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Treasury Issues Final Debt/Equity Regulations, Tempers Controversial Approach Taken in Proposed Regulations

On October 13, 2016, the U.S. Department of Treasury released the highly-anticipated final and temporary regulations under Section 385 of the Internal Revenue Code. The April 4, 2016 proposed regulations in this area had drawn widespread criticism from practitioners and others as being fraught with a slew of unresolved technical issues and overbroad in their attempt to address certain (ostensibly inversion-related) earnings stripping transactions. The temporary and final regulations retain much of the structure and approach of the proposed regulations in terms of recharacterizing certain intercompany debt obligations as equity and requiring more extensive documentation of certain of these obligations, but also cut back significantly the scope of the proposed regulations, ease compliance burdens, and expand the availability of exceptions to the rules.

The Final Section 385 Regulations

- ***In General.*** The final Section 385 regulations, like the proposed regulations, recharacterize certain debt instruments (so called “expanded group instruments” or “EGIs”) between members of an “expanded group” (i.e., a group of entities with a corporate common parent having 80 percent direct and indirect ownership) as stock where a corporation that is an expanded group member:
 - (i) distributes the debt instrument to another expanded group member as a dividend,
 - (ii) issues the debt instrument to another expanded group member in exchange for stock of an expanded group member, or
 - (iii) issues the debt instrument to an expanded group member in exchange for assets in certain tax-free reorganizations.

The final regulations retain the general provisions of the recharacterization rules, including the 36-month principal purpose rule (which is a *per se* rule which treats any EGI issued less than 36 months after or 36 months prior to a distribution or acquisition as being issued for a principal purpose of funding such distribution or acquisition).

- ***Overall Limitations in Scope.*** The final regulations are considerably narrower in scope than the proposed regulations. As a general matter, they do not apply to certain types of entities that the proposed regulations would have covered. More specifically the final regulations do not apply to:

- debt issued by foreign issuers (though it should be noted that Treasury has reserved on this issue and is likely to promulgate additional guidance addressing foreign issuers in the future);
- S corporations (eliminating second class of stock concerns); or
- RICs or REITs that are not 80-percent controlled (by vote or value) by members of an otherwise existing expanded group (and thus debt of a taxable REIT subsidiary to its REIT parent is not covered).

Like the proposed regulations, the final rules do not cover corporate blocker entities capitalized with debt instruments by their investment fund partnership equity owners, although the IRS is continuing to study this type of shareholder debt. Moreover, the “recharacterization rules” and the documentation rule (as discussed below) provide further exemptions for certain entities or debt arrangements. The collective operation of these rules effectively limits their application to certain debt instruments issued by U.S. corporations to their foreign affiliates. This limitation addresses many of the concerns raised by practitioners and taxpayers about the use of offshore treasury arrangements between members of a multinational group.

The Recharacterization Rules

- ***Final Regulations Preserve and Expand Exceptions to Debt Recharacterization Rules.***
The regulations expand the scope of the exceptions to recharacterization:
 - The regulations retain the \$50 million *de minimis* exception for EGIs that would otherwise be recharacterized as equity, and eliminate the proposed regulations’ “cliff effect” for this exemption. Under the final regulations, the first \$50 million of intergroup debt is exempt whether or not the group has intergroup debt in excess of \$50 million.
 - The regulations retain and expand the earnings and profits exception of the proposed regulations. The earnings and profits exception under the proposed regulations would have exempted from recharacterization an amount equal to the current earnings and profits of that EGI’s issuer generated in the year the EGI is created. The final regulations remove the effective “use it or lose it” feature of the proposed regulations by broadening this earnings and profits exception to include the issuer’s accumulated earnings and profits for taxable years ending on or after April 5, 2016 during which the issuer was a member of the expanded group. The regulations include extensive rules on how to calculate the relevant earnings and profits balance.
 - The regulations include a new rule for netting contributions made by members of the expanded group and distributions made by the recipient member during a period beginning 36 months

before and ending 36 months after the contribution or distribution for purposes of determining whether an EGI was issued in an impermissible manner or for an impermissible purpose.

- The regulations also include a new exception for certain acquisitions of expanded group stock where the acquired stock is delivered as equity compensation to individual employees, directors, or independent contractors in consideration for services rendered by such individuals to a member of the expanded group.
- The recharacterization rules do not apply to certain cash management arrangements and certain short-term debt (although there is no such exception from the documentation rules discussed below) or debt issued by certain regulated entities, including banks and insurance companies.
- ***Certain Mechanical Rules.*** Among other provisions, the final regulations include mechanical rules to address concerns about the interaction of the recharacterization rules and certain other specialized tax provisions. Namely:
 - The regulations contain certain mechanics that limit certain of the regulations' collateral implications, such as special rules for computing cancellation of indebtedness income.
 - Like the proposed regulations, the final regulations apply to debt instruments issued by controlled partnerships (or disregarded entities). However, in lieu of treating the holder of a recharacterized EGI issued by a controlled partnership (or DRE) as holding equity of such partnership (or DRE), the regulations contain complex mechanics to, in effect, push the recharacterization of the EGI up to the level of the controlling corporation.

Documentation, Bifurcation and Effective Date

- ***Documentation.*** Like the proposed regulations, the final regulations include certain documentation requirements (enforceable legal documentation, standard creditor rights, demonstration of an ability to pay and ongoing maintenance and controls) for EGIs issued in the form of debt. More specifically:
 - This rule applies to expanded groups with (i) group assets over of \$100 million, or (ii) total annual revenue over \$50 million or (iii) if any member of the expanded group is publicly traded.
 - In its current form, the documentation rule does not apply to repurchase or “repo” instruments or other instruments that are not “in form” debt, though Treasury has reserved on this issue. It should be noted, however, that the recharacterization rules discussed above still apply to such instruments.

- The final regulations have backed away from the proposed regulations' automatic recharacterization for failure to comply with the documentation requirements, establishing instead a rebuttable presumption (a so called "good housekeeping" exception) that EGIs that fail to meet these requirements are equity.
- In response to numerous concerns commentators raised about the compliance burdens of the proposed regulations, the final regulations:
 - expand the time period for providing documentation (the 30-day deadline of the proposed regulations for an issuer to comply with these requirements has been extended to the due date of the issuer's next return, which is consistent with current transfer pricing documentation requirements);
 - relax certain credit analysis standards; and
 - allow for the use of master agreements for certain types of debt.
- Certain EGIs (notably in the context of regulated insurance and banking entities) are presumed to be in compliance with the rules by virtue of compliance with other regulatory schemes.

Taxpayers who are not required to satisfy the requirements of the documentation rule may nevertheless wish to consider building their files to address some or all of the documentation requirements contained therein, as these may assist with future Internal Revenue Service audits.

- ***Debt/Equity Bifurcation.*** The proposed regulations contained a provision that would have allowed the IRS to treat certain purported debt instruments as part debt and part equity. The final regulations eliminate this rule entirely. Notwithstanding the foregoing, the operation of the exceptions under the recharacterization rules can result in a purported debt instrument being treated as part debt and part equity under the rules.
- ***Effective Date.*** The recharacterization rules generally only apply to tax years ending on or after January 19, 2017 and generally do not apply to EGIs issued prior to April 5, 2016. The regulations provide transition rules for the recharacterization of certain EGIs, including EGIs that would be treated as stock on or before January 19, 2017. The documentation rule generally applies to EGIs issued on or after January 1, 2018.

We will continue to follow developments in this area and report as matters progress.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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