
Tax Alert

Treasury Releases Final Debt-Equity Regulations – Part III



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Our third and final Tax Alert on Treasury's section 385 regulations addresses the "recast" provisions of the regulations and also considers the regulations' impact on areas such as cash pooling arrangements. Our two previous Tax Alerts are available here:

[Part I](#)

[Part II](#)

Before we dive into these areas, it is worth taking note of Treasury's motivations in issuing the regulations. Congress enacted section 385 in 1969 to grant Treasury the power to set standardized rules determining whether an instrument qualifies as debt or equity. Treasury exercised its authority under the long dormant law in April of this year, releasing proposed section 385 regulations. In doing so, Treasury set its sights on a more modern issue: protecting the U.S. tax base from corporate inversions and earnings stripping. Accordingly, the proposed Section 385 regulations did not simply provide definitional rules for classifying financial instruments. Instead, they created a complex structure intended to prevent companies from shifting income to foreign jurisdictions via interest deductions. They also apply in the domestic context to prevent shifting of income and losses, thus wholly domestic taxpayers must still be prepared to comply with the regulations. After extensive public comments, Treasury finalized the regulations this October.



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Recharacterization/Debt Recast Rules:

The final section 385 regulations contain recast rules that target certain transactions perceived to be abusive by recharacterizing debt instruments as equity. These rules apply to debt instruments, or “expanded group interests” (EGIs), issued between members of the same “expanded group.” An expanded group is defined with reference to a modified application of the affiliated group rules set forth in Section 1504(b). Unlike an affiliated group, an expanded group includes related foreign corporations.

The recast rules recharacterize debt instruments as equity when such instruments are issued in certain specified transactions. The final regulations generally treat the following instruments, issued between members of the same expanded group, as equity:

1. EGIs issued to a shareholder as a distribution with respect to the issuer’s stock;
2. EGIs issued in exchange for stock of an expanded group member; or
3. Certain EGIs issued as consideration in an exchange pursuant to an internal asset reorganization.

The regulations contain considerable detail and provide for certain some exceptions in the treatment of these three transactions which goes beyond the scope of this Alert. However, Taxpayers should be aware that Treasury has identified these three unfunded debt instruments as coinciding with earnings stripping with little associated economic effect or non-tax motivation. Further, the recharacterization of an EGI under the recast rules is not rebuttable. Accordingly, taxpayers should seek assistance from their tax advisors before issuing any debt instrument that could implicate these rules.

As a further trap for unwary taxpayers, the final regulations retain the proposed regulations’ “funding rule” that characterizes any EGI as equity if it is issued within a three year period before or after any of the above three transactions. Although numerous commenters requested that Treasury reconsider this per se funding rule, Treasury concluded that no other option was practical given the fungible nature of money and the risk that the recast provisions would be otherwise easily circumvented.

Cash Pooling & Short Term Funding Arrangements:

Commentators also raised concerns about the potential for the proposed regulations to disturb cash pooling arrangements of corporate treasury operations. Fortunately, the temporary section 385 regulations (issued contemporaneously with the final regulations) seek to exempt cash pooling arrangements from being recast as equity under the funding rule. The regulations provide multiple tests to exempt cash pooling arrangements. The most useful one will likely be the “270-day test” which exempts certain instruments bearing arms-length interest rates with terms of 270 days or less.

The temporary regulations also contain a broadened ordinary course exception which will generally exempt ordinary course loans reasonably expected to be repaid within 120 days of issuance. This exempts debt such as trade payables from being recast as equity under the section 385 regulations.

Elimination of the Bifurcation Rule:

The final section 385 regulations removed the proposed regulations’ “bifurcation” rule. Under the proposed rule, the IRS, but not taxpayers, would have the ability to classify an issued instrument as part-debt and part-equity. This proposed rule was eliminated from the final regulations, in part, because of the many comments Treasury received regarding the rule’s lack of specificity and its difficult application in practice. As such, the final section 385 regulations leave in place the “all-or-nothing” approach which classifies an issued instrument as either debt or equity.

However, the preamble to the final section 385 regulations indicates that Treasury will continue to study this issue, leaving the door open for future implementation of a bifurcation rule.

State Tax Implications:

As taxpayers seek to comply with the rules and requirements of the final section 385 regulations, they must also bear in mind how these rules may apply at the state level. It is unclear to what extent states will adopt the section 385 regulations. And, although most states conform their tax system to the Internal Revenue Code, they do not necessarily fully adopt the associated federal regulations. If a taxpayer's debt is recast as equity by the IRS, they will need to evaluate how a recasted EGI is treated at the state level.

Please contact your WeiserMazars tax professional for more information.

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