Treasury Impact of Proposed Regulations under Section 385

The IRS and Treasury Department have proposed new rules under Section 385 of the US tax code dealing with related party transactions. The concern for corporate treasuries is that intercompany arrangements and liquidity structures, such as cash pooling, may be scrutinized and penalized by the IRS as a result of these rules. Treasury Alliance Group believes that this risk is small for properly documented and managed treasury structures.

Section 385 has been in place since 1969 and was designed to determine whether interest in an entity should "be treated as stock or indebtedness for purposes of the Code." But the regulations were never put into effect. The result has been that perceived mishandling of related party transactions has been dealt with through the courts which have created a body of case law with varying sets of facts and conclusions. The lengthy proposal places major emphasis on documentation and reporting of related party transactions.

Treasury Alliance Group believes that an explicit objective of the proposed update to the 385 regulation relates to clarifying and documenting the nature and intent of related party transactions in order to disqualify debt instruments that should be reclassified as capital. So it's important for concerned treasurers and tax advisors to review the potential impact on all types of intercompany cash flows which can include:

- **Intercompany receivables and payables:** these related party flows are treated in a similar fashion to third party transactions. There are clear terms and conditions and pricing is normally at arm's length vetted by tax with a thorough transfer pricing review. Intercompany settlements outside these parameters are likely to attract attention from US and local authorities. Extending this to POBO and COBO arrangements where a single entity handles the receivables or payables for related entities should not be an issue provided that they are handled either as loans or fee-based services on an arm's length basis.

- **Multilateral netting:** allows treasury to manage the intercompany transactions by settling and netting all cross currency, cross border invoices on a periodic, usually monthly, basis.

Treasurers may use netting as a tool to lead or lag intercompany payments for both FX and liquidity management reasons, but any extension should not go beyond 90 days. Pricing and payment conditions for the goods or services invoiced remain unchanged.

- **Short-term intercompany loans:** utilizing internally available cash is a standard treasury practice. The handling of withholding tax for these loans is usually jurisdictional in nature so it can sometimes make more sense to use bank financing. The proposed 385 rules might impose more scrutiny on these loans—but if there is clear and current documentation with arm's length terms and conditions this should not be an issue.

- **Physical cash pooling:** minimizes idle bank balances and reduces occasional overdrafts on a currency by currency basis. Movements between accounts are categorized as intercompany loans between a header entity and the participating subsidiaries. Specific loan documentation related to the pool structure is prepared in advance. The holding entity acts as an agent for the group, is not a principal, and does not hold stock in any of the companies. The sweeping entries are documented daily through the bank transactions and arm's length interest is paid or charged either monthly or quarterly. Physical cash pooling is a transparent and logical liquidity management tool. The documentation and management of the cash flows leaves a sufficient audit trail that would satisfy even a conservative interpretation of the 385 proposed update. For domestic ZBA sweeping structures, the ruling apparently would not apply as there is a comment stating that "the proposed regulations should not apply to issuances of interests and related transactions among members of a consolidated group because the concerns addressed in the proposed regulations generally are not present when the issuer's deduction for interest expense and the holder's corresponding interest income offset on the group's consolidated federal income tax return."

- **Notional cash pooling:** requires more caution as the lack of documentation for many notional pools may come under further scrutiny if the 385 proposals are enacted. In many notional arrangements treasury is not required to pay or charge interest to the participants as there is no physical movement of cash. So the explicit statement that the IRS wants information on "applicable instruments that are not indebtedness in form…" could be ultimately interpreted as applying to notional pooling. Another concern for those engaged in notional pooling is that the proposals include a three year retrospective look-back requirement for any debt issues that are scrutinized. For example, if one of the pool participants is tagged with a tax issue, that could cascade to all of the intercompany borrowing in the pool and then interest expense may be considered non-taxable and would have to be treated as a deemed dividend.

Interest optimization, where a bank pays interest to a pool header entity based on total net balances across more than one currency is not considered intercompany lending. It is a negotiated bank service where bank interest is applied to the net position of accounts held by a single legal entity and so 385 would not come in to play.

For cash pooling the only reference in the 136 page proposal requires that documentation be in place and a pooling arrangement is allowed only if this is the case and the relationships and responsibilities of the participants are clearly defined. For physical pooling the intercompany loan documentation and daily statements from the bank alone constitute a clear audit trail. But be prepared to evaluate more transparent intercompany arrangements if you have notional pooling in place.

In summary, corporate treasury in conjunction with their tax advisors should understand potential areas of impact with any intercompany arrangements now in place. It may be prudent to refresh pooling documentation and clarify the arm's length nature of any IHB or Treasury Center activities.

Concern, but certainly not panic is in order as the primary focus of 385 appears to target cash inversion and stock contributions that can, if not properly documented, be considered equity. The proposal cites two cases where the related party transactions were of significant size—$188 million and $363 million—considerably more than would typically be handled in an intercompany loan arrangement or cash pool.

Well-structured treasury arrangements with specific intercompany loan documentation, interest amounts and schedules that are clearly laid out and developed in collaboration with corporate tax for cash pooling, IHB or any other type of intercompany or "on-behalf" arrangements are unlikely to experience any problems or tax scrutiny. If that's not the case in your company, now is the time to review these types of transactions—even if the proposed 385 update is never implemented.

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