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Final U.S. Debt-Equity Regulations Are Not as Sweeping as Feared

Authors: [Peter Glicklich](#), Gregg M. Benson and Heath Martin

On October 13, 2016, the Treasury Department released final regulations (and related temporary regulations) under section 385 (Final Regulations).¹ The Final Regulations recharacterize certain issuances of related-party debt as equity for U.S. federal tax purposes.

The Final Regulations represent a revision of proposed regulations released on April 8, 2016 (Proposed Regulations). The Proposed Regulations were intended to limit the ability of multinational companies to shift profits outside the United States through intercompany financing transactions. They generated intense controversy among tax practitioners, who criticized the Proposed Regulations both for exceeding the Treasury Department's administrative authority under section 385 and for their burdensome overbreadth. Many practitioners feared that the Proposed Regulations would apply to many routine and inoffensive transactions engaged in by multinational groups of corporations – for instance, by preventing the use of cash pooling arrangements and treasury centres.

The public responded with numerous and extensive comments, both in writing and at a public hearing that occurred on July 14, 2016. The U.S. Congress joined the furor over the Proposed Regulations when a number of prominent senators and representatives voiced their opposition to the Proposed Regulations. These efforts culminated in a public letter from Senate Finance Committee Chairman Orrin Hatch to Treasury Secretary Jacob Lew in which he called on the Treasury Department to delay the process in order to rewrite the rules.

Because of the widespread opposition to the Proposed Regulations, the preamble to the Final Regulations includes detailed responses to many of the public's comments, including explanations of the reason for the rejection of certain comments. Unusually, the preamble includes a lengthy justification for the rules, including an argument that the Final Regulations should affect only about 1,200 corporate groups. Throughout the preamble, the Treasury Department repeatedly explains that the Final Regulations should affect only large taxpayers with closely related affiliates that issue debt instruments (which can otherwise be structured to create tax advantages).

In many ways, the Final Regulations represent a retreat from the aggressive rules of the Proposed Regulations. Many of the changes in the Final Regulations relax or reduce the scope of the rules as originally proposed. The Treasury Department and the IRS have exceeded practitioners' expectations by quickly issuing the Final Regulations in the face of public uproar and producing a regulatory package that will ultimately affect far fewer taxpayers and transactions.

The General Rules

The Final Regulations generally provide that debt issued by a corporation to an affiliated corporation (or a partnership controlled by an affiliated corporation) is recharacterized as equity if the debt is issued in connection with (i) a distribution to shareholders, (ii) an exchange for stock of an affiliate or (iii) certain exchanges for property in an asset reorganization (these three groups of transactions are referred to here as Specified Transactions). Debt issued by a corporation to an affiliate is also recharacterized as equity if the debt is issued with a principal purpose of funding a Specified Transaction. This rule is referred to in the Final Regulations as the funding rule.

The Final Regulations also include a *per se* rule under which certain debt issuances are presumptively treated as subject to the funding rule. Under the *per se* rule, any issuance of debt during the 72-month period beginning 36 months before, and ending 36 months after, the date of a Specified Transaction is treated as having been issued with a principal purpose of funding the Specified Transaction.

There are several exceptions to the rules described above. Among these, the amount of any Specified Transaction is reduced by the earnings and profits of the corporation that issues the applicable debt. In addition, the rules described above do not apply to the first \$50 million of debt issued by a corporation, to short-term debt or to funding new investments through a controlled subsidiary.

The Final Regulations also include extensive documentary requirements for debt issued between affiliated corporations. To be subject to the documentary requirements, the debt must be issued by a member of a group with at least one publicly traded corporation, a group with at least \$100 million in assets or a group with at least \$50 million in revenue.

What's New in the Final Regulations

The main changes in the Final Regulations include the following:

- S corporations are excluded from the rules entirely, and RICs and REITs are treated similarly to partnerships – that is, they are excluded from the rules if they are not controlled by a corporation.
- While retaining an 80% vote or value requirement for affiliation, downward attribution has been eliminated. This will be a relief to many private equity sponsors and their funds, which would otherwise have been deemed to hold all their investments through an affiliated group.
- The Final Regulations do not apply to debt issued by non-U.S. issuers.
- Financial service entities subject to federal regulation and supervision, such as certain banks and insurance companies, are generally exempt from the recharacterization rules in the Final Regulations. In addition, debt issued by these entities are subject to less onerous documentary requirements.
- Short-term loans are generally excluded from the Final Regulations, including cash pool arrangements and international treasury centres.
- The earnings and profits exclusion has been changed to remove “use-it-or-lose-it” features.
- The Final Regulations allow distributions and acquisitions to be offset by contributions to capital for the purposes of the recharacterization rule.
- The “cliff effect” of the \$50 million exception from the recharacterization rule has been eliminated, enabling all taxpayers to exclude the first \$50 million of debt.
- The effective date of the documentary requirements has been delayed until January 1, 2018. In addition, the 30-day deadline for an issuer to comply with the documentary requirements has now been extended to the due date of the issuer’s next tax return. Moreover, documentary failures now no longer automatically result in recharacterization of debt as equity where the group otherwise substantially complies with the rules.
- The Final Regulations have dropped a rule that would have allowed the IRS to bifurcate a single financial instrument into a debt component and an equity component. The Treasury Department will continue to study issues raised by this rule.

Effective Date

The Final Regulations are generally expected to be effective on January 19, 2017. The Final Regulations also include a transition rule under which debt issued after April 4, 2016 will remain subject to the funding rule, even if it is refinanced before the effective date of the Final Regulations

Conclusion

As noted above, the Treasury Department and IRS successfully mitigated the severity of the Proposed Regulations in response to the vigorous public comment they generated. One is tempted to ask whether the initial aggressiveness of the rules were intended to ease the way to the Final Regulations after the initial reaction died down.

In any case, while the rules provided by the Final Regulations remain extremely complex, they have been relaxed in a number of ways favourable to the taxpayer in comparison to the Proposed Regulations. But the extent of taxpayers' victory in this regulatory process will only be known after practitioners work through the details. In the meantime, issuers of intercompany debt are strongly urged to work closely with their tax advisers to avoid the pitfalls of section 385.

¹Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the Code) or the Treasury Regulations promulgated thereunder.

Key Contacts: [R. Ian Crosbie](#), [Geoffrey S. Turner](#), [Michael N. KandeV](#) and [Peter Glicklich](#)

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