

## US tax newsletter | November 2016



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Proposed v/s Final IRC Section 385 regulations  
This thought leadership paper provides a comparative analysis.

On October 13, 2016, the US Treasury Department (*‘the Treasury’*) and the Internal Revenue Service (*‘the IRS’*) released final and temporary regulations under Internal Revenue Code Section 385 (*‘TD 9790, the final regulations’*). The final regulations have significantly narrowed the scope of the proposed regulations.

### **Effective date for applicability of final 385 regulations:**

It generally applies to tax years ending on or after January 19, 2017, which is 90 days after the Final Regulations are published in the Federal Register (*October 21, 2016*).

### **Documentation Rule:**

The Documentation Rule (*‘Reg. Section 1.385-2’*) applies only to an EGI that is issued or deemed to be issued on or after January 1, 2018. Consequently, an EGI issued or deemed to be issued before January 1, 2018, will not be subject to the rules of Reg. Section 1.385-2. Additionally, despite the delayed implementation date, taxpayers should consider preparing written documentation of the four indebtedness factors for debt instruments issued prior to January 1, 2018 under general US federal income tax principles.

### **Recharacterization Rule:**

The Recharacterization Rule, applies to debt instruments issued on or after April 5, 2016. The Transition Rules provide that covered debt instruments issued after April 4, 2016, and before January 19, 2017, will be recharacterized as stock on January 19, 2017, subject to an anti-abuse rule.

### **Differences between proposed and final regulations:**

Although the final regulations retain much of the general approach of the proposed regulations, they also contain numerous and significant modifications, detailed below:

Proposed regulations	Final regulations
<p><b>Covered member</b></p> <p>In the proposed regulations, all the members of an expanded affiliated group were covered. Thus, even the foreign corporations were covered within the scope.</p>	<p>Reg. Section 1.385-1 limits the present scope of the final regulations to debt instruments issued by a domestic corporation (<i>and certain partnerships and disregarded entities with domestic corporate owners</i>). Reg. Section 1.385 1(c)(2) achieves this result by introducing the new fundamental concept of a ‘covered member’, defined as a member of an expanded group that is a domestic corporation.</p>

	This change has the effect of excluding, foreign-to-foreign and US-to-foreign ( <i>'outbound'</i> ) loans from the scope.
<b>Bifurcation Rule</b>	
This Rule allowed the IRS to bifurcate an instrument into part debt and part equity, based upon an analysis of the relevant facts and circumstances.	The final regulations removed the general 'bifurcation' Rule contained in the proposed regulations. Thus, it is back to All or None rule.
<b>Documentation Rule</b>	
The compliance deadline was within 30 days from the date the debt instrument was issued.	Documentation Rules apply only to an EGI that is issued or deemed issued on or after January 1, 2018. The compliance deadline is the issuer's federal income tax return filing date ( <i>considering all applicable extensions</i> ).
Required separate credit analyses for each debt issuance.	Annual credit analysis may be used to support an issuer's ability to repay multiple debt instruments.
The Documentation Rules generally apply to an EGI between members of the same 'expanded group including Controlled Partnerships'.	Documentation rules do not apply to partnership issued debt.
An EGI issued by a disregarded entity ( <i>a 'DRE'</i> ) that doesn't satisfy the Documentation Rules is recharacterized as stock to the disregarded entity itself.	An EGI issued by a disregarded entity ( <i>a 'DRE'</i> ) that doesn't satisfy the Documentation Rules is recharacterized as stock of its regarded owner.
<b>Non-compliance of documentation requirements</b>	
Failure to comply with the Documentation Rules generally results in an EGI being recharacterized as stock for all US tax purposes.	Failure to comply with the Documentation Rules generally results in an EGI being recharacterized as stock for all US tax purposes. However, in the final regulations, two new exceptions have been added: - Rebuttable presumption: If the expanded group is otherwise 'highly compliant', the EGI is respected as debt if issuer clearly establishes that the EGI is properly treated as debt under common law. - Taxpayer remedy: Taxpayer can remedy ministerial or non-material non-compliance or error, if the remedy is complete prior to the IRS discovery.
<b>Affirmative use reservation</b>	
The proposed regulations prohibited taxpayers from affirmatively using the Re-characterization and documentation Rule by non-compliance to convert the debt instruments into stock.	The final regulations are expressed reservation on this point in Reg. 1.385-2, while the Treasury and the IRS are further considering this issue.
<b>Transaction Rule</b>	
The proposed regulations exempted debt instruments issued in General Rule or Funding Rule transactions to the extent of the issuer's current	The final regulations expand the earnings and profits exception in the proposed regulations. The final regulations exempt debt instruments

earnings and profits.	issued in such transactions to the extent of the earnings and profits accumulated in tax years ended on or after April 5, 2016, and derived while the entity was a member of the same expanded group.
<b>The cliff effect of the US\$ 50 million threshold exception.</b>	
The Rule in the proposed regulations applied if the covered debt instruments exceeded US\$ 50 million.	The Re-characterization Rule applies to the extent the covered debt instruments exceeds US\$ 50 million.
<b>Key exceptions to transaction rule</b>	
None	<ul style="list-style-type: none"> <li>- Instruments issued by certain regulated financial institutions;</li> <li>- Ordinary-course loans which are expected to be repaid within 120 days;</li> <li>- Interest-free loans, on which imputation is not applicable;</li> <li>- Short-term funding arrangement; &amp;</li> <li>- Compensatory stock acquisitions.</li> </ul>

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