Final and Temporary Section 385 Regulations

October 14, 2016

On October 13, the IRS and the Treasury Department released **final and temporary regulations under section 385** relating to the classification of certain intercompany loans as debt or equity for U.S. federal income tax purposes. The regulations make a number of significant changes to the proposed regulations that were released in April, including (i) a number of new exceptions that apply to, among other things, cash pooling and similar short-term arrangements, transactions between foreign subsidiaries of U.S. companies, and transactions between members of regulated financial groups, (ii) expanded exceptions for ordinary course transactions, distributions out of earnings and profits and distributions that can be netted against capital contributions, and (iii) revised effective date and transition rules. However, the basic structure of the regulations remain unchanged, including the inclusion of the so-called funding and per se funding rules.

This memorandum, which assumes general familiarity with the proposed regulations, summarizes certain of the most important aspects of the regulations (which, together with the preamble, are over 500 pages). Early next week, we will circulate a more detailed memorandum on the regulations. In addition, we will host a live webinar on the regulations on Friday, October 21, at 9:00 am, a detailed invitation for which will be distributed early next week. Register for our upcoming webcast **here**.

General Provisions (Reg. § 1.385-1)

- Regulations Limited to U.S. Borrowers. In a significant limitation on the scope of the regulations, the regulations apply only to indebtedness issued by members of an expanded group that are domestic corporations for federal income tax purposes, and reserve on the application of the regulations to indebtedness issued by foreign corporations. [Preamble, pp. 21-23; Reg. § 1.385-1(c)(2), p. 382]
  - This has the effect of, among other things, excluding foreign-to-foreign transactions from the application of the regulations.
- Elimination of Bifurcation Rule. The regulations do not include the "bifurcation" rule which was included in the proposed regulations, with Treasury indicating that it will continue to study this issue. [Preamble, p. 49; Reg. § 1.385-1(e), p. 389]
- Changes to the Definition of Expanded Group. The definition of an expanded group continues to be based on concepts similar to those used to define the term "affiliated group" in section 1504(a). Changes to the definition include:
  - S corporations are excluded from being expanded group members.
  - RICs and REITs are generally excluded from being expanded group members, unless the RIC or REIT is controlled by members of the expanded group.
  - "Direct or indirect" ownership is generally determined by reference to the attribution rules under section 318, with certain modifications.
  - The regulations reserve on the application of the "downward attribution" rules in section 318(a)(3), which, if those rules applied, could result in "brother-sister" groups of affiliated corporations that are commonly controlled by non-corporate owners being members of a single affiliated group.

        - Notably, this reservation will limit attribution through commonly-held partnerships, an issue of great concern under the proposed regulations.
    - The option attribution rule in section 318(a)(4) applies only to options, as defined in Reg. § 1.1504-4(d), that are reasonably certain to be exercised as described in Reg. § 1.1504-4(g) and, in the case of an option within a consolidated group, only if the option is treated as stock or as exercised under Reg. § 1.1504-4(b). [Preamble, pp. 28-41; Reg. § 1.385-1(c)(4), pp. 382-384]
- No Special Rules for Blocker Corporations. The regulations do not adopt any special rules for debt instruments issued by "blocker" corporations of the type commonly used by investment partnerships. [Preamble, pp. 44-45]
- Consequences of Recharacterization. The regulations contain several clarifications and new rules that address the consequences of the deemed exchange of a debt instrument for stock under the regulations, including:
    - The holder is treated as realizing an amount equal to the holder's adjusted basis in the debt instrument that is deemed to be exchanged for stock.
    - The issuer is treated as retiring the debt instrument for an amount equal to its adjusted issue price as of the date of the deemed exchange (and, for purposes of section 108(e)(8), the stock deemed issued is treated as having a fair market value equal to the adjusted issue price of the debt instrument).
    - The rules of section 988 apply to generally require the holder and issuer of a debt instrument that is deemed to be exchanged for stock to recognize any exchange gain or loss.
- Effective Date. Reg. § 1.385-1 applies to taxable years ending on or after January 19, 2017 (90 days after October 21, 2016, the date on which the regulations are scheduled to be published in the Federal Register). [Reg. § 1.385-1(f), p. 389]

Documentation Rules (Reg. § 1.385-2)

Under the proposed regulations, an "**expanded group instrument**" or "**EGI**" would be treated as stock if the taxpayer failed to comply with certain documentation and record keeping requirements (the "**documentation requirements**"). The final regulations retain this general rule, but include several significant changes, exceptions and clarifications.

- Timely Preparation of Documentation. The regulations require documentation with respect to an EGI to be completed no later than the time for filing the issuer's federal income tax return, including extensions, for the year that includes the "relevant date" for such documentation (in many cases, the issue date), replacing the 30- and 120-day compliance periods under the proposed regulations. [Preamble, pp. 54-55; Reg. § 1.385-2(a)(3)(i), pp. 407-408]
- Delayed Implementation. The regulations delay the implementation of the documentation requirements, applying only to EGIs issued on or after January 1, 2018. [Preamble, pp. 7, 51; Reg. § 1.385-2(d)(2)(iii), p. 413]
- Rebuttable Presumption for Highly Compliant Taxpayers. Under the proposed regulations, an EGI that failed to meet the documentation requirements (an "**undocumented EGI**") would be automatically treated as stock. The final regulations relax this rule, providing that for members of an expanded group that has a high degree of compliance, the undocumented EGI will be presumed to be stock, but the taxpayer may rebut that presumption by clearly establishing sufficient common law factors to treat the EGI as indebtedness. [Preamble, pp. 55-59; Reg. § 1.385-2(b)(2), pp. 394-395]

- To demonstrate a high degree of compliance, the expanded group must meet one of the following tests for the calendar year in which there exists an undocumented EGI:
  - The quarterly average of the aggregate adjusted issue price of all outstanding EGIs that meet the documentation requirements is more than 90% of the quarterly average of the aggregate adjusted issue price of all outstanding EGIs.
  - No undocumented EGI has an issue price greater than $100 million, and the quarterly average of the total number of EGIs that meet the documentation requirements is more than 95% of the quarterly average of the total number of EGIs outstanding at the end of each quarter.
  - No undocumented EGI has an issue price greater than $25 million, and the quarterly average of the total number of EGIs that meet the documentation requirements is more than 90% of the quarterly average of the total number of EGIs outstanding at the end of each quarter. [Preamble, pp. 55-59; Reg. § 1.385-2(b)(2), pp. 394-395]
- The regulations also provide that a ministerial or non-material failure or error that is discovered and corrected prior to the IRS's discovery of the failure or error is not taken into account. [Preamble, p. 59; Reg. § 1.385-2(b)(2)(iii), pp. 396-397]

- Cash Pooling and Similar Arrangements. The regulations provide special rules regarding the application of the documentation requirements to revolving credit agreements, cash pooling arrangements and similar arrangements that cover multiple EGIs under a master agreement ("**master agreements**").
  - Master agreements are generally subject to the documentation requirements.
  - With respect to EGIs governed by a master agreement, a single credit analysis may be prepared and used on an annual basis for EGIs issued by a member up to an overall amount of indebtedness set forth in an annual credit analysis (see below), with the first credit analysis required to be performed upon the execution of the master agreement.
  - Notional cash pooling arrangements are generally subject to the same documentation requirements as physical cash pooling arrangements where the notional cash pool provider operates as an intermediary (*e.g.*, where the cash received by the notional cash pool provider from expanded group members is required to equal or exceed the amount loaned to expanded group members). [Preamble, pp. 71-76; Reg. § 1.385-2(c)(3)(i), pp. 404-407]
- Instruments Issued by Regulated Entities. Treasury declined to provide broad exclusions from the documentation requirements for regulated financial institutions and insurance companies. [Preamble, pp. 67-68] However, the regulations provide exceptions from the documentation requirements for certain EGIs issued by those taxpayers.
  - An EGI issued by an "**excepted regulated financial company**" (as defined in Reg. § 1.385-3(g)(3)(iv)) that contains terms required by a regulator in order for the EGI to satisfy regulatory capital or similar rules that govern resolution or orderly liquidation will be treated as complying with the documentation requirements, provided at the time of issuance it is expected that the EGI will be paid in accordance with its terms.
  - A similar rule applies to an EGI issued by a "**regulated insurance company**" that requires the issuer to receive approval or consent of an insurance regulatory authority prior to making payments of principal or interest.
  - Treasury stated in the preamble that it was aware that certain instruments required by regulators raise common law debt-equity issues that extend beyond the scope of the regulations. No guidance is provided in the regulations on these instruments, but Treasury

indicates that such guidance is under consideration. [Preamble, pp. 69-71; Reg. § 1.385-2(c)(1)(iii), pp. 398-399]

- Exclusions for Certain Instruments. The documentation requirements do not apply to certain interests, including:
  - Certain obligations that are treated as debt under other provisions of the Code or Treasury regulations, such as obligations between members of a consolidated group, production payments treated as a loan under section 636(a) or (b), REMIC regular interests and debt instruments deemed to arise under Reg. § 1.482-1(g)(3). [Preamble, p. 71; Reg. § 1.385-2(d)(2)(ii), pp. 412-413]
  - The regulations reserve on the applicability of the documentation requirements to obligations that are not in form debt. [Reg. § 1.385-2(c)(3)(ii), p. 407]
- Market Standard Documentation Safe Harbor. The regulations provide a safe harbor pursuant to which documentation that is customarily used in comparable third-party transactions (*e.g.*, trade payables with unrelated parties) may be used to satisfy the documentation requirements to establish (i) an unconditional obligation to pay a sum certain and (ii) the existence of creditors' rights. [Preamble, p. 77; Reg. § 1.385-2(c)(1)(ii), p. 398]
- Reasonable Expectation of Ability to Repay. The regulations clarify and provide several new rules relating to the requirement that there exist written documentation establishing the ability of the issuer to repay any EGI, including:
  - An annual credit analysis generally may be prepared that covers multiple EGIs issued by a single issuer, up to the amount specified in the analysis, provided that such EGIs are issued on any day within the 12-month period beginning on the date on which the analysis in the annual credit analysis is based (the "**analysis date**").
  - If there is a specified "material event" (including, *e.g.*, a material change in the issuer's line of business or a disposition by the issuer of 50% or more by value of certain assets) with respect to the issuer within the year beginning on the analysis date, the annual credit analysis cannot be used to satisfy this requirement for EGIs with relevant dates on or after the date of the material event, but a new annual credit analysis may be performed with an analysis date after the date of the material event.
  - Documentation establishing the ability to repay the EGI may assume that the principal amount of an EGI may be satisfied with the proceeds of another borrowing by the issuer, provided that such assumption is reasonable. [Preamble, pp. 82-85; Reg. § 1.385-2(c)(2)(iii), pp. 400-403]
- Obligations of Disregarded Entities. The regulations provide that if an obligation of a disregarded entity that is owned by a corporate member of an expanded group is treated as stock as a consequence of failing to meet the documentation requirements, the stock is treated as having been issued by the corporate owner of the disregarded entity. This rule changes the result under the proposed regulations, which would have caused the disregarded entity to become a partnership for tax purposes. [Preamble, pp. 60-61; Reg. § 1.385-2(e)(4), pp. 416-417]

Recharacterization Rules (Reg. § 1.385-3 and Temp. Reg. § 1.385-3T)

- Basic Framework of Proposed Regulations Maintained. Despite comments requesting the withdrawal or complete overhaul of proposed § 1.385-3, the regulations retain the general approach of the proposed regulations:
  - A "**general rule**" treats debt issued to a member of the expanded group as equity if it is issued in a distribution, in an acquisition of stock of an expanded group member or in

exchange for property in an asset reorganization (a "**distribution or acquisition**"). A "**funding rule**" backstops this general rule by treating debt issued to an expanded group member as stock to the extent it funds a distribution or acquisition. [Preamble, p. 100; Reg. § 1.385-3(b)(2)-(3), pp. 419-426]

- The non-rebuttable "**per se funding rule**" applies the funding rule to debt issued during the six-year period surrounding a distribution or acquisition. [Preamble, p. 156; Reg. § 1.385-3(b)(iii), pp. 421-423]
- Indebtedness that is recharacterized as stock under § 1.385-3 is treated as stock for all purposes, except (in a change from the proposed regulations) in determining whether a corporation is a member of an affiliated group under section 1504(a). [Preamble, p. 115; Reg. § 1.385-3(b)(1), pp. 419-420]
- There is an exemption for a member's distributions and acquisitions to the extent of the member's earnings and profits, although (as described below) the regulations materially expand the earnings and profits available for this exclusion. [Preamble, p. 209; Reg. § 1.385-3(c)(3), pp. 432-437]
- Repayments and distributions with respect to debt recharacterized as stock may cause "cascading" recharacterizations of other debt instruments under the funding rule. [Preamble, pp. 117-120]

- Exceptions for Certain Debt Instruments. In response to comments, the final regulations add exemptions for certain types of debt instruments:
  - Debt Issued by Regulated Entities. Instruments issued by regulated financial companies (and their subsidiaries other than subsidiaries engaged in commodity-related or merchant banking activities) and regulated insurance companies subject to specific regulatory capital or leverage requirements (but not captive insurance companies or non-insurance entities within an insurance group) are exempt from both the general rule and the funding rule. [Preamble, pp. 250-253; Reg. § 1.385-3(g)(3)(iv), pp. 451-453]
  - Cash Management and Short-Term Debt. Four categories of debt instruments are excluded from the scope of the funding rule under the exception that applies to "**qualified short-term debt instruments**":
    - A debt instrument is a "**short-term funding arrangement**" if it meets either of the following tests (but an issuer cannot apply both tests in any one taxable year):
      - The "**specified current assets test**" is generally met if the debt instrument bears no greater than an arm's-length rate of interest and, immediately after the debt issuance, the issuer's balance of expanded group debt that satisfies certain exceptions to the funding rule does not exceed the issuer's "short-term financing needs" (generally, the maximum amount of non-cash current assets reasonably expected to be reflected on the issuer's balance sheet as a result of ordinary course business transactions during the subsequent 90-day period or the issuer's normal operating cycle, whichever is longer).
      - The "**270-day test**" is generally met if the debt instrument has a term of 270 days or less (or is an advance under a revolving credit agreement) and bears an arm's-length rate of interest, where the issuer is not a net borrower (i) from the lender for more than 270 days during a taxable year or 270 consecutive days across taxable years or (ii) from any other member of the expanded group for more than 270 days during a taxable

year with respect to debt instruments that otherwise would satisfy the 270-day test (other than ordinary course loans and interest-free loans, described below).

- An arm's-length rate of interest for purposes of the above tests is generally determined applying the principles of section 482 with respect to certain comparable short-term instruments.

- An "**ordinary course loan**" is a debt instrument issued as consideration for the acquisition of property, other than money, in the ordinary course of the issuer's trade or business and that is reasonably expected to be repaid within 120 days of issuance. This is an expansion of the ordinary course exception in the proposed regulations, which only covered payables with respect to expenses that are currently deductible under section 162 or currently includible in the issuer's cost of goods sold or inventory.
- An "**interest-free loan**" must not provide for stated interest, original issue discount, imputed interest under section 483 or section 7872, or be subject to a required interest charge under section 482.
- A "**deposit with a qualified cash pool header**" is a demand deposit received by a qualified cash pool header pursuant to a cash management arrangement. A "qualified cash pool header," in turn, is defined as "a member of an expanded group, controlled partnership, or QBU described in § 1.989(a)-1(b)(2)(ii) that is owned by an expanded group member, that has as its principal purpose managing a cash-management arrangement for participating expanded group members" and that maintains deposits in excess of loans to participating members on its books and records in the form of cash, cash equivalents, or third-party deposits, securities, or obligations. Note that the requirement that a qualified cash pool header have as "its principal purpose" cash management may preclude entities that have multiple roles within a group from qualifying. In addition, while there are no specific rules with respect to notional cash pools, the preamble notes that to the extent a notional cash pool is treated under tax principles as a loan directly between expanded group members, those loans may be eligible for a qualified short-term debt exception. [Preamble, pp. 178-189; Reg. § 1.385-3T(b)(3)(vii), pp. 469-474]

- $50 Million of Indebtedness. Up to $50 million in debt instruments that would otherwise be recharacterized is exempted from the general and funding rules. Although the $50 million threshold amount remains the same as in the proposed regulations, it no longer has a cliff effect. [Preamble, p. 227; Reg. § 1.385-3(c)(4), p. 443]

- Exceptions for Certain Distributions and Acquisitions. The final regulations add to and expand the exceptions from the general and funding rules for each of the following types of distributions and acquisitions:
  - Post-April 4 Accumulated E&P. Distributions and acquisitions to the extent of the member's earnings and profits accumulated in taxable years ending after April 4, 2016 and during the period that the member is a member of an expanded group with the same expanded group parent, computed as of the close of the member's taxable year. By expanding the exception for earnings and profits to cover accumulated earnings and profits, the regulations no longer incentivize companies to distribute notes currently to the extent of current earnings. [Preamble, pp. 209-212; Reg. § 1.385-3(c)(3), pp. 432-437]
  - Equity Contributions. After taking into account other exceptions, including the earnings and profits exception, distributions and acquisitions that would otherwise cause a

recharacterization of debt are first offset by "**qualified contributions**." Qualified contributions generally include any contribution of property (other than expanded group stock, related party debt and certain other excluded property) made within 3 years before or after the distribution or acquisition. [Preamble, pp. 219-225; Reg. § 1.385-3(c)(3)(ii), pp. 437-443]

- Acquisitions from a Subsidiary. Acquisitions of expanded group stock from a direct or indirect subsidiary (the "**subsidiary stock acquisition exception**") where the acquirer does not generally relinquish control of the seller pursuant to a pre-existing plan (other than where the seller ceases to be a member of the expanded group). This represents an expansion from the prior "subsidiary stock issuance rule" that required a 36-month holding period, the absence of which is now a rebuttable presumption of such a pre-existing plan. [Preamble, pp. 196-197; Reg. § 1.385-3(c)(2)(i), pp. 429-430]
- Compensatory Equity. Acquisitions of expanded group stock that is delivered to employees, directors, or independent contractors in consideration for services rendered to the expanded group. [Preamble, pp. 203-204; Reg. § 1.385-3(c)(2)(ii), p. 430]
- Dealer in Securities. Certain acquisitions of expanded group stock by a dealer in securities in its ordinary course of dealing. [Preamble, pp. 205-206; Reg. § 1.385-3(c)(2)(iv), pp. 430-431]

- Additional Funding Rule Exceptions. Finally, certain distributions and acquisitions are exempted from the funding rule:
  - Transfer Pricing Adjustments. Deemed distributions and acquisitions resulting from transfer pricing adjustments under section 482 are excepted from the funding rule. [Preamble, p. 205; Reg. § 1.385-3(c)(2)(iii), p. 430]
  - Limited Exception Addressed at Cascading Recharacterizations. For purposes of the funding rule, an acquisition does not include any acquisition of a debt instrument that is itself treated as stock under the funding rule, provided the acquisition is not part of a plan or arrangement to avoid the application of the funding rule. [Preamble, pp. 120-122, § 1.385-3(c)(2)(v), pp. 431-432] However, a repayment of a debt instrument that is recharacterized as stock is still treated as a distribution for purposes of the funding rule. [Preamble, pp. 117-119]
  - Liquidations and Spin-offs. Additional exceptions to the funding rule apply to distributions of property in a complete liquidation under section 331 or section 332, and distributions of stock under section 355 not preceded by a reorganization described in section 368(a)(1)(D). [Preamble, pp. 168-170; Reg. § 1.385-3(g)(10)-(11), pp. 454-455]
- Predecessors and Successors. The regulations clarify that the definition of predecessors and successors is limited to those explicitly provided under the regulations. [Preamble, p. 159; Reg. § 1.385-3(g)(20)(i), p. 456] In addition:
  - For purposes of the per se funding rule, a debt instrument will not be treated as funding a distribution or acquisition unless the funding and distribution or acquisition occur during the 6-year period beginning 3 years prior to the transaction that created the predecessor-successor relationship. [Preamble, pp. 159-160; Reg. § 1.385-3(b)(3)(v)(B), p. 425]
  - A distributing corporation and controlled corporation in a distribution or exchange to which section 355 applies cease to have a predecessor and successor relationship when they cease to be members of the same expanded group. [Preamble, pp. 160-161; Reg. § 1.385-3(g)(20)(ii), p. 456]

- Additional Rules and Clarifications for Controlled Partnerships. The regulations maintain the aggregate approach to controlled partnerships but include notable changes and additions to the approach in the proposed regulations:
  - An expanded group partner's share of a controlled partnership's assets is determined under a liquidation value percentage approach instead of a profits interest approach. [Preamble, p. 267; Reg. § 1.385-3T(f)(2)(i)(B), p. 477]
  - An expanded group partner is still treated as the issuer with respect to the partner's share of a debt instrument issued by a controlled partnership to an expanded group member, which is based on the partner's anticipated allocations of the partnership's interest expense. [Preamble, p. 269; Reg. § 1.385-3T(f)(3)(ii)(A), pp. 479-480]
  - To avoid collateral consequences, a novel "deemed conduit approach" is adopted for recharacterizing a debt instrument issued by a controlled partnership, where the holder is deemed to transfer the debt to the relevant partner in exchange for stock in that partner (which transfer is otherwise ignored for purposes of section 752 allocations). [Preamble, pp. 272-275; Reg. § 1.385-3T(f)(4), pp. 480-484; Reg. § 1.752-2(c)(3), p. 516]
- Changes to Timing and Operating Rules. Among other numerous departures from the proposed regulations, the final regulations adopt the following notable changes:
  - Tacking for Significant Modifications. For significant modifications other than changes in obligors or co-obligors and material deferrals of payments, the modified instrument is generally treated as issued on the original issue date for purposes of the per se funding rule. [Preamble, p. 243; Reg. § 1.385-3(b)(3)(iii)(E), p. 424]
  - Limitations on Duplicative Recharacterizations. The final regulations provide that once a debt instrument is recharacterized as stock under the funding rule, the distribution or acquisition that caused that recharacterization cannot cause a recharacterization of another debt instrument after the first instrument is repaid. [Preamble, pp. 119-120; Reg. § 1.385-3(b)(6), p. 428]
  - Straddling Expanded Groups. The per se funding rule generally will not apply to a debt instrument that is issued subsequent to a distribution or acquisition, when the issuer's counterparty to the distribution or acquisition is not a member of the same expanded group, and the parent of the issuer's expanded group is different than the expanded group parent at the time of the distribution or acquisition. [Preamble, pp. 165-166; Reg. § 1.385-3(b)(3)(iii)(D), p. 422]
  - Bifurcated Instruments. An issuer may designate whether a payment that not required to be made pursuant to the terms of the instrument (*e.g.*, a prepayment) is allocated to the stock or debt portion of a bifurcated instrument, but otherwise, payments are treated as made pro-rata with respect to each portion. [Preamble, pp. 115-116; Reg. § 1.385-3(d)(5)(ii), p. 448]
- Effective Date. The regulations apply to taxable years ending on or after January 19, 2017 with respect to debt instruments issued after April 4, 2016. Transition rules provide that, although no instrument will be treated as stock prior to January 19, 2017, payments other than stated interest on instruments that would be recharacterized as stock prior to that date but for the applicability date of Reg. § 1.385-3 or the transition rules constitute distributions for purposes of the funding rule. Taxpayers may elect to consistently apply the rules of the proposed regulations for instruments after April 4 and before October 13, 2016. [Preamble, pp. 321-332; Reg. § 1.385-3(j), pp. 465-468]

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