

New US Debt-Equity Rules Target Earnings Stripping

October 20, 2016

On October 13, 2016, the IRS and the Treasury Department issued [new rules](#) largely designed to prevent highly related corporate taxpayers from claiming the tax benefits of “earnings stripping,” or the payment of excessive deductible interest by a corporation to a related person when such interest is (wholly or partially) tax-exempt in the hands of the related person.

These new rules were issued as temporary and final regulations (the “385 Regs”) under Section 385 of the Internal Revenue Code (the “Code”), which gives the Treasury Department authority to write rules governing when an interest in a corporation is debt (which usually provides for deductible interest) or equity. The 385 Regs represent several significant compromises by the IRS, which had issued a far broader, more disruptive version earlier this year in proposed form (the “proposed regs” – see [related coverage](#)). On the other hand, one of the most controversial aspects of the proposed regs – the per se funding rule – was preserved.

The 385 Regs have four main components: (1) general provisions, (2) the documentation rules, (3) the recharacterization rules, and (4) consolidated group rules.

General provisions

Rules limited to US corporations. One of the most important compromises is that the 385 Regs apply only to debt instruments issued by domestic corporations that are part of an “expanded group” or “EG”. By carving out foreign issuers, including controlled foreign corporations (“CFCs”), this relieves many concerns raised by the prior regs, including that they could have prevented US shareholders from claiming the benefit of foreign tax credits (especially in the context of the possible operation of the proposed regs on typical corporate treasury and cash management functions)

Expanded group. Several changes were made to what entities are included in an EG, which generally refers to a highly-related corporate group connected by at-least-80-percent common stock ownership. S corporations and non-controlled RICs and REITs are generally exempt from being part of an EG. Some of our clients may be interested to note that:

- Under the final rules, multiple private investment funds managed by the same investment manager may be an EG because a common investment adviser (or related entity) owns all the voting interests in the funds.
- The 385 Regs do not adopt special rules for debt instruments used by investment partnerships, including those issued by blockers.

Elimination of the bifurcation rule. The new rules do not include the proposed regs’ bifurcation rule that permitted the IRS on audit to divide a debt instrument into part-debt and part-stock. The IRS and Treasury Department will continue to study this rule.

Documentation rule

Timely preparation requirement; delayed implementation. To qualify as a debt instrument, the proposed regs required specific documentation within 30- and 120-days of the “relevant date” (typically, the issue date). Under the 385 Regs, this documentation is

not required until the time for filing the issuer's federal income tax return (including extensions) for the year that includes the relevant date. Taxpayers will have until the filing date of their taxable year that includes January 1, 2018, to complete the documentation requirements. The documentation rules do not apply to an EG instrument issued by a foreign issuer, an S corporation, or between consolidated group members, and they generally exclude RICs, REITs and controlled partnerships

Rebuttable presumption for highly compliant EGs. Under the proposed regs, failure to satisfy the documentation requirements results in automatic recharacterization of the instrument as equity. Under the new rules, if the taxpayer is otherwise "highly compliant" with the documentation requirements, an instrument that is not properly documented is presumed to be equity (rather than automatically treated as equity), and the taxpayer may rebut the presumption with common law debt factors. The new rules provide three quantitative tests for whether a taxpayer is otherwise "highly compliant"; these tests generally measure whether the taxpayer's other outstanding EG instruments are properly documented. The 385 Regs further soften the consequences of non-compliance by adding an exception for ministerial or non-material failures or errors.

The 385 Regs also streamlined compliance with the documentation requirements with regard to revolving credit agreements, cash pooling arrangements, and similar arrangements that cover multiple EG instruments under a master agreement. The new rules also clarified how taxpayers may satisfy the requirement for documenting the reasonable expectation of the borrower's ability to repay. Finally, if an instrument issued by an entity that is disregarded as separate from its sole owner for tax purposes (a "disregarded entity" or "DRE") is recharacterized as equity under the documentation rules, the owner (rather than the DRE) will be treated as the issuer (thus preventing the DRE from becoming a partnership, which could create the potential for gain recognition and other significant collateral issues).

Recharacterization rules

The 385 Regs carried over the "general rule", which treats debt as equity if it is issued in (1) a distribution, (2) an acquisition of stock of an EG member, or (3) an exchange for property in an asset reorganization (a "distribution or acquisition"); and the "funding rule", which treats as equity any debt issued to an EG member (a "funded member") to the extent it funds a distribution or acquisition. Under the "per se funding rule," debt is irrebutably presumed to be equity if it was issued within three years before or after a distribution or acquisition.

Exceptions. The 385 Regs added several exceptions that generally limit the general rule and funding rule to non-ordinary course transactions, including:

- **E&P limitation.** A distribution or acquisition is exempt to the extent of the corporation's post-April 4, 2016 earnings and profits that were accumulated while it was a member of the same EG.
- **Netting qualified contributions.** Distributions and acquisitions are taken into account only to the extent they exceed increases to the borrower's equity from certain capital contributions that occurred (i) while the borrower was a member of the same EG, and (ii) during the 3-year before and after the distribution or acquisition occurred.
- **Acquisitions from a sub.** An acquisition of stock of an EG member from a majority-owned subsidiary, provided the acquirer controls the seller immediately following the acquisition and does not relinquish control pursuant to a plan that existed at the time of the acquisition.
- **Reorgs & other significant transactions.** For purposes of the funding rule, a "distribution" generally does not include a liquidating distribution or a spin-off that is not preceded by a "D" reorganization.
- **Short-term debt instruments.** To facilitate non-tax motivated cash management techniques, such as cash pooling, revolving credit agreements, and ordinary course short-term lending outside a formal cash-management arrangement, the funding rule does not apply to certain "qualified short-term debt instruments."
- **"Cascading recharacterizations."** For purposes of the funding rule, an "acquisition" does not include an acquisition of an EG instrument that was recharacterized as stock under the funding rule. This provides limited relief for "cascading

recharacterizations”, situations in which the recharacterization of one EG instrument could lead to deemed transactions that result in the recharacterization of other EG instruments.

Taxpayers that cannot fit into one of these exceptions should note that up to \$50 million in EG debt instruments that would otherwise be recharacterized under these rules is exempt. Only EG instruments in excess of this \$50 million threshold is subject to equity treatment. This is a welcome development as the proposed regs had a “cliff effect” – as soon as you went over \$50 million, all EG instruments from dollar one were recharacterized as equity.

Consolidated groups

Under the propose regs, all members of a consolidated group are treated as one corporation (the “one corporation rule.”) Under a new “order of operations rule,” a transaction involving one or more members of a consolidated group is first characterized under federal tax law without regard to the one corporation rule, and then the recharacterization rules are applied to the transaction as characterized to determine whether the debt instrument is treated as stock, treating the consolidated group as one corporation, unless otherwise provided.

When a member of an EG ceases to be a member of its original consolidated group but continues to be a member of the same EG (a “departing member”), the departing member’s history of transactions with other consolidated group members is disregarded.

When an EG member joins a consolidated group, and continues to be a member of the same EG (a “joining member”) the joining member and the consolidated group it joins are predecessor and successor for purposes of the funding rule, which treats a predecessor or successor of a funded member the same as the funded member.

Effective date

The 385 Regs are effective as of their date of publication in the Federal Register (expected October 21, 2016), and apply to taxable years ending on or after the date 90 days after the publication date (expected January 19, 2017). If a debt instrument would be treated as equity under the 385 Regs during the 90 days after the date of publication, the instrument will be treated as if it were exchanged for stock immediately after the 90th day (expected January 20, 2017) but only to the extent that the instrument is held by a member of the issuer’s EG immediately after the 90th day. Taxpayers may elect to apply the proposed regs to debt instruments issued after April 4, 2016, and before October 13, 2016, provided those rules are consistently applied. As noted above, the documentation requirements do not apply to interests issued or deemed issued before January 1, 2018.

Implications

These new rules involve a variety of technical requirements and demand careful attention. Cooley lawyers are experienced in helping clients navigate these tricky waters.

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