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U.S. Treasury Will Scale Back Debt-Equity and Certain Other Regulations

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On the basis of an executive order by President Trump to reduce the burden of tax regulations, the Secretary of the Treasury (Secretary) identified on June 22, 2017, eight regulations from January 1, 2016, to be reviewed (June Report). The Secretary has now provided final recommendations (October Report). We describe the more significant developments below. It is apparent that at least some of these recommendations could affect Canada-U.S. transactions and, in that context, they may be relevant for Canadian readers.

Debt-Equity Regulations

Background. In 2016, the Treasury issued lengthy temporary and final regulations on the treatment of certain debt as equity, including (i) per se recast as equity of certain debt issued by a corporation to a related party (the distribution rules) and (ii) regulations that establish extensive documentation requirements (the documentation rules). Following the June Report, the IRS had announced a delay in application of the documentation rules until 2019.

News. The Treasury is considering revoking the documentation rules in their entirety and publishing more limited rules. With respect to the distribution rules, the Treasury acknowledges that the rules may be overly broad. The Treasury has decided to delay further changes since changes in connection with the pending tax reform agenda may limit the need for these rules.

Foreign Goodwill Regulations

Background. Section 367 of the Internal Revenue Code of 1986, as amended (Code) generally triggers gain on outbound asset transfers with an exception for active foreign businesses. Historically, foreign goodwill and going-concern value could be transferred under that exception. The 2017 regulations removed the exception for foreign goodwill.

News. The Treasury expects to propose regulations expanding the active foreign business exception to outbound transfers of foreign goodwill and going-concern value.

Regulations on Treatment of Partnership Liabilities

Background. Under the disguised-sale rules of section 707 of the Code, if a partner contributes property to a partnership and receives a distribution within two years, the distribution may be recharacterized as proceeds from a disguised sale. Debt-financed distributions are generally subject to such recharacterization only to the extent that the distribution exceeds the contributing partner's allocable share of the debt. Under prior law, a partner could essentially convert nonrecourse debt into recourse debt, thereby effectively increasing the size of a debt-financed distribution without triggering the disguised-sale rules. Prior law permitted a partner to be allocated a greater share of a nonrecourse liability of the partnership, permitting "bottom dollar guarantees" under which the partner is not liable from the first dollar of debt.

The 2016 regulations treat all partnership liabilities as nonrecourse liabilities for these purposes, significantly limiting the ability to use leveraged partnerships and debt-financed distributions without triggering gain. In addition, the regulations under section 752 of the Code deny recognition of bottom-dollar guarantees because they lack significant non-tax business purpose.

News. Although warranting further study, the Treasury is considering revoking the 2016 regulations other than those pertaining to bottom-dollar guarantees.

Proposed Family Transfer Regulations

Background. Under section 2704 of the Code, taxpayers may be limited in reducing the fair market value of an interest in family-controlled entities for estate and gift tax purposes on the basis of non-commercial restrictions on their dispositions or liquidations. The proposed regulations would have broadened restrictions that are disregarded for these purposes.

News. The Secretary determined that the proposed regulations would subject taxpayers to burdensome compliance obligations and will withdraw the proposed regulations.

Temporary Regulations on Certain Transfers of Property to Regulated Investment Companies and Real Estate Investment Trusts

Background. Prior to the issuance of temporary regulations under the *Protecting Americans from Tax Hikes Act of 2015* (PATH Act), property could be transferred to a real estate investment trust tax-free. The PATH Act prevents spinoffs that could accomplish that objective.

News. The Treasury will reduce the scope of the temporary regulations, which were acknowledged to be potentially overreaching.

Conclusion

The current administration believes that U.S. corporations have been over-burdened by unduly complex recent regulations. The recommendations in the October Report scale back a number of these regulations. There is a new risk of such look-back reviews when administrations change – and ironically, this could undermine the perceived certainty that Treasury regulations bring to tax planning.

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