

An Overview of the Proposed Regulations under Section 385

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Presenters

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Agenda

Outline of the Proposed Regulations

- § 1.385-1
 - Definitions and operating rules, including part-debt/part-stock rules
- § 1.385-2
 - Documentation and information requirements necessary for certain instruments issued between related parties to be treated as debt for federal tax purposes
- § 1.385-3
 - Provides rules that treat certain instruments between related parties in connection with certain transactions as stock even if otherwise debt
- § 1.385-4
 - Special rules regarding transactions described in the -3 regulations above, as they relate to consolidated groups

Prop. Reg. § 1.385-1
Part Debt, Part Stock

Part Debt, Part Stock – § 1.385-1

- Current law treats an instrument generally as wholly debt or wholly equity based on a facts and circumstances test
- Prop. Reg. § 1.385-1 authorizes the Commissioner to treat a related-party interest in a corporation as part indebtedness and part stock

Part Debt, Part Stock – § 1.385-1 (con't)

- Applies to in-form debt instruments issued between members of a Modified Expanded Group (“MEG”)
 - MEG - 50% threshold for relatedness
- All members of a consolidated group (as defined in §1.1502-1(h)) are treated as one corporation
- Effective date:
 - Applies to certain related-party interests issued (or deemed issued as a result of a check-the-box election) on or after the date the Proposed Regulations are issued as final regulations

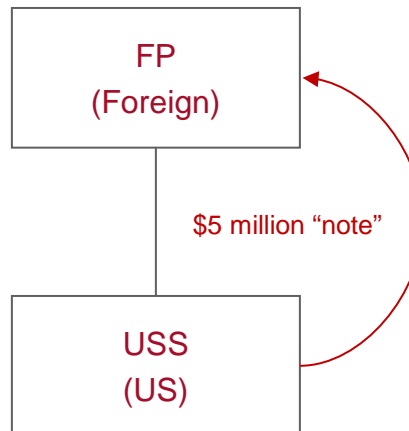
Part Debt, Part Stock – § 1.385-1 (con't)

- Practical Implications
 - Recharacterization Risks
 - Lack of Clarity
 - Rule Interactions

Bifurcation: Example

Part Stock Recast

Facts: The IRS determines that, at issuance, USS cannot reasonably be expected to repay more than \$3 million of the principal.



Analysis: It is possible the IRS may treat \$2 million as USS stock. See Preamble, Section II.C., Prop. Reg. § 1.385-1(d)(1).

Prop. Reg. § 1.385-2
Documentation Requirements

Documentation Requirements – § 1.385-2

- Establishes **threshold** documentation requirements that must be satisfied for certain related-party interests in a corporation to be considered indebtedness
 - Required for Expanded Group Instruments (“EGI”)
- Purpose
- Effective date:
 - Applies to related-party interest in a corporation issued on or after the date the Proposed Regulations are issued as final regulations

Documentation Requirements (con't)

- A related-party debt instrument will be subject to the documentation requirements only if one of the following three tests are met:
 - (1) Publicly traded stock test
 - (2) Asset test
 - (3) Income test
- There is no de minimis rule.

Documentation Requirements (con't)

- The required documentation must establish the following four requirements for an instrument to be considered as debt:
 - (1) A binding obligation to repay the advanced funds;
 - (2) Creditor's rights to enforce the terms of the debt;
 - (3) A reasonable expectation that the funds advanced can be repaid;
and
 - (4) After the instrument is issued, actions evidencing an ongoing and genuine debtor-creditor relationship.
- Timing requirements for the documentation – 30 days from the issuance of the debt; 120 days following any payment on the debt

Documentation Requirements (con't)

– Types of documentation:

▪ Written obligation evidencing:

- Obligation to pay a sum certain on demand or at fixed time(s)
- Enforceable creditor's rights (e.g., right to trigger default/acceleration for nonpayment of interest/principal)
- Liquidation preference over shareholders

▪ Collateral agreements (e.g., guaranties, subordination agreement)

▪ Ability to pay (e.g., debt/equity ratio, cash flow projections, financial statements, business forecasts, asset appraisals)

– Maintenance

Documentation Requirements (con't)

- Cash pooling
 - EGI issued pursuant to cash pooling arrangement or internal banking service that involves account sweeps, revolving cash advance facilities, overdraft set-off facilities, operational facilities, or similar features must comply with documentation requirements
 - Documentation must contain the relevant legal rights and responsibilities of any members of the expanded group and any entities that are not members of the expanded group in conducting the operation of the cash pooling arrangement or internal banking service

Practical Implications/Strategies

- Infrastructure in place to:
 - Implement central location for loan documentation
 - Track payments of principal and interest on debt instruments
 - Provide notifications for missed payments, steps taken to collect, and amendments to agreements
 - Provide notification when debt instruments (issued before or after 4/4/16) are modified
 - Provide notification if any transactions occurred or will occur that would trigger the Per Se Stock Rule

Prop. Reg. § 1.385-3

Recast Rules

Recast Rules – Prop. Reg. § 1.385-3

- Provides two sets of rules that would treat certain expanded group (“EG”) debt instruments as stock for U.S. federal tax purposes.
 - General rule
 - Funding rule
- An EG generally consists of entities connected through chain of ownership (at least 80% vote or value).
- Purpose

General Rule

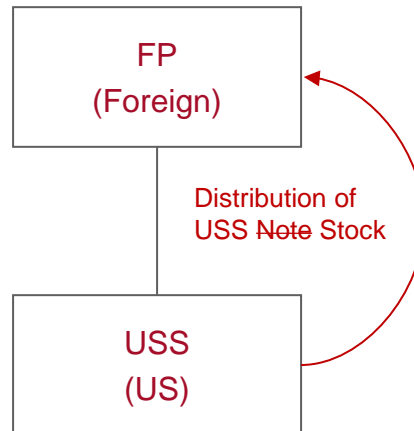
- Unless an exception applies, a debt instrument issued by a corporation to an EG member is treated as stock for all U.S. federal income tax purposes if it is issued in—
 - (i) a distribution;
 - (ii) exchange for EG stock (except for “exempt exchanges” which are certain stock transfers that occur pursuant to an asset reorganization); or
 - (iii) exchange for property in an asset reorganization if the instrument is received by a target shareholder that is an EG member with respect to its target stock.

- Exceptions

General Rule: Examples

Note Distribution

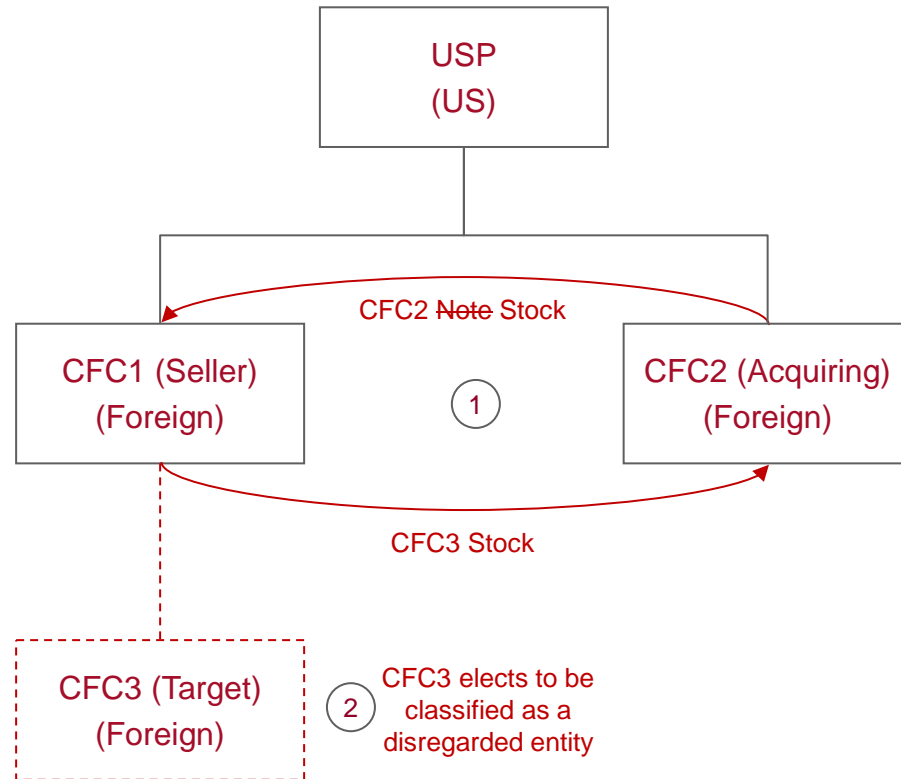
Facts: USS issues a promissory note to FP.



General Rule: Examples

Asset Reorganization

Facts: First, CFC2 issues a promissory note to CFC1 in exchange for CFC3 stock. Second, CFC3 makes an election to be classified as a disregarded entity for U.S. federal income tax purposes.



Funding Rule

- A debt instrument is treated as stock if it is a “principal purpose debt instrument.”
- A “principal purpose debt instrument” is a debt instrument issued by a corporation (the “funded member”) to an EG member in exchange for property with a principal purpose of funding—
 - (i) a distribution of property by the funded member to an EG member (other than certain distributions pursuant to an asset reorganization);
 - (ii) an acquisition of EG stock (other than in an exempt exchange) by the funded member from an EG member in exchange for property other than EG stock; or
 - (iii) an acquisition of property by the funded member in an asset reorganization (to the extent that a target shareholder that is an EG member receives boot with respect to its target stock).

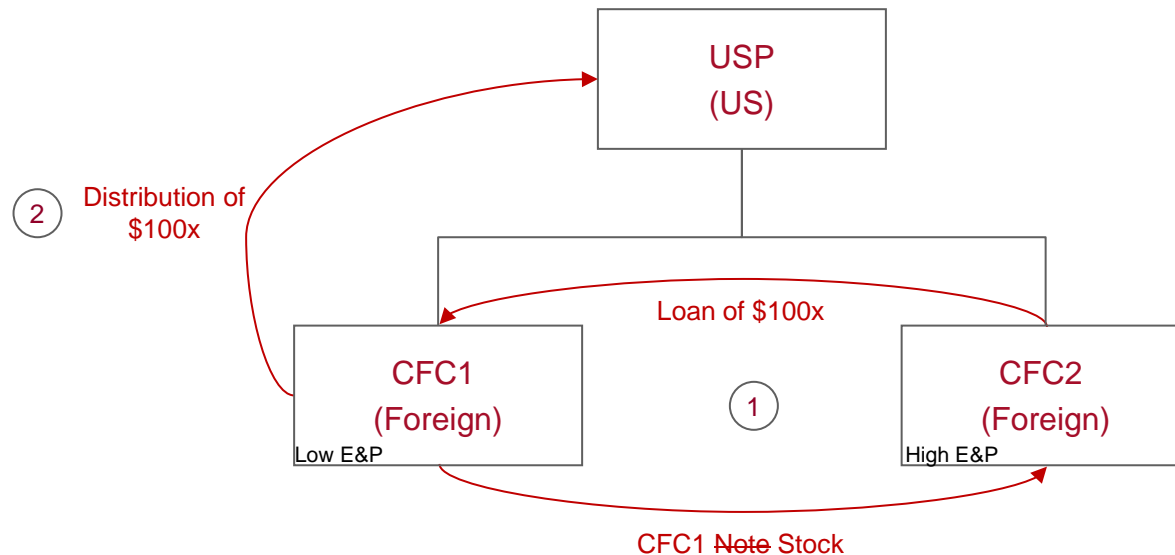
Funding Rule (Continued)

- Facts and circumstances test
- 72 Month Rule

Funding Rule: Example

Funded Distribution

Facts: First, CFC2 loans \$100x to CFC1 in exchange for a promissory note. Second, CFC1 distributes \$100x to USP.



Exceptions to General Rule and Funding Rule

- Current E&P Exception
- Threshold Exception

Disregarded Entities and Partnerships

– Disregarded Entities

- If the General Rule or the Funding Rule applies to recast debt issued by a disregarded entity as stock, the owner of the disregarded entity is deemed to issue the relevant instrument and the corresponding equity interest, thereby preserving the disregarded entity's disregarded status.

– Partnerships

- Similarly, if a partnership issues debt that is recharacterized under the General Rule or the Funding Rule, the partners (rather the partnership) are treated as issuing the equity in proportion to their profits and capital interests in the partnership, thereby avoiding the creation of a new interest and partner in the partnership.

Anti-Abuse Rule

- Debt instrument may be treated as stock if issued with a principal purpose of avoiding application of Prop. Reg. § 1.385-3.
- Allows IRS to treat instruments not denominated as debt as stock.

Timing Rules

- Instrument subject to the General Rule, Funding Rule, or Anti-Abuse Rule is generally treated as stock upon issuance.
- There are exceptions, including if a debt instrument is considered to fund a distribution or acquisition under the 72 month rule and the debt instrument is issued in a taxable year prior to the distribution or acquisition.

No Affirmative Use

- Taxpayers may not affirmatively use or invoke the rules of Prop. Reg. § 1.385-3 for “a principal purpose of reducing the federal tax liability of any member of the expanded group that includes the issuer and holder of the debt instrument by disregarding the treatment of the debt instrument that would occur without regard to [Prop. Reg. § 1.385-3].”

Effective Date

– General Effective Date

- Applies to (i) debt instruments issued on or after April 4, 2016, and (ii) debt instruments treated as issued earlier as a result of a CTB election that is filed on or after April 4, 2016.

– Transition Rules

- When applying the Funding Rule, distributions/acquisitions are only taken into account if they occurred on or after April 4, 2016.
- Recharacterization of a debt instrument as equity only occurs 90 days after final regulations are issued.

– Refinancing

- The effective date rules relate to the date an instrument is issued, including deemed issuances.
- An instrument that undergoes a significant modification is deemed reissued under Treas. Reg. § 1.1001-3.



Florida Bar Comments

- Due July 8, 2016