Client Update
Finalized Section 385 Regulations Ease Burdens on Private Equity Industry

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Last week, the Treasury Department and Internal Revenue Service ("IRS") issued final and temporary regulations under section 385 of the Internal Revenue Code (the "Final Regulations") addressing the treatment of certain debt instruments issued between related parties as stock for U.S. federal income tax purposes. The Final Regulations reduced the scope and burden of the new rules in ways that should present welcome relief for members of the private equity industry.

The Final Regulations, as discussed in greater detail in our Client Update issued on October 18, 2016, finalize proposed regulations issued on April 4, 2016 (the "Proposed Regulations"). While generally adopting the framework set forth in the Proposed Regulations, the Final Regulations are narrower in scope in several important ways. Most notably, in the private equity context, the IRS and Treasury Department did not extend the Final Regulations to debt instruments issued by blocker corporations to the fund or its partners, and turned off certain "downward" attribution rules that could have swept loans between wholly unrelated entities into this regime. This Client Update discusses these changes and addresses other aspects of the Final Regulations that are particularly relevant to the private equity industry.

1. FINAL REGULATIONS RESERVE ON APPLICATION TO BLOCKER LOANS

Although the Proposed Regulations sought comments on whether debt issued by a blocker corporation (a "blocker loan") should be included within the scope of the new rules, the Treasury Department and the IRS ultimately reserved on these matters in the Final Regulations. Thus, blocker loans are currently outside of the scope of the Final Regulations, except to the extent the blocker corporation is directly or indirectly owned by an 80%, or greater, corporate shareholder, as discussed in more detail below. This means that most blocker loans will not be subject to the onerous documentation and equity recharacterization rules imposed by the Final Regulations.

Although most blocker loans will generally not be subject to the Final Regulations, private equity funds may nevertheless find it prudent to comply with the documentation requirements to avoid IRS challenges to debt characterization under a general debt-equity analysis. The documentation requirements were discussed in detail in our prior Client Update on the Proposed Regulations.

Scenarios in which blocker loans will be subject to the Final Regulations include cases where (i) a domestic blocker corporation is established for a single corporate investor (*i.e.*, a fund of one or a separately managed account) and (ii) an offshore feeder entity, treated as a corporation for U.S. tax purposes and established for non-U.S. and tax-exempt investors, makes an investment through a domestic blocker corporation. Since the corporate investor or feeder would own directly or indirectly more than 80% of the blocker corporation, the blocker corporation and the investor or feeder would form an "Expanded Group" and the blocker loan would be subject to the recharacterization rules and documentation requirements of the Final Regulations. Among other things, this would mean that each distribution by the blocker corporation would require testing to ensure that it does not run afoul of the "funding rule," which treats a debt instrument issued within 36 months before or after a distribution by an Expanded Group member as equity absent an applicable exception.

The Final Regulations offer some limited relief from the harshness of this result that was not available under the Proposed Regulations, particularly in relation to the funding rule:

- The Final Regulations provide that distributions out of a corporation's earnings and profits generated since April 4, 2016 during the period that the issuer was a member of the Expanded Group do not violate the funding rule (under the Proposed Regulations, a corporation could only avail itself of earnings and profits generated during the year of the distribution, with no ability to carry over unused earnings and profits to subsequent years).
- The Final Regulations also allow distributions to be netted against certain qualified contributions of property to the corporation (a concept that did not exist under the Proposed Regulations). A contribution to a blocker corporation's equity capital may therefore shield distributions that are not otherwise protected by the earnings and profits exception described above. This new exception could prove particularly useful because it provides a limited opportunity to undo distributions retroactively that would otherwise violate the funding rule by recontributing amounts to the blocker

corporation, so long as the corrective action is taken before the end of the taxable year in which the distribution occurs.

- The Final Regulations expanded the $50 million debt exemption under the Proposed Regulations. Under the Final Regulations, the first $50 million of debt of an Expanded Group otherwise subject to recharacterization (after taking into account the other exceptions) will not be recharacterized. The Proposed Regulations only offered this exemption if the total debt subject to recharacterization did not exceed $50 million.

It is worth noting that under both the Proposed Regulations and the Final Regulations, distributions that occur after all blocker loans are repaid do not run afoul of the funding rule (but may create issues for subsequent blocker loans made to the same blocker corporation).

2. FINAL REGULATIONS RESERVE ON DOWNWARD ATTRIBUTION

As discussed in the D&P Client Update, the Final Regulations reserve on the application of certain "downward" attribution rules. Such rules could have resulted in a fund being deemed to own all of the stock in various corporations owned by its partners, which stock could then be further attributed to the fund's corporate portfolio companies for purposes of determining membership in an Expanded Group.

The absence of downward attribution under the Final Regulations should be welcome news for funds and their investors. In particular, a banking subsidiary of a fund investor may now extend a loan to a corporate portfolio company without fear that such loan will be converted into an "Expanded Group Instrument" subject to the Final Regulations through downward attribution of the banking subsidiary's stock into such portfolio company's Expanded Group, a result under the Proposed Regulations that seemed unintended but nevertheless required by a mechanical application of the Proposed Regulations' downward attribution rules. Similarly, portfolio companies (or corporate alternative investment vehicles) under the common ownership of a fund can extend loans to each other without fear of equity recharacterization on account of the downward attribution rules of the Proposed Regulations. However, it is worth noting that the Final Regulations reserve on the application of "downward" attribution to situations where corporations are commonly controlled by a non-corporate entity.

3. GENERAL APPLICATION OF THE FINAL REGULATIONS

Although the Final Regulations significantly ease some of the concerns over basic private equity tax structuring raised by the Proposed Regulations, the new

rules will still apply to certain intercompany debt at the portfolio company level. The sections below describe some of the most important changes made by the Final Regulations. Our prior Client Update describes these rules in greater detail.

- *Per Se Rule*- The Final Regulations retain the per se rule, which was one of the most controversial aspects of the Proposed Regulations. However, portfolio companies should find it easier to navigate these rules with the expansion of the earnings and profits exception and the introduction of the qualified contributions exception.
- *Documentation Requirements Relaxed*- The Final Regulations extend the time period for satisfying the documentation requirements so that such requirements must now be met before the debt issuer has filed its federal income tax return for the year in question. This should allow tax preparers to review debt issuances during tax season and address any unintentional documentation failures. The Final Regulations also give some fairly narrow relief for violations if an Expanded Group is "highly compliant" with the documentation requirements.
- *Non-U.S. Corporations Exempted*- In a significant shift from the Proposed Regulations, the Final Regulations reserve on the treatment of debt issued by foreign corporations. This should significantly lower the burden of the Final Regulations on a multinational corporate group that funds non-U.S. subsidiaries with debt, regardless of whether that debt is owed to a U.S. or non-U.S. entity.

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Please do not hesitate to contact us with any questions.