IRS FINALIZES CONTROVERSIAL EARNINGS STRIPPING REGULATIONS WITH SIGNIFICANT MODIFICATIONS

The Treasury Department finalized the hotly-debated regulations under Section 385 (the “earnings stripping” regulations) last week. As reported in our client alert dated April 7, 2016, the regulations were initially issued in proposed form on April 4, 2016 with an April 4, 2016 effective date for significant parts of the regulations.

As intended, the proposed earnings stripping regulations had an immediate chilling impact on both announced and contemplated transactions. The Treasury Department invited and has received extensive comments on the proposed regulations many of which have been highly critical. In addition several commentators have questioned the validity of the regulations arguing that the Treasury Department lacks authority to promulgate the regulations.

The final regulations are accompanied by a massive 500+ page Treasury Decision and modify the proposed regulations in significant ways in response to comments. Among other changes, the final regulations expand the $50 million indebtedness threshold in the proposed regulations. Under the final regulations, the $50 million threshold is applicable to all taxpayers. Thus, the final regulations are generally applicable only with respect to and to the extent of indebtedness exceeding $50 million. In addition, the implementation of the new “documentation rules” has been delayed to January 1, 2018, which will give taxpayers more time to adjust and adopt internal procedures to comply with the new rules. The final regulations also drop the controversial “bifurcation rule” under which debt could be partially recharacterized as equity.

Commentators have suggested that the proposed regulations are invalid and there have been indications that taxpayers may challenge the validity of the final regulations. However, the Treasury Department clearly takes the position that it has the authority under Section 385 of the Internal Revenue Code to issue the regulations. According to Treasury Decision (T.D. 9790):

Section 385 authorizes the Secretary of the Treasury to prescribe rules to determine whether an interest in a corporation is treated for purposes of the Code as stock or indebtedness (or as in part stock and in part indebtedness) by setting forth factors to be taken into account with respect to particular factual situations. Under this authority, the proposed regulations provided specific factors that, when present in the context of purported debt instruments issued between highly-related corporations, would be dispositive

I. Summary of the Proposed Regulations

At the heart of the proposed regulations, the Treasury Department adopted a "distribution rule" under which intercompany debt created through a distribution of newly created debt to a related person without corresponding financing or funding of the issuer would be treated as equity. This rule was squarely aimed at so-called "inversion transactions" (notably the proposed inversion of Pfizer) in which U.S. corporations migrates to foreign jurisdictions and typically leverage their U.S. operations through distributions of debt to the new foreign parent. Under the proposed regulations, debt created through distributions or a series of transactions having a similar effect to a distribution would be treated as equity and interest accruing on such debt would thus not be deductible.

The proposed regulations included a "funding rule" that treated as stock a purported debt instrument that was issued in exchange for property, including cash, with a principal purpose of using the proceeds to fund a distribution to a controlling shareholder or another transaction that achieves an economically similar result. The proposed regulations included a "per se" application of the funding rule that treated a purported debt instrument as funding a distribution or other transaction with a similar economic effect if it was issued in exchange for property (other than in the ordinary course of purchasing goods or services from an affiliate) during the period beginning 36 months before and ending 36 months after the funded member made the distribution or undertook the transaction with a similar economic effect.

The proposed regulations also adopted a contemporaneous documentation rule (the "documentation rule") applicable to related party debt instruments under which the absence of timely preparation of documentation and financial analysis evidencing four essential characteristics of indebtedness would conclusively establish that a purported debt instrument would be treated as stock for tax purposes. The stated rationale for this rule was that related parties by definition do not deal independently with each other which made it difficult for the IRS to determine whether the debt was created on arm's length terms. Unlike unrelated parties, related parties frequently extend debt without contemporaneous analysis of the creditworthiness of the borrower. For this reason, the proposed regulations specified the type of the documentation necessary to substantiate the treatment of related-party instruments as indebtedness, including documentation to establish an expectation of repayment and a course of conduct that is generally consistent with a debtor-creditor relationship.

The proposed regulations gave the IRS the authority to treat certain interests in a corporation for federal tax purposes as indebtedness in part and stock in part (the "bifurcation rule"). Several commentators objected to this rule on the basis that it went beyond the establishment of debt/equity criteria and therefore exceeded the authority of the Treasury Department under Section 385.

II. Summary of Significant Modifications to the Proposed Regulations.

The Treasury Department has accommodated many of the fundamental and more frequent comments made over the past several months and dropped the controversial bifurcation rule, presumably in an effort to stymie attempts to invalidate the final regulations. The Treasury Department indicated that that the modifications of the proposed regulations were adopted in response to comments in order to "achieve a better balance between minimizing the burdens imposed on taxpayers and fulfilling the important policy objectives of the proposed regulations". The most important modifications of the proposed regulations were summarized in the Treasury Decision as follows:

Changes to the overall scope of the regulations:

- Exclusion of foreign issuers. The final regulations do not apply to debt issued by foreign corporations or other foreign issuers.
- Exclusion of S corporations and non-controlled RICs and REITs. S corporations and non-controlled regulated investment companies and real estate investment trusts are exempt from all aspects of the final regulations.
- Removal of general bifurcation rule. The final regulations do not include a bifurcation rule; the Treasury Decision states that the Treasury Department and the IRS will continue to study this issue.

Changes to the documentation requirements:

- Extension of period required for timely preparation. The final regulations eliminate the proposed regulations' 30-day timely preparation requirement, and instead treat documentation and financial analysis as timely prepared if it is prepared by the time that the issuer's federal income tax return is filed (taking into account all applicable extensions).
- Rebuttable presumption based on compliance with documentation requirements. The final regulations provide that, if a taxpayer is otherwise generally compliant with the documentation requirements, then a rebuttable presumption, rather than per se recharacterization as stock, applies in the event of a documentation failure with respect to a purported debt instrument.
- Delayed implementation. The final regulations apply only to debt instruments issued on or after January 1, 2018.

Changes to the rules regarding distributions of debt instruments and similar transactions:

- Exclusion of debt instruments issued by regulated financial groups and insurance entities. The final and temporary regulations do not apply to debt instruments issued by certain specified financial entities, financial groups, and insurance companies that are subject to a specified degree of regulatory oversight regarding their capital structure.

- Treatment of cash management arrangements and other short-term debt instruments. The final and temporary regulations generally exclude from the scope of the regulations deposits pursuant to a cash management arrangement as well as certain advances that finance short-term liquidity needs.

- Limiting certain "cascading" recharacterizations. The final and temporary regulations narrow the application of the funding rule by preventing, in certain circumstances, "cascading" consequence of recharacterizing a debt instrument as stock.

- Expanded earnings and profits exception. The final and temporary regulations expand the earnings and profits exception to include all the earnings and profits of a corporation that were accumulated while it was a member of the same expanded group and after the day that the proposed regulations were issued.

- Expanded access to $50 million exception. The final and temporary regulations remove the "cliff effect" of the threshold exception under the proposed regulations, so that all taxpayers can exclude the first $50 million of indebtedness that otherwise would be recharacterized.

- Credit for certain capital contributions. The final and temporary regulations provide an exception pursuant to which certain contributions of property are "netted" against distributions and transactions with similar economic effect.

- Exception for equity compensation. The final and temporary regulations provide an exception for the acquisition of stock delivered to employees, directors, and independent contractors as consideration for the provision of services.

- Expansion of 90-day delay for recharacterization. The 90-day delay provided in the proposed regulations for debt instruments issued on or after April 4, 2016, but prior to the publication of final regulations, is expanded.

III. Effective Dates

The final regulations apply generally to taxable years ending on or after January 19, 2017. However, the following are worth noting:

- Since the documentation requirements in regulations §1.385-2 apply only to interests issued or deemed issued on or after January 1, 2018, including those issued on or after January 1, 2018 under a master agreement in place before January 1, 2018, taxpayers will have until the filing date of their taxable year that includes January 1, 2018, to complete the documentation requirements.

- The final regulations provide certain transition rules, and grandfather debt instruments issued before April 5, 2016. Accordingly, the final regulations do not require taxpayers to redetermine their federal income tax liability for any taxable year ending before January 19, 2017.

- The final regulations are generally not retroactive. Any recharacterization under the final regulations will change an instrument's federal tax characterization only prospectively. To the extent an instrument is retired on or before January 19, 2017, it will not be affected by the final regulations.

The final regulations will likely be the subject of significant discussions over the weeks and months ahead. While the Treasury department has made significant accommodations to comments made by taxpayers, it is clearly not stepping down on the effort to overhaul the debt/equity rules. It will probably be some time before the full impact of the final regulations can be assessed due in part to the sheer size of the underlying Treasury Decision (500 + pages).

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Klas Holm
Partner
kholm@curtis.com
212.696.8800

Kuang-Chu Chiang
Counsel
kchiang@curtis.com
212.696.6058