Dorothy Coleman

Vice President
Tax and Domestic Economic Policy

July 7, 2016

Internal Revenue Service
CC:PA:LPD:PR (REG-108060-15)
Room 5205
P.O. Box 7604, Ben Franklin Station
Washington, DC 20044

Submitted through Federal Rulemaking Portal: www.regulations.gov

RE: REG 108060-15, Treatment of Certain Interests in Corporations as Stock or Indebtedness

Attention: Austin M. Diamond-Jones and Raymond J. Stahl

Dear Mr. Diamond-Jones and Mr. Stahl:

The National Association of Manufacturers (NAM) – the largest industrial association in the United States representing manufacturers in every sector and in all 50 states – has serious concerns about the proposed Section 385 regulations released by the U.S. Department of Treasury ("Treasury") on April 4, 2016, in which the Treasury retroactively imposes broad rules to 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 (e.g., inversions), these overly 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 and investments in plant and equipment.

The NAM believes that, if finalized, the proposed regulations would create a serious disadvantage for U.S. investment relative to global investment, and make businesses in the United States less competitive in the global economy, exacerbating the competitive disadvantage created for many manufacturers in the United States by the high U.S. corporate tax rate and the out-of-date system for taxing foreign earnings.

Accordingly, we respectfully request that the Treasury Department withdraw the proposal. If the regulations instead are finalized, we urge Treasury to modify the rules to accommodate accepted business practices and avoid unduly harsh results. Our comments, which are discussed in more detail below, identify many of the consequences of the proposed regulations that we have identified to date. There are no doubt additional adverse impacts that we have not yet discovered given the compressed timeframe for review and comment.

Overview

The proposed regulations would recharacterize related-party debt as equity unless stringent documentation requirements are met, despite the fact that an instrument is respected as debt under current tax precedent, bankruptcy law and local law. Even if the documentation requirements are met, the proposed regulations would impose per se stock treatment if the debt is issued in specific intercompany transactions (the General Rule), or used, or deemed to be used, to fund specific distributions and acquisitions (the Funding Rule). A separate bifurcation rule in the regulations allows the Internal Revenue Service (IRS) to treat an instrument as part debt and part equity.

Rules that recharacterize an instrument from debt to equity raise several technical, policy and practical concerns.[1] As a preliminary matter, recharacterization impacts the satisfaction of various stock ownership standards under numerous tax code provisions including Sections 1504, 1563, 267, 269, 338, and 368(c) and the S corporation prohibitions on more than one class of stock and ownership of stock by impermissible shareholders.

The proposed regulations will disrupt all these determinations and consequently the ability to use intercompany financing. This uncertainty inhibits a business' finance and treasury functions, capital structure and routine funding of its ordinary operations.

The recharacterization of an instrument from debt to equity also may result in the permanent disallowance of a foreign tax credit associated with a payment treated for U.S. tax purposes as a dividend. For example, if a loan by a brother controlled foreign corporation (CFC) to a sister CFC is recharacterized as equity, the brother CFC may have a less than 10 percent voting interest in the sister CFC, which would eliminate deemed paid foreign tax credits under Section 902. The result is an increase in the cost of capital and double taxation.

The rules also will create cross-border hybrid instruments. Conceptually, the creation of hybrid instruments conflicts with the Base Erosion and Profit Shifting (BEPS) initiative spearheaded by the Organisation for Economic Cooperation and Development (OECD), which has the effect of eliminating jurisdictional differences in the treatment of hybrid instruments. The BEPS initiative however is focused specifically on eliminating taxpayer-favorable jurisdictional differences (e.g., double non-taxation), while the proposed Section 385 regulations will create taxpayer-unfavorable jurisdictional differences (e.g., double taxation). The creation of hybrid instruments also will shift income out of the U.S. (foreign company issuing debt to U.S. company, which is deemed to be stock for U.S. tax purposes), or shift earnings and profits away from ultimate U.S. taxation (foreign to foreign loans treated as stock). The creation of hybrid instruments also will result in double taxation due to a loss of foreign tax credits, and create additional withholding taxes in conflict with the treatment of interest and dividends under the policies incorporated in U.S. income tax treaties.

Moreover, the proposed regulations conflict with the best practices agreed to in BEPS Action 4 (Interest deductions and other financial payments). Contrary to Treasury statements, these proposed regulations are not narrowly targeted rules to address base erosion. Rather, they are overly broad in scope and apply to virtually every related-party loan and impact the business operations of every domestic and multinational group.

To avoid the consequences of reclassifying related-party debt into equity, the regulations will force companies to rely more on third-party debt. All businesses require ready access to cash, such that effective, efficient cash management is essential to multinational enterprises (MNEs). Being able to efficiently move cash allows a company to reduce outside borrowing costs and fund its basic operations. Additionally, efficient cash management enables a company to fund one-time costs such as mergers and acquisitions, mitigate currency exposure, reduce withholding taxes, address currency controls, provide needed liquidity, aggregate buying power, and reduce treasury costs. By restricting the use of inter-company debt, the regulations will increase the finance costs for U.S companies and increase their external debt. The effect is a higher cost of capital that will remove funding from other business activities, such as research and development, the expansion of operations, and the acquisition of complementary businesses and assets.
Many U.S. companies have committed bank credit facilities that include limits regarding the level of external debt, interest expense, and subsidiary debt. Using debt for routine activities locks up

[1] As described herein, the regulations raise significant concerns regarding the authority of Treasury to prescribe the Proposed Regulations under section 385(a), the coordination of such rules with certain Code provisions, and the burden placed on taxpayers to comply with the rules on a retroactive basis.

capacity that would otherwise be available to fund strategic initiatives. Under this proposal companies would see an increase in debt and interest expense that could cause them to exceed covenant limits resulting in a loss of external funding and creating liquidity issues for U.S. operations (investment, staffing, etc.).

In addition, the guarantees required to obtain third-party debt may run afoul of other tax code sections, creating additional compliance challenges. Third-party debt also must be reported to investors on financial statements, increasing leverage, debt-equity ratios and interest expense.

Problems Posed by Prop. Reg. 1.385-3

Cash Pooling and Short-Term Loans

Multinational groups typically manage cash through technical cash pooling arrangements and short-term intercompany loans. Indeed, in a June 2016 survey of NAM members, 82% of respondents said that they use cash pooling or intercompany loans to fund operations or investments for different affiliates.

Under technical cash pooling arrangements, one member of the group acts as a central bank for the group to manage and often fund day-to-day operating cash needs as well as mid- and long-term financing. This allows companies to efficiently use group-wide cash and minimizes the cost and need for third-party borrowing. Under the proposal, the debt instruments issued in these cash pooling arrangements, which in some cases number thousands a day, would be subject to the proposed regulations.

Here is an example that illustrates some of the problems posed by the proposed regulations:

> *Example 1:* Parent P has five subsidiaries, S1 through S5, with S5 managing the group's cash. S1, S2 and S3 sequentially each generate $100 excess cash, which they loan to S5, and S5 loans $300 to S4. S5 also generates an additional $100 cash of its own, which it dividends to P, causing the $100 loan from S1 to be stock. S4 then repays $100 of its loan, which S5 uses to repay S1. This then is treated as a distribution, causing the S2 loan to be stock. S4 repays another $100, which S5 uses to repay the $100 S2 loan. The repayment of the original S2 loan is treated as a redemption distribution with respect to the deemed equity resulting from the operation of the conversion of the S2 loan to equity. This redemption is taxable as a deemed dividend, which, under the funding rule, causes the original loan from S3 to S5 to be treated as equity. S4 repays the final $100, and S5 uses that to repay the $100 S3 loan. Since the S3 loan has been recast as equity following the prior deemed redemption, this loan repayment is also treated as a redemption of stock and a deemed dividend. As a result, the loans from S1, S2 and S3 are each deemed to be $100 investments in the stock of S5, and all three of the deemed stock investments are treated as redeemed in taxable dividends. In reality S5 only made a total $100 distribution to P.

This example reflects both the complexity and the domino effect of applying these rules to normal cash management transactions that occur on a daily basis. Movement of cash in this manner is executed to meet the treasury needs of a multinational business, 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 resulting in the distortion of the income of the group members. If P is a domestic corporation, the ownership requirements of Sections 901 and 902 allowing for foreign tax credits may not be satisfied, and the deemed redemptions may result in double taxation.[2]

It also is important to note that companies will need to account for cash pooling transactions separately under U.S. and local GAAP because of the different treatment of debt and equity.

Cash pooling is an integral operation for nearly all MNEs as it allows efficient usage of cash within a global organization. Similarly, many corporations use short-term loans for daily operations. Depending on its structure, a global manufacturer may use a combination of cash pool and short-term loans. These decisions depend on where the cash is located and the needs of the entity that requires the liquidity.

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

Impact on S Corporations

The proposed regulations also significantly impede the ability of businesses organized as subchapter S corporations to utilize their cash effectively. In particular, the bifurcation rule in the proposed regulations, which allows the IRS to treat a debt instrument as part debt and part stock, could cause a subchapter S corporation to lose its S status and become taxed as a C corporation.

In order to qualify as an S corporation, an entity must have only one class of stock (identical rights to distribution and liquidation proceeds) and must be owned only by eligible shareholders (examples of ineligible shareholders include C corporations, foreign corporations, partnerships, insurance companies and non-resident aliens). The reclassification to stock, or part stock, could inadvertently create an ineligible S corporation shareholder (e.g., if the debt reclassified to stock was held by a C corporation, the C corporation would become an ineligible S corporation shareholder); and/or the reclassification to stock could create a second class of stock via preferred return consideration on the debt instrument.

> *Example 2:* An individual owns all the stock of S corporation X, and all the stock of C corporation Y, which owns subsidiary Z. X buys the stock of Z from Y for a note. Under the proposed rules, the note becomes stock of X. S corporation shareholders, along with most closely held ownership structures, routinely loan money to, and between, S corporations in which they have a common ownership stake. If the IRS recharacterizes this debt as stock under the bifurcation rule, this could create a second class of stock and cause the S corporation to be taxed as a C corporation.

The proposed regulations do not apply to corporations filing a consolidated tax return. S corporations under common ownership, however, 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.

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[2] In addition to the potential for double taxation, it appears that a loan that is valid under Section 954(c)(6) could be overridden by the proposed regulations. It is unlikely that the Treasury has the authority to override Congress' intent to allow businesses to efficiently manage cash through CFC-to-CFC loans. Congress enacted Section 954(c)(6) in 2004, 25 years after it enacted Section 385. The proposed regulations would negate Congressional intent by layering on a tracing requirement to ensure that the proceeds of a loan were not used for an "illegal" purpose (e.g., dividends, related party stock acquisition, or certain asset acquisitions).

Distributions from Accumulated E&P

Under the proposed regulations, when a company deploys its cash via intercompany debt that is 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 "safe harbor" for distributions that do not exceed current year E&P is problematic for many practical reasons including differences between U.S. GAAP, statutory accounting, and E&P; statutory restrictions on the payment of interim dividends (i.e., in the same year the earnings are earned) in many jurisdictions; and the inability to accurately forecast current E&P as a result of unpredictable business cycles and other factors. This problem is exacerbated for capital intensive industries where cash and E&P are mismatched.

> *Example 3:* The U.S. subsidiary (US-sub) of foreign parent (For-co) has $5 billion of accumulated E&P. US-sub borrowed $1 billion from For-co on Jan. 1 for U.S. capital investment in 2017. The proposed regulations allow US-sub to pay dividend payments to For-co up to the level of current year E&P. Any amounts distributed above current year E&P would result in a corresponding amount of debt being recast as equity. Assuming US-sub has no current year E&P in 2017, if it chooses to pay any amount of dividend from accumulated E&P to For-co, a corresponding amount of the $1 billion debt would be recast as equity and the corresponding interest deduction accompanying that amount would be disallowed and the interest payment likely would be subject to a higher withholding rate. In effect, US-sub must choose, after the debt instrument had already been issued on Jan. 1 (taxpayers cannot know on Jan. 1 what current E&P will be), whether to distribute a dividend or claim an interest deduction and apply withholding rates for interest payments.

> *Example 4:* Company A decides to build plant and equipment in year 1 to be funded through an equity infusion and intercompany financing. On the cash side, there is reduced cash flow for distributions, since it is being used to fund the upfront plant and equipment investment. On the E&P side, there is no reduced impact for depreciation, since the plant and equipment have not been placed in service. In year 3, the assets are placed in service and additional cash flow is generated from the business, but E&P is decreased as a result of the depreciation of the plant and equipment. Distribution of the year 3 cash flow would not be out of current E&P, but would be out of accumulated E&P from year 1 that was invested in year 1 and returned as cash flow in year 3.

The difficulty in predicting the current E&P amount (safe harbor) is further compounded by earnings in countries with volatile currencies. For example, predicting current E&P for entities operating in Venezuela, Russia, Ukraine, Nigeria, the Philippines and even Brazil in the current environment, is extremely difficult, particularly after adjusting for accruals, Section 197 amortization, and a myriad of other items. When operating in countries with volatile currencies, it is a good business practice to move cash out of the country via intercompany loans regularly and as often as possible. The proposed current E&P safe-harbor in the regulations limits the amount that can be loaned or distributed and restricts companies' ability to manage currency risk.

In addition, limiting the exception to current E&P restricts the ability of an expanded group to reallocate the group's capital through distributions to other entities within the expanded group from an entity that is projected to operate at a current-year E&P deficit due to depreciation and amortization. Since companies only may know or estimate current E&P when the tax return is filed the following year, under the proposal they must choose between risking a distribution in excess of current E&P or making a smaller distribution, which will result in a portion of current E&P each year being converted to accumulated E&P that cannot be distributed without implicating the regulations.

The NAM believes that, at a minimum, Treasury should include accumulated E&P to determine "exempt" distributions. By restricting distribution amounts to current E&P, the regulations will increase the cost of capital for companies investing in the United States. Indeed, the proposed regulations encourage behavior completely counterintuitive to maintaining and increasing investment in the United States. Specifically, U.S. subsidiaries of non-US parent companies are encouraged to repatriate earnings out of the United States up to their current E&P to avoid "locking in" cash in the United States. In addition, the regulations exacerbate the lock-out effect for U.S. MNEs interested in bringing cash back to the United States for investment.

Additionally, previously taxed income (PTI) should be freely distributable without being subject to proposed regulations. Taxpayers should not be penalized for distributing cash when such distributed earnings have already been taxed in the United States and there has never been a receipt of such cash. The rules governing subpart F income provide that PTI can be distributed without further U.S. tax consequences (except for currency exchange gains or losses). Accordingly, the inclusion of distributions of PTI under these proposed regulations would be fundamentally unfair and inconsistent with the policy of not taxing previously taxed income later upon distribution. Final regulations could achieve this by disregarding distributions of previously taxed income when calculating the amount of distributions in applying the regulations.

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. Under this *"per se"* rule, normal business transactions can be treated as abusive earnings stripping transactions where no such abuse is taking place.

The NAM believes that the 72-month *"per se"* rule impedes investment decisions and effective cash management, because it is excessively broad and administratively burdensome, linking transactions from multiple tax years that are factually unrelated.

> *Example 5*: Company A with multiple businesses in the United States decides to sell one of its businesses in year 1 as a part of its business strategy. The company distributes the proceeds from the sale (which are greater than the gain) in year 2. In year 3, the company decides to invest in new plant and equipment, and fund the investment with intercompany debt and equity. As a result of the dividend in year 2, the intercompany debt incurred in year 3 to fund new plant and equipment will be treated as equity under the *"per se"* rule, even though the business decisions are completely separate and generate new investment in U.S. assets.

The 72-month *"per se"* rule also would impact normal business operations. For example, common employee-stock compensation transactions that involve actual or deemed purchases of parent company stock by a subsidiary could trigger equity interests in the subsidiary because of intercompany loans. The Section 1032 regulations treat parent stock provided to a subsidiary for employee compensation as purchased by the subsidiary, regardless of whether the subsidiary pays for the shares. This deemed purchase appears to be a funding transaction under the proposed regulations because it is treated as an acquisition of expanded group shares by the subsidiary for at least Section 358. If the subsidiary borrows money from an intercompany cash pool within the prescribed 72 month period surrounding the stock acquisition, the earlier debt would become equity in the subsidiary. Use of parent stock to provide compensation to subsidiary employees is a long-standing practice that is used in the ordinary course of business and should not result in adverse consequences to the group. Applying the proposed regulations to convert loans to equity as a result of actual or deemed stock based compensation transactions is inconsistent with the policies embodied in the Section 1032 regulations, which are intended to facilitate such transactions.

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 should be limited to the tax year of the targeted transaction with a rebuttable presumption based on facts and circumstances.

In addition, we urge Treasury to look at a "double jeopardy" safe harbor so that each related-party debt instrument is only treated as funding a single covered transaction and if it qualifies for an exception, it should not be retested multiple times with respect to multiple covered transactions. For example, if a related-party debt would have been treated as equity in the year it was issued under the funding rule as a result of a covered transaction entered into in the same year or a prior year, but the current year E&P exception applies to prevent it from being recharacterized as equity, then that same debt should not later be treated as funding another covered transaction and retested.

As the proposed regulations are currently drafted, borrowing that is excluded from the funding rule under the current earnings exception (or another exception) in one year can later be retested and treated as equity as a result of a covered transaction in a subsequent tax year, which significantly reduces or eliminates the value of the current year earnings and other exceptions and is overly harsh.

Exception for Capital Expenditures

Under a *"de minimis"* rule in the regulations, an instrument will not be recast as equity if, immediately after issuance, the aggregated adjusted issue price of debt instruments held by group members does not exceed $50 million. Manufacturing is a capital intensive industry and many companies will quickly exceed the $50 million threshold for what are ordinary business expenses. For example, for one company a typical furnace rebuild costs $10 million or more, with approximately 20 rebuilds per year, or more than $200 million a year. These are ordinary course business expenditures and a critical investment for the company's operations. We strongly urge Treasury to include an exception to cover the intercompany financing of a group member's capital expenditures.

Exception for Post-Merger Integration

Many businesses grow through the acquisition of or merger with other companies. After an acquisition, businesses seek to create efficiencies by eliminating redundancies and combining companies in the same jurisdiction. The funding rule would make it extremely difficult (and in some instances, impossible) to generate the synergies intended in the reorganization. For example, an acquirer may have two or more entities in a jurisdiction post-merger. The acquirer may need to effectuate a cross chain sale of companies in order to properly combine them under local law, often for a note given the values at issue. This combination is needed to create synergies from the acquisition, and to comply with local country labor laws and agreements with work councils and trade unions. Additionally, business combinations are typically required to complete the integration of IT systems and to simplify the overall business conducted by the companies in a particular country post-acquisition. The proposed regulations, if finalized, may make such post-acquisition planning challenging, if not impossible, thereby eliminating important anticipated efficiencies that led to the acquisition in the first place. We strongly urge Treasury to include an exception for post-merger integrations.

Existing and Planned Debt and Projects

Many businesses use debt as a part of their permanent financing structure. In addition, multi-national groups often find it economically beneficial (if not absolutely necessary) to have one or a limited number of entities borrow funds from external parties and then on-lend to affiliates as required. At times, it may be necessary or prudent for an entity to borrow from an affiliate to replace an outstanding external debt.

The NAM believes that the regulations should provide an exemption for intercompany debt in existence when the regulations go into effect. Without such an exemption, the regulations essentially apply retroactively to penalize an entity for borrowing that took place before the effective date of the regulations to finance the start-up or expansion of its business.

Similarly, we urge Treasury to consider an additional grandfather rule relating to investments that were negotiated before the date that the regulations are generally effective. While Treasury's April 4 Fact Sheet provides that "the proposed regulations generally do not apply to related party debt that is incurred to fund actual business investment, such as building or equipping a factory," this is not reflected in the proposal. Typical development of such a project will span five or more years until official startup of the operation. We believe that, for companies that have decided to invest in U.S. plant and equipment before the regulations are finalized and have negotiated contracts and solidified commitments with third parties (as well as prepared for internal financing to build such plant and equipment), an additional rule should be added to include instruments issued relating to such project as grandfathered debt under the proposed regulations.

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

Overview

Extensive, unprecedented and unnecessary documentation requirements will impose additional and significant audit, due diligence, compliance and administrative costs on companies operating in the United States, diverting capital and energy from investment and job creation and restricting additional investment.

In particular, the proposal contains unrealistic documentation for short-term inter-company loans and an opportunity for a discrepancy between the accounting capital structure and the tax structure if debt is recast as equity. Significant amounts of human capital would be required to create and maintain the extensive documentation required and/or monitor and track any debt/equity differences that may arise.

Tight Deadline

The proposed regulations would grant only 30 days following the issuance of debt for taxpayers to finalize the required documentation substantiating that an instrument should qualify as debt for U.S. tax purposes. This is an extremely short time frame in which to comply with major new documentation requirements with respect to each and every cross border related-party debt entered into by companies and there is no overwhelming policy concern to maintain such a tight deadline.

> *Example 6:* US-sub of parent company (For-co) has a foreign subsidiary under its US consolidated group (For-sub). Parent For-co has a financing center set up in home country to service group subsidiaries outside of US. For currency exchange reasons and centralization, For-sub borrows directly from parent For-co financing center. Even though For-sub is under US-sub's consolidated group, it may not be practical for US-sub to track and document

routine borrowing of For-sub. Therefore, For-sub's borrowings are unlikely to be documented in a contemporaneous manner and would likely be recast as equity.

As a result of the increased cost and administrative burden of the document requirements, we request that Treasury, at a minimum, extend the 30-day deadline for complying with documentation and substantiation requirements.

Specifically we recommend that a taxpayer be permitted to finalize such documentation by the time it must file the tax return (including extensions) for the year in which the debt is issued. This approach would permit companies to allocate resources more effectively and to address such documentation requirements as part of their annual compliance process, similar to the process for providing transfer pricing documentation.

Additionally we recommend that the required documentation requirements be limited to the documentation necessary to support the legal rights/obligations of creditors/debtors under local law, bankruptcy law and/or existing tax precedent. Otherwise, the rules merely impose an additional compliance burden to create documentation that does not serve a substantive purpose.

Ordinary Course Trade Payables

As currently drafted, intercompany trade payables are covered by the Treas. Reg. 1.385-3, *provided however*, that the 72-month *per se* rule does not apply to a debt instrument that arises in the ordinary course of the issuer's trade or business in connection with the purchase of property or the receipt of services to the extent that it reflects an obligation to pay an amount that is currently deductible by the issuer under Section 162 or currently included in the funded member's cost of goods sold or inventory. In addition, the amount of the obligation cannot exceed the amount that would be ordinary and necessary to carry on the trade or business of the issuer if it was unrelated to the lender. The documentation rules do not contain a similar exception, and the definition of "applicable instrument" as "any interest issued or deemed issued that is in form a debt instrument" would seem to cover intercompany trade payables. Since short-term debt is not required to accrue interest under either Section 482 or the original issue discount provisions, and therefore does not present a base erosion concern, NAM recommends that all ordinary course trade payables should also be excluded from application of the documentation rules. For the same reason, NAM recommends that all short-term, non-interest bearing debt, whether a trade payable or otherwise, should be excluded from application of the documentation rules.

Establish a Penalty Regime In Lieu of Recast

Subject to an uncertain reasonable cause exception, the failure to timely document a transaction converts a loan that is in substance debt into equity, contrary to more than half a century of case law. While we understand the IRS' desire to obtain documentation, the consequence of recharacterizing the debt as equity far outweighs the lack of documentation. Consequently, the NAM recommends moving the documentation rules to 26 U.S.C. § 6000, et seq., and thereby look to an applicable penalty provision in cases where a taxpayer does not timely prepare adequate documentation.

Limited Small Business Exemption

The NAM also recommends that the final rules include an expanded exemption for small businesses. Under the proposed regulations, the documentation requirements apply to affiliated groups that either are publically traded, have total assets over $100 million or have more than $50 million total annual revenue.

We believe that the thresholds are too low, imposing a significant and unnecessary compliance burden on manufacturers that do not have the resources to develop and maintain the necessary compliance infrastructure. The NAM recommends that Treasury modify the proposal so that the documentation requirements will apply only to affiliated groups that are publicly traded large accelerated filers (*i.e.*, issuers with a public float above $700 million); have total assets exceeding $700 million; or have more than $1 billion total annual revenue.

State Tax Considerations

The proposed regulations provide that all members of a consolidated group are treated as a single entity. While this may seem to reduce the burden placed on wholly domestic U.S. taxpayers, this is not necessarily true. Many states that do not follow a "consolidated group" concept may require the minimum documentation requirements and enforce the funded distribution rules at a state level. This means that many ordinary cash management strategies between consolidated group members (e.g., cash pooling, intercompany cash sweeps, intercompany debt) will trigger a significant compliance burden, which many US companies are currently unprepared to handle and likely unaware of the requirements. Given the impact of these broad changes, NAM recommends that the proposed regulations, if finalized, provide additional time to understand and implement processes to comply with these administrative burdens.

Timeline for Adoption

Retroactivity

Companies' analyses and business planning are further complicated by the retroactive April 4, 2016, proposed effective date for the 1.385-3 rules. In order to understand the broad effects of these proposed rules, corporate tax departments must confer with their corporate treasury counterparts located across the globe. Moreover, with the potential for existing debt to experience a "significant modification," even the current financing structures of many businesses are at risk. As of April 4, 2016, companies now have to plan, deploy cash and conduct their operations as if the proposed regulations are already in effect (as well as under current law), at the same time they try to analyze and understand the proposed rules, making prudent cash management more difficult, if not impossible.

For example, already this year, rather than dividend excess cash in a foreign subsidiary to the parent company for use within the United States, one NAM member limited this foreign subsidiary's intercompany dividend to its forecasted current earnings and profits, which was one third of the amount they would have otherwise distributed to the United States parent.

Moreover, since the proposed regulations were not included in Treasury's updated 2015-2016 Priority Guidance Plan, released February 5, 2016, businesses did not have any advance notice of this far-reaching proposal.

Transition Period

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. This would be consistent with Congressional requests that the regulations consider exceptions or special rules, including transition rules. Taxpayers will 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. In the event a taxpayer does not have adequate processes, the results could be catastrophic, including a financial restatement.

Many NAM members do not currently track operating loans, dividends and intercompany transactions in a way that would be necessary to apply the funding rule.[3] Hundreds of intercompany transactions are occurring on a daily basis, and corporations generally have not had to worry about subpart F income on intercompany loans for the past twelve years given the application of Section 954(c)(6).

As a result, businesses will require significant time to build systems to address the documentation and funding rules. In the case of the Foreign Account Tax Compliance Act (FATCA), financial institutions needed at least 18 months to implement new systems to capture the required information. Treasury recognized the significant programming demands and extended the effective date to take into account the technology challenges of creating and implementing new systems. There are still parts of FATCA that have yet to be implemented.

The proposed regulations apply to a much broader class of taxpayers, and corporations do not have sufficient information technology (IT) capacity in many cases to implement the required systems in a truncated period of time. The proposed regulations would require taxpayers to track loans and other seemingly unrelated transactions in a way not required before April 4, 2016. Many manufacturers are located in parts of the country where it will be difficult to hire personnel to build the IT infrastructure necessary to trace loans and monitor transactions. As a result, these manufacturers may be required to outsource the programming and implementation of the required systems at a very significant cost.

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 be in the untenable position of not being able to insure full compliance with the regulations and will thus have to refrain from any distributions whatsoever or risk the possibility of an inadvertent mistake that cannot be rectified under the current rules. Given the risk of adverse financial statement impacts, corporations will have no choice but to shut down all distributions for fear of running afoul of the funding rule.

Treasury's Authority under Section 385

In addition to our policy concerns with the regulations, the NAM also is concerned that the proposed Section 385 regulations exceed the scope of Treasury's authority under the statute.

Scope of Section 385

Section 385(b) imposes significant limits on the authority granted by Section 385(a), and these regulations clearly go beyond what is permitted under those limits.

Section 385(a) provides:

> The Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness).

If Section 385 said nothing more than this with regard to the authority granted to Treasury to issue regulations distinguishing between debt and equity, then these regulations would probably be within that grant of authority. However, Section 385 continues with Section 385(b):

[3] As discussed at a June 21, 2016, NAM meeting with Treasury officials, NAM members are cataloging their related party loan portfolios with the assistance of outside advisers. This process is a time consuming and it is likely that most NAM members will not have a complete list of such loans if Treasury finalizes the regulations with a 2016 effective date.

> The regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists…

Section 385(b) then goes on to list five factors that “the regulations may include among other factors.” Thus, Section 385(b) represents a significant limit on the authority granted by Section 385(a). It is clear the proposed Section 385 regulations *do not* “set forth factors” to evaluate the debtor-creditor relationship. Instead, the regulations set forth bright line rules prescribing that, under the circumstances specified in the rules, an instrument denominated as debt by the corporation will instead be automatically treated as stock.

Moreover, the legislative history of Section 385 is consistent with the statutory text. The Senate Finance Committee Report describing Section 385 notes the provision grants Treasury authority to issue “regulatory guidelines” for determining whether a corporate instrument represents stock or debt. The report states:

> …these guidelines are to set forth factors to be taken into account in determining, with respect to a particular factual situation, whether a debtor-creditor relationship exists or whether a corporation-shareholder relationship exists.

The Administrative Procedure Act calls for judicial review of agency actions that are “..found to be… in excess of statutory jurisdiction, authority, or limitations.[4] For the reasons discussed above, we believe that the proposed regulations, if finalized, are “in excess of statutory jurisdiction, authority, or limitations,” and thus would be held unlawful and set aside if challenged in court.

Retroactive Application

The regulations, if finalized, would be applicable to debt instruments issued on or after April 4, 2016, the date the proposed regulations were issued. Even if the regulations are found to fall within the scope of authority granted by Section 385, we believe that the retroactive application of the regulations is an impermissible abuse of discretion by Treasury.

Section 7805(b) of the Internal Revenue Code addresses the extent to which tax regulations may be made effective retroactively to events occurring before the date final regulations are issued. While Section 7805(b) was amended in 1996 to provide detailed rules on the extent to which regulations may be made effective retroactively, the amended version of Section 7805(b) is applicable only to regulations relating to statutory provisions enacted on or after the date of enactment of the amendment, July 30, 1996. Since Section 385 was enacted in 1969, regulations issued under Section 385 are subject to the version of section 7805(b) enacted in 1954.

Before the 1996 amendment, Section 7805(b) provided:

> The Secretary may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect.

Thus, the general rule under the 1954 version of Section 7805(b) was that tax regulations could be made effective retroactively. However, case law had held that retroactive application of tax regulations was subject to challenge under an abuse of discretion standard.[5]

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[4] 5 U.S.C. § 706(2)(C)
[5] *See*, *e.g.*, *Anderson, Clayton & Co. v. United States*, 562 F.2d 972, 979 (5th Cir. 1977).

In the Supreme Court's decision in *Manhattan General Equipment Co. v. Commissioner*, 297 U.S. 129 (1936), the Court permitted retroactive application based on the rationale that the amended regulation was "no more retroactive in its operation than is a judicial determination construing and applying a statute to a case in hand." *Id.* at 135. This rationale basically relies on the concept that the amended regulation, like a court decision, was simply saying what the law always was.

This rationale clearly does not apply in the case of regulations that give Treasury a broad grant of authority to create a new structure of rules that do not in any meaningful way represent an interpretation of the statutory provision authorizing the regulations, but instead represent policy decisions by Treasury. Even if the regulations are not invalidated as being beyond the scope of Section 385, the retroactive application of the regulations to debt instruments issued before the final regulations are issued represents an abuse of discretion. Clearly these regulations are radically changing the law regarding the recharacterization of debt as equity from the factor-based analysis that has been applied by the courts to a set of bright line rules that produce very different results from the results produced under the traditional factor-based analysis.

Accelerated Timeline

As noted above, under the APA, a reviewing court can "hold unlawful and set aside" agency action if it concludes the agency action exceeded the agency's statutory authority. Another ground for a court to "hold unlawful and set aside" agency action is if the court concludes the agency action was "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law,''[6] normally referred to as the arbitrary and capricious standard.

In *Motor Vehicle Manufacturers Association v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29 (1983), the Supreme Court ruled that, in order to uphold agency action under this standard, a court must be satisfied that the action "was the product of reasoned decision-making," *Id.* at 52.[7] In this case, Treasury has adopted an artificially and unrealistically accelerated timeline for finalizing these regulations. This extreme haste, in and of itself, is sufficient to violate the arbitrary and capricious standard by making it impossible for Treasury to engage in the "reasoned decision-making" that is the fundamental requirement of the arbitrary and capricious standard.

When the proposed regulations were issued, Treasury made clear that it intended to finalize the regulations within five months, without regard to the fact that these regulations represent a radical change in the law. Despite repeated requests both from business and Congress for a longer comment period, Treasury imposed a three-month window for submitting comments and scheduled a hearing for a week after the comment deadline. The condensed time table does not give the Treasury Department sufficient time to read and evaluate the merits of the public comments, especially in light of the complexity of the material.

Although the APA permits agencies to promulgate force-of-law rules that are immediately effective, agencies must have "good cause" to issue immediately effective rules and prevent regulated parties from providing notice and comment thereon.[8] Here, Treasury does not (and cannot) meet the requirements of the good cause exception because it has not established why complying with the notice-and-comment process would be impracticable, unnecessary,

[6] 5 U.S.C. § 706(2)(A)

[7] *See also*, *e.g.*, *Judulang v. Holder*, 132 S. Ct. 476, 484 (2011) (reviewing courts must "ensur[e] that agencies have engaged in reasoned decision-making.").

[8] 5 U.S.C. § 553.

or contrary to the public interest.

Rationale for Regulations

There also are other reasons why the regulations violate the arbitrary and capricious standard. For example, statements in the preamble explaining the rationale for adopting the particular rules in the regulations raises similar reasons to ones the Tax Court identified in *Altera Corp. v. Commissioner*, 145 T.C. No. 3 (2015), as why the regulation in that case violated the arbitrary and capricious standard. Specifically, in *Altera* the Tax Court agreed with the taxpayer's contention that "that the preamble to the final rule fails to rationally connect the choice that Treasury made in issuing a uniform final rule with the facts on which it purported to rely." The same weakness is in the preamble to the Section 385 regulations. Specifically, one of the rules in these regulations treats debt instruments issued in a distribution by a subsidiary to its parent corporation as stock. The preamble presents the following rationale for this rule:

> In many contexts, a distribution of a debt instrument similar to the one at issue in *Kraft* lacks meaningful non-tax significance, such that respecting the distributed instrument as indebtedness for federal tax purposes produces inappropriate results….
>
> In light of these policy concerns, the proposed regulations treat a debt instrument issued in fact patterns similar to that in *Kraft* as stock. The factors discussed in *Kraft* and *Talbot Mills,* including the parent-subsidiary relationship, the fact that no new capital is introduced in connection with a distribution of debentures, and the typical lack of a substantial non-tax business purpose, support the conclusion that the issuance of a debt instrument in a distribution is a transaction that frequently has minimal or nonexistent non-tax effects.[9]

The mismatch between the rationale presented in this passage from the preamble and the scope of the rule adopted is very close to the mismatch between the rule and the rationale identified in the Tax Court's *Altera* decision.

The same weakness exists with respect to the preamble's explanation of the rationale for the rules relating to debt instruments issued in exchange for affiliate stock and debt instruments issued in internal asset reorganizations. The preamble states:

> Like distributions of debt instruments, issuances of debt instruments to acquire affiliate stock *frequently* have limited non-tax significance….
>
> ….Internal asset reorganizations *can operate* in a similar manner to section 304 transactions as a device to convert what otherwise would be a distribution into a sale or exchange transaction without having any meaningful non-tax effect.[10]

The fact that these classes of transactions "frequently" or "can" present policy concerns is not a proper explanation for adopting rules that treat debt instruments issued in these types of situations *in all cases* as stock. This is exactly the same type of violation of the arbitrary and capricious standard that was identified in the portion of the *Altera* opinion quoted.

[9] 81 Fed. Reg. 20917.

[10] *Id.* at 20917, 20918 (emphasis added).

Conclusion

In overturning existing tax policy and well-established case law, the proposed Section 385 regulations will significantly increase the cost of doing business in the United States, creating further obstacles to investment, job creation and economic growth. The broad impact of the proposal goes well beyond sound tax policy and will have a significant adverse impact on manufacturers in the United States, raising the cost of capital and limiting the ability of companies to fund operations and bring back cash to the United States.

Manufacturers, in particular are impacted by the proposed regulations. Manufacturing is a capital intensive activity and often requires debt to facilitate its natural business cycle as products are manufactured and sit in inventory awaiting distribution and ultimate sale. Consequently, nearly all manufacturers will have significant debt (internal to the extent possible and external if required) to fund normal operations. For example, the regulations will prevent manufacturers from paying dividends for a six- year window without recharacterizing debt to equity, which can have severe consequences. This seems particularly unreasonable given the ordinary (and basically required) nature of the underlying activity of the capital intensive manufacturing sector.

The regulations will impose significant administrative costs on global and domestic manufacturers in the United States, ranging from the additional cost of third-party debt, increased interest expense, new costs for tracking debt, new legal fees, significant costs arising from system changes, additional currency risks, higher hedging costs and external audit fees, diverting important resources from capital investment and job creation and making the U.S. a less attractive place to do business.

Moreover, the uncertainty created by the rules makes prudent business planning difficult. These unclear and sometimes ambiguous rules will create more uncertainty for companies in the United States. In addition, these are the most wide-ranging regulations proposed in the past 20 years, overturning 80 years of case law and nullifying existing tax provisions enacted with bipartisan Congressional support. Piecemeal changes like these to our current system, particularly those made through regulations without open consideration and debate, make a bad system far worse and penalize companies that create and maintain U.S. jobs.

While NAM members believe that the regulations should be withdrawn for further consideration, at a minimum we request that Treasury:

- Exempt from equity treatment cash pool loans and intercompany short-term loans that are executed as a result of a treasury management system and used to finance operating costs or capital expenditures among related parties;
- Exempt subchapter S corporations from the final regulations;
- Allow companies to make distributions of accumulated earnings without triggering a recharacterization;
- Allow companies to make distributions of previously taxed income (PTI) without triggering a recharacterization;
- Eliminate the ”*per se* rule” and any debt recast should be limited to the tax year of the targeted transaction with a rebuttable presumption based on facts and circumstances;
- Provide an exception for intercompany company financing of a group member’s capital expenditures;
- Provide an exception for post-merger integrations;
- Provide an exemption for intercompany debt and negotiated contracts in existence when the regulations go into effect;

- Extend the 30-day deadline for complying with documentation and substantiation requirements and expand the small business exemption;
- Limit required documentation to requirements needed to support legally enforceable debt under local or bankruptcy law;
- Exclude ordinary course trade payables and all short-term, non-interest bearing debt, whether a trade payable or otherwise, from application of the documentation rules;
- Establish a penalty regime for the documentation rules in lieu of a recharacterization;
- Limit the application of the documentation requirements to affiliated groups that are publicly traded large accelerated filers (*i.e.*, issuers with a public float above $700 million); have total assets exceeding $700 million; or have more than $1 billion total annual revenue; and
- Provide a transition rule that delays the effective date of the regulations until January 1, 2019.

While the comments above outline our preliminary concerns with the proposed regulations, the short time frame for comments 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. We urge Treasury to discuss the impact of these regulations with company treasurers and CFOs to understand the grave unintended non-tax consequences for these rules, which go well beyond the "abusive transactions" that Treasury is intending to curb.

Given the impact on jobs, investment and economic growth, 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.

Thank you in advance for your consideration of our requests. We look forward to meeting with you and your staff to discuss our concerns. If you have any questions, please feel free to contact me at (202) 637-3077 or dcoleman@nam.org.

Sincerely,

Dorothy Coleman

Dorothy Coleman