

Tax Update

Controversial Debt-Equity Regulations Finalized With Limited Fixes, Concessions and Reservations by Government

October 24, 2016

On October 13, 2016, Treasury and the IRS issued important new final and temporary regulations (the “**Regulations**”) under section 385 of the Internal Revenue Code addressing the treatment of intercompany debt for U.S. federal income tax (“**U.S. tax**”) purposes. The Regulations generally will apply to taxable years ending after January 18, 2017, while the documentation requirements described below will apply to debt instruments issued after December 31, 2017. The proposed version of the Regulations, issued in April 2016, attracted controversy due to its broad reach and strict requirements as well as arguments that the rules exceeded the authority granted to Treasury by Congress.

The overall structure of the Regulations remains largely the same as that of the proposed rules, although significant issues are reserved on, including the application of the Regulations to foreign issuers of intercompany debt, and significant exceptions have been added, including for certain short-term cash pooling arrangements.

Part I below provides an overview of the Regulations, and Part II below highlights important differences between the Regulations and the proposed rules and describes certain other significant issues in the Regulations.

I. Overview of Regulations

Under U.S. tax law, interest payments on debt generally are deductible, while the payor of a dividend generally receives no deduction. The government has become increasingly concerned that multinational companies, particularly in connection with an inversion, create debt in their U.S. operations and cause their U.S. subsidiaries to pay interest to foreign affiliates, effectively shifting earnings from the United States to foreign jurisdictions with lower corporate tax rates. The preamble to the Regulations indicates that preventing this “earnings stripping” is the core purpose of the new rules. Nevertheless, the Regulations have a far broader reach and potentially affect transactions having nothing to do with inversions or earnings stripping.

The Regulations seek to address earnings stripping primarily by making it more difficult to classify many intercompany loans as debt for U.S. tax purposes. The Regulations apply to debt issued to a related entity by a domestic corporation or by certain “flow-through” entities, but exclude debt between members of a consolidated group and adopt threshold asset and other requirements to reduce the Regulations’ application to taxpayers other than large corporate groups. For this purpose, two entities are related if they belong to the same “expanded group,” which generally means that they are directly, indirectly, or constructively connected through chains of 80% or greater ownership. The Regulations impose two principal restrictions on a taxpayer’s ability to classify an instrument as debt for U.S. tax purposes when issued within an expanded group by a domestic corporation or certain flow-through entities.

First, the Regulations require that taxpayers prepare and maintain documentation (the “**Documentation Rules**”) with respect to debt instruments issued or deemed issued by a U.S. member of an expanded group (or a disregarded entity thereof) to another member of an expanded group (or a disregarded entity thereof or a “controlled partnership” that is 80% owned by that expanded group) (“**EGIs**”). The required documentation must demonstrate: (i) an unconditional obligation to pay a sum certain, (ii) creditor’s rights for the holder, (iii) a reasonable expectation that the issuer would be able to repay the loan and (iv) the existence of a debtor-creditor relationship between the issuer and holder. With some notable exceptions, the Regulations treat EGIs that fail to satisfy the Documentation Rules as equity for U.S. tax purposes.

Second, the Regulations take aim at transactions in which one member of a corporate group issues debt to another member but arguably does not receive any additional net investment. A “**General Rule**” automatically recasts debt instruments issued or deemed issued by a U.S. member of an expanded group (or a disregarded entity thereof or a partnership with one or more U.S. partners that is a controlled partnership with respect to that expanded group) (“**covered debt instruments**”) to another member of the expanded group (or a disregarded entity thereof or a partnership that is a controlled partnership with respect to that expanded group) in certain covered transactions. Subject to some exceptions, the General Rule recasts as equity covered debt instruments issued in the following transactions: (i) a distribution of the covered debt instrument, (ii) an issuance of the covered debt instrument in exchange for stock of an expanded group member or (iii) an issuance of the covered debt instrument in exchange for property as part of an asset reorganization.

A separate “**Funding Rule**” generally recasts covered debt instruments issued to a member of the issuer’s expanded group (or a disregarded entity thereof or a partnership that is a controlled partnership with respect to that expanded group) within 36 months before or after the issuer undertakes one of the following covered transactions: (i) distributions of property to an expanded group member, (ii) acquisitions of expanded group stock from an expanded group member or (iii) acquisitions of property in connection with certain asset reorganizations. The government retained this “per se rule” from the proposed rules despite significant concern from commentators about the rule’s breadth and unintended consequences. The Funding Rule can also recast a debt instrument issued outside this 36-month period with a principal purpose of funding a covered transaction.

While maintaining these core mechanics from the proposed rules, the Regulations incorporate significant changes, which may ameliorate their impact for some taxpayers. Part II, below, discusses several of these changes, as well as other significant issues in the Regulations.

II. Significant Changes and Issues in the Regulations

A. General

- Reservation on Foreign Issuers. The Regulations currently apply only to debt instruments issued or deemed issued by domestic corporations (including intercompany debt issued by disregarded entities of domestic corporations and by controlled partnerships in which a domestic corporation holds an interest directly or indirectly).
 - The government's reservation on this issue, which commentators requested in the form of a "foreign to foreign" exception, temporarily exempts many transactions from the Regulations, such as most foreign securitizations (including most CLOs). However, the Regulations will still potentially apply to U.S. securitizations (including many student loan and credit card receivables securitizations).
- Very Limited Guidance on Consequences of Recasts. A brief section of the Regulations provides minimal guidance on the consequences of a recast of intercompany debt and the Regulations' deemed exchange treatment. The lack of clarity in this area remains an issue for taxpayers in planning transactions, understanding the consequences of the Regulations and complying with the Regulations' various new requirements.
- Exclusion of S Corporations, Some REITs and RICs. The Regulations generally do not apply to debt instruments issued or held by "S" corporations, or to debt instruments issued or held by real estate investment trusts and regulated investment companies (*i.e.*, mutual funds) that are not controlled (directly or indirectly through chains of 80% or greater ownership) by members of an expanded group.
- Removal of General Bifurcation Rule. The Regulations remove a provision in the proposed rules that authorized the government to bifurcate an instrument into part debt and part equity, though the preamble to the Regulations indicates that this issue is still under study.
- Exceptions for Regulated Entities. The Regulations now largely exempt or provide reduced requirements for intercompany debt instruments issued by certain classes of regulated financial companies and their subsidiaries or by certain regulated insurance companies.

- Deemed Conduit Approach for Flow-Throughs. With respect to a recast of an intercompany debt instrument issued by a flow-through entity such as a controlled partnership, the Regulations adopt the “deemed conduit” approach advocated by several commentators. Rather than recasting debt issued by a controlled partnership or a disregarded entity as equity in the partnership/disregarded entity (which could have adverse collateral consequences) or requiring another adjustment, the Regulations instead deem the holder of the putative debt instrument to have transferred all or a portion of the debt to certain partners in/owners of the issuer that belong to the same expanded group in exchange for deemed stock of those partners/owners.
 - Although this approach is preferable to recasting the debt as equity in the flow-through entity, it nonetheless may give rise to serious tax issues. For example, if the partner is a domestic corporation and the putative debt holder is a non-U.S. person, then “interest” payments on the putative debt instrument may be recast as U.S.-source dividends and, if so, may be subject to withholding. It is unclear who would be the “withholding agent” required to remit the withholding to the IRS in this case. The Regulations also take the position, challenged by some commentators, that an instrument recast as equity under the Regulations is treated as equity, and produces dividends, for purposes of U.S. tax treaties.
- Fixes to Definition of “Expanded Group”. The Regulations introduce various changes to the definition of an “expanded group,” including narrowing the situations in which one entity is considered to constructively own another. Notably, multiple chains of corporations owned by a single non-corporate entity generally would not form a single expanded group under the Regulations.
- Fixes to Predecessor/Successor Rules. The Regulations provide that an entity is no longer a “predecessor” or “successor” of another entity as a result of a spinoff or splitoff after the two cease to be members of the same expanded group and incorporate several other fixes to predecessor and successor issues from the proposed rules.
- Exemption for Deemed Debt Instruments. The Regulations now generally exempt several classes of instruments explicitly treated as debt under the Internal Revenue Code, including REMIC regular interests.
- Requests for Broad Exceptions Rejected. The Regulations do not incorporate certain general exemptions sought by commentators, including for (i) securitization transactions, (ii) transactions in which control of an entity is tested under section 368(c) of the Internal Revenue Code and (iii) retention of equity or debt pursuant to risk retention requirements.

- Treatment of Certain Entities Unclear. The Regulations fail to clarify the treatment of several types of entities, including grantor trusts and qualified REIT subsidiaries. To the extent debt issued or held by such entities is subject to the Regulations, it is unclear how the Regulations would apply and how taxpayers could avoid the recast of such debt.

B. General Rule and Funding Rule (Regulation §§ 1.385-3 and 1.385-3T)

- Effective Date. The General Rule and Funding Rule apply to taxable years ending after January 18, 2017, and generally will not recast a covered debt instrument as equity until that date and generally will not apply to covered debt instruments issued prior to April 5, 2016. Taxpayers may elect to apply the proposed rules instead with respect to instruments issued after April 4, 2016 and before October 13, 2016.
- Exclusions for Qualified Short-Term Debt. The Funding Rule now generally does not apply to covered debt instruments relating to the following types of short-term obligations:
 - Certain short-term funding arrangements, which are arrangements with interest rates not exceeding arm's length rates that meet other requirements intended to ensure that the instrument is repaid in the short term and satisfies the issuer's short-term funding needs.
 - Certain deposits under cash pooling arrangements. This change, together with the exception for short-term funding arrangements above, partially addresses criticism that the proposed rules would have effectively disallowed cash pooling structures used by most large companies. While these changes are significant, it is unclear whether the exceptions will sufficiently cover short-term borrowings under cash pools. In addition, the Regulations generally do not provide specific relief for notional cash pools.
 - Loans issued as consideration to fund the acquisition of property (other than money) in the ordinary course of the issuer's trade or business and that are reasonably expected to be repaid within 120 days of issuance. The proposed rules contained a different version of this exception with more requirements, though that version did cover borrowings to fund the receipt of services as well as the acquisition of property, and did not require repayment within 120 days.
 - Certain interest-free loans.
- Fix for Cascading Recast Issue. The Regulations amend the Funding Rule to avoid a possible "cascading" effect in which the holder of a covered debt instrument at the time the instrument was recast was deemed to engage in a covered acquisition, leading to the recast of the holder's outstanding debt.

- Exemptions for Spinoffs and Liquidations. Tax-free distributions of stock under sections 354(a)(1), 355(a)(1) or 356 of the Internal Revenue Code, such as spinoffs and splitoffs, and distributions of property in complete liquidation under sections 336(a) or 337(a) of the Internal Revenue Code, no longer count as covered distributions under the Funding Rule. The proposed rules generally treated a complete liquidation as a covered distribution and treated a spinoff or splitoff as a covered distribution unless preceded by a section 368(a)(1)(D) reorganization.
- Expanded E&P Exception. A covered transaction may now be offset to the extent the corporation undertaking the action possesses earnings and profits (“E&P”) accumulated (i) in taxable years ending after the April 4, 2016 issuance of the proposed rules and (ii) while the corporation was a member of the same expanded group with the same group parent. The exclusion for accumulated E&P of new expanded group members is intended to discourage acquisitions of corporations for the purpose of utilizing their E&P. The proposed rules included a similar exception, but only considered current E&P.
- Offset for Qualified Contributions. A covered transaction may now be offset by certain capital contributions to the company undertaking the covered transaction, generally within 36 months before or after the covered transaction.
- Expanded Threshold Exception. Under the General Rule and Funding Rule, a “threshold exception” now prevents the recast of \$50 million in covered debt instruments within an expanded group. A similar exception in the proposed rules applied only to an expanded group that had \$50 million or less in expanded group debt that would be treated as stock, and was entirely inapplicable if the expanded group issued more than \$50 million in such debt.
- Subsidiary Stock Acquisition Exception. The General Rule and Funding Rule now provide an exception for acquisitions of expanded group stock from a subsidiary in which the acquiror generally retains 50% control of the subsidiary for a specified period after the acquisition. This exception is a broader version of the proposed rules’ “acquisition of subsidiary stock by issuance” exception.
- Additional Specific Exceptions. The General Rule and Funding Rule now generally do not apply to (i) acquisitions of expanded group stock for use as equity compensation for individuals, (ii) deemed transactions resulting from transfer pricing adjustments and (iii) subject to certain limitations, acquisitions of covered debt instruments by an expanded group member in its role as a securities dealer.
- Exception to Recast Treatment for Consolidated Group Purposes. The Regulations now generally provide that covered debt instruments recast as equity under the General Rule or the Funding Rule will not be treated as stock for purposes of determining a corporation’s eligibility for affiliated group membership under section 1504(a) of the Internal Revenue Code.

- Recast Timing Change. A covered transaction occurring after the issuance of a covered debt instrument will no longer cause the covered debt instrument to be recast under the per se rule until the date of the covered transaction. Under the proposed rules, such a covered debt instrument could have been recast as of issuance in some circumstances, an especially burdensome result given that the covered transaction may not have been considered at the time of the issuance.

C. Documentation Rules (Regulation § 1.385-2)

- Effective Date. The Documentation Rules apply only to EGIs issued after December 31, 2017, a significant extension from the proposed rules, which generally would have applied to EGIs issued on or after the date of publication of final regulations in the Federal Register.
- Exclusion of Partnership Debt. The Regulations generally exempt EGIs issued by partnerships from the Documentation Rules.
- Expanded Time for Records Preparation. The Documentation Rules now extend the time for preparation of records until the date for filing of the relevant issuer's federal tax returns (taking into account all applicable extensions) with respect to the relevant taxable year. By contrast, the proposed rules generally set a deadline of only 30 or 120 days after a particular "relevant date."
- Allowances for Master Agreements. The Documentation Rules clarify their application to situations where a single master agreement governs multiple EGIs, which may be the case with revolving credit facilities and cash pooling arrangements. The Documentation Rules generally permit taxpayers to demonstrate expectation of the obligor's ability to repay with respect to EGIs subject to such agreements by preparing a single credit analysis annually (and upon occurrence of any material change with respect to the issuer).
- New and Expanded Saving Rules. The Regulations contain several additional or expanded exceptions to the Documentation Rules dealing with documentation failures:
 - If an expanded group meets certain requirements to demonstrate that it is "highly compliant" with the Documentation Rules, specific compliance failures will now produce only a rebuttable presumption of equity status, rather than *per se* treatment as equity, for the relevant EGI.
 - If a taxpayer establishes "reasonable cause" for failure to comply with the Documentation Rules, the Regulations will now disregard this failure in determining compliance and permit the determination of the debt or equity status of the relevant EGI under general tax principles.

- In determining compliance with the Documentation Rules, the Regulations now disregard certain non-material or ministerial failures and errors that are resolved prior to discovery by the IRS.
- Uneven Retesting Requirement. The Documentation Rules require that an EGI that ceases to be recast as equity (for instance, if the holder of an EGI transfers it to a person that is not a member of the same expanded group) must be tested anew for debt or equity status. It is unclear whether this treatment, which differs from the treatment under the General Rule and Funding Rule, is intentional and, if so, what the rationale is for such treatment.

III. Further Developments

The Regulations now apply to a reduced range of transactions and instruments, and they reserve on many issues, including their application, in whole or in part, to most foreign issuers, U.S. branches of foreign issuers, and instruments that are not in form debt, the treatment of separate expanded groups with a single common non-corporate parent and the ability of taxpayers to affirmatively use the Regulations for a tax benefit. Future regulations are likely to address some or all of these issues and may impose new requirements and/or limit or remove existing exceptions, so taxpayers should prepare for additional compliance work in this area. In addition, a legal challenge to the validity of the Regulations remains possible in light of the unprecedented scope of the Regulations' changes to a fundamental tenet of the tax law. The Regulations' voluminous preamble, discussing the comments received and justifying the government's approach and authority under the Internal Revenue Code, may be designed to buttress the government's position in any such litigation.

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