Oral Testimony before the Internal Revenue Service on the Sec. 385 Proposed Regulations
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July 14, 2016

The NAM is the nation's largest industrial association and voice for more than 12 million women and men who make things in America. Manufacturing in the United States supports more than 17 million jobs, and in 2014, U.S. manufacturing output reached a record of nearly $2.1 trillion. The NAM is committed to achieving a policy agenda that helps manufacturers grow and create jobs.

I appreciate the chance to highlight the NAM's serious concerns with the rules that will treat related-party debt issued in common business transactions as equity. While the proposal was released as part of a package of guidance designed to curb cross-border mergers, these broad regulations go well beyond inversions and threaten legitimate and well-established business practices, from corporate reorganizations to day-to-day funding activities to business portfolio decisions to investments in plant and equipment.

The Impact on Manufacturers

In a June 2016 NAM survey, more than two thirds of respondents said the regulations would alter routine funding of business operations. Manufacturing is a capital intensive industry and intercompany loans play an important role in the natural business cycle of manufacturers as products are manufactured and sit in inventory awaiting distribution and ultimate sale. Plainly stated, intercompany loans allow manufacturers to efficiently move cash, which in turn reduces outside borrowing costs, enables the funding of one-time costs such as mergers and acquisitions, mitigates currency exposure, reduces withholding taxes, addresses currency controls, provides needed liquidity, and aggregates buying power.

By restricting the use of intercompany debt, the regulations will increase the financing costs of U.S companies. In fact, 60 percent of manufacturers responding to our survey said the regulations would push them to rely more on third party debt, increasing the cost of capital. A higher cost of capital will take resources from other business activities, such as R&D, the expansion of operations, and the acquisition of businesses and assets.

More than 80 percent of respondents in our survey said the regulations would result in increased compliance burdens and costs. These new administrative costs on global and domestic manufacturers in the United States, including costs for tracking debt, legal fees, costs arising from system changes, additional currency risks, higher hedging costs and external audit fees, also will divert funds from capital investment and job creation.

Moreover, the uncertainty created by the rules makes prudent business planning difficult. These sometimes ambiguous rules will create more uncertainty for companies in the United

States. In addition, the rules nullify some existing tax provisions enacted with bipartisan Congressional support. Piecemeal changes to our current system, particularly those made through regulations without open consideration and debate, make a bad system far worse.

Problems Posed by Prop. Reg. 1.385-3

Cash Pooling and Short-Term Loans

Global manufacturers typically manage cash through cash pooling arrangements and short-term intercompany loans. Indeed, in our June 2016 survey, 82 percent of respondents said they use cash pooling or intercompany loans to fund operations or investments, primarily for improved oversight and control over cash management.

Under the proposed regulations, the debt instruments issued in cash pooling arrangements—which can number thousands a day for a single company —would be subject to the complexity and domino effect of the recast rules even though cash pools are set up to meet a business' treasury needs, not to execute a tax-benefited transaction. The proposed regulations cause intercompany loans to be recast as a series of cross chain equity investments and redemptions, thereby distorting the income of the group members.

Additional clarification is needed to ensure that such standard business practices do not become administratively impossible to operate. Any final guidance should exempt cash pool loans and inter-company short-term loans executed as a result of a treasury management system and used to finance operating costs or capital expenditures among related parties.

Distributions from Accumulated E&P

Under the proposed regulations, when a company deploys its cash via intercompany debt deemed to fund a distribution or an acquisition, that debt is recharacterized as equity to the extent the debt exceeds the issuer's current earnings and profits (E&P). Since there is little conceptual difference between current and accumulated E&P, not permitting the distribution of accumulated earnings is an unwarranted burden on business-motivated decisions, including mitigating currency risk, managing cash needs and projections, minimizing risk factors and managing leverage.

The NAM believes that, at a minimum, Treasury should include accumulated E&P to determine "exempt" distributions.

Extended Look Back/Forward Periods and Rules

The proposed regulations include an irrebuttable presumption (*"per se"* rule) that a debt instrument is treated as stock if it is issued during the 72-month period beginning 36 months before the date of a distribution or covered acquisition.

The NAM believes that this *"per se"* rule impedes investment decisions and effective cash management, linking transactions from multiple tax years that are factually unrelated. This is a particularly important issue for manufacturers. In our recent survey, more than two-thirds of respondent have restructured their company and/or made an acquisition within the past three years.

The NAM feels strongly that companies should not be forced to take into consideration a six year horizon when making routine business decisions. We believe that the 72-month "*per se* rule" should be eliminated and any debt recast limited to the tax year of the targeted transaction with a rebuttable presumption based on facts and circumstances.

Impact on S Corporations

The proposed regulations also impede the ability of businesses organized as subchapter S corporations to utilize their cash effectively. More than two-thirds of manufacturers are organized as pass-through entities, primarily S corporations.

In order to qualify as an S corporation, an entity can have only one class of stock and must be owned only by eligible shareholders (Ineligible shareholders include C corporations, foreign corporations, partnerships, insurance companies and non-resident aliens). The reclassification of debt to stock, or part stock, part debt, could inadvertently create an ineligible S corporation shareholder or a second class of stock, thus disqualifying the entity as an S corporation.

While the proposed regulations do not apply to corporations filing a consolidated tax return, S corporations under common ownership are not permitted to file a consolidated tax return and thus, the proposed regulations apply to commonly-owned S corporations, even those with solely domestic activity. The NAM strongly recommends that subchapter S corporations be exempted from the final regulations.

Problems with Documentation Requirements Under Prop. Reg. 1.385-2

Extensive, new documentation rules will impose additional and significant audit, due diligence, compliance and administrative costs on companies operating in the United States.

In particular, the proposal contains new requirements for short-term inter-company loans that will require significant amounts of human capital to create and maintain the extensive documentation required and/or monitor and track any debt/equity differences that may arise.

Manufacturers are particularly concerned that a taxpayer will only have 30 days following the issuance of debt to finalize the required documentation for every cross border related-party debt entered into by the company.

At a minimum, we request that Treasury drop the 30-day deadline for complying with documentation requirements and permit taxpayers to finalize documentation by the time they must file the tax return for the year in which the debt is issued. This would permit companies to allocate resources more effectively and to address such documentation requirements as part of their annual compliance process.

Timeline for Adoption

Business planning is further complicated by the retroactive, proposed effective date for the 1.385-3 rules. While companies are still trying to analyze and understand the ambiguities of the proposed rules, as of April 4, they now have to plan, deploy cash and conduct their operations as if the proposed regulations are already in effect.

Given the sweeping changes brought about by the proposed regulations, the NAM recommends that Treasury provide an extended time line for implementation of the new rules. Taxpayers need to develop the necessary internal processes to properly document related-party loans, track intercompany transactions that could give rise to the funding rule, and address any changes required to cash pooling.

Indeed, less than one-fifth of the respondents in our June survey said they currently are able to comply with the proposed documentation requirements and almost one-third of respondents said it would take them more than a year to develop and implement the technology and oversight system just to comply with the new rules.

Treasury should therefore provide a transition rule that delays the effective date of the proposed regulations until January 1, 2019. Without a transition rule, many NAM members will not be able to insure full compliance with the regulations and will either have to refrain from making any distributions or risk the possibility of an inadvertent mistake that cannot be rectified under the current rules.

Conclusion

While my comments today, as well as our July 7th submission to Treasury, outline our preliminary concerns with the proposed regulations, the short time frame for responding to the proposal has limited our ability to do a more in-depth analysis of the full impact of the proposal. It is clear however, that the proposed regulations affect the core nature of almost every NAM member: how a manufacturer makes working capital decisions.

The broad impact of the proposal already is having a significant adverse impact on businesses in the United States. Indeed, in our June 2016 survey, nearly one third of respondents said they have reconsidered or put on hold any new investments or plans to repatriate funds from foreign subsidiaries because of the proposed regulations.

Thus, it is critically important that Treasury dedicate adequate time and resources for a thorough review and analysis of the public comments on the proposal and the potential impact of the proposed regulations before moving forward on any final rules.

Accordingly, we respectfully request that the Treasury Department withdraw the proposal at this time. If the regulations are finalized, we urge Treasury to modify the rules to accommodate accepted business practices and avoid unduly harsh results.

Thank you again for the opportunity to discuss the NAM's concerns with the Section 385 regulations. This concludes my testimony. I would be happy to answer any of your questions.