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Notice 2017-38 – Comments on the Final and Temporary Regulations Under Section 385

Dear Sir or Madam:

On July 7, 2017, the Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS") issued Notice 2017-38, *Implementation of Executive Order 13789 (Identifying and Reducing Tax Regulatory Burdens)* (the "Notice").[1] The Notice identifies eight tax regulations issued between January 1, 2016, and April 21, 2017, that Treasury has found to impose an undue financial burden on U.S. taxpayers or add undue complexity to the federal tax laws, or both. The final and temporary regulations under section 385, concerning the treatment of certain interests in corporations as stock or indebtedness,[2] were identified in the Notice as significant tax regulations requiring additional review.

Executive Order 13789 requires Treasury to recommend specific actions—potentially ranging from streamlining problematic rule provisions to full repeal—to mitigate the burden imposed by these regulations in a final report submitted to the President by September 18, 2017.[3] To that end, Treasury and the IRS have requested comments on whether the regulations described in the Notice should be rescinded or modified, and in the latter case, how the regulations should be modified in order to reduce burdens and complexity. On behalf of Tax Executives Institute Inc. ("TEI"), I am pleased to respond to

[1] 2017-30 I.R.B. 147.

[2] T.D. 9790, 81 Fed. Reg. 72,858 (Oct. 21, 2016). Unless otherwise indicated, all references to "section" are to sections of the Internal Revenue Code of 1986, as amended (the "Code"), and all references to "Treas. Reg. §" are to sections of the current Treasury regulations thereunder.

[3] Exec. Order No. 13,789, 82 Fed. Reg. 19,317 (Apr. 26, 2017).

the government's request for comments on the final and temporary section 385 regulations.[4]

About Tax Executives Institute

TEI is the preeminent association of in-house tax professionals worldwide. Our more than 7,000 members represent 2,800 of the leading companies in North and South America, Europe, and Asia. TEI represents a cross-section of the business community, and is dedicated to developing and effectively implementing sound tax policy, promoting the uniform and equitable enforcement of the tax laws, and reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike. As a professional association, TEI is firmly committed to maintaining a tax system that works—one that is administrable and with which taxpayers can comply in a cost-efficient manner.

TEI members are responsible for managing the tax affairs of their companies and must contend daily with the provisions of the tax law relating to the operation of business enterprises, including complying with complex regulations regarding the treatment of interests in corporations as stock or indebtedness, such as those under section 385. We believe that the diversity and professional training of our members enable us to bring a balanced and practical perspective to the issues raised by the final and temporary regulations under section 385, and we are eager to assist Treasury and the IRS in their laudable efforts to mitigate the financial burden and complexity of these regulations.

Comments

I. Overview

Section 385 authorizes the Secretary of the Treasury to prescribe regulations to determine whether an interest in a corporation is to be treated, for purposes of the Code, as stock or indebtedness by setting forth factors to be taken into account with respect to particular factual situations. On April 4, 2016, Treasury and the IRS issued proposed regulations under section 385 concerning the treatment of certain interests in corporations as stock or indebtedness, along with a request for public comments.[5] In response to this request, TEI submitted comments on July 6, 2016.

On October 13, 2016, Treasury and the IRS issued final and temporary regulations under section 385, primarily comprising: (i) rules establishing threshold documentation requirements that ordinarily must be satisfied for purported debt among related parties to be treated as

[4] Please note that TEI is concurrently submitting comments, under separate cover, in response to Notice 2017-38 on the final regulations under section 987 (T.D. 9794, 81 Fed. Reg. 88,806).

[5] REG-108060-15, 81 Fed. Reg. 20,912 (Apr. 8, 2016).

indebtedness for federal tax purposes (the "Documentation Requirements" in Treas. Reg. § 1.385-2); and (ii) transaction rules that treat as stock certain debt issued by a corporation to a controlling shareholder in a distribution or in another related-party transaction that achieves an economically similar result (the "Transaction Rules" under Treas. Reg. §§ 1.385-3 and -3T). The regulations generally affect domestic corporations, including those that are partners in certain partnerships, when those corporations or partnerships issue purported debt to related corporations or partners.

As set forth above, Treasury and the IRS issued the Notice on July 7, 2017, requesting comments on the final and temporary regulations under section 385. Shortly thereafter, on July 27, 2017, Treasury and the IRS issued Notice 2017-36 announcing a delay in the application of the Documentation Requirements by 12 months. This welcomed announcement was made in response to the concern that taxpayers have continued to raise with the application of the Documentation Requirements to interests issued on or after January 1, 2018, and in light of further actions concerning the final and temporary section 385 regulations in connection with the ongoing review thereof. We applaud Treasury and the IRS for affording the public this important opportunity to comment on the financial burden and complexity of those regulations. We submit these comments in the sincere hope that Treasury and the IRS will recognize the immense burden that the final and temporary section 385 regulations place on large businesses, and work with stakeholders to craft administrable rules that taxpayers can implement and apply at a reasonable expense commensurate with the intended policy benefit.

II. Documentation Requirements in Treas. Reg. § 1.385-2

Treasury regulations section 1.385-2 generally requires taxpayers to prepare and maintain certain documentation with respect to purported debt instruments subject to the regulations (referred to therein as "expanded group interests" or "EGIs").[6] The Documentation Requirements prescribe the minimum documentation necessary to substantiate the presence of four factors that are essential to the treatment of an EGI as indebtedness for federal tax purposes. Those four factors are: (1) the issuer's binding obligation to pay a sum certain; (2) the holder's rights to enforce payment; (3) a reasonable expectation of repayment; and (4) a course of conduct that is generally consistent with a debtor-creditor relationship.[7]

The Documentation Requirements apply to EGIs issued by domestic borrowers and require that the taxpayer's documentation for a given taxable year be prepared by the time the issuer's federal income tax return is filed.[8] If the requisite documentation is not prepared and

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[6] The final and temporary section 385 regulations generally apply to indebtedness of a covered member (defined as a domestic corporation) owed to a member of an expanded group (80-percent vote or value ownership test). Treas. Reg. § 1.385-1(c)(2), (4).

[7] Treas. Reg. § 1.385-2(c)(2)(i)–(iv).

[8] Treas. Reg. § 1.385-2(c)(4)(i), (d)(2)(iii).

maintained with respect to an EGI in accordance with the Documentation Requirements, and no exception applies, then the interest will be treated as stock (equity) for all federal tax purposes. Compliance with the Documentation Requirements, however, does not establish that an EGI is indebtedness; it serves only to satisfy the minimum documentation for the determination to be made under general federal tax principles.

A. Financial Burden of Compliance

In the preamble to the final and temporary section 385 regulations, Treasury and the IRS estimated that the Documentation Requirements will impact only 6,300 of the roughly 1.6 million C corporations in the United States (0.4 percent). The total start-up expenses for these affected taxpayers is estimated to be $224 million in 2016 dollars, or an average of $35,600 per firm, with ongoing annual compliance costs estimated to be $56 million in 2016 dollars, or an average of $8,900 per firm.

Based on TEI members' extensive experience complying with U.S. federal income tax laws, these estimates appear grossly understated. Assuming an average personnel cost of $300 per hour, the foregoing start-up (first-year) estimate implies that one person could digest the regulations, review the company's facts and financial information, and prepare all of the requisite documentation in less than 120 hours. Given the broad scope and complexity of the Documentation Requirements, as discussed below, that is impracticable. Based on TEI member experience, a more realistic estimate of an affected multinational corporation's total start-up expenses would exceed $1 million.[9]

B. Complexity Considerations

The extreme financial burden of complying with the Documentation Requirements is driven, in large part, by the overbreadth of their scope. They add significant administrative complexity to the tax compliance process, particularly with respect to more ordinary-course transactions (i.e., debt issued/incurred in the ordinary course of business). For instance, the Documentation Requirements apply not only to EGIs issued in standalone legal agreements, such as a note, but also to intercompany receivables and payables reflected as debt in a ledger, trade payable, accounting system, journal entry, or similar arrangement that is not generally evidenced by separate legal instrumentation, including cash-pooling arrangements. Unlike the Transaction Rules, the Documentation Requirements do not except any qualified short-term debt instruments from their scope.

The requirement to prepare and maintain substantiating documentation with respect to each of the four indebtedness factors generally applies to each EGI separately, adding further

[9] This estimate includes the cost of developing the necessary systems and processes to comply with the Documentation Requirements, as discussed below.

complexity to the compliance process. For instance, the regulations require the preparation and maintenance of written documentation establishing, as of the date of issuance, that the issuer's financial position supported a reasonable expectation of the issuer's intention and ability to meet its payment obligations under the terms of the EGI (e.g., a credit analysis). Additional complexity arises from the requirement to prepare and maintain documentation evidencing the debtor-creditor relationship, such as the issuer's timely payments of principal and interest. If the issuer does not make a payment of interest or principal that was due and payable under the terms of the EGI, then there must be written documentation evidencing the holder's reasonable exercise of the diligence and judgment of a creditor (i.e., an arm's length approach to enforce its rights). This requirement must be satisfied on an issuer-by-issuer basis, not on a consolidated return basis.

Large multinational taxpayers often have thousands, if not tens of thousands, of routine intercompany transactions to which the Documentation Requirements will apply. Most existing internal control systems are simply not designed to accommodate the breadth and complexity of the Documentation Requirements, especially in the case of ordinary-course transactions. As a result, many taxpayers are being forced to develop sophisticated new systems and processes to comply—standalone systems that have no relevance to financial controls or financial accounting. To many TEI members and the companies that they support, this represents an unreasonably complex and onerous burden.

Given the inordinate breadth and complexity of the Documentation Requirements, and the grossly underestimated compliance costs associated therewith, we respectfully request that Treasury and the IRS suspend the application of Treas. Reg. § 1.385-2 and reconsider the scope of its application. Consistent with the foregoing discussion, Treasury and the IRS should incorporate appropriate and administrable scope limitations that except, for example, intercompany debt arising in ordinary-course business transactions, such as non-interest bearing trade payables and receivables. TEI intends to submit additional comments to Treasury and the IRS in this regard in response to Notice 2017-36.

III. Transaction Rules under Treas. Reg. §§ 1.385-3 and -3T

Treasury regulations sections 1.385-3 and -3T provide rules that can recharacterize purported debt of U.S. issuers as equity if issued to a related person as part of a transaction or series of transactions that does not result in new investment in the operations of the issuer. The Transaction Rules generally treat as stock a purported debt instrument issued by a domestic corporation to a related person (i.e., a member of the "expanded group") in a distribution or in another transaction that achieves an economically similar result.[10] The Transaction Rules also include a "funding rule," which treats as stock a purported debt instrument issued by a

[10] Treas. Reg. § 1.385-3(b)(2).

domestic corporation in exchange for property, including cash, with a principal purpose of using the proceeds to fund a distribution to a related person or another transaction that achieves an economically similar result.[11] The funding rule generally applies to reclassify covered debt instruments issued during the period beginning 36 months before and ending 36 months after the date of the distribution or other transaction (the 72-month "per se period").[12] The Transaction Rules apply retroactively to covered debt instruments issued after April 4, 2016, the date the proposed section 385 regulations were issued.[13]

The Transaction Rules are subject to a number of important exceptions that are intended to limit their scope to transactions undertaken outside the ordinary course of business by large taxpayers with complex organizational structures. In the preamble to the final and temporary regulations, Treasury and the IRS emphasized that the Transaction Rules are intended to apply in particular factual situations where there are elevated concerns about related-party debt being used to create significant federal tax benefits without having meaningful non-tax effects (e.g., earnings stripping). As exemplified below, however, the Transaction Rules' inordinate complexity and unadministrable exceptions make their application to ordinary-course business transactions unavoidable.

A. Financial Burden of Compliance

Large business taxpayers are being compelled to incur substantial costs to develop databases and accounting processes to track and account for the thousands of routine intercompany transfers and obligations subject to the per se calculations of the Transaction Rules. For some corporations, such database and accounting work may take years to complete. For them, complying with the final and temporary section 385 regulations in the near term is a practical impossibility.

As previously discussed, the preamble to the final and temporary section 385 regulations included understated—in our view, grossly understated—estimates of the compliance costs associated with the Documentation Requirements in Treas. Reg. § 1.385-2. The compliance cost estimates used to support the regulations also appear to disregard the additional financial burden of complying with the Transaction Rules under Treas. Reg. §§ 1.385-3 and -3T. Multinational enterprises are particularly hard-hit by these rules. Those companies will be required to develop complex administrative processes and computer systems to track all of their intercompany debt. Complying with the per se funding rule will be particularly costly, as it arguably is the most burdensome, complex, and disruptive to companies' cash-management practices. Under the per se funding rule, each time a domestic corporation issues a covered

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[11] Treas. Reg. § 1.385-3(b)(3)(i).

[12] Treas. Reg. § 1.385-3(b)(3)(iii) (the "per se funding rule").

[13] Treas. Reg. § 1.385-3(g)(3)(i).

debt instrument to a related person it must review all such transaction(s) that occurred within the last 36 months and then monitor any such activity for the next 36 months. For large multinational groups, effectively tracking their intercompany debt will require multimillion-dollar expenditures related to up-front systems costs that could take up to 24 months to complete. Ultimately, the internal systems work required to properly track and comply with the final and temporary section 385 regulations is not unlike the work that financial institutions were required to undertake to comply with the regulations implementing the Foreign Account Tax Compliance Act, the effective date of which was delayed for several years in large part to accommodate the time needed to make systems changes. Here, in stark contrast, the Transaction Rules feature a retroactive effective date. This is simply impracticable, both administratively and economically.

Furthermore, as part of this tracking process, multinationals are required to maintain two separate organizational charts—one reflecting underlying legal and commercial realities that treats debt instruments in form and substance as debt for all but U.S. federal tax purposes, and another solely for federal tax purposes reflecting debt "deemed" as equity under the Transaction Rules. The latter chart would require constant, real-time revision as short-term "equity" instruments are deemed issued and "redeemed" as cash is moved around the group.

It is thus a serious question whether large multinational taxpayers will be able to effectively comply with the Transaction Rules despite their best efforts to do so, especially considering the April 4, 2016, effective date.

B. Complexity Considerations

As stated above, the Transaction Rules are subject to a number of important exceptions that are intended to limit the rules' scope to transactions undertaken outside the ordinary course of business by large taxpayers with complex organizational structures. For example, to facilitate non-tax motivated cash-management techniques, such as cash pooling or revolving credit arrangements, as well as ordinary course short-term lending outside a formal cash-management arrangement, the Transaction Rules provide an exception to the funding rule for "qualified short-term debt instruments." Pursuant to that exception, a debt instrument is treated as a qualified short-term debt instrument, and thus excluded from the scope of the funding rule, if the instrument is a short-term funding arrangement that meets one of two alternative tests—the specified current assets test or the 270-day test—or is an ordinary course loan, an interest-free loan, or a deposit with a qualified cash pool header.

In theory, Treasury and the IRS expect that the exception for qualified short-term debt instruments generally will prevent the treatment as stock of short-term debt instruments issued in the ordinary course of an expanded group's business (e.g., debt instruments arising from financing provided by a cash pool header pursuant to a cash-management arrangement). In

practice, however, the exception is administratively impossible for many taxpayers to satisfy and also fails to cover one of the most common intercompany debts incurred by foreign-parented U.S. multinational groups—debt balances in a cash pool. While the exception covers deposits to cash pooling arrangements, it does not apply to U.S. issuers that are net borrowers from cash pools.

Another notable exception to the Transaction Rules exempts debt instruments to the extent of the earnings and profits accumulated by the issuing corporation in taxable years ending on or after April 5, 2016, and derived while the entity was a member of the same group. To qualify for this exception, taxpayers must establish and maintain a special "expanded group earnings account," adding yet further complexity and compliance burden to the rules.

Finally, despite safe harbors insulating intercompany transactions between members of the federal consolidated group, the Transaction Rules could nonetheless create technical and administrative complexities for state tax purposes. The state complexities could vary wildly depending on whether and to what extent individual states choose to adopt or reject the new federal rules, or whether they remain silent regarding the application of the federal rules at the state level. For instance, separate company reporting states seeking to apply the federal rules at the state level could attempt to recharacterize the deductibility of related-party interest expenses if the documentation requirements are not met, even though such transactions would be protected by the one corporation rule at the federal level. The documentation requirements could thus be exponentially greater for multistate taxpayers. Moreover, the Transaction Rules would require multistate taxpayers to create and maintain state-specific procedures and organizational charts, tracking the impacts of the regulations on a state-by-state basis.

In view of the above, we respectfully reiterate our assertion that the Transaction Rules' inordinate complexity and unadministrable exceptions make their application to ordinary-course business transactions unavoidable. We therefore urge Treasury and the IRS to withdraw and thoroughly reconsider the Transaction Rules under Treas. Reg. §§ 1.385-3 and -3T in consultation with affected taxpayers across industry lines, with an eye toward crafting administrable rules that can be implemented and applied at a reasonable expense. TEI and its members stand ready to assist Treasury and the IRS in this regard.

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TEI's comments were prepared under the aegis of TEI's Federal Tax Committee, whose Chair is Sandhya K. Edupuganty. Watson M. McLeish, Tax Counsel at TEI, coordinated the preparation of TEI's comments. If you have questions about TEI's comments, please contact Mrs. Edupuganty at (214) 479-1010 or Sandhya_e@ti.com, or Mr. McLeish at (202) 470-3600 or wmcleish@tei.org.

Respectfully submitted,

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