
Tax Alert

Treasury Releases Final Debt-Equity Regulations – Part I



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On October 13, 2016, the Department of the Treasury (Treasury) issued final and temporary regulations under Internal Revenue Code (IRC) Section 385 to curb earnings stripping by treating certain related-party debt instruments as equity for tax purposes.

The final regulations come after wide-ranging proposed regulations issued on April 4, 2016. The proposed regulations surprised many tax practitioners and affected parties due to their extensive scope and departure from historical practice which relied on certain judicial principles in classifying instruments as debt or equity.

The final Section 385 regulations maintain the overall approach of the proposed regulations. They allow Treasury to recharacterize a debt instrument as equity if the instrument does not meet new documentation requirements. They also identify certain prohibited transactions in which a debt instrument will automatically be characterized as equity, regardless of its substantive characteristics. However, after taking into consideration numerous public comments, Treasury has modified the proposed regulations in a manner which significantly restricts their scope.

This Tax Alert provides an overview of the effective dates, entities covered, and highlights the reduced scope of the final and temporary regulations. We will issue additional Tax Alerts on other key aspects of the regulations.



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Effective Dates:

The final regulations are scheduled to become effective on October 21, 2016, the tentative date of publication in the Federal Register.

However, Treasury has delayed implementation of the documentation requirements. Under the final regulations, the documentation requirements will be effective on January 1, 2018. Therefore, the rules will not apply to financial instruments issued prior to 2018. Additionally, the proposed regulations were modified so that taxpayers need not have documentation in place until the deadline for filing their tax return, including extensions. These changes will provide taxpayers with additional time to comply with the new documentation rules.

Treasury also delayed the potential recharacterization of debt instruments issued on or before publication of the final regulations. The proposed rules were made applicable to instruments issued on or after April 4, 2016. Although the final regulations do not change this date, they do delay the actual recharacterization of instruments into equity for tax purposes. No instrument issued before October 22, 2016 will be recharacterized as equity until 90 days after publication, or January 19, 2017 (assuming a publication date of October 21, 2016).

Reduced Scope:

The regulations generally apply to “covered members” which the regulations define as domestic corporations that are members of an “expanded group.” The definition of an expanded group is based upon a modified definition of an affiliated group under Section 1504(b), generally requiring 80% common ownership and the filing of consolidated tax returns. Unlike an affiliated group, an expanded group also includes foreign corporations. The regulations are applicable to any “expanded group interest” (EGI), which is an interest in a member of an expanded group held by a member of the same expanded group. Accordingly, debt instruments issued by a member of an expanded group to another member of the same expanded group are potentially covered under the regulations.

Treasury has significantly scaled back the scope of the proposed regulations to generally cover instruments issued by certain domestic corporations (and controlled partnerships). The final regulations do not apply to instruments issued by the following entities:

- *Foreign Corporations.* This change significantly limits the scope of the Section 385 regulations. The exclusion of debt issued by foreign issuers relieves what would have been a significant compliance burden for large multinational groups. It also obviates the potential loss of foreign tax credits posed by recharacterizing debt issued between foreign entities. However, the preamble notes that application of the regulations to foreign corporations requires “further study” and as such, Treasury reserves the possibility that these rules could be implemented in the future.
- *S Corporations.* Characterization of an S Corporation debt instrument as equity would have potentially created a second class of stock, jeopardizing the entity’s status as an S Corporation. Additionally, as a flow through entity, there was less concern about the potential for earnings stripping.
- *Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs)* that are not part of a controlled group. Like S Corporations, RICs and REITs are generally flow-through entities that do not implicate earnings stripping concerns, and recharacterization of their debt instruments could jeopardize the entities’ federal tax status. However, unlike S Corporations, RICS and REITS will be subject to the Section 385 Regulations if they are controlled by members of the expanded group.

The regulations also exempted certain entities from the rules that recast debt instruments as equity in certain prohibited transactions. However, these entities must still comply with the documentation requirements. These partially-exempted entities include:

- Certain regulated financial institutions that generally include insured depository institutions, bank holding companies, certain nonbank financial companies, registered broker-dealers, and swap dealers.
- Certain regulated insurance companies. However, this exception does not apply to certain captive insurance companies to which the Section 385 regulations will still apply.

Additionally, the documentation requirements do not apply to interests between members of the same consolidated group. This removes a large number of purely domestic instruments from the reach of the Section 385 regulations. However, the regulations are still applicable in a circumstance involving two domestic members of an expanded group. As a result, taxpayers must be aware that the regulations may still apply in a strictly domestic context involving no foreign entities.

Our next Tax Alert will discuss the impact of the documentation rules set forth in the final regulations.

Please contact your WeiserMazars tax professional for more information.

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