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Overview

• On April 4th, Treasury announced proposed Section 385 regulations giving the IRS the authority to recharacterize related party debt as stock, or as part debt and part stock

• These regulations would apply to a wide variety of common business practices, including loans from one domestic corporation to another and the pooling of cash into common bank accounts

• S corporations in particular need to pay attention, because having their debt recharacterized as stock could result in losing their S corporation status
Basic Structure of the Proposed Regulations

• **385-1**: Defines “expanded groups” and “modified expanded groups” and gives the IRS the authority to “bifurcate” some of their debt instruments as part debt and part equity (Effective DOP)

• **385-2**: Outlines the documentation rules for related party debt for “expanded groups” that are publicly held, have revenues over $50 million or assets over $100 million in revenues (Effective DOP)

• **385-3 & 4**: Treats debt instruments of certain transactions as stock and provides an exemption for debt instruments issued and held within affiliated groups filing consolidated returns (Effective April 4, 2016)
Costs Associated with 385

• For S and C corporations alike, the costs of complying with the new 385 rules will be substantial

• Larger companies will need to invest in significant new paperwork and reporting compliance

• Businesses of all sizes will need to prepare to have their debt recharacterized, meaning they could lose interest deductions and owe additional taxes on newly designated “dividends”

• It’s likely companies will seek to exchange related party debt for commercial debt. The interest charged by the lender would be a new cost to the business
Components Necessary to Trigger Bifurcation Rule (385-1)

• To fall into definition of “Expanded” and “Modified Expanded” Groups, you need:
  1. A group of investors that control of two or more corporations
  2. A loan and/or cash pooling between members of the group
• That’s it – no international component is necessary
• A Modified Expanded Group can include individuals, partnerships, trusts and estates, as well as C corporations and S corporations
• There is no de minimis exception for this rule -- it is not limited to big companies
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Particular Challenge to S Corporations

• S corporations are unique in the tax code in that they can lose their S election if they violate any of the following restrictions:
  • S corporations may have only one class of stock
  • They are limited to 100 or fewer shareholders
  • Shareholders are restricted to US residents, estates and certain trusts and exempt entities
  • Recharacterizing debt as equity could cause an S corporation to have a second class of stock and/or an ineligible shareholder and lose its S status.
• The same could happen for so-called qualified S Corporation subsidiaries (Q-sub), which are required to be 100 percent owned by the parent S Corporation
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What does it Mean When an S Corp Loses its Status?

- **Option 1**: The corporation appeals to the IRS to have its S status restored. This process can take years, the IRS fees and professional fees can run into the tens of thousands of dollars (IRS filing fees for a business with $1m of revenue would be $28,300), and it would require that the cause of termination – in this case the loan turned to equity – be fixed, meaning the S corporation may have to find a different means of financing its operations.

- **Option 2**: The corporation reverts to C status as of the date of the offending debt/equity. The corporation will have to pay entity level taxes back to the date of the termination. All distributions made during that time – even those to pay taxes on the S corporation’s income – will be recharacterized and taxable as dividends to the shareholders.
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Example #1 – Brother-Sister Company

- Typical “Brother-Sister” company with common shareholders and cash pooling
- Would be a “Modified Expanded Group” under proposed regulations and the cash pooling could be reclassified as part stock under the bifurcation rule
- Companies could need to end the cash pooling arrangement and/or give up their S corporation status
Example #2 – Actual Domestic Manufacturing Company

- Manufacturing company operating in Midwest and Southeast with $70m in revenues and 400 employees
- All elements of “Modified Expanded Group” are present
- Company would need to end informal lending between companies to avoid losing its S election in companies C, E, and F

Diagram:

- Owners of Companies A, B, C, D, E, F
- Company F (S Corp)
- Company E (S Corp)
- Company D (LLC)
- Company C (S Corp)
- Company B (LLC)
- Company A (LLC)
- Bank

Informal Lending

Primary Loan
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**S Corporation Actions to Date**

- Joined the NAM-led trade association letter to Treasury calling on them to delay making the regulations final
- Sent an S-Corp letter to Hill tax writers identifying our concerns
- Met with Treasury and the IRS to make clear the implications of the regulations and asked them to:
  1. Slow process so that government and stakeholders have a chance to identify unintended consequences and delay the effective date to give affected companies time to reorganize their finances
  2. Exclude S corporations from the “expanded” and “modified expanded groups”
  3. Ensure that S corporations and Q-Subs that have their debt recharacterized do not lose their S corp status
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Take-Aways

- Proposed 385 regulations will impose significant costs on businesses of all sizes operating in the US
- These regulations are not limited to inversion or base erosion activities – they apply to purely domestic businesses engaged in normal business practices
- S corporations in particularly are at risk – they face the same costs as other businesses, but also could lose their S designation, resulting in significant legal costs and the necessity to reorganize their finances
- Treasury should:
  1. Slow down the process and delay the effective date
  2. Take S corps out of the expanded and modified expanded groups
  3. Ensure that S corporations and Q-Subs do not lose their S corp status
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