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Final §385 Regulations Apply to CFC Loans to Domestic Corporations

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The Treasury and IRS recently issued final regulations under §385 that reclassify certain indebtedness as equity.[1] While the final regulations have limited application to U.S.-based multinationals, they do apply to obligations of domestic corporations to related controlled foreign corporations (''CFCs''). It is critical to avoid such debt being reclassified as stock under the regulations because of the significant adverse U.S. tax consequences.

Final §385 Regulations

An interest in a corporation generally is classified as debt or stock based on factors set forth in case law.[2] The courts look at multiple factors in assessing whether purported debt should be reclassified as equity. Debt features include that the instrument is in the form of debt, has a fixed maturity, contains an obligation to pay interest regardless of profits, and is not subordinate. No single factor is controlling, and the application of the factors depends on the particular facts and circumstances. There are hundreds of litigated cases that address the issue of whether an instrument is debt or equity.[3]

The final §385 regulations impose additional requirements for an instrument classified as debt under common law to be treated as debt for tax purposes. These special rules apply, however, only to debt issued by a domestic corporation to a related person (i.e., a member of the ''expanded group'').[4] Therefore, the special rules do not apply to debt issued by a CFC. In addition, the reclassification rules generally do not apply to loans between members of a consolidated group.[5]

The §385 regulations provide that debt issued by a domestic corporation to a related corporation must satisfy detailed documentation requirements to be considered as debt. In addition, such debt will be reclassified as stock if issued in a specified transaction or issued to fund such a transaction.

The regulations require that records be maintained documenting:

- The issuer's unconditional obligation to pay a sum certain;
- The holder's creditor's rights; and
- The reasonable expectation of the issuer's ability to repay the debt.

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[1] T.D. 9790, 81 Fed. Reg. 72,858 (Oct. 21, 2016). The regulations generally apply to taxable years ending on or after January 19, 2017, with respect to debt instruments issued after April 4, 2016. Reg. §1.385-3(j). *See also* REG-108060-15, 81 Fed. Reg. 20,912 (Apr. 8, 2016) (proposed regulations); Yoder, *Code Sec. 385: Proposed Debt vs. Equity Regs Would Limit Planning*, 42 Int'l Tax J. 3 (July-Aug. 2016).

All section references are to the U.S. Internal Revenue Code of 1986, as amended (the ''Code'') or the Treasury regulations thereunder, unless otherwise indicated.

[2] Reg. §1.385-1(b).

[3] *See, e.g., Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968); *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972). *See* discussion of cases in Staff of the Joint Committee on Taxation, *Overview of the Tax Treatment of Corporate Debt and Equity*, CX-45-16 (May 20, 2016).

[4] The final §385 regulations generally apply to indebtedness of a covered member (defined as a domestic corporation) owed to a member of an expanded group (80% vote or value ownership test). Reg. §1.385-1(c)(2), §1.385-1(c)(4). The final regulations also apply to debt issued by a disregarded entity of a domestic corporation, and, in certain cases, to debt issued by partnerships within an expanded group that have domestic corporate owners. Reg. §1.385-1(c)(1), §1.385-1(c)(3), §1.385-1(c)(4).

[5] Reg. §1.385-4T. However, for state tax purposes the exception for loans between consolidated group members may not apply if the state does not follow the federal consolidated return rules.

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In addition, documentation must be maintained regarding the ongoing activity after a debt is issued evidencing the debtor-creditor relationship, such as paying interest and principal and enforcing default provisions.[6] The documentation requirements apply to debt issued on or after January 1, 2018.[7]

Intercompany payables arising from ordinary course transactions are subject to the §385 documentation requirements. Special rules are provided for documenting revolving credit agreements, cash pooling arrangements, and similar arrangements that cover intercompany indebtedness under a master agreement.[8]

Debt issued by a domestic corporation to a member of the expanded group that is properly documented will nevertheless be reclassified as equity when issued:

- In a distribution with respect to stock;
- In exchange for stock in an expanded group member; or
- In exchange for property in an asset reorganization and a related shareholder in the transferor corporation receives the debt.[9]

In addition, a related-party loan that funds any of the above transactions generally would be reclassified as stock.[10]

There are several important exceptions to the transaction rule. First, an instrument is not reclassified to the extent of the corporation's earnings and profits accumulated in taxable years ending after April 4, 2016. To the extent that the amount of the instrument exceeds such accumulated E&P, the amount subject to reclassification is reduced by qualified contributions made to the issuer within three years before or after the distribution or acquisition.[11] Furthermore, any group indebtedness otherwise subject to the transaction rule is reduced by $50 million.[12]

The funding rule generally applies to reclassify debt issued for property during the period 36 months before and ending 36 months after a relevant distribution or acquisition transaction. Loans outside this period can be subject to the funding rule if issued for property with a principal purpose of funding the relevant distribution or acquisition transaction.[13] The preamble explains that the funding rule applies only to debt instruments issued for property and that debt instruments issued in exchange for the use of property or the performance of services are outside the scope of the funding rule.[14]

Exceptions are provided to the funding rule for certain short-term loans. Indebtedness will not be reclassified if issued in the ordinary course of the issuer's trade or business and is reasonably expected to be repaid within 120 days (e.g., a trade payable).[15] An exception is also provided for debt instruments with short-term interest rates to the extent of the issuer's current assets other than cash and cash equivalents. Alternatively, an exception is provided for debt instruments with short-term interest rates and a term of 270 days or less, provided that the issuer is relying on the exception with respect to all lenders for less than 270 days during the taxable year.[16] A short-term interest rate is one that does not exceed an arm's-length interest rate (as determined under §482 principles) for a comparable instrument that has a term no greater than the longer of 90 days or the issuer's "normal operating cycle."[17]

Section 956

An obligation of a domestic corporation to a related CFC is considered as an investment in U.S. property held by the CFC for purposes of §956. Subpart F generally requires the U.S. shareholders of the CFC to include in income the average of the amounts of such loans outstanding on the last day of each quarter.[18] This amount is reduced by the CFC's earnings that were previously subject to U.S. taxation under Subpart F, and limited to the earnings and profits of the CFC that have not been previously subject to U.S. taxation. An inclusion under §956 is treated as a dividend for purpose of applying the foreign tax credit rules.[19]

Exceptions to the definition of U.S. property are provided for receivables held by a CFC that arise in

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[6] Reg. §1.385-2.

[7] Documentation must be completed by the due date of the issuer's tax return for the year of issuance (including extensions). Reg. §1.385-2(c)(4).

[8] Reg. §1.385-2(c)(3).

[9] Reg. §1.385-3(b)(2) (the "general rule"). The regulations do not generally address hybrid financing arrangements. For a discussion of such arrangements, see Yoder, *Cross-Border Hybrid Financing Arrangements*, Int'l Tax J. (Jan.-Feb. 2015), at 3.

[10] Reg. §1.385-3(b)(3) (the "funding rule").

[11] Reg. §1.385-3(c)(3). In the case of consolidated groups, the earnings and profits of the issuing corporation and all of its lower-tier consolidated return subsidiaries can be aggregated.

[12] Reg. §1.385-3(c)(4). Also, exceptions are provided for shares acquired for compensation and for acquisitions of stock in a direct or indirect subsidiary. Reg. §1.385-3(c)(2)(i), §1.385-3(c)(2)(ii).

[13] Reg. §1.385-3(b)(3)(iv). The regulations apply the fungibility principle, such that even if a loan is issued to purchase property, the funding rule nevertheless can apply to treat the loan as funding a prior or subsequent specified transaction.

[14] T.D. 9790, 81 Fed. Reg. at 72,902–03 (Oct. 21, 2016).

[15] Reg. §1.385-3T(b)(3)(vii)(B).

[16] Reg. §1.385-3T(b)(3)(vii)(A)(2).

[17] Reg. §1.385-3T(b)(3)(vii)(A)(*1)(ii*).

[18] §951(a)(1)(B), §956.

[19] §960.

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connection with the sale or processing of property or the provision of services. These exceptions apply only to the amount of an obligation that is ordinary and necessary to carry on the trade or business of both the CFC and related U.S. person.[20]

An exception also is provided for an obligation of a related U.S. person held by a CFC at the end of a quarter if the loan is repaid within 30 days from the time it is incurred (the ''30-day exception''). This exception applies only if the CFC does not hold for 60 or more days during its taxable year any obligations of related U.S. persons which would be subject to §956.[21]

A CFC may affirmatively make a loan to a related domestic corporation that is subject to §956 when a CFC has earnings that were previously taxed under Subpart F and a dividend distribution would be subject to foreign taxation or legal restrictions. The loan should not trigger an inclusion under Subpart F to the extent of the CFC's previously taxed earnings.[22] In addition, multinational groups may have a CFC make loans (which, of course, are not subject to foreign withholding taxes) subject to §956 to related domestic corporations if the CFC's earnings are subject to a high effective foreign income tax rate, and the accompanying deemed paid foreign taxes would offset U.S. taxes and result in excess foreign tax credits.

Application of §385 to CFC Loans to Domestic Affiliates

General. In the normal case, a loan made by a CFC to a related domestic corporation will be classified as debt under common law. There generally will be particular vigilance in satisfying the factors for debt treatment because, as discussed below, treating such loans as stock results in significant detrimental U.S. tax consequences.

Such loans also must now avoid treatment as stock under the final §385 regulations even if they clearly satisfy the common law standards for treatment as debt. First, they must comply with the §385 documentation requirements, which apply to any loan made by a CFC to a related domestic corporation (i.e., a member of the expanded group). This includes short-term loans and intercompany trade or services receivables. If the documentation rules are not satisfied for a loan, it will be reclassified as equity.[23]

If a CFC loan to a related domestic corporation is properly documented, it will be necessary to confirm that the loan is not subject to the specified transaction rules that can apply to reclassify the loan as stock. Those rules generally should not apply to such loans because the §385 regulations do not apply to a loan issued by a domestic corporation for cash or to payables resulting from ordinary course business transactions. In addition, it will be uncommon for a publicly traded domestic company to engage in one of the specified transactions involving a CFC (or any related person), and in any event, one of the exceptions may apply (e.g., the earnings and profits exception).

Finally, it will be necessary to confirm that the funding rules do not apply to reclassify a CFC loan made to a related domestic corporation. This rule would apply if the domestic corporation (or a member of the consolidated group) implemented one of the above-specified transactions within three years before or three years after the loan, or the loan otherwise has a principal purpose to fund such a transaction. As mentioned above, the funding rule generally does not apply to short-term loans and to obligations arising from providing services or for the use of property.

Section 956. If the §385 regulations apply to reclassify a CFC's loan to a related domestic corporation as equity — e.g., because the instrument does not satisfy the documentation requirements — the investment would nevertheless continue to be subject to §956. That section applies to investments in stock in, as well as obligations of, related domestic corporations.[24]

Reclassifying a CFC loan as equity raises an issue concerning the application of various §956 exceptions for obligations. For example, the exceptions for trade payables and services payables apply only to ''obligations,'' which the regulations define as indebtedness.[25] Because the §385 regulations are intended to determine the status of an instrument for all federal income tax purposes,[26] there may be a question concerning whether these exceptions are available for a payable that is reclassified as stock.[27]

In addition, a loan reclassified as equity may not qualify for the 30-day exception, since the 30-day exception applies only to ''obligations.'' The 60-day limitation may not take into account an obligation that is reclassified as equity. On the other hand, a loan reclassified as equity which is outstanding during a

[20] §956(c)(2)(C); Reg. §1.956-2(b)(1)(v), §1.956-2T(d)(2)(ii). A 60-day safe harbor is provided for services receivables.

[21] Reg. §1.956-2T(d)(2)(iv).

[22] §951(a)(1)(B), §959.

[23] The regulations provide exceptions to *per se* stock classification if a group demonstrates a high degree of compliance with the documentation requirements, the failure is a ministerial error or non-material, or there is reasonable cause for failing to properly document a loan. Reg. §1.385-2(c)(2).

[24] §956(c)(1)(B).

[25] Reg. §1.956-2T(d)(2).

[26] 81 Fed. Reg. at 72,871 (Oct. 21, 2016).

[27] A CFC's prepayments for inventory, services or royalties generally are not treated as indebtedness, and therefore should not be subject to the §385 regulations. *See* Yoder, *Improving Efficiency of Global Cash Utilization: Accelerated Payments for Inventory*, 38 Tax Mgmt. Int'l J. 171 (Mar. 13, 2009).

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quarter but not on the last day of the quarter should not be an investment in U.S. property under §956.

Other Consequences of Equity Treatment. There are other detrimental U.S. tax consequences of reclassifying a CFC loan to a related domestic corporation as stock. First, the domestic corporation would not be entitled to a deduction for interest expense,[28] but the interest income generally would be subject to taxation in the CFC's country of tax residence.

Furthermore, a payment of interest that is treated as a payment of a dividend could be subject to 30% U.S. withholding tax.[29] The stock ownership resulting from the reclassified debt instrument would not provide voting rights required to meet the typical voting stock ownership threshold to qualify for reduced withholding tax under U.S. income tax treaties.[30] In addition, if some interest on the instrument accrues but is not paid, the accruals could be deemed to be taxable stock dividends under §305(b). Moreover, the repayment of the principal amount of a reclassified loan can be treated as a dividend if the loan is to a domestic brother-sister affiliate, and therefore also can be subject to a 30% withholding tax.[31]

In addition, if the principal repayment by a domestic brother-sister affiliate is treated as a dividend, it would be Subpart F income to the CFC.[32] In calculating net Subpart F income, such dividend should be reduced by the 70% dividends received deduction.[33] The net amount of Subpart F income would be included in the income of the U.S. shareholder generally as U.S.-source income for foreign tax credit purposes, in which case U.S. tax liability on such income could not be reduced by foreign tax credits.[34] The earnings and profits resulting from treating the principal repayment as a dividend — unreduced by the dividends received deduction — would be taken into account for purposes of applying §956 to the loan, but any amount included in the income of the U.S. shareholders as Subpart F income would give rise to previously taxed income, which would reduce the amount of any inclusion under §956.[35]

In sum, the consequences of the regulations reclassifying as equity a loan from a CFC to a U.S. affiliate can be a disaster, and the final §385 regulations require additional analysis and compliance to avoid this result. Therefore, U.S.-based multinationals should enhance their protocols and procedures for monitoring and limiting CFC loans to related domestic corporations. Vigilance in documenting such loans, including ordinary course payables and short-term loans, is critical. In addition, planning using §956 loans must carefully analyze the final §385 regulations and confirm that the transaction and funding rules do not apply (which is an ongoing process).

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[28] *See* §163(a) (providing a deduction for "all interest paid or accrued within the taxable year on indebtedness").

[29] §881(a), §1441(a).

[30] For example, under the U.S.-Luxembourg Income Tax Treaty of 1996, Article 10, in order to qualify for the reduced 5% rate on dividends, the beneficial owner of the dividend must own "directly at least 10 percent of the voting stock of the company paying the dividends."

[31] §302(d). If the loan is to a parent or grandparent, the repayment should be treated as a payment in exchange for the stock rather than as a dividend, because a subsidiary is not attributed ownership of its direct or indirect parent for purposes of the dividend and redemption rules. §302(a); Rev. Rul. 74-605, 1974-2 C.B. 97. In certain cases the deemed redemption of stock upon the repayment could give rise to taxable gain for the CFC that would also be treated as Subpart F income.

[32] §954(c)(1)(A). Section 954(c)(6) would not be available because the dividend payor would not be a related CFC. In addition, the Subpart F exception that applies to U.S.-source income effectively connected with a U.S. trade or business would not apply. §952(b). *See* Yoder, *The Interplay between Subpart F and the Effectively Connected Income Rules*, 45 Tax Mgmt. Int'l J. 625 (Oct. 4, 2016).

[33] §243. *See* PLR 200952031 (holding that distributions from a domestic corporation to a CFC were eligible for a dividends received deduction under §243). *See also* §954(b)(5) (Subpart F income is reduced for deductions allocated and apportioned to such income, including taxes).

[34] §904(h)(1); *but see* §904(h)(10) (election to treat domestic source income as separate basket foreign source income if a treaty applies).

[35] Earnings arising from the repayment of the principal that are not otherwise taxable to the U.S. shareholders under Subpart F can be subject to further taxation when distributed to the U.S. parent. *See* Yoder, *CFC Sandwich Structures: Applying the DRD to Subpart F Income & CFC Dividends*, 40 Tax Mgmt. Int'l J. 616 (Oct. 14, 2011).

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