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Executive Director

W. PATRICK EVANS
Chief Tax Counsel

September 1, 2017

Internal Revenue Service
Attn: CC:PA:LPD:PR
(Notice 2017-36)
1111 Constitution Avenue N.W.
Washington, D.C. 20224

Via E-mail: Notice.Comments@irs.counsel.treas.gov

Notice 2017-36 – Comments on the Final Documentation Regulations Under Section 385

Dear Sir or Madam:

On July 28, 2017, the Department of the Treasury (“Treasury”) and the Internal Revenue Service (“IRS”) issued Notice 2017-36, *One-Year Delay in the Application of § 1.385-2* (the “Notice”).¹ The Notice announces Treasury’s and the IRS’s intention to delay by 12 months the application of the intercompany debt documentation requirements in Treas. Reg. § 1.385-2.² This welcomed announcement was made in response to concerns that taxpayers have continued to raise with the application of those requirements to interests issued on or after January 1, 2018, and in light of further actions concerning the final and temporary regulations under section 385 in connection with Treasury’s regulatory review efforts pursuant to Executive Order 13789.³

Treasury and the IRS intend to amend Treas. Reg. § 1.385-2 to apply only to interests issued or deemed issued on or after January 1, 2019. To that end, the Notice invites comments on whether the proposed amendment and delay will afford adequate time for taxpayers to develop the necessary systems and processes to comply with the regulations. On behalf of Tax Executives Institute Inc. (“TEI”), I am pleased to accept the government’s invitation to comment on this important matter.

¹ 2017-33 I.R.B. 208.

² 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 issued thereunder.

³ Executive Order 13789, 82 Fed. Reg. 19,317, requires Treasury to recommend specific actions to mitigate the burden imposed by certain tax regulations, including the final and temporary regulations under section 385, in a final report submitted to the President by September 18.

About TEI

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 administering 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 complex regulations regarding the treatment of interests in corporations as stock or indebtedness—such as those under section 385. We believe the diversity and professional experience of our members enables TEI to bring a balanced and practical perspective to the issues raised by Treas. Reg. § 1.385-2, and we are eager to assist Treasury and the IRS in their important efforts to mitigate the financial burden and administrative complexity of these regulations.

Comments

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.⁴ In response to this request, TEI submitted detailed comments on July 6, 2016.⁵

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 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

⁴ REG-108060-15, 81 Fed. Reg. 20,912 (Apr. 8, 2016).

⁵ Comments from TEI to the IRS on Proposed Regulations Under Section 385 (July 6, 2016)

(<https://www.tei.org/advocacy/submissions/tei-comments-ss-385-proposed-regulations-allowing-irs-recharacterize-related>).

partnerships, when those corporations or partnerships issue purported debt to related corporations or partners.

Following the issuance of the final Documentation Requirements in Treas. Reg. § 1.385-2, the final and temporary regulations under section 385 were collectively identified in Notice 2017-38 as significant tax regulations requiring additional review pursuant to Executive Order 13789.⁶ Notice 2017-38, which was issued on July 7, requested comments on all aspects of the final and temporary regulations under section 385. TEI submitted responsive comments on August 7, in which we recommended that Treasury and the IRS suspend the Documentation Requirements in Treas. Reg. § 1.385-2 and reconsider the scope of their application.⁷ To that end, we urged Treasury and the IRS to adopt appropriate, administrable scope limitations to lessen the inordinate compliance burden that the Documentation Requirements impose on taxpayers. And while our members certainly appreciate the 12-month delay announced in Notice 2017-36, their ultimate concerns remain unaddressed; complying with the Documentation Requirements, even with a 12-month delay, remains an impracticably expensive and burdensome prospect. TEI, therefore, reasserts our recommendation that the Documentation Requirements in Treas. Reg. § 1.385-2 be suspended while Treasury and the IRS work with stakeholders to craft more administrable rules—and exceptions—with which taxpayers can comply at a reasonable expense, commensurate with the intended policy benefit.

A. Overview of the Documentation Requirements

Treas. Reg. § 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”).⁸ 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.⁹

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

⁶ I.R.S. Notice 2017-38, 2017-30 I.R.B. 147.

⁷ Comments from TEI to the IRS Under Notice 2017-38 on the Final and Temporary Regulations Under Section 385 (Aug. 7, 2017) (<https://www.tei.org/advocacy/submissions/tei-submits-comments-irs-response-notice-2017-38-final-and-temporary-section>). Our comments of August 7 also recommended that Treasury and the IRS withdraw the Transaction Rules under Treas. Reg. §§ 1.385-3 and -3T due to significant compliance and administrability concerns.

⁸ 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).

⁹ Treas. Reg. § 1.385-2(c)(2)(i)–(iv).

federal income tax return is filed.¹⁰ If the requisite documentation is not prepared and 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 recent *Tax Notes* article cited a former Assistant Secretary of the Treasury for Tax Policy as saying that “the documentation rules for the section 385 regulations shouldn’t be that onerous, and the administration’s deregulatory efforts may have helped tip the scales in favor of the delay.”¹¹ We respectfully disagree with the proposition that complying with the final Documentation Requirements “shouldn’t be that onerous” and suggest it derives from an overly simplistic view of the treasury function of large business taxpayers—a misguided view, which ultimately led to the adoption of an overly complex set of rules.

The following discussion describes the immense financial and administrative burdens imposed on taxpayers by the Documentation Requirements in Treas. Reg. § 1.385-2 and recommends several remedial modifications for Treasury and the IRS to adopt.

B. Financial and Administrative Burdens

1. Compliance Costs

In the preamble to the final and temporary regulations under section 385, 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 to be grossly understated. Assuming an average personnel/professional 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 required 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.¹²

¹⁰ Treas. Reg. § 1.385-2(c)(4)(i), (d)(2)(iii).

¹¹ Stephanie Cumings, *Delays Fuel Speculation About Regulatory Future*, 156 Tax Notes 1064 (Aug. 28, 2017).

¹² This estimate includes the cost of developing the necessary systems and processes to comply with the Documentation Requirements, as discussed below.

2. Administrative Complexity

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 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, accounting system, open account intercompany debt ledger, trade payable, journal entry, or similar arrangement that is not generally evidenced by separate legal instrumentation, including cash-pooling arrangements. And, unlike the Transaction Rules, the Documentation Requirements do not except any qualified short-term debt instruments from their scope—a questionable policy choice, particularly given the relatively small amounts of interest involved.

The requirement to prepare and maintain substantiating documentation for each of the four indebtedness factors generally applies to each EGI separately, adding further 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. And 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 they support, this represents an impracticably expensive and onerous burden, and sharply contradicts the earlier premise that complying with the Documentation Requirements “shouldn't be that onerous.”

C. Recommendations

Given the inordinate breadth and complexity of the Documentation Requirements, and the grossly underestimated compliance costs associated therewith, we respectfully urge Treasury

and the IRS to suspend Treas. Reg. § 1.385-2 and reconsider the scope of its application. Consistent with the foregoing discussion, Treasury and the IRS should adopt appropriate, administrable scope limitations to lessen the excessive compliance burden that the Documentation Requirements impose on taxpayers. Two critical limitations include: (i) a de minimis rule excepting interests under a threshold amount, specified as either a fixed dollar amount or a percentage of assets; and (ii) a general rule (or rules) excepting certain categories of transactions that do not raise earnings-stripping concerns. A prime example of the latter would be ordinary-course business transactions (i.e., debt arising/issued in the ordinary course of business). The volume of such transactions for large business taxpayers makes virtually any documentation requirement overly burdensome, especially given the harsh consequences of failing to comply (e.g., the loss of related interest deductions, the creation of a new class or classes of equity interests). And, as articulated in the preamble to the final section 385 regulations, the very nature of ordinary-course business transactions makes them an unlikely means of accomplishing abuse and a poor candidate for ultimate recharacterization as stock. This rationale would also support an exemption from the Documentation Requirements for interests created under cash-pooling and similar arrangements, as well as for certain short-term and non-interest bearing interests. Such day-to-day intercompany funding mechanisms have a fundamentally different nature than long-term funding efforts and little or no ability to facilitate targeted earnings stripping.

TEI respectfully reasserts that the proposed amendment and delay announced in Notice 2017-36 will be inadequate to address the serious implementation and compliance concerns raised by the Documentation Requirements. We therefore request the indefinite suspension of Treas. Reg. § 1.385-2 while Treasury and the IRS work with stakeholders across industry lines to craft more administrable rules (and exceptions) with which taxpayers can comply at a reasonable cost, commensurate with the intended policy benefit. TEI and its members stand ready to work with Treasury and the IRS in this regard.

TEI's comments were prepared under the aegis of TEI's Federal Tax Committee, the Chair of which is Sandhya K. Edupuganty. Watson M. McLeish, Tax Counsel for TEI, coordinated the preparation of TEI's comments. Should 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,
Tax Executives Institute, Inc.



Robert L. Howren
International President