which then borrows from either of the other cash pools, could taint those cash pools as well. The result of one small intercompany transaction could be felt throughout the global cash management system.

Let's not forget about BEPS

The Organisation for Economic Co-operation and Development's (OECD) BEPS Action 4 addresses the deductibility of interest (the OECD issued a final report on this item in October 2015). Action 4 is aimed at

subsidiaries with significant tax deductions related to interest expense while the global company as a whole has little or no external debt. The final report recommends an approach based on a fixed ratio rule, which limits an entity's net deductions for interest (and payments economically equivalent to interest) to a percentage of its EBITDA. BEPS Action 4 is more akin, in its operation, to Section 163(j) of the US tax code, as it aims to reduce interest payment deductions while leaving the underlying debt instrument intact.

Treasury's approach to limiting interest deductions as set forth in the proposed regulations differs markedly from that proposed by the OECD.

One primary goal of the OECD's BEPS initiative is to better harmonize the tax rules faced by entities operating in multiple jurisdictions. It appears that

the proposed regulations under Section 385 may be inconsistent with that goal and may add another layer of complexity for multinational corporations. It will be interesting to see how other countries react to the BEPS Action 4 recommendations vis-à-vis Treasury's approach. If multiple countries were to adopt related-party debt rules similar to those found in the proposed regulations, layered with rules similar to those proposed in BEPS Action 4, multinational companies would face complex compliance burdens.

The takeaway

While the intended target of the proposed regulations under Section 385 may be large, publicly traded multinationals, the breadth of these regulations will affect other entities, including privately owned US inbounds, and even entities doing

business only within the United States. The courts have established a considerable amount of case law over the years that has guided both taxpayers and the IRS as to whether an interest in a corporation should be treated as debt or equity. Rather than construct regulations around these long-standing principles, the US Treasury has proposed mechanical regulations that will, for example, recast as equity a debt instrument if the taxpayer does not generate and maintain documentation.

Whether taxpayers need to create a new system of internal controls to generate and maintain documentation on internal loans, revise their organization structure, or utilize third-party financing, the proposed regulations under Section 385 will impact the cost of operating and investing within the United States for US inbound companies.

Let's talk

For a deeper understanding of how these issues might affect your business, please reach out to one of the PwC professionals listed below, or your local [PCS contact](#):

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