Treasury's Proposed Section 385 Regulations

Meeting with Office of Information and Regulatory Affairs

October 12, 2016

Executive Order #12866

Under Executive Order #12866, each agency shall:

- Identify the problem that it intends to address,
- Design its regulations in the most cost effective manner to achieve the regulatory objective,
- Assess both the costs and benefits of the intended regulation, and
- Tailor its regulations to impose the least burden on society . . . consistent with obtaining the regulatory objectives.

Application to Prop. Treas. Reg. § 1.385-3 & -4

Identified Problems to be Addressed:

- Reduce the tax benefits of inversion transactions
- Limit erosion of U.S. tax base

Scope of Proposed Regulation:

› Whereas the tax benefits of inversions and earnings stripping are achieved primarily by having *U.S. corporations* issue debt to foreign persons, the Proposed Regulations would potentially apply to *all debts* issued between related persons on a *global* basis.

› Whereas there are only approximately 67 U.S. corporations that have gone through inversion transactions over the last three decades, the Proposed Regulations would apply to debt issued by tens of thousands of corporations, both foreign and domestic.

› Given the broad and mechanical nature of the Proposed Regulations, and the Funding Rule in particular, they would apply far more often to routine intercompany transactions involving no tax planning whatsoever than to debt producing earnings stripping benefits.

Collateral Costs Imposed on Business by Prop. Treas. Reg. § 1.385-3 & -4

The collateral costs that the Proposed Regulations would impose on business was the subject of extensive comments.

- The successive application of the mechanical rules of Prop. Treas. Reg. § 1.385-3 would recharacterize routine internal financings involving no tax planning as equity, such as cash pooling, with dire tax consequences.
    - *See*, *e.g.*, PwC Comment Letter at pp. 178-182, NYSBA Comment Letter at pp. 159-162, AICPA Comment Letter at pp. 11-16.
- Recharacterizing related-party debt of foreign subsidiaries would lead to loss of foreign tax credits, double tax foreign earnings, and make internal business restructurings impossible.
    - *See*, *e.g.*, NYBSA Comment Letter at pp. 122-130, PwC Comment Letter at pp. 120-163.

Collateral Costs Imposed on Business by Prop. Treas. Reg. § 1.385-3 & -4

Because the recharacterization of related-party debt would be so difficult to avoid, and the tax consequences would be so dire, multinational groups would be driven to avoid routine inter-company financing transactions, such as cash pooling.

- Groups would be driven to substitute external borrowing for internal funding,
  - increasing external financing costs,
  - reducing returns on equity,
  - increasing credit exposure to foreign banks,
  - complicating internal netting and hedging programs,
  - forcing existing intercompany financings onto the balance sheets of the banking system, and
  - making internal treasury controls massively more difficult.
- *See*, *e.g*., Novantas Comment Letter at pp. 1-5, P&G Comment Letter at pp. 2-6, ExxonMobil Comment Letter at pp. 1-3.

Key Issues that Must Be Addressed in Finalizing Prop. Treas. Reg. § 1.385-3 & -4 – Apply Only to Debt Issued by U.S. Corporations

- The application of the regulations should be limited to the debt instruments giving rise to the targeted earnings stripping and inversion benefits, *i.e.*, debt issued by U.S. corporations.
  - Such a change would dramatically limit the collateral costs of forcing U.S. based multinational groups to apply the rules on a global basis.
  - Such a change would make it easier to limit the viral application of the regulations and to accommodate routine treasury operations.
- *See*, *e.g*., ABA Comment Letter at pp. 73-75; *see also* NYSBA Comment Letter at p. 7, DC Bar Comment Letter at pp. 102-105.

Key Issues that Must Be Addressed in Finalizing Prop. Treas. Reg. § 1.385-3 & -4 – Provide Exemptions for Routine Treasury Operations

- Effective exemptions should be provided for debt arising from routine internal treasury operations far broader than those in the Proposed Regulations, including exemptions for cash pooling and internal banking.
  - Multinational groups must be permitted to use their internal liquidity to fund operations, expansion, and investment.
- *See*, *e.g.*, PwC Comment Letter at pp. 169-182, P&G Comment Letter at pp. 2-3, USCIB Comment Letter at pp. 19-21.

Key Issues that Must Be Addressed in Finalizing Prop. Treas. Reg. § 1.385-3 & -4 – Prevent "Viral" Effect of Successive Application of Rules

- The rules set forth in Prop. Treas. Reg. § 1.385-3 should not be applied successively, to avoid the "viral" effect of the recharacterization of one debt instrument resulting in the recharacterization other debt instruments.
- *See*, *e.g.*, PwC Comment Letter at pp. 178-182, NYSBA Comment Letter at pp. 159-162, AICPA Comment Letter at pp. 11-16.

Key Issues that Must Be Addressed in Finalizing Prop. Treas. Reg. § 1.385-3 & -4 – Additional Issues

- **Current-Year E&P Exception**. The current-year earnings and profits exception should be expanded to include previously taxed income ("PTI") and accumulated earnings and profits.
  - *See*, *e.g*., DC Bar Comment Letter at pp. 86-87, PwC Comment Letter at pp. 86-89.
- **The 72-Month *Per Se* Rule**. This rule should be either changed to a presumption, rather than a per se rule, or the period should be shortened, or both.
  - *See*, *e.g*., NYSBA Comment Letter at pp. 94-100, Baker & McKenzie Comment Letter at pp. 65-68.
- **Transition Period**. To give taxpayers time to implement revised cash management and financing practices, the application of the regulations should be deferred to taxable years beginning on or after January 1, 2019.
  - *See*, *e.g*., KPMG Comment Letter at pp. 5-11; *see also* BRT Comment Letter at p. 14.

Application to Prop. Treas. Reg. § 1.385-1 & -2

Identified Problem to be Addressed:

- To facilitate IRS examination of related-party debt instruments.

Scope of Proposed Regulation:

- Requires taxpayers to prepare the equivalent of a litigation file for every related-party debt instrument within 30 days of its issuance, even though the probability of any particular debt instrument being challenged is infinitesimal.
- Under current law, the IRS already may hold a taxpayer to its burden of proof with respect to any debt instrument.
- Penalty for failure to document contemporaneously, automatic equity characterization, is disproportionate to policy goal.

The compliance burden is dramatically underestimated in Notice of Proposed Rulemaking.

- *See*, *e.g*., BRT Comment Letter, Technical Appendix at pp. 15-18.

Authority Issues

Many commentators, including leading bar associations, have questioned the authority of the Treasury to issue the Proposed Regulations in their present form.

- *See*, *e.g*., DC Bar Comment Letter at pp. 14-24, ABA Comment Letter at pp. 35, 142-144, USCIB Comment Letter at pp. 44-53, Baker & McKenzie Comment Letter at pp. 28-46, Jones Day Comment Letter at pp. 1-2, PwC Comment Letter at pp. 46-64, Deloitte Comment Letter at pp. 55-59, KPMG Comment Letter at pp. 56-67.
- The Proposed Regulations would overturn well-established case law and ignore Code provisions dealing with related-party debt.

The sanction for failure to meet the 30-day documentation requirement of Prop. Treas. Reg. § 1.385-2, automatic characterization as equity, does not appear to be supported by section 385.

Courts might be more likely to view final regulations as a valid exercise of regulatory authority if the scope of the regulations better matched the stated policy objectives.