

# **Proposed Section 385 Regulations**

10/11/2016

# Proposed Section 385 Regs

## Objective

Treasury wants to limit "earnings stripping" by inverted and other foreign-HQ companies (payment of excessive interest to parties not subject to US tax, like foreign entities). For a U.S. company, there are very few circumstances in which earnings stripping can occur.

Treasury also wants to limit cash distributions from foreign subs of U.S.-HQ companies that are not repatriating foreign earnings.

## Collateral damage

The proposal extends well beyond its objectives, covering a wide range of ordinary-course business transactions. Including these transactions in the final rule would impose significant compliance costs that greatly exceed Treasury's estimates. Furthermore, including these transactions would result in serious and unintended negative consequences such as the loss of foreign tax credits and the taxation of formerly-tax-free restructurings.

## Bottom line

If finalized as written, the proposed rule would damage domestic, non-inverted companies that utilize treasury functions in the normal course of business. The regulation could even harm the competitiveness of these U.S.-HQ companies by imposing higher funding costs and subjecting them to added burdens that their global competitors do not have to bear.

Treasury should not apply these regulations to transactions between foreign subsidiaries of a U.S. company. Ordinary-course treasury funding, business-restructurings, and many other ordinary transactions between such foreign entities do not present any risk of U.S. earnings stripping or involve foreign distributions without earnings.

# Centralized Treasury Centers

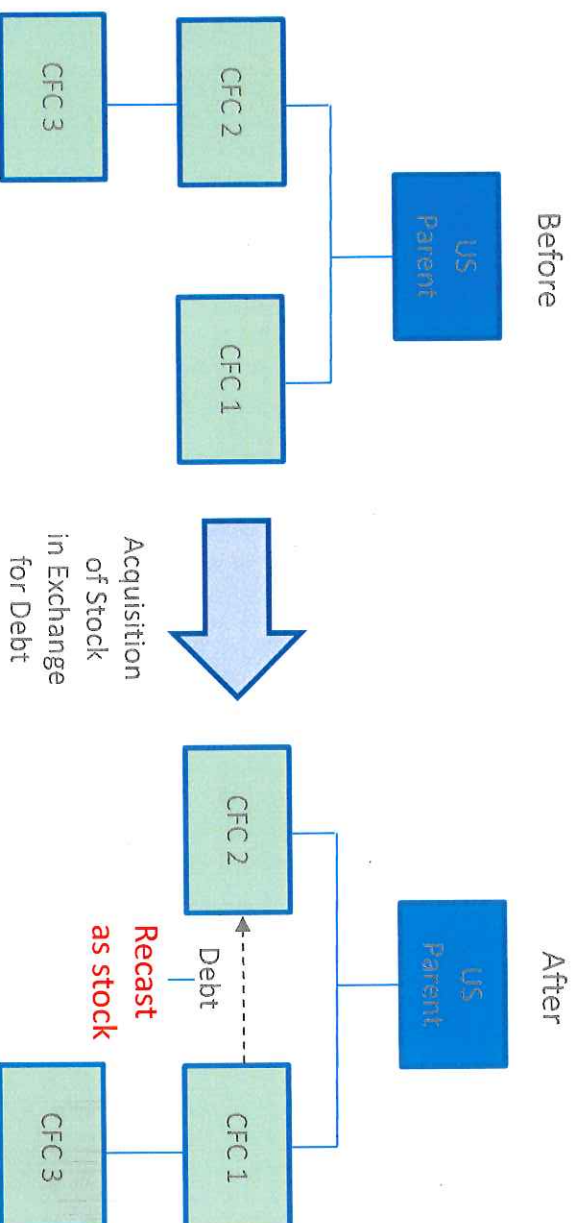
## Overview

- U.S. companies often manage the financial needs of their affiliates through a centralized treasury center. These treasury centers operate like an **internal bank** that provides a single face to 3<sup>rd</sup>-party banks and the capital markets.
- Companies establish centralized treasury centers to achieve **non-tax efficiencies** and **economies of scale** compared to the alternative of having each affiliate enter into separate financial transactions with 3<sup>rd</sup>-party banks.
  - Treasury centers manage **offsetting financial positions** within the corporate group. For example, excess cash in one affiliate funds the cash needs in another affiliate via loans to / from treasury center. And offsetting FX or interest-rate exposures among affiliates are netted via hedging transactions with treasury center.
  - Treasury centers then enter into financial transactions with 3<sup>rd</sup>-party banks that reflect the group's **net financial position**. Net transactions with 3<sup>rd</sup>-parties reduce the group's bank credit exposure and transaction fees/costs.

## Common features

- Companies often have separate treasury entities for different currencies, regions or countries
- Treasury centers typically provide short-term funding to affiliates via a "cash-pool" - unutilized cash from affiliates is automatically swept to the treasury center as deposits, and affiliates fund their daily cash needs by making draws on these deposits
- Treasury centers also provide longer-term funding to affiliates, like 3 -5 year revolving loan facilities; debt that is match-funded to an affiliate's long-term assets; and debt funding for an affiliate where equity funding presents legal, economic or political risks (e.g., restrictions on equity distributions)

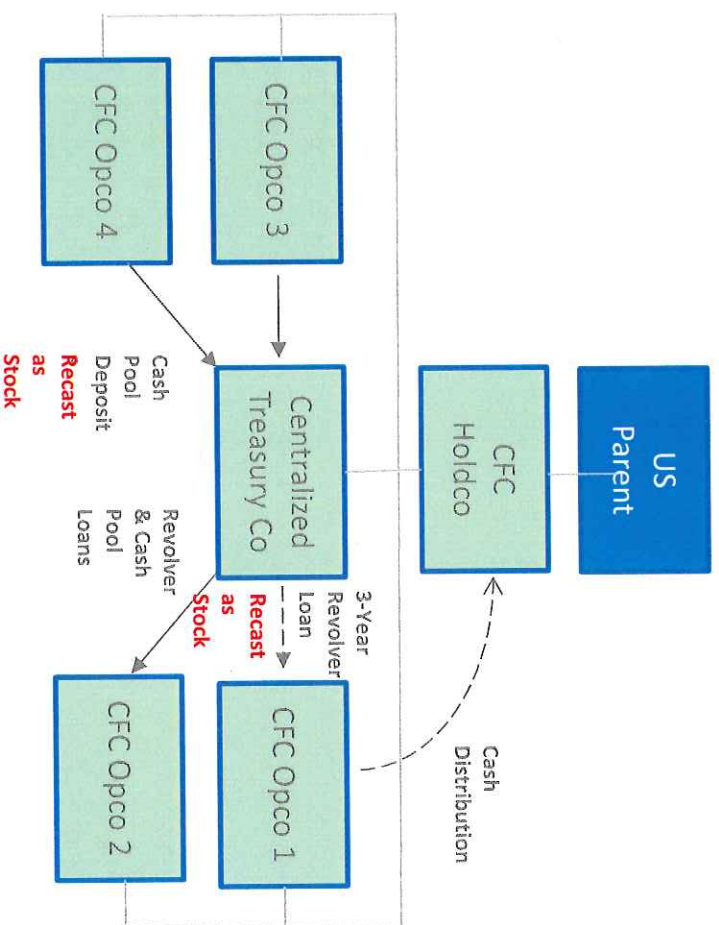
# Application of Regs to Foreign-to-Foreign Transactions



- What U.S. tax policy is served by applying regs to transactions between CFCs?
- No risk of U.S. earnings stripping
  - No distribution of foreign cash without earnings

- A CFC is a foreign subsidiary of a U.S.-resident corporation

# Impact of Regs on Ordinary-Course Treasury Funding

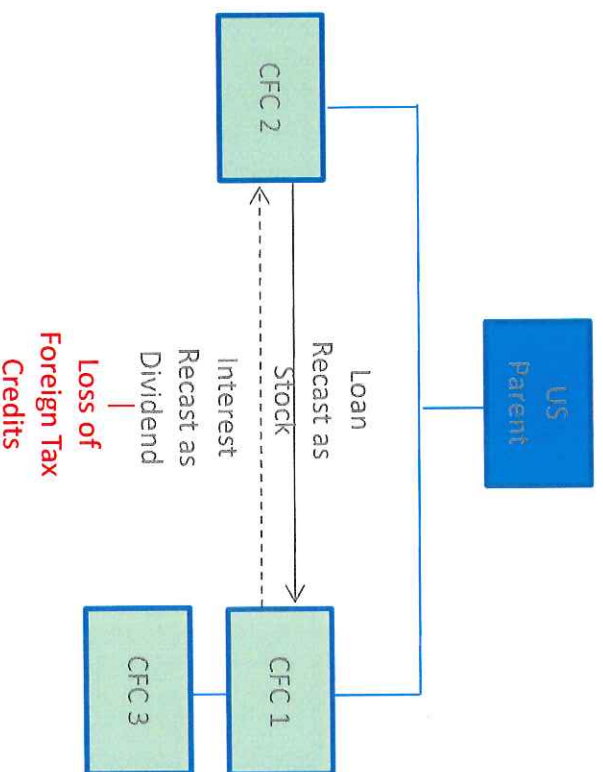


- Centralized Treasury Co, a CFC, enters into 3-year cash-pool facility with CFC Opco 1-4
  - CFC Opco 3-4 make deposits with the cash pool and CFC Opco 2 makes a draw from the cash pool
- Treasury Co also enters into 3-year revolving loan facilities with CFC Opco 1 - 2
- 2 years after making a cash draw under the revolving loan facility, CFC Opco 1 distributes earnings to CFC Holdco
- Under the 385 Regs, upon CFC Opco 1's cash distribution, Treasury Co's loan to CFC Opco 1 is recharacterized as stock
- This has a cascading effect – causing the cash pool deposits of CFC Opco 3-4 to be recharacterised as stock of Treasury Co



# Example of Tax Costs Resulting From Regs

## Loss of Foreign Tax Credits



- Earnings of a CFC are subject to US tax when distributed to the U.S. parent
- To avoid double taxation, the US parent receives a credit against its U.S. tax for the foreign taxes paid by the CFC
- To qualify for the foreign tax credit, the US parent or other affiliate that owns stock in the CFC must hold at least 10% voting rights in the CFC
- Debt recast as stock under the 385 Regs will cause of loss of foreign tax credits because the debt instrument will typically not provide the holder with voting rights