



US Inbound Corner

The continued relevance of section 385 recast rules and impact for multinationals

As interest rates and inflation have continued to climb, we are seeing an increase in the number of non-US parented groups that need to adjust their financing profile to either account for more intercompany debt at their US subsidiaries or pull cash out of their US subsidiaries. Before implementing any such change, we recommend analyzing such change under Treas. Reg. § 1.385-3 to ensure that it doesn't inadvertently cause a new or existing loan to be recharacterized as equity.

Prior to the enactment of the Tax Cuts and Jobs Act in 2017, **and prior to the enactment of several additional measures that limited the potential tax benefit of interest expense** (e.g., no BEAT rules under IRC section 59A, **anti hybrid rules under IRC section 267A, expansion of the application of the dual consolidated loss rules of 1503(d)** and a higher interest expense deduction limit under IRC section 163(j)), the Treasury and IRS issued the debt recharacterization rules under Treas. Reg. § 1.385. Under the general rule of Treas. Reg. § 1.385-3, a covered debt instrument (**CDI**), which is a debt instrument (other than certain specialized and short-term debt instruments) issued by a covered member (other than excepted regulated financial companies and regulated insurance companies),

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is recast as equity to the extent it is issued by a covered member to another expanded group member in the following transactions:

- a distribution;
- in exchange for expanded group stock (other than in an exempt exchange); or
- in exchange for property in an asset reorganization (to the extent that a shareholder-expanded group member immediately before the reorganization receives the CDI with respect to its stock in the transferor corporation) ("**Covered Transactions**").

Additionally, Treas. Reg. § 1.385-3 contains a funding rule, whereby a debt instrument can be recharacterized as equity if the debt instrument is treated as funding one of the Covered Transactions listed above within 36 months before or 36 months after the

completion of a Covered Transaction by a different group member. Certain exceptions apply to the general rule and funding rule if, among other things, there are sufficient "expanded group earnings", "qualified contributions", or the \$50 million threshold exception applies.

With the passage of the Tax Cuts and Jobs Act in 2017, there was an expectation that the Treasury and IRS may repeal the debt recharacterization rules of Treas. Reg. § 1.385. However, no repeal has happened to date. Therefore, it is imperative that any non-US parented group that seeks to either fund its US subsidiaries with debt, or pull cash out through distributions, model its ability to do so under Treas. Reg. § 1.385-3 by tracking the available expanding group earnings account, qualified contributions account, and \$50 million threshold exception.

Calendars to watch

Upcoming Tax Events:	
June 21	Dbriefs: Financial accounting and reporting for income taxes: Midyear update
July 17	Dbriefs: Navigating interest expense limitations under IRC Section 163(j)



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