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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

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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)

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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

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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-subs), 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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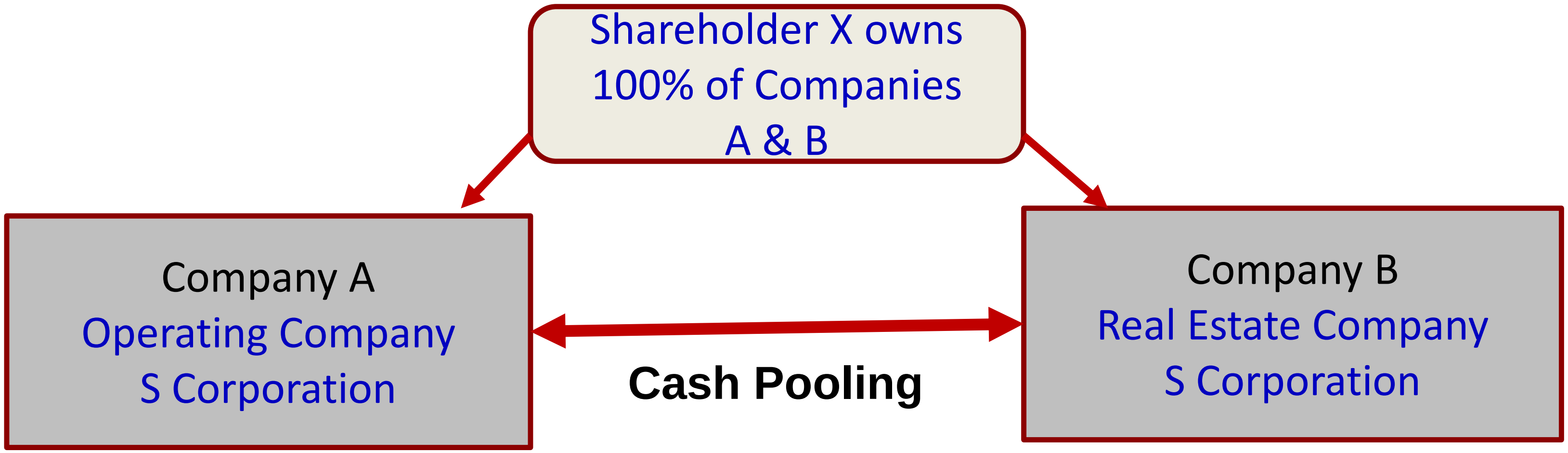
Example #1 – Brother-Sister Company



- 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

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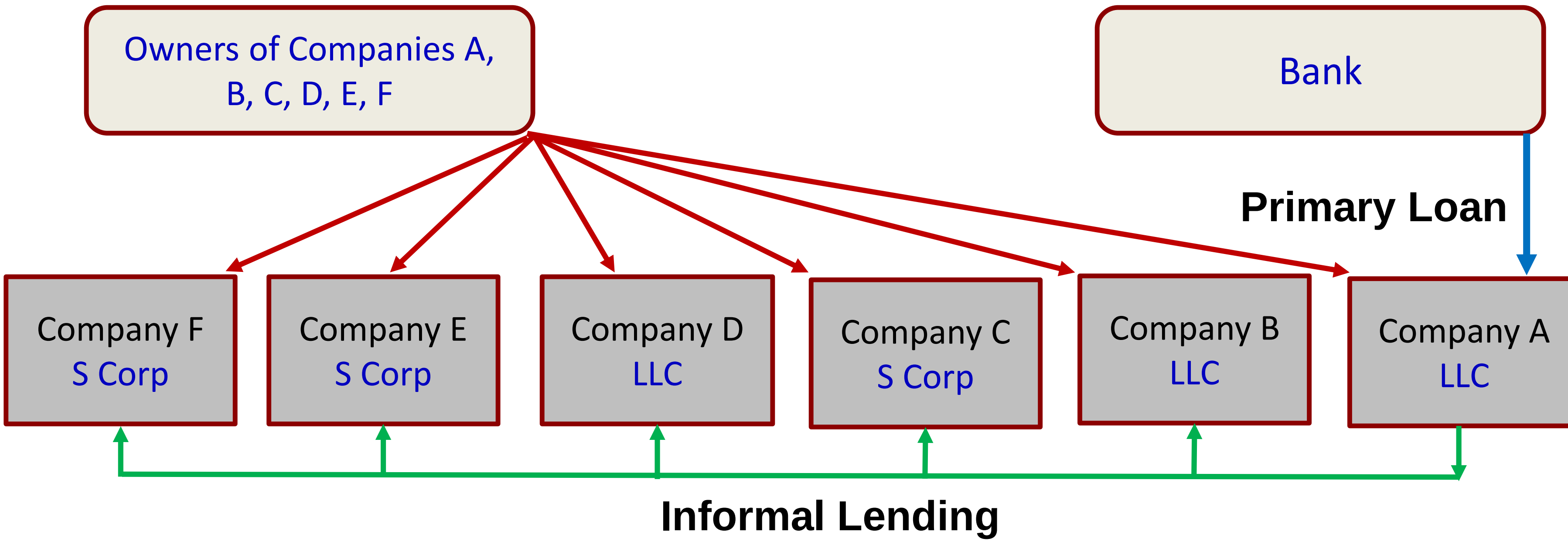
Example #2 – Actual Domestic Manufacturing Company



- 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

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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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