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Highly-Anticipated Final Regulations on Related-Party Debt Instruments Issued

Final Regulations Provide Some Helpful Exceptions to Taxpayers, but Retain Core Recharacterization Provisions From the Proposed Regulations

On October 13, 2016, the US Department of the Treasury and the Internal Revenue Service released final and temporary regulations under section 385 of the Internal Revenue Code (the "Regulations") that contain rules requiring that certain related-party debt instruments be recharacterized as equity where specified documentation requirements are not satisfied or the debt instruments are issued under certain circumstances described in more detail below. While generally retaining the framework and key operative rules contained in the proposed section 385 regulations, issued on April 4, 2016 (including the "funding rule" and "per se funding rule," which have been the subject of considerable criticism from commentators), the Regulations contain a number of meaningful changes and exceptions.[1] In particular, the Regulations contain new exceptions for cash pooling arrangements, short-term loans and instruments issued by foreign issuers.

The Regulations also delay the effective date of the documentation requirements to apply only to expanded group instruments issued on or after January 1, 2018. Under the Regulations, the general rule and funding rule apply to taxable years ending after January 19, 2017 with respect to expanded group instruments issued after April 4, 2016.

The key changes from the Proposed Regulations are summarized below:

General Scope of Regulations

- Limitation to US Corporate Borrowers. The overall scope of the Regulations was narrowed to cover only debt instruments issued by "covered members," which are defined as members of an "expanded group" that are classified as corporations for US tax purposes (including corporations organized outside of the United States that are treated as domestic corporations under section 953(d), section 1504(d) or section 7874(b)). The Regulations reserve on their application to corporate issuers that are not classified as domestic corporations

[1] For a detailed discussion of the Proposed Regulations, please see our prior discussion of the Proposed Regulations, which is available at http://www.shearman.com/~/media/Files/NewsInsights/Publications/%202016/06/Proposed-Regulations-on-RelatedParty-Debt-Instruments-Would-Result-in-Dramatic-Adverse-Tax-Consequences-TX-060316.pdf.

(*i.e.*, non-US issuers), noting that the application of the Regulations to debt instruments issued by non-US corporations requires further study.

  - Under the Regulations, the definition of an expanded group is generally based on the definition of an "affiliated group" contained in section 1504, but also includes non-US corporations, controlled RICs and REITs and certain corporations connected indirectly through partnerships.

- Carve-out for Non-Controlled REITs and RICs and S corporations. The definition of the term "expanded group" was modified such that (i) REITs and RICs that are not controlled by members of the expanded group and (ii) S corporations are not members of the expanded group, and thus generally are not subject to the Regulations.

Bifurcation Rule

- The "bifurcation rule," which would have permitted the IRS to recharacterize certain debt instruments as part debt and part equity for US tax purposes, was eliminated. The preamble to the Regulations noted that Treasury and the IRS will continue to study this rule.

Documentation Requirements of Reg. § 1.385-2

- While the documentation requirements in the Regulations retain the same basic framework as the Proposed Regulations, the Regulations contain helpful changes. These changes include lengthening the period of time to prepare the required documentation and exceptions to the per se recharacterization of debt instruments in the case of highly compliant expanded groups and non-material errors in complying with the documentation requirements.

  - The documentation requirements require that expanded groups comply with certain documentation and recordkeeping requirements with respect to expanded group instruments. If the expanded group does not comply with such requirements, the expanded group instrument will generally be automatically recharacterized as equity for US tax purposes unless an exception applies.

- Timing for Documentation Preparation. The Regulations extended the day by which the issuer of an expanded group instrument must comply with the documentation requirements from 30 days or 120 days, as the case may be, after the "relevant date" under the Proposed Regulations to the due date of the issuer's US tax return (taking into account any extensions) for the issuer's taxable year that includes the "relevant date."

- Rebuttable Presumption for Certain Expanded Groups. Under the Proposed Regulations, an expanded group instrument failing the documentation requirements was per se recharacterized as equity regardless of whether the instrument would otherwise be treated as debt under common law principles. In contrast, if the documentation requirements with respect to an expanded group instrument are not timely satisfied, but the applicable expanded group demonstrates a "high degree of compliance" with the documentation requirements, a presumption will apply that the expanded group instrument will be classified as stock (rather than per se recharacterization); however, such presumption can be rebutted if the taxpayer establishes that the debt should be respected as such under common law principles (with the factors set forth in the documentation requirements being significant factors to be taken into account in this analysis).

- For this purpose, an expanded group can demonstrate a high degree of compliance with the documentation requirements if:
  - expanded group instruments representing at least 90 percent of the aggregate adjusted issue price of all covered expanded group instruments comply with the documentation requirements;
  - no covered expanded group instrument with an issue price in excess of $100,000,000 failed to comply with the documentation requirements and less than 5 percent of the expanded group instruments outstanding failed to comply with the documentation requirements; or
  - no covered expanded group instrument with an issue price in excess of $25,000,000 failed to comply with the documentation requirements and less than 10 percent of the expanded group instruments outstanding failed to comply with the documentation requirements.

- Ministerial and Non-Material Failures. Further, a ministerial or non-material failure or error in complying with the documentation requirements will not cause an instrument to be recharacterized; provided that such failure or error is corrected prior to the discovery of such failure or error by the IRS.
- Debt Issued by Disregarded Entity. If an expanded group instrument issued by a disregarded entity is recharacterized as equity due to a failure to satisfy the documentation requirements, the equity is deemed issued by the disregarded entity's owner, and not the disregarded entity itself. Under the Proposed Regulations, the recharacterized equity was treated as equity of the disregarded entity, which had the effect of converting the disregarded entity into a partnership.
- Cash Pooling Arrangements. Although the Regulations did not exempt cash pooling and similar arrangements from the documentation requirements, the Regulations contain special rules applying the documentation requirements to cash pooling arrangements covering multiple expanded group instruments under a single master agreement.
- Effective Date. The documentation requirements are only applicable to expanded group instruments issued on or after January 1, 2018.

Recharacterization Rules of Reg. § 1.385-3 and Reg. § 1.385-3T

- Notwithstanding requests by commentators to remove or significantly rewrite the "general rule," the "funding rule" and the "per se funding rule," the overall structure of those rules remain mostly unchanged.
  - Under the "general rule," an expanded group instrument is recharacterized as stock for US tax purposes when it is issued in connection with one of three specified transactions (a distribution of a note, as consideration for the stock of another member of the expanded group or as boot in connection with an intercompany asset reorganization).
  - Under the "funding rule," an expanded group instrument will be recharacterized as stock when such debt instrument is issued by the borrower (referred to as the "funded member") in connection with: (i) a distribution of cash or other property to another member of the expanded group (other than a distribution of stock in connection with an intragroup asset reorganization that is permitted to be received without the recognition of gain or income), (ii) an acquisition of the stock of another member of the expanded group by the funded member, other than in an "exempt exchange," in exchange for property (other than the stock of the funded member) or (iii) an exchange for property in

connection with an asset reorganization *and* the debt instrument is either (x) issued with a principal purpose of funding one of the three enumerated types of acquisitions or distributions or (y) issued at any time during the 72-month period beginning 36 months before the issuing corporation engages in one of the three enumerated acquisitions or distributions (referred to as the "per se funding rule").

- Exceptions for Debt Instruments Issued by Regulated Financial Companies and Regulated Insurance Companies. Debt instruments issued by regulated financial companies (*i.e.*, financial institutions that are subject to specific regulatory capital or leverage requirements) and their subsidiaries (other than those subsidiaries held pursuant to the complementary activities authority, merchant banking authority or grandfathered commodities activities authority) are exempt from both the general rule and funding rule. Similarly, debt instruments issued by regulated insurance companies (other than captive insurance companies) are exempt from the general rule and funding rule.
- Expansion of Earnings and Profits Exception. Under the Proposed Regulations, the aggregate amount of distributions and acquisitions that would otherwise result in a debt instrument being recharacterized under the general rule or the funding rule was reduced by the current earnings and profits of the distributing member. Under the Regulations, this exception is expanded so the aggregate amount of distributions and acquisitions that would otherwise result in a debt instrument being recharacterized as equity under the general rule or the funding rule, as applicable, is reduced by the applicable member's earnings and profits (determined at the end of each taxable year) that were accumulated in taxable years ending after April 4, 2016 and during which the applicable member was a member of an expanded group with the same expanded group parent.
- Capital Contribution Offset. The amount of distributions and acquisitions that would otherwise result in a debt instrument being recharacterized as equity under the general rule or the funding rule, as applicable, is reduced by the fair market value of the stock of the applicable member issued to the transferor member in exchange for property (other than stock of a member of the expanded group and property acquired by the transferor in an internal asset reorganization) at any time during the period generally beginning three years before the date of the distribution or acquisition and ending on the earlier of (i) the third anniversary of the date of the distribution or acquisition and (ii) the last day of the first taxable year that a debt instrument would, absent the application of this exception, be treated as stock.
  - Accordingly, this exception provides taxpayers the opportunity to mitigate the impact of an inadvertent distribution or acquisition by making a capital contribution to the borrower before the last day of the first taxable year that the debt instrument would otherwise be recharacterized under the general rule or the funding rule.
- Exceptions for Acquisition of Expanded Group Stock. The Regulations expand the circumstances in which a member of an expanded group may acquire the stock of another member of the expanded group without causing a debt instrument to be recharacterized as equity under the general rule or the funding rule:
  - The "subsidiary stock issuance exception" to the funding rule contained in the Proposed Regulations is expanded to not only cover new issuances of stock of a 50 percent or greater owned subsidiary in exchange for property, but also acquisitions of *existing* stock of an expanded group member from a 50 percent or greater owned subsidiary. Such exception is renamed the "subsidiary stock acquisition exception" in the Regulations. Additionally, this exception now applies with respect to the second prongs of both the general rule *and* the funding rule (under the Proposed

Regulations, it only operated as an exception to the funding rule). The requirement contained in the Proposed Regulations that the funded member own 50 percent or more of the stock of the subsidiary during the 36-month period beginning on the date of the exchange is replaced with a requirement that the funded member not lose control of the transferee pursuant to a pre-existing plan (unless the loss of control also results in the funded member and the transferee ceasing to be members of the same expanded group).

- An exception to the general rule and the funding rule is created for acquisitions of expanded group stock where the expanded group stock is acquired by a member and then delivered by such member to employees, directors or contractors in consideration for services provided to the expanded group.
- Acquisitions of expanded group stock by a dealer in securities in its ordinary course of dealing are not covered by the general rule and the funding rule.
- In response to commentary regarding the cascading effect of the Proposed Regulations, the Regulations state that, for purposes of the funding rule, an acquisition of expanded group stock does not include an acquisition of a debt instrument that is recharacterized as equity under the funding rule so long as such acquisition is not part of a plan or arrangement to avoid the funding rule's application.

- Expansion of the $50 Million De Minimis Exception. Under the Proposed Regulations, if the aggregate adjusted issue price of all expanded group instruments otherwise subject to recharacterization under the general rule or the funding rule did not exceed $50 million, such debt instruments would not be recharacterized as equity under such rules; however, once the aggregate adjusted issue price exceeded $50 million, all of such debt instruments would be recharacterized as equity. Under the Regulations, the $50 million threshold remains unchanged, but only the portion of the aggregate adjusted issue prices of the expanded group instruments otherwise subject to recharacterization that exceeds $50 million is subject to recharacterization under the general rule and the funding rule (thus eliminating the "cliff effect" contained in the Proposed Regulations).
- Cash Pooling & Short-Term Debt. The Temporary Regulations contain a broad exception to the funding rule for "qualified short-term debt instruments." Qualified short-term debt instruments include the following:
  - Specified Assets Exception. A debt instrument with a rate of interest not in excess of an arm's-length rate of interest that would be charged with respect to a comparable debt instrument of the issuer; provided that, immediately after the issuance of the debt instrument, the aggregate outstanding balance of debt instruments issued by the issuer that satisfy (i) the arm's-length interest rate test contained in this specified assets exception, (ii) the 270-day test described below, (iii) the ordinary course loan exception described below or (iv) the interest-free loan exception not exceed the issuer's "short-term financing needs" (generally the maximum of the amount of specified current assets reasonably expected to be reflected, under applicable financial accounting principles, on the issuer's balance sheet as a result of transactions in the ordinary course of business during the longer of the issuer's normal operating cycle and the subsequent 90-day period or the issuer's normal operating cycle).
  - 270-Day Test. A debt instrument if (i) either (x) the term of the debt instrument is 270 days or less or (y) the debt instrument is an advance under a revolving credit agreement (or similar arrangement) and the debt instrument contains a rate of interest that is less than or equal to an arm's-length interest rate and (ii) both (x) the issuer of the instrument is not a "net borrower" from the debt instrument's holder for more than 270 days during the taxable year of the issuer, and in the case of a debt instrument outstanding during consecutive taxable years, more than 270

consecutive days during such consecutive taxable years, and (y) the issuer of the instrument is not a "net borrower" from any other member of the expanded group for more than 270 days during the taxable year of the issuer.

- For purposes of determining whether a member is a "net borrower" for this purpose, debt instruments not satisfying the 270-day term or arm's-length interest rate requirements set forth in part (i) of the immediately preceding bullet and loans described in the two immediately succeeding paragraphs are disregarded.

- Ordinary Course Loan Exception. A debt instrument issued as consideration for the acquisition of property in connection with the trade or business of the issuer; provided that such debt instrument is reasonably expected to be repaid no more than 120 days from its date of issuance.

- Interest-Free Loan Exception. A debt instrument that does not provide for stated interest, does not have original issue discount, does not contain imputed interest under section 483 or 7872 and section 482 does not require interest to be charged under such debt instrument.

- Demand Deposit Exception. A debt instrument that is a "demand deposit" received by a "qualified cash pool header" under a cash management agreement; provided the deposit does not have a purpose of facilitating the avoidance of the purposes of Reg. § 1.385-3 or § 1.385-3T with respect to a qualified business unit that is not a "qualified cash pool header." For this purpose, a "qualified cash pool header" means a member of an expanded group, a controlled partnership or a qualified business unit owned by an expanded group member, in each case whose principal purpose is managing a cash management arrangement for participating expanded group members, and the excess (if any) of the funds on deposit with the qualified cash pool header over the outstanding balance of loans made by the qualified cash pool header is maintained on the qualified cash pool header's books and records in the form of cash or cash equivalents, third-party deposits, securities or other obligations.

- Effective Date and Transition Rule. The general rule and the funding rule apply to expanded group instruments issued after April 4, 2016, but only apply with respect to taxable years ending on or after January 19, 2017. Accordingly, no expanded group instruments will be recharacterized as equity before January 19, 2017. However, taxpayers should be aware that all payments (other than payments of stated interest) made under debt instruments that would otherwise be recharacterized as equity under the general rule and funding rule but for the January 19, 2017 effective date of the Regulations are classified as distributions for purposes of recharacterizing other instruments as equity under the funding rule.

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