
Potential Impacts of Proposed Section 385 Regulations: Inbound and Outbound Examples

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Proposed Section 385
Regulations*

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Contents

Executive Summary	1
II. Overview of Proposed Section 385 Regulations	2
III. Inbound Examples	4
A. Expansion of Domestic Manufacturing Operations	4
B. Loss of Treaty Benefits Due to Foreign-to-Foreign Loan	6
IV. Outbound Examples	8
A. Cash Pooling	8
B. Hedging	13
V. Compliance Costs	15
A. Description of Documentation Requirements of Proposed Regulations	15
B. Aggregate Scope of Impact of Documentation Requirements	15
C. Cost Estimate of Documentation and Compliance Requirements	16
VI. Investment Impacts	19
A. Methodology	19
B. Results	19
Appendix. Example Details	21

Executive Summary

On April 4, 2016, the Department of the Treasury and the Internal Revenue Service (“IRS”) issued a Notice of Proposed Rulemaking under Internal Revenue Code section 385. The Proposed Regulations contain three sets of rules: (1) they authorize the IRS to treat certain related-party debt arrangements as part stock and part debt; (2) they establish a contemporaneous documentation requirement that must be satisfied for certain related-party debt to be respected as debt; and (3) they treat certain categories of related-party debt as equity, including a rule treating debt issued within a 72-month time frame of certain distributions or acquisitions as stock for all purposes of the Code (“Per Se Recharacterization Rules”).

This report provides four illustrative examples of the potential impact of the Per Se Recharacterization Rules on investment by US-based companies abroad and foreign-based companies in the United States. In addition, the report provides information obtained from a large US company on the hours of resources it estimates it would require to comply with the Proposed Regulations.

These four examples, all involving internal financing with economic substance, business purpose, arm’s length terms, and appropriate documentation, illustrate that the Per Se Recharacterization Rules have the potential to cause a large reduction in (1) the amount of US investment by foreign-based multinational companies, and (2) the ability of US-based multinationals to compete for investment opportunities abroad.

For each of the four examples, the impact of the Proposed Regulations is quantified first under a base case in which the taxpayer retains its present law tax structure and then under one or more alternative scenarios in which the taxpayer restructures to mitigate the impact of the Per Se Recharacterization Rule. The four examples are summarized below:

- 1. Expansion of US manufacturing operations by foreign-headquartered company.** A US subsidiary of a German automobile manufacturer finances a \$300 million expansion of its US sport utility vehicle plant using \$100 million of retained earnings and \$200 million of loans from its German parent.
 - Increase in cost of capital: 0.23 to 1.04 percentage points
 - Equivalent increase in corporate tax rate: 7 to 30 percentage points
 - Reduction in investment: 16 to 72 percent.
- 2. Loss of US treaty benefits by a foreign-headquartered company due to a foreign-to-foreign loan.** A Japanese manufacturing company has two lines of business, one of which it is consolidating under a subsidiary in Japan and the other under a subsidiary in Hong Kong. To better align its global operations, the Japanese subsidiary, which owns the company’s US operations, buys an operating company from the Hong Kong subsidiary in exchange for a \$100 million note.
 - Increase in cost of capital: 0.26 to 3.0 percentage points
 - Equivalent increase in corporate tax rate: 8 to 87 percentage points
 - Reduction in investment: 18 to 100 percent.
- 3. Foreign cash pooling arrangement by a US-based multinational company.** A US multinational company uses a foreign finance company to redeploy cash generated by its UK and German subsidiaries to its French subsidiary, which needs additional cash to support its operations.
 - Increase in cost of capital: 2.4 to 20.8 percentage points
- 4. Foreign currency hedging transaction by a US-based multinational company.** The French subsidiary of a US multinational company borrows €100 million from an affiliated foreign finance company to finance an expansion in France. The finance company swaps the Euro-denominated loan for a \$115 million US dollar-denominated loan with an unrelated counterparty.
 - Increase in cost of capital: 0.31 to 3.19 percentage points
 - Equivalent increase in corporate tax rate: 6 to 9 percentage points
 - Reduction in investment: 13 to 22 percent.

For the two inbound examples (examples 1 and 2), the Per Se Recharacterization Rule increases the cost of finance between 0.23 to 3.0 percentage points with a potential reduction in the affected inbound US investment of between 16 and 100 percent. This increased cost is equivalent to, at a minimum, a 7 percentage point increase in the US statutory tax rate or, at most, an 87 percentage point increase (i.e., increasing the 35-percent federal rate to a range from 42 percent to over 100 percent).

For the outbound example involving foreign cash pooling (example 3), the Per Se Recharacterization Rule potentially increases the cost of debt finance by 2.4 to 20.8 percentage points.

For the outbound example involving foreign currency hedging (example 4), the potential impact of the Per Se Recharacterization Rule on the cost of finance ranges from 0.31 to 3.19 percentage points, with a potential reduction in the affected outbound investment of as much as 22 percent. This is equivalent to an increase in the US corporate statutory tax rate of as much as 9 percentage points.

Moreover, even in situations where the Per Se Recharacterization Rules result in no reclassification of internal financings, the documentation requirements in the Proposed Regulations will impose substantial compliance costs on both US- and foreign-based taxpayers.

Both foreign-based companies with US operations and US-based companies with foreign operations will need to comply with the documentation requirements in the Proposed Regulations or risk the possibility of recharacterization of related-party debt as equity. These documentation requirements apply to ordinary course of business trade receivables, potentially affecting millions of transactions per year for each affected company. Using information obtained from a Fortune 100 company on the hours of resources it will require to comply, we estimate that the company's one-time compliance system set up costs would be \$2.75 million, and that recurring annual compliance costs in the first year and thereafter would be \$1.25 million. The annual ongoing compliance costs for this *one* company are 10 percent of the government's estimate of the total documentation and reporting costs for *all* taxpayers.

While compliance and documentation costs will vary by company, this example illustrates that total economy-wide compliance costs will be substantially greater than the documentation and reporting costs estimated by the IRS.

This report was prepared by PricewaterhouseCoopers LLP on behalf of the Organization for International Investment and the Business Roundtable.

I. Introduction

On April 4, 2016, the Department of the Treasury and the Internal Revenue Service (“IRS”) issued a Notice of Proposed Rulemaking under Code section 385. The Proposed Regulations contain three sets of rules: (1) they authorize the IRS to treat certain related-party debt arrangements as part stock and part debt; (2) they establish a contemporaneous documentation requirement that must be satisfied for certain related-party debt to be respected as debt; and (3) they treat certain categories of related-party debt as equity, including a rule treating debt issued within a 72-month time frame of certain distributions or acquisitions as stock for all purposes of the Code (“Per Se Recharacterization Rules”).

This report provides illustrative examples of the potential impact of the Per Se Recharacterization Rules on investment by US-based companies abroad and foreign-based companies in the United States. In addition, the report provides information on the estimated cost a multinational company would incur to comply with the documentation requirements in the Proposed Regulations.

The related-party loans in each of the examples are made at arm’s length, i.e., on the same terms as would be available from an unrelated lender, and meet the documentation requirements in the Proposed Regulations. The loans all have economic substance and have non-tax business motivations, e.g., to finance new investment, hedge currency exposure, or to consolidate ownership of subsidiaries within a single line of business through an internal reorganization.

Notwithstanding the economic substance, business purpose, and arm’s length terms of the loans in these examples, the Per Se Recharacterization Rules would cause one or more related-party loans to be treated as equity for all purposes of US tax law. The economic cost and potential investment impact of the Proposed Regulations is quantified under a base case in which the taxpayer retains its present law tax structure and then under one or more scenarios in which the taxpayer restructures to mitigate the impacts of the Per Se Recharacterization Rule.

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II. Overview of Proposed Section 385 Regulations

Section 385 of the Internal Revenue Code provides Treasury with authority to prescribe regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for US federal tax purposes as stock or indebtedness, in whole or in part.¹ It is clear from the statutory language that Congress intended for any regulations so prescribed to set forth factors to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor or corporation-shareholder relationship exists.²

On April 4, 2016, the Department of the Treasury and the Internal Revenue Service issued a Notice of Proposed Rulemaking under Code section 385. At a high level, the Proposed Regulations contain three sets of rules: (1) they authorize the IRS to treat certain related-party debt arrangements as part stock and part debt;³ (2) they establish a contemporaneous documentation requirement that must be satisfied for certain related-party debt to be respected as debt;⁴ and (3) they treat certain categories of related-party debt as stock, including a rule treating debt issued within a 72-month time frame of certain distributions or acquisitions as stock for all purposes of the Code.⁵

The Per Se Recharacterization Rules contain both a “General Rule” and a “Funding Rule.” The General Rule would recharacterize related-party debt instruments⁶ as stock if the instrument is issued in one of three situations: (1) in a distribution,⁷ (2) to acquire related-party stock,⁸ or (3) as consideration in an asset reorganization.⁹ The Funding Rule would recharacterize as equity a loan made with “a principal purpose” of funding an affiliate’s entering into one of the three transactions described in the General Rule.¹⁰ For example, a loan made between affiliates with a principal purpose of funding a cash dividend by the funded affiliate may be recharacterized as equity under the Funding Rule.

Significantly, although the Funding Rule’s use of the term “principal purpose” implies a subjective, intent-based standard, for many situations the rule is quite mechanical and not dependent on intent. Under the “Per Se” prong of this rule, a related-party debt instrument would be conclusively treated as issued with a principal purpose of funding a distribution or acquisition if the instrument is issued within three years either before or

¹ Section 385(a).

² Section 385(b) (“The regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists.”).

³ Prop. Reg. sec. 1.385-1(d)(1).

⁴ Prop. Reg. sec. 1.385-2.

⁵ Prop. Reg. secs. 1.385-3, 1.385-4.

⁶ The terms “related-party debt instrument” and “related party” are used as a shorthand. The Per Se Recharacterization Rules generally apply to debt instruments issued by a member of an expanded group and held by another member of an expanded group. See Prop. Reg. secs. 1.385-3(b)(2), (3). An expanded group is generally defined as an affiliated group under section 1504(a) but: (1) without regard to the exceptions under section 1504(b)(1)-(8) (relating to foreign corporations and certain other corporations), (2) by changing the requisite ownership threshold to 80 percent of vote or value (rather than vote and value), and (3) by extending the group to corporations indirectly held by other members, applying the constructive ownership rules under section 318 as modified by section 304(c)(3). See Prop. Reg. sec. 1.385-1(b)(3). For this purpose, a debt instrument means an interest that would, but for the application of Prop. Reg. sec. 1.385-3, be treated as a debt instrument as defined in section 1275(a) and Treas. Reg. sec. 1.1275-1(d). See Prop. Reg. sec. 1.385-3(f)(3).

The Proposed Regulations do not apply to indebtedness between members of a consolidated group and instead treat a consolidated group as a single taxpayer (*i.e.*, one corporation). Prop. Reg. sec. 1.385-1(e). However, certain debt instruments may become subject to the Proposed Regulations if and when the instrument or a party to the instrument ceases to be within the consolidated group. In this regard, various transition rules generally provide that if an instrument or corporation enters or exits the consolidated group, then such instrument, or any instruments issued or held by such corporation, will be treated as repaid on the date of entry or issued on the date of exit, as appropriate.

⁷ Prop. Reg. sec. 1.385-3(b)(2)(i).

⁸ Prop. Reg. sec. 1.385-3(b)(2)(ii).

⁹ Prop. Reg. sec. 1.385-3(b)(2)(iii). Prop. Reg. sec. 1.385-3(b)(2)(i)-(iii) sets forth the three broad categories of proscribed transactions that will be recharacterized as stock under the General Rule.

¹⁰ Prop. Reg. sec. 1.385-3(b)(3)(ii).

after a distribution or acquisition (i.e., within a 72-month period centered on the date of the distribution or acquisition).¹¹ Thus, if one affiliate (i.e., the funded member) borrows from another affiliate and if, within three years of the date of the borrowing, the funded member makes a distribution or acquisition, the debt is deemed to be a “principal purpose” debt instrument and is therefore recharacterized as equity.

An exception to the Per Se Rule (but not the documentation rule) is provided for instruments that arise from a sale of inventory or the performance of services (other than treasury services)¹² in the ordinary course of the issuer’s business.¹³ There are a few limited exceptions under the Per Se Recharacterization Rules,¹⁴ but there are no exceptions for cash pools, short-term obligations, working capital loans, purchase property indebtedness, or de minimis transactions.

When a debt instrument is recharacterized under the Proposed Regulations as equity, whether pursuant to the Commissioner’s discretion, due to a documentation failure, or as a result of the Per Se Recharacterization Rules, it is so characterized for all purposes of the Code. The type of stock it becomes is determined based on the terms of the instrument.¹⁵ Consequently, recharacterized debt frequently will be treated as nonvoting preferred stock with a fixed redemption date.¹⁶

¹¹ Prop. Reg. sec. 1.385-3(b)(3)(iv)(B).

¹² See 81 Fed. Reg. 20912, 20924 (Apr. 8, 2016) (“This exception ... is not intended to apply to intercompany financing or treasury center activities ...”).

¹³ Prop. Reg. sec. 1.385-3(b)(3)(iv)(C).

¹⁴ There are three notable exceptions: First, the aggregate amount of distributions and acquisitions taken into account with respect to any given taxable year is reduced by the issuer’s current-year earnings and profits. Prop. Reg. sec. 1.385-3(c)(1). Second, a funded stock acquisition will not result in the recharacterization of the funding debt instrument if the stock is acquired in exchange for property contributed to the issuer of the stock and the transferor owns at least 50 percent of the voting power and value of the issuer of the stock for at least three years thereafter. Prop. Reg. sec. 1.385-3(c)(3). Finally, the Per Se Recharacterization Rules do not apply at all if the aggregate amount of debt that would otherwise be recharacterized under the Per Se Rules is less than \$50 million. Prop. Reg. sec. 1.385-3(c)(2). Aside from these three exceptions and the ordinary course exception described above, no other exceptions apply.

¹⁵ See 81 Fed. Reg. 20912, 20922 (Apr. 8, 2016).

¹⁶ It therefore frequently would be nonqualified preferred stock for purposes of section 351(g)(2). Depending on the circumstances, it also could be section 306 stock, section 1504(a)(4) preferred stock, or fast pay preferred stock.

III. Inbound Examples

A. Expansion of Domestic Manufacturing Operations

The first inbound example illustrates the impact of the Proposed Regulations on a factory expansion in the United States by a US subsidiary that is financed by a loan from a foreign parent company.

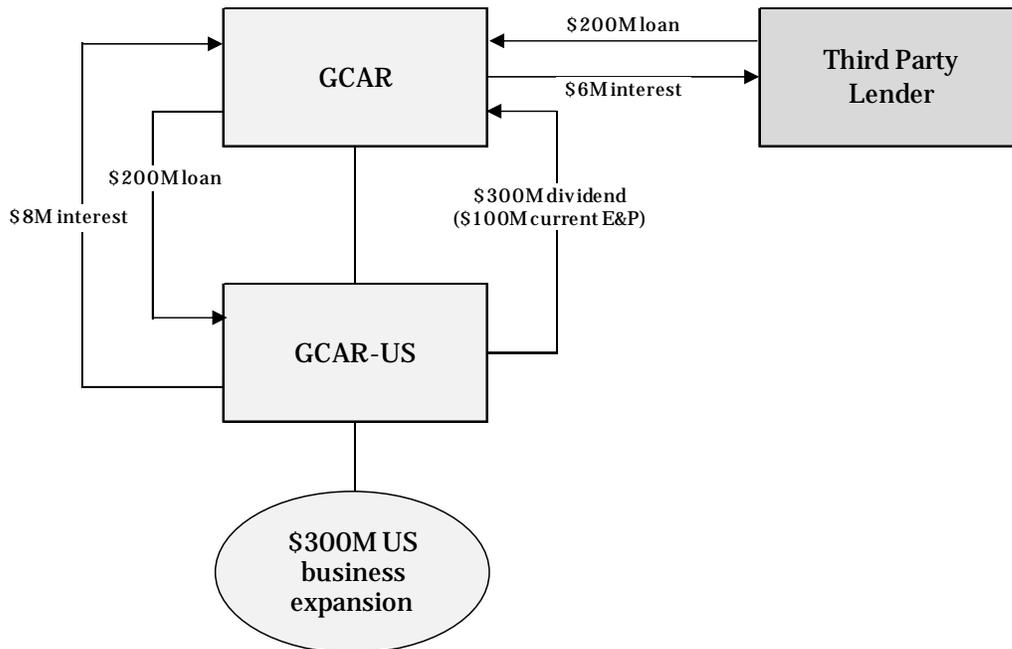
GCAR is a publicly traded automobile manufacturer headquartered in Germany with a US plant that manufactures SUVs primarily for the US market (see **Figure III.A**). The US subsidiary (“GCAR-US”) earns \$100 million in 2016, 2017, 2018, and 2019 and at the end of 2019 distributes a dividend of \$300 million to GCAR. In 2020, GCAR-US builds another production facility in the United States to meet growing demand for SUVs in the US and foreign markets.

GCAR-US finances the \$300 million expansion using \$100 million of retained earnings and a \$200 million loan from GCAR. GCAR borrows the \$200 million that it lends to its US subsidiary from a German bank. GCAR’s collateral includes its worldwide assets while GCAR-US’s collateral is limited to its own assets; consequently, GCAR is able to borrow on better terms than GCAR-US.

In this example, it is assumed that GCAR can borrow \$200 million with a 20-year term at a 3.0 percent interest rate, or \$6 million per annum. GCAR then loans the funds to GCAR-US for 20 years at an interest rate of 4.0 percent per annum, which is comparable to the rate a commercial bank would charge GCAR-US. Overall, the debt-to-equity ratio of GCAR-US does not exceed 1.5 to 1.

Figure III-A

US Business Expansion by US Subsidiary Financed by Foreign Parent Loan: Present Law Structure



Present Law

Under present law, GCAR-US may deduct the \$8 million per year of interest expense on the \$200 million debt incurred to expand its US production facilities. Under the US-German treaty, no withholding tax would be imposed on the interest payment.

Proposed Regulations: Scenario 1.--Retain present law structure

By contrast, under the Proposed Regulations, the \$200 million loan from GCAR would be recharacterized as equity because within a 36-month period prior to the loan, GCAR-US made a distribution to GCAR that was \$200 million in excess of current earnings and profits (“E&P”). As a result, the \$8 million of annual interest payments would be recharacterized under the Proposed Regulations as dividends to the extent of GCAR’s current and accumulated earnings and profits, which are not deductible for US tax purposes.

Under the Proposed Regulations (and assuming US states also follow the Proposed Regulations), at a combined federal and state income tax rate of 38.9 percent¹⁷, the after-tax cost of the \$8 million in interest expense would increase from \$4.9 million (61.1% of \$8 million) to \$8 million. Relative to the \$300 million investment in the US factory, this is a 104 basis point increase in the cost of finance (\$8 million minus \$4.9 million as a percent of \$300 million).

To avoid the adverse tax consequences of loan recharacterization, GCAR-US would have to avoid paying dividends in excess of earnings and profits within the period beginning 36 months before and ending 36 months after receiving the \$200 million loan from GCAR, in effect “trapping” earnings in the United States.

Proposed Regulations: Scenario 2.--Borrow from unrelated party

To mitigate the adverse impacts of the Proposed Regulations, GCAR-US could borrow from a bank rather than use parent debt. As GCAR would not be financing the expansion, it would be able to reduce its borrowing by \$200 million. Under this scenario, as a result of using an unrelated lender, GCAR’s net income would be reduced by \$2 million (the \$8 million of interest received and the \$6 million of interest paid under present law). After German federal and state income taxes, which currently average 30.2 percent¹⁸, the after-tax cost of using a third-party lender is \$1.4 million (\$2 million times 69.8%). Relative to the \$300 million investment in the US factory, this is a 47 basis points increase in the cost of finance (\$1.4 million as a percent of \$300 million).

Proposed Regulations: Scenario 3.--Retain US earnings

Had GCAR anticipated the need to expand its US manufacturing operations in 2020, it could have mitigated the impacts of the Proposed Regulations by reducing the \$300 million dividend in 2019 to \$100 million and using GCAR-US’s retained earnings to fund the expansion. In this case, the \$8 million interest payment from GCAR-US to GCAR is eliminated, with a corresponding increase in US tax and decrease in German tax. The net increase in tax is \$0.699 million per year (38.9% less 30.2% times \$8 million) or 23 basis points increase in the cost of finance (\$0.699 million as a percent of \$300 million). GCAR is assumed to continue to borrow \$200 million to replace the \$200 million dividend from GCAR-US.

¹⁷ The OECD Tax Database estimates that the average combined top federal and state corporate income tax rate in the United States is 38.9 percent. See, <http://stats.oecd.org//Index.aspx?QueryId=58204> (accessed June 29, 2016).

¹⁸ See OECD Tax Database.

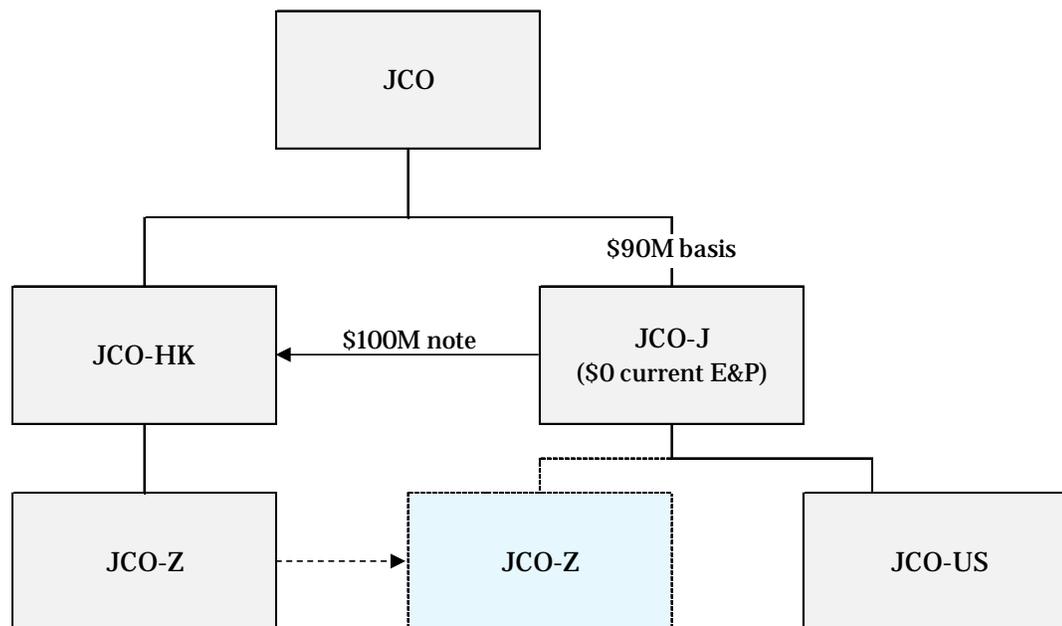
B. *Loss of Treaty Benefits Due to Foreign-to-Foreign Loan*

The second inbound example illustrates how a US subsidiary can lose US tax treaty benefits under the Proposed Regulations as a result of a loan between two related foreign entities.

JCO is a diversified publicly traded Japanese manufacturing company. It has two wholly owned subsidiaries: JCO-J incorporated in Japan and JCO-HK incorporated in Hong Kong. JCO's basis in JCO-J is \$90 million. JCO's US distribution, marketing, and customer support is conducted through JCO-US, a wholly owned subsidiary of JCO-J. JCO-J's basis in JCO-US is \$10 million. JCO-US pays a \$10 million dividend annually to JCO-J. JCO's country Z distribution, marketing, and customer support is conducted through JCO-Z, a wholly owned subsidiary of JCO-HK (see **Figure III.B**).

JCO wishes to reorganize its country Z operations underneath JCO-J to improve operational efficiency. To accomplish this restructuring, JCO-HK sells JCO-Z to JCO-J in exchange for a \$100 million note.

Figure III-B. -- Foreign-to-Foreign Loan: Present Law Structure



Present Law

Under present law, JCO-US qualifies for the benefits of the US tax treaty because JCO-J (a wholly owned Japanese subsidiary of a publicly traded Japanese parent) owns 100 percent of JCO-US. Consequently, JCO-US does not withhold on the \$10 million of dividends paid to JCO-J. Japan's top corporate tax rate is 29.97 percent¹⁹ and Japan exempts 95 percent of dividends received from foreign subsidiaries. Consequently, \$0.15 million of Japanese tax is owed on the \$10 million dividend. JCO-J's acquisition of JCO-Z from JCO-HK would have no US tax consequences under present law.

Proposed Regulations: Scenario 1.--Retain present structure

¹⁹ See OECD Tax Database.

Under the Proposed Regulations, JCO-J's loan from JCO-HK would be recharacterized as a \$100 million equity investment by JCO-HK in JCO-J. As a result, JCO's ownership percentage of JCO-J would fall from 100% to 47% (\$90 million/\$190 million) and JCO-US would no longer qualify for the benefits of the US-Japan treaty.²⁰ As a result, distributions from JCO-US to JCO-J would be subject to withholding at a 30 percent rate instead of the zero percent treaty rate. Consequently, total taxes paid on JCO-US's \$10 million annual dividend to JCO-J would increase by \$3 million (30% withholding rate on \$10 million dividend) to \$3.15 million. This is equivalent to a 300 basis point reduction in the annual return on JCO-J's investment in JCO-US (see details in the Appendix).

Proposed Regulations: Scenario 2.--Borrow from a related party

To avoid the loss of treaty benefits, JCO-J could finance the acquisition of JCO-Z by borrowing \$100 million from JCO. Assuming JCO charges JCO-J the same interest as JCO-J would have paid on the note under present law and that JCO-HK distributes the full proceeds from the sale of JCO-Z to JCO, there will be a one-time increase in total taxes paid of \$6.5 million (from \$0.15 million to \$6.65 million). The increase in tax is attributable to the 5 percent Hong Kong withholding tax on the \$100 million distribution plus the \$1.5 million Japanese tax on this dividend. Assuming a 4 percent discount rate (the assumed interest rate on the loan) the one-time increase is equivalent to an annual increase in taxes of \$0.26 million or 26 basis points relative to JCO-J's investment in JCO-US (see details in appendix).

²⁰ JCO-J could previously have qualified for benefits as a subsidiary of a publicly traded company. However, JCO-J would lose the ability to qualify under this test once it has a non-US, non-Japanese intermediate owner.

IV. Outbound Examples

A. Cash Pooling

The first outbound example illustrates the impact of the Proposed Regulations on cash pooling arrangements. Although this example is presented in the context of a US multinational, similar impacts also arise for foreign-based multinationals with US operations.

A principal treasury function in the day-to-day operations of a multinational enterprise is to redeploy cash generated by one member of the affiliated group to fund operations of other group members. Such cash deployment can take place both within a single country and across the globe. Internal cash management allows multinational enterprises, whether based in the United States or abroad, to reduce their external financing expense and maximize their returns on equity.

Multinational enterprises efficiently redeploy cash through a variety of internal cash management techniques, including cash pools and intercompany loans. Cash pools act as internal banks within a multinational group, taking deposits, or borrowing, from dozens or hundreds of affiliates and lending the proceeds to dozens or hundreds of affiliates. The balances often roll and fluctuate on a daily basis, resulting in hundreds or thousands of related-party borrowings and repayments per day passing through the corporation acting as the cash pool (*i.e.*, the “cash pool leader” or “cash pool head”).

Effective internal cash management requires the ability to mobilize and redeploy cash quickly. Theoretically, an enterprise’s available funds could be redeployed through distributions and capital contributions, but practically it is difficult to do so. Declaring and paying distributions takes time; many jurisdictions restrict entities from declaring distributions in excess of distributable reserves; cross-border distributions frequently are subject to withholding taxes and explicit capital controls may limit distributions. These concerns multiply as funds travel through each level of a sprawling corporate structure. Consequently, a more efficient manner of mobilizing and deploying cash is through direct intercompany loans. Frequently, these loans can be issued and repaid in less time, with less cost, and subject to fewer restrictions than distributions and capital contributions.

Two common practices for internal cash management are long-term intercompany financing and short-term cash pooling. The scale and complexity of a large multinational group’s cash management practices result in some debt instruments falling along a spectrum between long-term intercompany financing and short-term cash pooling.

Long-term intercompany financing typically involves term loans or revolving credit facilities pursuant to which a cash-surplus affiliate makes available to a cash-deficit affiliate significant funds for capital expenditures and related investments. These loans are similar to bank loans, with the benefit that the interest income that would have been earned by the bank instead is kept within the enterprise to further promote growth and investment.

Short-term cash pooling typically involves multiple affiliates pooling excess funds and making those funds available to other affiliates with cash shortfalls.²¹ This pooling typically is accomplished by having each affiliate maintain a separate bank account within which it deposits its cash or from which it can overdraw on a daily basis to meet its operating needs. Under a standing set of transfer instructions, all positive cash balances in affiliates’ accounts are swept at the end each day into the bank account of the entity serving as the cash pool leader, and all overdrafts in accounts of affiliates are covered by automatic transfers from the cash pool leader’s

²¹ Treasury regulations with respect to the Foreign Account Tax Compliance Act (“FATCA”) provide a definition of treasury center activities not dissimilar from this common understanding of short-term cash pooling:

Managing the working capital of the expanded affiliated group (or any member thereof) such as by pooling the cash balances of affiliates (including both positive and deficit cash balances) or by investing or trading in financial assets solely for the account and risk of such entity or any members of its expanded affiliated group.

Treas. Reg. § 1.1471-5T(e)(5)(i)(D)(1)(iv).

This definition does not, however, include the related and equally important function of long-term intercompany financing.

account. Such arrangements often are referred to as daily zero-balance cash pooling because the closing daily balance in the account of each affiliate other than the cash pool leader is zero.

When positive cash amounts are transferred from an affiliate's account to the cash pool leader account, that transfer generally is recorded pursuant to standard facility documentation as a loan to, or deposit with, the entity that owns the cash pool leader account. If, however, the affiliate currently is in a net borrowing position with the cash pool, the cash transfer is recorded as a repayment against that borrowing. When cash is transferred automatically from the cash pool leader account to cover an overdraft in an affiliate's account, that cash transfer is recorded as a loan to that affiliate. Because these sweeps can occur on a daily basis among dozens or hundreds of affiliates, the corporation serving as the cash pool leader can be entering into dozens or hundreds of related-party funding transactions a day, and hundreds or thousands of related-party funding transactions per year.

These cash pooling arrangements allow a multinational enterprise to deploy liquidity across its various operating subsidiaries, while minimizing both the aggregate cash balances needed and external funding costs. Cash pools also allow an enterprise to aggregate cash surpluses and shortfalls within currency environments and thus minimize the enterprise's net foreign currency exposure that must be hedged.²² In larger multinational enterprises, these cash pools often are tiered, sometimes with affiliates directly participating in a local country cash pool, which participates in a regional cash pool, which in turn participates in a global cash pool.

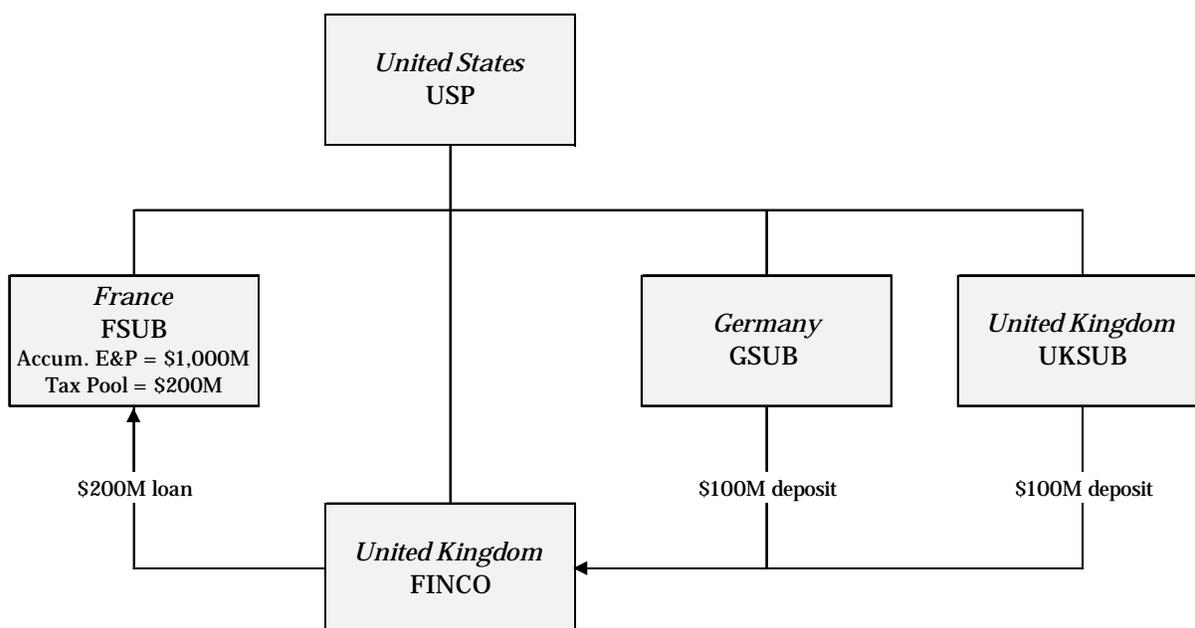
Example

For the sake of simplicity, we focus on an unrealistically simple hypothetical fact pattern relating to cash pooling. USP, a US parent of a multinational group, owns all the outstanding stock of four foreign subsidiaries: FSUB (French), GSUB (German), UKSUB (UK), and FINCO (UK). FSUB, GSUB, and UKSUB, are operating companies, and FINCO serves as the foreign group's treasury center and cash pool leader (see **Figure IV.A**). To the extent the foreign operating entities have excess cash, they deposit that cash with FINCO in the cash pool. If one of the foreign operating entities needs funds (*e.g.*, to service monthly payroll expenses), the entity borrows from FINCO rather than obtaining financing through the use of a third-party lender.

In this example, GSUB and UKSUB each deposit excess cash of \$100 million with FINCO and FSUB borrows \$200 million from FINCO for one year to cover its cash shortfall. FINCO charges 4% on loans and pays 1% on deposits and, over the course of a year, earns a net margin of 3% on the \$200 million of aggregate deposits, or \$6 million.

²² Because an enterprise's affiliates typically maintain their accounts in their own functional currencies, the debts arising between the affiliates and the cash pool typically are denominated in the functional currencies of the affiliates, and the foreign currency risk is centralized in the entity serving as the cash pool leader, where it can be managed through hedging. Interest generally accrues on affiliates' borrowings from the cash pool at a rate higher than the rate of interest that accrues on their deposits with the cash pool, with the result that the cash pool leader earns a spread on its activities.

Figure IV-A. -- US Multinational Company Foreign Cash Pooling Arrangement: Present Law Structure



Present Law

Under present law, the \$6 million in net earnings of FINCO is subject to UK tax at a rate of 20%, resulting in \$4.8 million of after-tax income (80% of \$6 million).

We further assume in this example that to resolve a transfer pricing examination issue, FSUB's income is subject to a retroactive reduction resulting in a deemed dividend to USP of \$300 million, which is \$200 million in excess of FSUB's current E&P of \$100 million. This adjustment occurs within 36 months after FSUB borrows from FINCO. Under present law, this deemed dividend has no effect on FSUB's loan. After the transfer pricing adjustment, FSUB has accumulated E&P of \$1 billion on which it has paid \$200 million of French tax.

Proposed Regulations: Scenario 1.--Retain present law structure

Under the Proposed Regulations, the consequence of the deemed dividend is that FSUB's borrowing from FINCO is recharacterized as stock for all purposes of the Code. The type of stock it becomes is based on the terms of the instrument, which in many cases will be nonvoting preferred stock with a fixed redemption date.

As a result of the recharacterization, the \$8 million of interest payments on FSUB's borrowing will be treated as distributions with respect to the deemed stock now treated as held by FINCO.²³ Furthermore, the \$200 million principal payment on the borrowing will be characterized as redemptions of the stock and treated as distributions under section 302(d). This deemed dividend then will result in FSUB's next draw from the cash pool being recharacterized as equity, and so on *ad infinitum*. These distributions will result in \$208 million of dividends to FINCO.²⁴

The dividends will reduce the foreign taxes in FSUB's foreign tax pool by \$41.6 million (\$200 million tax pool times the ratio of \$208 million of dividends to \$1 billion of accumulated E&P),²⁵ but will not move the foreign taxes to FINCO's foreign tax pool because FINCO does not own at least a 10-percent voting interest in FSUB.²⁶

²³ See 81 Fed. Reg. 20912, 20922, 20925 (Apr. 8, 2016).

²⁴ See section 301(c).

²⁵ Sections 301(c)(1), 316(a). Presumably these dividends would not result in subpart F income due to the related-party look-through exception. See section 954(c)(6); see also Notice 2007-9, 2007-1 C.B. 401.

²⁶ See Treas. Reg. § 1.902-1(a)(1)-(4), (8)(i), and (11).

Consequently, the USP Group will permanently lose the \$41.6 million of foreign tax credits associated with the E&P paid from FSUB to FINCO.

Further, because FSUB's borrowing is recharacterized as a nonvoting equity interest held by FINCO, USP no longer controls FSUB within the meaning of section 368(c) while the borrowing is outstanding.²⁷ Therefore, any contributions of assets by USP to FSUB would become a taxable exchange rather than a tax-free contribution,²⁸ and any intended reorganizations with FSUB likely will fail because USP no longer controls FSUB.²⁹

In addition, because FINCO is viewed as making an equity investment in FSUB, the deposits it holds from GSUB and UKSUB also will be recharacterized as equity investments. This cascading effect may cause a reduction in FINCO's UK tax pool when GSUB and UKSUB withdraw their deposits, eliminating the possibility to credit these taxes.

At a minimum, in this example, the cash pooling arrangement causes USP to permanently lose the ability to credit \$41.6 million of French tax, or 20.8 percentage points (\$41.6 million/\$200 million) on \$200 million of loans from the cash pool. In addition, USP likely will lose the ability to credit UK tax due to the cascading impact of FSUB's debt recharacterization.

The cumulative effect on a cash pool's ability to engage in intercompany lending only worsens as the enterprise grows in size. The simple example described above consists of a single cash pool with only three participants. Many multinational enterprises, however, maintain a separate cash pool for each country in which they have multiple subsidiaries to minimize local tax issues such as withholding taxes. These local country cash pools then may participate in a currency-specific cash pool to minimize the impact of currency risks. Finally, the currency-specific cash pools may feed into a multi-currency global cash pool which centralizes both cash and currency risk.

In a common structure like this, if a cash pool participant engages in a proscribed transaction and thereby taints the local country cash pool head, this has the potential to successively infect the currency-specific cash pool (*i.e.*, if the local country cash pool head borrows from the currency-specific cash pool during the 72-month period) and the global cash pool (*i.e.*, if the currency-specific cash pool head borrows from the global cash pool during the 72-month period). As discussed above, these effects accumulate as balances fluctuate, eventually magnifying a small "foot fault" by one participant into a systemic problem that recharacterizes funding transactions across the global cash management system.

The consequences of the potential systemic recharacterization described above are severe. With extensive cross-chain equity interests being issued and repaid on a daily basis, a multinational enterprise's global operations could experience (i) widespread loss of foreign tax credits; (ii) inability to effectuate tax-free capitalizations, reorganizations, and liquidations; (iii) non-economic subpart F income from mismatched foreign currency exposures; (iv) concerns of fast-pay stock and listed transactions; and (v) unmanageable complexity and uncertainty associated with a structure for US tax purposes that is completely disconnected from the enterprise's structure for commercial, financial accounting, and foreign tax purposes.³⁰

²⁷ In particular, section 368(c) defines control as direct ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of other classes of stock. In the example described above, after the FSUB borrowing is recharacterized, USP would continue to own 100 percent of the total combined voting power of FSUB, but it would own zero percent of FSUB's nonvoting stock (*i.e.*, the deemed stock).

²⁸ See section 351(a) (requiring the transferor(s) control the transferee within the meaning of section 368(c)).

²⁹ See sections 355(a)(1)(A) (requiring a distribution of section 368(c) control) and 368(a)(1) (describing transactions that qualify as reorganizations, often by reference to control under section 368(c)).

³⁰ The above discussion has focused on physical cash pooling and intercompany financing. Some companies use notional cash pooling to manage cash deployment and foreign currency exposures. Instead of actual cash transfers between participants and a pool head, a third-party bank notionally nets participants' accounts to determine the aggregate interest to pay or charge based on the group's net cash position. As a result, cash-poor affiliates can borrow from the bank based on the strength of other affiliates' deposits at a reduced financing cost. Because each participant deposits or borrows in its functional currency, this system also effectively manages the foreign currency exposures that an internal cash pool head would otherwise need to manage.

Although notional cash pooling is conducted entirely through interactions with a third-party bank and generally does not include related-party transactions, consideration should be given to whether the bank could be treated as a

Proposed Regulations: Scenario 2.--Use a commercial bank for cash pooling

Given the high tax and compliance costs of accidentally triggering recharacterization, US multinationals may seek to protect themselves by using third-party banks to manage their foreign subsidiary cash. In this case, assuming that FSUB can obtain bank credit at 4% and GSUB and UKSUB earn 1% on their bank deposits, net interest income of \$6 million (\$8 million paid by FSUB and \$2 million earned by GSUB and UKSUB) will be paid to third-parties and UK tax of \$1.2 million would be eliminated. Thus, the net cost of external cash pooling would be \$4.8 million (\$6 million of net interest payments less \$1.2 million of tax savings). If commercial bank terms are less advantageous, the cost to the USP group will be more than \$4.8 million, or 240 basis points on \$200 million of loans from the cash pool.

conduit, resulting in the participants being treated as directly loaning to one another. For example, Rev. Rul. 87-89, 1987-2 C.B. 195 (*obsoleted in part by* Rev. Rul. 95-56), Rev. Rul. 76-192, 1976-1 C.B. 205, and Treas. Reg. § 1.881-3(c) address circumstances where, for purposes of sections 956 and 881, borrowings from a bank are treated as borrowings from a related party if the bank would not have made the loan on the same terms but for the related party's deposit with the bank. The Proposed Regulations provide no guidance with respect to notional cash pooling, but these (and other) conduit authorities arguably might support treating notional cash pool deposits and borrowings as deemed related-party debt instruments that are subject to potential recharacterization.

B. Hedging

The second outbound example illustrates how the Proposed Regulations can adversely affect a US multinational company that hedges its foreign currency exposure. Similar situations may also arise for inbound companies.

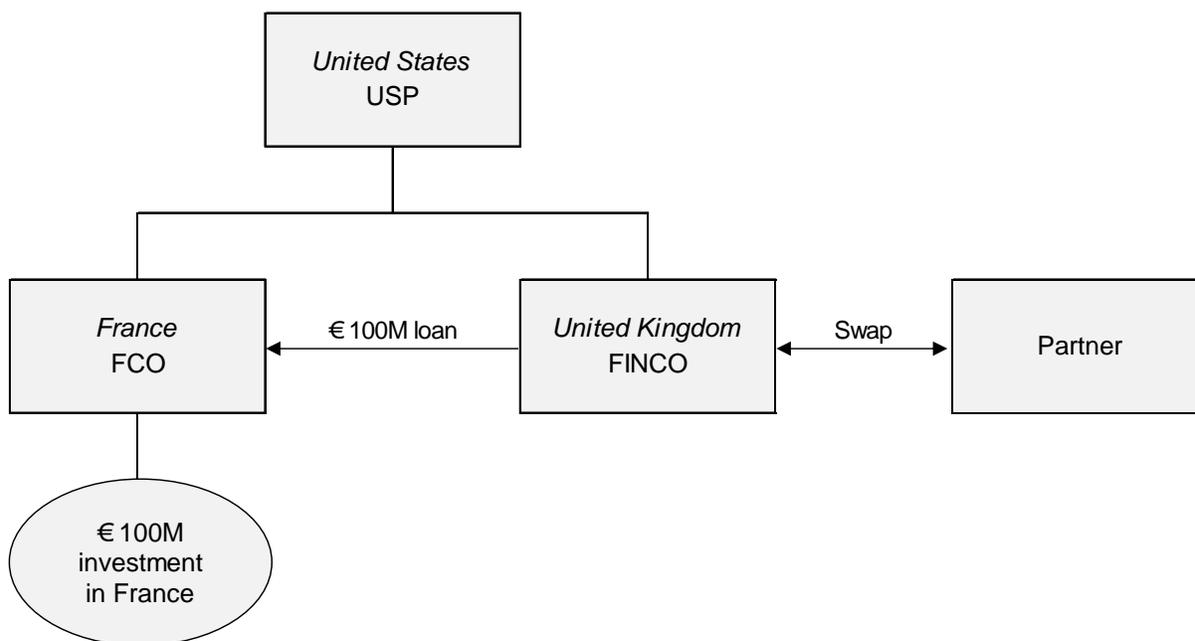
Frequently, a US multinational’s operating companies will borrow from a related finance subsidiary in a currency other than the currency used by the finance subsidiary for tax and financial reporting purposes (i.e., the “functional” currency). To hedge against a decline in value in the currency in which the loan is denominated, the finance subsidiary may enter into a currency swap contract that effectively locks in the exchange rates for future non-functional currency denominated interest and principal payments. The net effect is the same as if the finance subsidiary had made a loan to the operating company in the finance subsidiary’s functional currency, i.e., a synthetic functional currency loan.

Example

In 2017, a French subsidiary (FCO) pays a €200 million dividend to its US parent (USP) in a year when it has €100 million of earnings and profits (see **Figure IV.B**). In 2018, FCO wishes to undertake a €100 million expansion of its French operations. Consequently, FCO borrows €100 million, repayable in five years, with an interest rate of 4 percent, from its related UK finance subsidiary (FINCO). FINCO uses the US dollar as its functional currency and is subject to 20-percent income tax under UK law. The current exchange rate is \$1.15 per Euro.

To hedge currency exposure, FINCO swaps the Euro-denominated loan into a \$115 million (US dollar) loan with an interest rate of 4 percent under the tax rules for integrated hedges. In 2023, the exchange rate for the Euro decreases to \$1.10, and FINCO receives repayment of the €100 million loan, and then pays €100 million and receives \$115 million under the swap agreement. Under present law, no gain or loss is recognized on the loan repayment or the swap because the loan and swap are integrated for tax purposes.

Figure IV-B. -- US Multinational Company Hedging Transaction: Present Law Structure
 [Recharacterization and Subpart F Income]



Present Law

Under present law, where a finance subsidiary swaps a non-functional currency loan for a functional currency loan, the combination of the loan and the swap can be treated for tax purposes as if the finance subsidiary had borrowed in its functional currency, with the result that no gain or loss will be recognized due to currency fluctuations. As a result, in this example no gain or loss is recognized on the loan repayment because the loan and swap are integrated for US tax purposes.

Proposed Regulation: Scenario 1.--Retain present law structure

Under the Proposed Regulations, the loan from FINCO to FCO will be recharacterized as equity because FCO paid a dividend within the 36-month period prior to receiving the €100 million loan from FINCO. As a result, integrated tax treatment would not be available. USP will recognize gain of \$5 million of subpart F income in 2023 (the excess of €100 million received translated at \$1.15 over the \$110 million amount paid on the swap). No currency gain or loss would be accounted for on the repayment of the borrowing, because the repayment would be recharacterized as redemption of shares.

At a 38.9-percent combined federal and state corporate income tax rate, this increases USP's tax by \$1.94 million in 2023. Annuitizing at a 4-percent rate over the five-year period of the hedge, the annual increase in tax burden is \$0.359 million, or 31 basis points on a \$115 million investment in France.

Proposed Regulations: Scenario 2.--Third-party loan

To avoid the risk of taxation on non-economic gains (i.e., gains that are offset by equal losses), USP may prefer that FCO borrow from an unrelated party rather than FINCO. In this case FCO borrows €100 million from a bank at 4 percent while FINCO has \$115 million of excess cash that it deposits in a bank account that pays 1 percent interest. While FINCO could dividend this excess cash to USP, this would trigger \$44.28 million (38.9 percent of \$115 million) of US tax liability; consequently, unless USP never expects to need cash for future foreign investments, it will be better to retain the cash offshore. In this case, FINCO's annual net income is reduced from €4 million (4 percent of €100 million) to \$1.15 million (1 percent of \$115 million). When the exchange rate for the Euro is \$1.15, this amounts to a loss of \$3.45 million of interest income. As the interest income received on FINCO's deposit is subject to US tax under subpart F (because the CFC look through rules do not apply), the US parent would owe \$0.45 million of US tax (38.9 percent of \$1.15 million) before credit for UK tax of \$0.23 million (20 percent of \$1.15 million), and \$0.22 million of US tax after foreign tax credit. Thus, the annual change in after-tax cash flow is the sum of the lost interest income and the additional US subpart F tax liability (\$3.67 million), which is equivalent to an increase in the cost of the \$115 million expansion of 319 basis points (\$3.67 million/\$115 million).

V. Compliance Costs

A. Description of Documentation Requirements of Proposed Regulations

The Proposed Regulations impose significant new contemporaneous documentation requirements that must be satisfied as a precondition for related-party indebtedness to be treated as such.³¹ If the documentation requirements are satisfied, the intended indebtedness is analyzed as debt or stock (in whole or in part) under general federal income tax principles and the other requirements set forth in the Proposed Regulations. Failure to satisfy the documentation requirements results in the intended indebtedness being treated as stock unless the taxpayer can establish that its failure to satisfy the documentation requirements is due to reasonable cause.

Given the severe penalty for insufficient documentation, it is expected that taxpayers will need to implement significant new systems and controls to satisfy the documentation requirements. In addition, such systems may be necessary to monitor compliance with other aspects of the Proposed Regulations in an effort to avoid inadvertently triggering recharacterization of the debt instruments as stock. While the Proposed Regulations provide an exception to the “Per Se” rule for ordinary course of business trade receivables, no similar exception is provided to the documentation requirements.

The Proposed Regulations establish four categories of documentation requirements:

1. Evidence of an unconditional and legally binding obligation to pay a sum certain on demand at one or more fixed dates.
2. Evidence that indicates the holder has rights of a creditor, including a superior right to shareholders in the case of dissolution.
3. Evidence of a reasonable expectation of the issuer’s ability to repay the debt, such as cash flow projections, financial statements, business forecasts, asset appraisals, relevant financial ratios, or information on sources of funds.
4. Evidence of timely interest and principal payments (e.g., wire transfers or bank statements) or, in the case of either a failure to make required payments or an event of default, the holder’s reasonable exercise of the diligence and judgment of a creditor.

Of the four categories of documentation, the first three must generally be completed within 30 days of the instrument being issued. In addition, documentation of a reasonable expectation of the issuer’s ability to repay the debt must also occur no later than 30 days after each significant modification of the original instrument. Documentation of timely interest and principal payments must be prepared no later than 120 days after the due date of each required payment and the date of each default or acceleration event. Documentation must be maintained for all years that the debt is outstanding and until the period of limitations expires for any tax return with respect to which treatment of the instrument is relevant.

The effective date of the documentation requirements is generally for instruments issued or deemed issued on or after the date the Proposed Regulations are finalized. As a result, systems necessary for preparing and maintaining the required documentation would need to be in place at the time the Proposed Regulations are finalized.

B. Aggregate Scope of Impact of Documentation Requirements

Multinational corporations typically have significant interactions between the parent company and their foreign subsidiaries, as well as transactions between their foreign subsidiaries not directly involving the parent corporation. These interactions may take the form of financing arrangements, trade, service guarantees, and employee compensation, pension and stock option arrangements. Department of Commerce data provide insight into the aggregate volume of just some of these transactions. For example, sales by US foreign

³¹ Prop. Reg. Sec. 1.385-2.

subsidiaries to their US parent or to related foreign subsidiaries were \$1.7 trillion in 2013 – or an average of \$4.7 billion every day of the year – of which over 70 percent were sales between related foreign subsidiaries.³² For US subsidiaries of foreign multinational corporations, their imports and exports to their foreign parent and affiliated foreign subsidiaries totaled \$770 billion in 2013.³³ The Department of Commerce does not keep statistics on the trade among foreign multinational companies and their non-US foreign subsidiaries, but it is likely their non-US related-party trade constitutes an even larger percentage than the over 70 percent statistic for US multinational corporations cited above.

These trade statistics are useful in gaining an understanding of the scope of the documentation requirements of the Proposed Regulations, as each of the trade receivables resulting from these related-party sales potentially constitutes an instrument to which the contemporaneous documentation requirements apply. It also is suggestive of the disproportionate burden placed on companies to document instruments between foreign subsidiaries (or between a foreign parent and its non-US foreign subsidiaries) for which the risk to the US tax base is remote.

C. Cost Estimate of Documentation and Compliance Requirements

The Proposed Regulations will impose substantial start-up costs to develop the systems to provide contemporaneous monitoring and documentation of all interests treated as expanded group instruments. While the documentation requirements strictly apply only to instruments issued in the form of debt, systems will also need to track distributions among the parent and its subsidiaries in order to ensure that these distributions do not result in debt instruments being recharacterized as equity under the Proposed Regulations.

The documentation and monitoring required under such systems will far exceed any established processes of US companies. For example, for US financial statement purposes, reporting is generally necessary for corporations on a consolidated basis each quarter of the fiscal year. In contrast, the Proposed Regulations will effectively require real time reporting of instruments for each subsidiary on its related-party debt, including trade payables and trade receivables.

In addition, the design of the systems needed to document and monitor transactions cuts across all organizational lines of a company, including treasury, legal, accounting, financial planning and forecasting, tax, and even human resources.

Example. The following example represents an estimate of the federal income tax compliance burden imposed by the Proposed Regulations through information obtained from one large US multinational corporation that has undertaken an assessment of the hours of resources it anticipates it will require to comply. Documentation and compliance costs will vary by company, with some companies facing higher costs and others – particularly smaller companies without international operations – facing lower costs. Costs, however, are not all proportional to the asset size of a company, as some costs will have elements of fixed costs and other costs are more directly related to the volume of transactions rather than their dollar amount.

The company on which this estimate is based is a Fortune 100 company with significant operations in the United States and over a dozen foreign countries. The estimates exclude additional material compliance costs that could arise at the state level where states adopt the principles of the Proposed Regulations but require separate company reporting. These states might require that transactions within the consolidated group be monitored and documented for state income tax purposes even though such documentation would not be necessary for federal income tax purposes.

Based on recent year activity, the Fortune 100 company estimates that more than 10 million intercompany transactions would be subject to the documentation requirements in a given year.

The system necessary to document these transactions would require substantial engagement of its internal treasury, legal, accounting, financial planning and forecasting, tax, and information technology departments as well as external consultants providing these services.

³² Department of Commerce, Bureau of Economic Analysis, US MNE Activities: Preliminary 2013 Statistics, Majority-Owned Foreign Affiliates, Table II.E.1.

³³ Department of Commerce, Bureau of Economic Analysis, US Affiliate Activities: Preliminary 2013 Statistics, Majority-Owned Affiliates, Table II.H.1.

The company has estimated that the design of this system, including consulting with legal, tax, and accounting professionals to ensure appropriate capabilities, would require approximately 21,600 hours.

The average blended hourly cost of internal personnel and outside consultants, including wages, benefits, and overhead costs, is conservatively estimated to average approximately \$127 per hour based on Department of Labor data.³⁴ As a result, the start-up cost to implement this system would be approximately \$2.75 million. These start-up costs are detailed by function in **Table V-1**.

Table V-1.—Estimated Documentation and Compliance Costs for a Fortune 100 Company

Function	Estimated Cost by Function (rounded to nearest thousand)	Hours	Assumed Cost Per Hour
Start-up estimated costs by function			
Tax legal counsel consulting	\$145,000	1,087	\$133.61
Tax accounting consulting	\$841,000	6,293	\$133.61
Transfer pricing consulting	\$145,000	1,087	\$133.61
Internal corporate tax	\$200,000	1,500	\$133.61
Tax technology & implementation	\$370,000	3,261	\$113.43
Internal corporate treasury	\$125,000	750	\$167.32
Internal corporate legal	\$100,000	750	\$133.61
Internal corporate accounting	\$74,000	750	\$98.25
Accounting technology & implementation	\$493,000	4,348	\$113.43
Internal corporate financial planning and forecasting	\$125,000	750	\$167.32
Miscellaneous	\$131,000	1,029	\$127.33
Estimated start-up cost	\$2,749,000	21,605	\$127.24
Ongoing operations: Annual estimated operating cost	\$1,245,000	9,660	\$128.88
Total year 1 estimated cost (start-up and operations)	\$3,994,000	31,265	\$127.75
Total annual estimated cost after year 1 (operations only)	\$1,245,000	9,660	\$128.88

Source: Company estimates for hours by function; Department of Labor estimates for labor cost estimation, including wages, benefits, and overhead by occupation.

It is further estimated that annual operational and system maintenance activities would require 9,660 hours annually, or approximately 4.8 full-time equivalent employees.³⁵ Estimated annual operational costs are therefore approximately \$1.25 million. As a result, total first year implementation and operational costs are just under \$4 million. After the first year, annual operational and maintenance costs are estimated at approximately \$1.25 million (in 2016 dollars).

³⁴ The Department of Labor's Office of Policy and Research provides estimates of wage rates, benefits, and overhead costs (such as office space) by occupation. See "Labor Cost Inputs Used in the Employee Benefits Security Administration, Office of Policy and Research's Regulatory Impact Analyses and Paperwork Reduction Act Burden Calculations," March 2016, available at <https://www.dol.gov/ebsa/pdf/labor-cost-inputs-used-in-ebsa-opr-ria-and-pra-burden-calculations-march-2016.pdf>. Estimated hourly wages for 2016 from this source range from approximately \$37 for accountants to approximately \$67 for lawyers. Benefits to workers increase compensation costs by about 45 to 50 percent. Total compensation used in these estimates for 2016 ranges from a low of \$53 per hour for accountants to about \$97 per hour for both lawyers and financial managers. Overhead costs range from about 38 percent of compensation for lawyers to 84 percent of compensation for accountants. This results in fully loaded costs per worker in 2016 ranging from \$98.25 per hour for accountants to \$167.32 per hour for financial managers. These estimates are conservative in that the specialized personnel necessary for compliance with the Proposed Regulations will typically be more experienced and have higher compensation costs.

³⁵ These operational costs are estimated at 50 percent of all first-year expenses other than technology implementation costs; system maintenance costs are estimated at 35 percent of first-year technology implementation costs.

As a point of comparison, IRS estimates the Proposed Regulation's documentation requirements as imposing a burden of only 35 hours of time for the average respondent. The IRS estimates that 21,000 taxpayers would be required to complete this documentation, resulting in a total of 735,000 hours of documentation burden.³⁶ The IRS estimates a total annual cost of documentation of \$13 million per year,³⁷ which would imply an average cost of labor of \$18 per hour in the IRS estimates. It appears that the IRS estimates exclude start-up costs and may be limited to certain low-level reporting and documentation functions, excluding the costs of compliance to prevent related-party debt from being reclassified as equity under the Proposed Regulations.

As shown in Table V-1, even excluding start-up costs, the annual compliance burden estimated by the Fortune 100 company in this example requires 9,660 hours of labor for purposes of documentation and compliance. At an average cost of labor of approximately \$129 per hour, including benefits and overhead costs, this one company's ongoing compliance costs (excluding start-up costs) of \$1.245 million is equal to approximately 10 percent of the total paperwork burden estimated by IRS. Including start-up costs, the first-year documentation and compliance costs of this company (nearly \$4 million) is equal to approximately 30 percent of the total paperwork burden estimated by IRS.

While costs will vary by company, the estimates in Table V-1 suggest that the IRS has grossly understated the economy-wide documentation and compliance burdens of the Proposed Regulations.

³⁶ IRS, Notice of proposed rulemaking, April 4, 2016.

³⁷ Office of Management and Budget, Regulatory Impact Analysis, available at <https://www.regulations.gov/document?D=IRS-2016-0014-0001>.

VI. *Investment Impacts*

The examples in Sections III and IV illustrate the potential impact of the Per Se Recharacterization Rules on the after-tax cash flows of foreign-based companies in the United States and US-based companies abroad. Changes in after-tax cash flow may affect a company's investment decisions. This section estimates the potential investment impact of the Per Se Recharacterization Rules for three of the four examples discussed above.

A. *Methodology*

The response of foreign direct investment ("FDI") to a change in statutory income tax rates frequently is measured as a semi-elasticity, i.e., the percentage change in investment in response to a one percentage point increase in the statutory income tax rate. There are a large number of empirical studies that attempt to estimate the responsiveness of investment and international capital flows to changes in taxes. This literature uses a number of different measures of investment and taxes and a variety of econometric techniques. To synthesize the results of this literature, de Mooij and Ederveen (2008) conducted a meta-analysis of these studies.³⁸ A meta-analysis is a statistical method used to summarize the results of various studies.

The semi-elasticity of FDI with respect to the statutory tax rate is -2.4 in the de Mooij-Ederveen meta-analysis.³⁹ This implies that a one percentage point increase in the statutory tax rate in a country will reduce inbound FDI by 2.4 percent. We utilize this semi-elasticity to estimate the investment impacts of the Proposed Regulations by converting the change in annual after-tax cash flows in the preceding examples into equivalent income tax rate changes.

According to US tax returns for US manufacturing subsidiaries with 50 percent or more foreign ownership, the average return on assets (defined as taxable income divided by total assets) was 3.5 percent over the 2004-2013 period.⁴⁰ Consequently, taxable income generated on investments by US manufacturing subsidiaries is estimated to be 3.5 percent multiplied by the amount of the initial investment. Similarly, the taxable income generated by foreign subsidiaries of US companies was estimated using tax return data for US controlled foreign corporations.⁴¹ For foreign subsidiaries in France, earnings and profits averaged 5.0 percent of assets.

The equivalent income tax rate change corresponding to the change in after-tax cash flows in the preceding examples is equal to the change in after-tax cash flow divided into the taxable income generated by the corresponding investment. We calculate the equivalent tax rate change using estimated taxable income, based on the IRS statistics described above. The equivalent tax rate change for the preceding examples is used to estimate investment impacts based on the de Mooij-Ederveen semi-elasticity.

B. *Results*

Table VI-1 below summarizes the potential investment impacts of the Proposed Regulations for three of the examples discussed in this report. The estimated reduction in investment is large, ranging from 13.1 to 32.3 percent under the best case scenarios, which assume taxpayers restructure to mitigate the adverse impacts of the Proposed Regulations. These investment impacts are based on the facts and circumstances of the examples, and larger or smaller impacts could result under different fact patterns.

³⁸ de Mooij, Ruud A. and Sjeff Ederveen, "Corporate Tax Elasticities: A Reader's Guide to Empirical Findings," Oxford Review of Economic Policy, Vol. 24, No. 4, 2008, pp.680–697.

³⁹ See Table 3 in de Mooij, and Ederveen (2008).

⁴⁰ Data tabulated by the Internal Revenue Service's Statistics of Income Division and is available online at (<https://www.irs.gov/uac/soi-tax-stats-foreign-controlled-domestic-corporations>). The calculations above represent a weighted average of the return on assets for foreign-controlled domestic corporations over the most recent ten-year period for which data were available (2004-2013).

⁴¹ Data tabulated by the Internal Revenue Service's Statistics of Income Division and is available online at (<https://www.irs.gov/uac/soi-tax-stats-controlled-foreign-corporations>). The calculations above represent a weighted average of the return on assets for foreign-controlled domestic corporations for the five most recent years for which data were available (2004, 2006, 2008, 2010, and 2012).

Table VI-1. Estimated Investment Impact of Proposed Regulations for Specific Examples

Example/Scenario	Equivalent Change in Statutory Tax Rate (Percentage Point)	Percentage Change in Investment
Example III-A: Expansion of Domestic Manufacturing Operations		
Base Case (no mitigation)	30.0	-72.0%
Alternative Scenario #1 - Borrow from unrelated party	13.5	-32.3%
Alternative Scenario #2 - Use retained US earnings	6.7	-16.2%
Example III-B: Loss of Treaty Benefits		
Base Case (no mitigation)	86.7	-208.1%
Alternative Scenario #1 - Borrow from related party	7.5	-18.0%
Example IV-B: Hedging		
Base Case (no mitigation)	9.3	-22.4%
Alternative Scenario #1 - Borrow from unrelated party	5.5	-13.1%

Note: An investment response greater than 100 percent implies the investment would not be undertaken.

Appendix. Example Details

Example III.A -- Expansion of Domestic Manufacturing Operations

	Additional Parameters	Present Law	Scenario 1	Scenario 2	Scenario 3
Sources and Uses of Cash					
<u>GCAR-US</u>					
2019 income		100	100	100	100
Loan from GCAR		200	200	0	0
Third party debt		0	0	200	0
Dividend paid to GCAR		-300	-300	-300	-100
Investment		<u>-300</u>	<u>-300</u>	<u>-300</u>	<u>-300</u>
<i>Change in net cash position</i>		<i>-300</i>	<i>-300</i>	<i>-300</i>	<i>-300</i>
<u>GCAR</u>					
Dividend received from GCAR-US		300	300	300	100
Third party debt		200	200	0	200
Loan to GCAR-US		<u>-200</u>	<u>-200</u>	<u>0</u>	<u>0</u>
<i>Change in net cash position</i>		<i>300</i>	<i>300</i>	<i>300</i>	<i>300</i>
Annual Interest Income (+) and Expense (-)					
<u>GCAR-US</u>					
Loan from GCAR	4%	-8	-8	0	0
Third party debt	4%	0	0	-8	0
<u>GCAR</u>					
Loan to GCAR	4%	8	8	0	0
Third party debt	3%	-6	-6	0	-6
Tax Increase (+) or Decrease (-)					
<u>GCAR-US</u>					
Interest deduction	38.9%	-3.1	0.0	-3.1	0.0
<u>GCAR</u>					
Interest income	30.2%	2.4	2.4	0.0	0.0
Interest deduction	30.2%	-1.8	-1.8	0.0	-1.8
Income tax on dividend received	1.5%	4.5	4.5	4.5	1.5
Change in Total Worldwide Taxes					
Net interest income/expense		-6.0	-6.0	-8.0	-6.0
Net tax on investment		<u>-2.5</u>	<u>0.6</u>	<u>-3.1</u>	<u>-1.8</u>
After tax interest income/expense		-3.5	-6.6	-4.9	-4.2
Change from present law			-3.1	-1.4	-0.7
As a % of the investment			-1.04%	-0.47%	-0.23%

Example III.B -- Loss of Treaty Benefits

	Additional Parameters	Present Law	Scenario 1	Scenario 2
Sources and Uses of Cash				
<u>JCO-US</u>				
2019 income		100	100	100
Dividend paid to JCO-J		<u>-100</u>	<u>-100</u>	<u>-100</u>
<i>Change in net cash position</i>		0	0	0
<u>JCO-J</u>				
Dividend received from JCO-US		100	100	100
Loan from JCO		0	0	100
Cash payment to JCO-HK		0	0	-100
Note to JCO-HK		<u>-100</u>	<u>-100</u>	<u>0</u>
<i>Change in net cash position</i>		0	0	100
<u>JCO-HK</u>				
Cash payment from JCO-J		0	0	100
Note from JCO-J		100	100	0
Dividend to JCO		<u>0</u>	<u>0</u>	<u>-100</u>
<i>Change in net cash position</i>		100	100	0
<u>JCO</u>				
Dividend received from JCO-HK		0	0	100
Loan to JCO-J		<u>0</u>	<u>0</u>	<u>-100</u>
<i>Change in net cash position</i>		0	0	0
Annual Interest Income (+) and Expense (-)				
<u>JCO-J</u>				
Loan from JCO	4%	0	0	-4
Note to JCO-HK	4%	-4	-4	0
<u>JCO-HK</u>				
Note from JCO-J	4%	4	4	0
<u>JCO</u>				
Loan to JCO-J	4%	0	0	4
Taxes on Distribution by JCO-US				
Gross dividend distributed		10	10	10
Withholding tax on dividend	0%/30%	<u>0</u>	<u>3</u>	<u>0</u>
Net dividend received by JCO-J		10	7	10
Japanese tax on dividend received	1.5%	<u>0.15</u>	<u>0.15</u>	<u>0.15</u>
After-tax dividend income		9.9	6.9	9.9
Taxes Paid on Interest Income/Deductions				
Interest deductions for JCO-J	30%	-1.2	-1.2	-1.2
Interest income of JCO-HK	0%	0	0	0
Tax on subpart F income	30%	1.2	1.2	0
Interest income of JCO	30%	<u>0</u>	<u>0</u>	<u>1.2</u>
<i>Net taxes on interest income</i>		0	0	0
Taxes on Distribution by JCO-HK				
Gross dividend distributed		0	0	100
Withholding tax on dividend	5%	<u>0</u>	<u>0</u>	<u>5</u>
Net dividend received by JCO		0	0	95
Japanese tax on net dividend received	1.5%	<u>0.0</u>	<u>0.0</u>	<u>1.5</u>
After-tax dividend income		0.0	0.0	93.5
Other Taxes				
Income tax paid by JCO-HK on cash received	0%	0	0	0
Total Taxes				
Annualized taxes		0.15	3.15	0.41
Change in annualized taxes			3.00	0.26
As a percent of investment in JCO-US			3.00%	0.26%

Example IV.A -- Cash Pooling

	Additional Parameters	Present Law	Scenario 1	Scenario 2
FSUB				
Loan from FINCO		200	200	
Foreign Tax Pool		200	200	200
Deemed dividends				
Recharacterized interest payment			8	
Repayment of loan to FINCO			200	
Total deemed dividends		0	208	0
Accumulated E&P		1,000	1,000	1,000
Percentage reduction in foreign tax pool		0.0%	20.8%	0.0%
Lost foreign tax credits		0	41.6	0
FINCO				
Income from loan to FSUB (net interest income)	3%	6	6	0
Taxes on net interest income (net of FTC)	20.0%	1.2	1.2	0.0
After-tax net interest income		4.8	4.8	0.0
Change from present law			0.0	-4.8
Tax Cost			-41.6	-4.8
As a percent of original loan			-20.80%	-2.40%

Example IV.B Hedging
[Monetary amounts in millions]

Item	2018	2019	2020	2021	2022	2023	Close out
EXCHANGE RATE							
Dollars per Euro	1.15	1.15	1.15	1.15	1.15	1.15	1.1
PRESENT LAW							
Notional swap amount	\$115						
Swap interest received		\$4.60	\$4.60	\$4.60	\$4.60	\$4.60	
Swap interest paid		€4	€4	€4	€4	€4	
Net interest income on swap		\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	
Swap principal received							\$115
Swap principal paid							€100
Subpart F income		\$0	\$0	\$0	\$0	\$0	\$0
Tax on Subpart F income		\$0	\$0	\$0	\$0	\$0	\$0
After-tax cash flow		\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$5.00
Tax as a percent of investment		0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
PROPOSED REGULATIONS							
Scenario 1							
Notional swap amount	\$115						
Swap interest received		\$4.60	\$4.60	\$4.60	\$4.60	\$4.60	
Swap interest paid		€4	€4	€4	€4	€4	
Net interest income on swap		\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	
Swap principal received							\$115
Swap principal paid							€100
Subpart F income		\$0	\$0	\$0	\$0	\$0	\$5.00
Tax on Subpart F income		\$0	\$0	\$0	\$0	\$0	\$1.94
After-tax cash flow		\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$3.05
Annualized tax on subpart F	\$	0.36	\$ 0.36	\$ 0.36	\$ 0.36	\$ 0.36	\$ 0.36
Tax as a percent of investment		0.31%	0.31%	0.31%	0.31%	0.31%	0.31%
Scenario 2							
Deposit	\$115						
Deposit interest income		\$1.15	\$1.15	\$1.15	\$1.15	\$1.15	
Bank loan							
Bank borrowing	€100						
Interest paid on bank debt		€4.00	€4.00	€4.00	€4.00	€4.00	
Interest paid in US dollars		\$4.60	\$4.60	\$4.60	\$4.60	\$4.60	
Repayment of bank debt							\$115
Subpart F income (deposit interest)		\$1.15	\$1.15	\$1.15	\$1.15	\$1.15	\$0.00
Tax on Subpart F income after FTC		\$0.22	\$0.22	\$0.22	\$0.22	\$0.22	\$0.00
After-tax cash flow		(\$3.67)	(\$3.67)	(\$3.67)	(\$3.67)	(\$3.67)	\$0.00
After-tax cash flow as a percent of investment		-3.19%	-3.19%	-3.19%	-3.19%	-3.19%	0.00%