

# Client Update

## Treasury and IRS Issue Final Regulations Restricting Earnings Stripping Through Related-Party Debt

### NEW YORK

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Last week, the Treasury Department and Internal Revenue Service issued final and temporary regulations under section 385 of the Internal Revenue Code (the “[Final Regulations](#)”) recharacterizing certain debt instruments issued between related parties as stock for U.S. federal income tax purposes. The Final Regulations finalize proposed regulations issued on April 4, 2016 (the “Proposed Regulations”).

The Final Regulations are intended to reduce the tax benefits of inversion transactions and to limit the ability of multinationals to reduce their U.S. taxes by injecting debt into their U.S. subsidiaries through distributions of debt instruments and other economically similar transactions. However, the actual scope of the Final Regulations is far broader.

The Final Regulations are controversial because they overturn decades of precedent by treating certain debt issued between related parties as stock for U.S. tax purposes even if such debt is high quality and would, under regular tax principles, be treated as debt. However, in response to comments on the Proposed Regulations, Treasury and the IRS narrowed substantially certain aspects of the Proposed Regulations:

- The Final Regulations do not currently apply to debt issued by foreign corporations, and also include exceptions for debt issued by certain other entities, including regulated financial companies and regulated insurance companies. As in the Proposed Regulations, the Final Regulations do not apply to debt between members of a U.S. consolidated group.
- The Final Regulations simplify the Proposed Regulations’ documentation requirements and extend the effective date of the documentation requirements to 2018.

- The Final Regulations broaden the exceptions to the Proposed Regulations' distribution and funding rules.

This Client Update summarizes the significant differences between the Proposed and Final Regulations, which were discussed in detail in our prior [Client Update](#).

### THE PROPOSED REGULATIONS

- *General Framework.* Generally, the Proposed Regulations (i) treated related-party debt instruments issued in certain transactions as equity interests under the so-called “distribution” and “funding” rules, (ii) established documentation and information maintenance requirements for related-party debt instruments and (iii) provided for the possibility of bifurcating certain related-party debt instruments, which would be treated in part as debt and in part as equity.
- *Distribution Rule.* The Proposed Regulations' distribution rule recharacterized certain “EGIs” (debt instruments issued by one member of a corporation's “Expanded Group” and held by another member) as stock, even though they would otherwise be treated as debt under general tax principles, if issued (i) in a distribution, (ii) in exchange for stock of an Expanded Group member or (iii) in exchange for property in certain asset reorganizations (each a “distribution” or “acquisition”).
- *Funding Rule.* The Proposed Regulations' funding rule treated a debt instrument as stock if it was issued with a principal purpose of funding a distribution or acquisition described above. An instrument was deemed to be funding such a distribution or acquisition if it was issued by a member of an Expanded Group (a “funded member”) within the 36 months before or after such funded member made such a distribution or acquisition (the “72-month per se” rule).

### NARROWER SCOPE OF THE FINAL REGULATIONS

- *Foreign Issuers.* The Final Regulations do not currently apply to debt issued by foreign corporations. As a result, the burden imposed on multinational groups that lend to foreign members, either from a U.S. member or in foreign-to-foreign transactions, will be significantly reduced under the Final Regulations. The Treasury and IRS will, however, continue to study the application of the Final Regulations to debt issued by foreign corporations.

- *Financial Companies and Insurance Companies.* Debt issued by certain regulated financial companies (and their subsidiaries) and regulated insurance companies is exempt from the application of the funding rule. Moreover, certain instruments issued by a regulated financial company in order to satisfy regulatory capital requirements and “surplus notes” issued by a regulated insurance company are generally exempted from the documentation requirements if, at the time of issuance, it is expected that the relevant instrument will be paid in accordance with its terms.
- *RICs, REITs and S Corporations.* Instruments issued by a RIC, REIT or S corporation are generally excluded from the Final Regulations (unless, in the case of a RIC or REIT, the issuer is 80% or more controlled by an Expanded Group).
- *Debt Instrument Exclusions.* The Final Regulations exclude certain instruments that are expressly treated as debt under other provisions of the Code from the definition of “covered” debt instruments, including production payments, REMIC regular interests and debt instruments deemed to arise as a result of transfer pricing adjustments.
- *Qualified Short-Term Debt Exception.* The Final Regulations add an exception to the funding rule for “qualified short-term debt instruments” to accommodate ordinary-course loans and distributions and short-term cash management arrangements. Qualified short-term debt instruments include short-term funding arrangements that meet one of two alternative tests, certain ordinary-course loans, interest-free loans and certain deposits received pursuant to cash management arrangements.
- *No General Remediation Rule.* The IRS and Treasury declined to follow recommendations to provide a general remediation rule to mitigate the adverse consequences of a recharacterization.

#### DOCUMENTATION REQUIREMENTS SIMPLIFIED

- *Time for Preparing Required Documentation.* The Final Regulations extend the time period for satisfying the documentation requirements to the deadline for filing the issuer’s federal income tax return for the year in question (including all applicable extensions). This should allow issuers and their lenders to review debt issuances at the end of each year and address any unintentional documentation failures.

- *Relief for Generally Compliant Issuers.* The Final Regulations provide modest relief for documentation failures if the issuer's group is otherwise "generally compliant" with the documentation requirements—changing the consequence of a documentation failure from per se recharacterization to a rebuttable presumption. However, the scope of this relief is narrow.
- *Market Standard Safe Harbor.* The Final Regulations provide that documentation of a kind customarily used in comparable third-party transactions (such as that used to document trade payables with unrelated parties) may be used to satisfy the documentation requirements relating to an unconditional obligation to pay a sum certain and the existence of creditors' rights.

### EXCEPTIONS TO DISTRIBUTION AND FUNDING RULES

- *Expansion of Earnings and Profits Exception.* The Final Regulations expand the exception to the funding rule for distributions made out of earnings and profits, which now generally includes all earnings and profits ("E&P") accumulated in years ending after the issuance of the Proposed Regulations during the period that the issuer was a member of the group in question (under the Proposed Regulations, this exception was limited to the current year's E&P).
- *Exception for Certain Contributions.* The Final Regulations include an exception for distributions that can be attributed to certain qualified contributions of property, in effect allowing issuers to net distributions against contributions before applying the 72-month per se rule. Qualified contributions do not include contributions of Expanded Group stock or property acquired by a covered member in an internal asset reorganization.
- *\$50 Million Threshold Exception.* The Final Regulations provide that the first \$50 million of debt of an Expanded Group that would otherwise be recharacterized is excluded from the scope of the rules. This is an expansion of the rule in the Proposed Regulations, which provided that all debt of an Expanded Group would become subject to potential recharacterization once the \$50 million threshold was met.
- *72-month Per Se Rule.* The IRS and Treasury declined to follow recommendations to shorten the funding rule's 72-month per se rule or to provide taxpayers with the ability to rebut any resulting recharacterization, even in circumstances where the distribution or acquisition has no meaningful connection to the issuance of the EGI.

## EFFECTIVE DATES AND TRANSITION RULE

- *Effective Dates.* The Final Regulations extend the effective date for the documentation requirements by one year; these now apply to debt issued or deemed issued after January 1, 2018. However, debt issued after the publication of the Proposed Regulations on April 4, 2016 will be subject to the funding and distribution rules, subject to certain transition rules.
- *Transition Rule.* The Final Regulations include a transition rule for the 90-day period following the publication of the Final Regulations (scheduled for October 21, 2016). A debt instrument that otherwise would be treated as stock under the Final Regulations will only be recharacterized to the extent that the instrument is still held by Expanded Group members upon the expiration of this period.

## OTHER ITEMS OF INTEREST

In addition to the departures from the Proposed Regulations described above, the Final Regulations contain several other changes and clarifications that are important for taxpayers, including:

- *Bifurcation Rule Abandoned.* The Final Regulations do not provide for bifurcating instruments into part debt and part equity, though the issue remains under review by the IRS and Treasury.
- *Blocker Corporations.* In the Proposed Regulations, the Treasury sought comments on whether certain indebtedness commonly used by investment partnerships, including indebtedness issued by certain “blocker” entities, should come within the scope of the Regulations. The Final Regulations do not adopt special rules for debt instruments issued by or to investment partnerships, including indebtedness issued by “blocker” entities, although the IRS and Treasury will continue to study this area.
- *Downward Attribution.* The Final Regulations generally turn off the “downward” attribution rules, under which a partnership would otherwise be treated as owning all of the stock owned by its partners, for purposes of determining the membership of the “Expanded Group.” Were downward attribution principles to apply, the universe of “related” parties would have been far more sweeping, creating Expanded Groups even where there is minimal common ownership between its members and broadening the

scope of the Final Regulations beyond traditional concepts of relatedness. The Final Regulations reserve on the application of “downward” attribution to situations where corporations are commonly controlled by a non-corporate entity.

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Please do not hesitate to contact us with any questions.