July 7, 2016

ATTENTION: Section 385

The Honorable Mark J. Mazur
Assistant Secretary for Tax Policy
US Department of Treasury
1500 Pennsylvania Avenue, NW
Washington DC 20224

CC:PA:LPD:PR (REG-108060-15)
Room 5203
Internal Revenue Service
PO Box 7604
Ben Franklin Station
Washington DC 20044

Comments on Section 385 Proposed Regulations

Dear Mr. Mazur,

We respectfully submit the following comments for your consideration on behalf of the Associated General Contractors of America (AGC). AGC is the leading association in the construction industry, representing nearly 26,000 leading firms. AGC members are engaged in all forms of nonresidential construction and consist primarily of small businesses with the vast majority of our members (more than 70 percent) organized as pass-through entities.

Our comments regard a Notice of Proposed Rulemaking [REG-108060-15] dated April 4, 2016, in which the Department of Treasury ("Treasury") and Internal Revenue Service ("IRS") issued proposed regulations impacting debt-equity regulations under Internal Revenue Code section 385 (the "proposed 385 regulations").

Specifically, the following comments address Prop. Treas. Reg. §1.385-1, §1.385-2, and §1.385-3. Additionally, AGC requests the opportunity for an industry representative to speak during the public hearing on Thursday, July 14, 2016. Mr. Mike Lucki will provide oral testimony at that time, and his information along with an outline of the topics to be discussed will be submitted separately via regulations.gov.

We appreciate your attention to these comments, and welcome the opportunity to meet with you following the public hearing set for July 14th. If, after reviewing this letter, you have any questions or require additional information before the hearing, please do not hesitate to contact Brian Lenihan, AGC Director of Tax and Fiscal Affairs, at 202-547-4733.

Sincerely,

Jeffrey D. Shoaf
Senior Executive Director, Government Affairs

Comments on Proposed Regulations Under Internal Revenue Code Section 385

I. Proposed Section 385 Regulations

The proposed regulations were primarily created to combat so called "inversions" including restructuring where U.S. corporations emigrate to some type of foreign ownership, as well as "earnings stripping" by historic multinationals. However, the proposed regulations under Section 385 as drafted are not at all targeted at "inversions" and "earnings stripping." They are far more reaching and not limited to cross border transactions and would adversely affect many members of the AGC. The vast majority of AGC members are purely domestic and operate under normal business practices with no "inversion" or "base erosion" activity whatsoever. Many of our members also operate their businesses efficiently through several different legal entities for financing and limited liability protection purposes and would be considered a "modified expanded group" under the proposed regulations. Under the proposed regulations, their normal lending activity between related domestic entities possibly could be re-characterized as equity in whole or in part. This is especially concerning since the proposed rules could impose very severe tax consequences on companies that adhere to common and efficient business practices for construction companies. For instance, many of AGC members are organized as S corporations that commonly loan money between related entities, and having any debt re-characterized as equity would create a second class of stock as well as potentially adding an ineligible shareholder, both of which would invalidate the taxpayer's Subchapter S election.

II. Executive Summary

AGC submitted a letter dated June 28, requesting at a minimum that Treasury and IRS (1) extend the public comment period from July 7, 2016 to October 5, 2016; and (2) dedicate adequate time and resources for a comprehensive review and analysis of the public comments on the proposal rather than finalize the regulations on an arbitrary timeline. This rulemaking is extremely complex and it expands well beyond the "inversions" and "earning stripping" concepts that were its identified targets of this regulation. Most of the public comments we have reviewed thus far echo this same point. We believe that if finalized as proposed, the regulations will lead to a host of collateral consequences that are far more reaching than presumably intended and in turn, recommend that the proposed regulations be withdrawn to allow policymakers and stakeholders in the business community to develop a more targeted approach to prevent base erosion practices of certain companies.

If these regulations are not withdrawn, we further recommend that Treasury and the IRS significantly limit the applicability of the regulations to target only strategies that avoid U.S. tax on U.S. operations by shifting or "stripping" U.S. source income to lower tax jurisdictions through intercompany debt as stated in Notices 2014-52 and 2015-79. AGC believes that the proposed regulations should not apply in any way to purely domestic affiliated groups. Furthermore, AGC is a member of the S-CORP Association and supports the recommendations set forth in the letter submitted by the S-CORP Association dated July 7, 2016 which highlights abundant reasons why S corporations should be exempt from the proposed rules.

III. Recommendations

We recommend that the regulations be withdrawn or, at the very least, limited to groups that actually have loans with a foreign affiliate and have the ability to shift income to a lower tax jurisdiction. This would exempt most AGC members and many if not all S corporations.

If the these proposed regulations cannot be withdrawn, they should be rewritten to target only strategies that avoid U.S. tax by companies with both U.S. and non-U.S. operations. In addition, we feel that the rules under proposed regulations §1.385-1 impose extremely harsh tax consequences whereby the IRS has the discretion to treat any debt as equity based on the facts and circumstances are over-reaching and inadministrable. To achieve the agencies goals and to make the rule more administrable, the proposed regulations should include a de minimis rule where the IRS would not reclassify any debt as equity if the amount of the debt is less than $50 million, similar to the $50 million exception for the General and Funding Rules under §1.385-3. This is a reasonable method to reduce complexity and target significant tax avoidance activities.

We also believe that the documentation and maintenance rules under proposed regulations §1.385-2 are onerous and burdensome for taxpayers and probably ineffectively target many companies that would never even have the possibility of engaging "inversions" or "earning tripping." The documentation and maintenance rules in their current form apply only if:

1) stock of any member of the expanded group is publicly traded;
2) the total assets of any member of the group exceeds $100 million; or
3) the annual total revenue of any member of the group exceeds $50 million.

The construction industry is unique and general contractors have high revenues with very small margins. The $50 million threshold is to low and would affect many small general contractors. In order to better target these rules, we view that the thresholds for 2 and 3 above should be $1 billion and $500 million respectively. Furthermore, even for these size companies, the filing requirements should be no more than annually with normal tax filings.

Finally, under the Funding Rule of proposed regulations §1.385.3, the determination of whether a debt instrument is "issued with a principal purpose of funding a distribution or acquisition" is based on an analysis of all of the facts and circumstances. However, if debt is issued by a member during the period beginning 36 months before the date of the distribution or acquisition and ending 36 months after the date of the distribution or acquisition, it is treated as being issued with a principal purpose of funding the distribution or acquisition, known as the Per Se Rule.

The proposed regulations only provide a narrow exception to this over-reaching rule that applies to debt instruments issued in the ordinary course of the issuer's trade or business in connection with the purchase of property or the receipt of services, or currently included in the issuer's cost of goods or inventory. The exception should be broadened to include common business practices in the construction industry such as working capital loans between affiliates for current projects including joint ventures. It also common for businesses in the construction industry to have receivables and payables for retention on projects which could also be between affiliates and should also be excluded from the funding rule. We also believe that the 72 month time frame is an unreasonable burden on taxpayers and is inadministrable and should be shortened to 24 months (12 months before and 12 months afterward).

IV. Conclusion

In conclusion, we would like to stress that this regulatory proposal should be withdrawn and rewritten to target only significant "inversions" and "earning stripping" activities. If this proposal is finalized, the language should be limited in scope to avoid unintended consequences, poorly targeted compliance measures and unnecessary administrative burdens; and at a minimum, should only be applicable to affiliated groups that include a foreign entity <u>and</u> have significant international financing agreements with other subsidiaries <u>and</u> for that reason S corporations should be exempt. We are very concerned that, as proposed, these regulations will create uncertainty to related party taxpayers in the construction industry, particularly since the bifurcation rule can only be used by the IRS and not the taxpayers. The rules would be especially and unnecessarily hazardous to members operating as Subchapter S corporations since the Subchapter S election could become invalid under the second class of stock rule and the corporation would be subject to tax as a Subchapter C corporation, which would be punitively expensive and could threaten the very existence of their construction businesses.

We believe these recommendations will allow domestic taxpayers who have no opportunity to engage in base erosion practices to operate their businesses without the threat of the IRS re-characterizing some or all of their related party debt issued under normal business practices as equity. In addition, any expanded group with a foreign affiliate should not be overly burdened with regulatory requirements simply for expanding their legitimate businesses outside U.S. borders.

Thank you for your consideration of these comments.