

Internal Revenue Code §385 Debt/Equity Regulations

Over the years there has been little regulatory guidance regarding whether a “loan” is characterized as “debt” or “equity.” Ultimately, the analysis is one of facts and circumstances. On October 21, 2016, the US Treasury Department published final and temporary regulations (the “**Regulations**”) under Section 385 of the Internal Revenue Code.¹ These Regulations are considered the most important debt/equity regulations issued in years.

The Regulations affect, in particular, debt obligations of United States (“US”) subsidiaries to a foreign affiliate. US-to-foreign and foreign-to-foreign loans are excluded. Because of the broad nature of the Regulations your company should take appropriate measures to ensure that its intercompany financing, payables, and cash management processes and procedures will enable full compliance with the new rules. The Regulations have two main parts:

- 1) the Documentation Rules (effective for debt issued on or after January 1, 2018); and
- 2) the Recast Rules (effective for debt issued after April 4, 2016).

1. The Documentation Rules

The Documentation Rules will have the broadest impact, as they must be satisfied for a debt instrument to constitute indebtedness for US federal tax purposes. They apply to a wide variety of debt, including trade payables, issued by a US entity to another entity within an “expanded group” (“EG”) of affiliated entities (defined to include foreign affiliates) in which:

- a) any member of the EG has publicly traded stock,
- b) aggregate annual revenue of the EG is more than \$50 million, or
- c) total assets of the EG are more than \$100 million.

An EG generally includes all corporations connected to a common parent that owns, directly or indirectly, 80% by vote or value of each such corporation.

The Documentation Rules impose minimum written documentation, financial diligence and behavioral requirements. These rules require that:

- a) there is an unconditional and legal obligation to pay a sum certain,
- b) the holder has the rights of a creditor to enforce the obligation,
- c) there is a reasonable expectation, as of the date the debt is issued, that the debt will be repaid, and
- d) sufficient actions are being taken to evidence the debtor/creditor relationship, such as the timely payment of interest and penalties and the enforcement of debt terms.

The Documentation Rules apply only to debt instruments issued on or after January 1, 2018, and the documentation is not required to be completed until the due date of the issuer’s tax return, as timely extended, for the year in which the debt is issued or other relevant date. The maintenance rules require that the information be maintained for all tax years that the

¹ T.D. 9790 (10/21/2016).



debt it outstanding and until the statute of limitations expires for any tax return for which the treatment of the debt is relevant.

If the Documentation Rules are not satisfied, the affected debt would be treated as stock from the date of issuance or such relevant date on which the behavior of the issuer and holder was no longer consistent with the instrument being considered debt. However, recharacterization may be avoided under certain exceptions. For instance, if an EG has been highly compliant, then the automatic recharacterization instead becomes a rebuttable presumption. The Documentation Rules are in addition to, and not in lieu of, current requirements for an instrument to be considered debt.

2. Recast Rules

The Recast Rules have a narrower scope. Debt issued by a US entity is reclassified as stock if issued to certain entities with an EG in certain intra-group transactions. These transactions are:

- a) a distribution of covered debt instruments,
- b) issuances of covered debt instruments in exchange for stock of a member of an EG, and
- c) issuances of covered debt instruments as consideration in an exchange for property in certain intra-EG asset reorganizations.

The Recast Rules also extend to debt that is deemed used to fund such transactions. There are exceptions for certain transactions and types of debt instruments. Moreover, up to \$50 million of debt that would otherwise be Recast is exempt.

Summary

The Regulations will have a substantial impact on the intercorporate operations of medium and large foreign multinationals with US affiliates. The broadest impact is with respect to the Documentation Rules effective in 2018. The Regulations are highly controversial and will affect the way foreign companies do business in the US on a day-to-day basis. Many business groups have petitioned the Trump Administration to rescind them, but there is no certainty when and if such action will be taken.

Consideration should also be given to how US state and local taxing authorities will apply these debt/equity rules, whether by conforming with the US federal income tax treatment or applying them differently.

We recommend that companies begin to adopt strategies to comply with the Documentation Rules if the Regulations are not rescinded in the coming months. In light of the Recast Rules, we recommend that affected companies seek advice with respect to intercompany restructurings and other transactions that involve the use of debt.

The content in this Alert is for general information purposes only, and it should not be relied upon as professional advice.

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