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# Tax Alert

## Treasury Releases Final Debt-Equity Regulations – Part II



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This Tax Alert is the second in the Final Debt-Equity Regulations series regarding final Section 385 regulations specifically covering documentation rules.

See [Final Debt-Equity Regulations — Part I](#)

### Documentation Requirements

The documentation rules contained in the final Section 385 regulations maintain the same general requirements as the proposed 385 regulations. The regulations still mandate strict documentary requirements for an intercompany loan to be treated as debt for tax purposes. Failure to comply with these requirements will result in intercompany loans being characterized as equity, resulting in the elimination of interest expense deductions and other potentially adverse implications.

### Overview of Requirements

The section 385 regulations 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. Although members of the same consolidated group are exempt from the documentation requirements, an expanded group is defined more broadly than a consolidated group. Therefore, the documentation requirements may still apply in a purely domestic context involving related companies which do not join in filing a consolidated return.



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The final documentation rules retain the proposed regulations' four-part test to determine whether an EGI is treated as debt for tax purposes:

1. Written documentation evidencing a legally binding obligation to repay the borrowed funds must be timely prepared and signed by all relevant parties.
2. The intercompany instrument must also establish that the intercompany lender has the customary rights of a creditor to enforce the receipt of all required payments under the obligation. Moreover, the intercompany lender must possess a superior right over shareholders to share in the assets of the borrower if the borrower is dissolved or liquidated.
3. The intercompany lender must have a reasonable expectation of repayment at issuance of the EGI. Documentation evidencing such an expectation includes cash flow projections, financial statements, business forecasts, asset appraisals, and debt-to-equity or other financial ratios. Non-recourse financing must be supported by documentation establishing the fair market value of any property securing the instrument. The documentation may also reflect the assumption that the principal amount of the debt instrument will be satisfied with the proceeds of another borrowing by the issuer and the reasonableness of such assumption in the circumstances. The documentation may also include evidence that in the relevant circumstances, a third party would have lent funds with similar terms and conditions.
4. Documentation must be maintained that evidences an ongoing relationship during the life of the instrument consistent with an arm's-length debtor-creditor relationship. Upon the occurrence of any default, the documentation should evidence the "holder's reasonable exercise of the diligence and judgment of a creditor" such as the assertion of its creditors' rights and efforts to renegotiate the debt instrument. Any decision not to enforce creditors' rights must be supported by documentation indicating that such decision was a "reasonable exercise of the diligence and judgment of a creditor."

As in the proposed regulations, the documentation rules only apply to expanded corporate groups with total assets of \$100M, annual revenue of \$50M, or if any member of the group is publicly traded on an established financial market. These rules are effective on January 1, 2018, and do not apply to instruments issued before that date.

Additionally, the regulations provide a consistency rule that requires holders to characterize an instrument as debt if the issuer treated such instrument as debt. However, if the instrument is subsequently characterized as stock, both the issuer and holder must then treat the instrument as stock for tax purposes.

#### *Additional Relief Provided in Final Regulations*

Although the general documentation requirements are largely unchanged, Treasury has pared back the types of entities covered under the regulations. Debt instruments issued by foreign corporations; S corporations; and non-controlled RICs and REITs are exempt from the final section 385 regulations and therefore do not need to comply with the documentation rules.

Additionally, a company's documentation evidencing the issuance of debt is now treated as timely if it is completed by the company's federal income tax return deadline, including extensions. Under the proposed regulations, documentation would have been treated as timely only if it was prepared 30 days after the issuance of the debt instrument. Coupled with the 2018 effective date, taxpayers now have an extended period of time to become compliant with the new rules.

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The final regulations also liberalize the rules surrounding documentation failures. The proposed regulations provided a per se rule that automatically recharacterized an instrument as equity if it did not satisfy the documentation rules. The final regulations provide three exceptions to the per se recharacterization rule.

The first potential exception is the creation of a rebuttable presumption that a noncompliant instrument is equity. In order to overcome this presumption, the taxpayer must first demonstrate that its expanded group is otherwise “highly compliant” with the documentation requirements. This generally requires that EGIs representing at least 90% of the outstanding issue price of all covered EGIs within the expanded group comply with the documentation rules. Once high compliance is established, the taxpayer can rebut the presumed equity characterization using prescribed factors indicating debt: (1) an unconditional obligation to pay a sum certain; (2) creditor’s rights; (3) a reasonable expectation of ability to repay; and (4) actions evidencing the debtor-creditor relationship.

Second, there is also a reasonable cause exception requiring the demonstration of “significant mitigating factors” or that the failure arose from events beyond the taxpayer’s control. Upon establishing reasonable cause, the required information and documentation must also be prepared “within a reasonable time.” Third, the regulations provide that the “ministerial or non-material failure[s]” of a taxpayer may be corrected prior to discovery by the IRS.

Last, the final regulations add a market standard safe harbor which provides that documentation customarily used in comparable third-party debt transactions will satisfy the documentation requirements of the section 385 regulations. Although the documentation rules are not effective until 2018, a taxpayer is well advised to avoid undue delay in implementing appropriate procedures in light of the significant compliance burden imposed by the regulations and the adverse consequences associated with noncompliance.

Please contact your WeiserMazars tax professional for more information.

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