JONES DAY

OCTOBER 2016

COMMENTARY

Treasury Releases Final Debt/Equity Regulations

On October 13, 2016, the U.S. Treasury Department released final debt/equity regulations under section 385 of the Internal Revenue Code aimed primarily at preventing earnings stripping by U.S. corporations. These final regulations generally follow regulations first proposed on April 4, 2016, but with significant cutbacks in scope and modifications to substantive rules. Certain of these regulations (primarily relating to the treatment of partnerships and U.S. consolidated groups) have been issued in temporary and proposed form, meaning that the temporary rules will generally expire within three years unless finalized, and the proposed rules are held out for future comments.

Overview of Proposed Regulations

The proposed regulations generally created three sets of rules for related-party corporate-issued debt. Specifically, they: (i) enabled the IRS to treat certain related-party debt as partially equity (a bifurcation rule); (ii) specified due diligence and documentation that must be undertaken and maintained in order for certain related-party debt to be respected as debt for U.S. tax purposes (a documentation rule); and (iii) required certain related-party debt issued in specified transactions to be treated as stock of the issuer for U.S. tax purposes (a transaction-based recharacterization rule). The effect of the application of these rules would be the denial of any interest deduction taken with respect to recharacterized debt and the recharacterization of "interest" payments as distributions with respect to stock (potentially treated as dividends for U.S. tax purposes).

The proposed regulations would have applied to debts between members of an "expanded group," generally including all corporations (foreign and domestic) related through direct or indirect stock ownership of 80 percent of the voting power or 80 percent of the value. The proposed regulations did not apply to debts directly between members of a U.S. consolidated group.

Overview of Final Regulations

The final regulations retain some of the rules described in the proposed regulations, but eliminate and make significant modifications to many others. A summary of the final regulations is set forth below.

Changes in Final Regulations

Exceptions for Foreign Issuers, S Corporations, REITs, and Regulated Companies. Unlike the proposed regulations, the final regulations exempt foreign issuers but reserve on whether rules applicable

© 2016 Jones Day. All rights reserved.

to debt issued by foreign corporations might be implemented in the future. Thus, the final regulations generally apply only to U.S.-to-foreign related-party debt (or U.S.-to-U.S. related-party debt in the unlikely event that the issuer and holder are in the same expanded group but not the same U.S. consolidated group). This scope limitation applies to both the documentation rule and the transaction-based recharacterization rule. Therefore, the final regulations do not apply to foreign-to-foreign or foreign-to-U.S. related-party debt. As a result, the majority of cases that remain subject to these final regulations involve a U.S. company that issues debt to a foreign expanded group member (likely the parent of such expanded group). Similarly, the final regulations generally do not apply to debt issued or held by S corporations or real estate investment trusts ("REITs"), and many of the rules in such regulations do not apply to certain types of financial services, insurance, or other regulated corporations.

Bifurcation Rule not Finalized. The proposed regulations would have enabled the IRS to bifurcate a related-party debt instrument, treating it as partially debt and partially equity. The final regulations do not contain such a rule, although Treasury indicated that it will continue to study whether or not to create such a rule in the future. Thus, the traditional debt/equity analysis generally remains an "all or nothing" determination under the final regulations (although the transaction-based recharacterization rule described below may treat an instrument as partially equity based on the transaction in which it is issued).

The Final Documentation Rule. Consistent with the proposed regulations, the final regulations generally require related-party debt to satisfy certain documentation requirements. Specifically, such documentation must contain the following four core items: (i) the legally binding obligation to pay a sum certain; (ii) a typical third-party creditor right of enforcement; (iii) evidence of a reasonable expectation of the borrower's ability to repay pursuant to the terms of the instrument; and (iv) manifestation of an ongoing arm's-length debtor-creditor relationship during the life of the debt.

In addition to many other changes, the final regulations contain two substantial modifications to the documentation rules previously contained in the proposed regulations.

First, whereas the proposed regulations generally required most of the documentation to be prepared within 30 days of issuance of an applicable debt instrument, the final regulations extend the deadline for such documentation to the due date of the issuer's U.S. federal income tax return for the year that the debt instrument is issued (or any other relevant date required under the regulations). The final regulations set forth a fairly precise description of the materials required to meet this documentation requirement.

Second, the proposed regulations provided that any related-party debt failing to satisfy the documentation rules would be treated as per se equity for U.S. tax purposes. Although the final regulations provide that failure to satisfy the documentation rules will generally result in per se equity treatment, they also provide that if the taxpayer can provide that it complied with the documentation requirements to a "high" degree, such taxpayer will instead be subject to a rebuttable presumption that the debt instrument is equity for U.S. tax purposes. The final regulations also contain a reasonable cause exception for those cases where noncompliance is due to reasonable failures.

Finally, the final regulations provide that the documentation requirements apply only to debt instruments issued on or after January 1, 2018. This delayed effective date provides taxpayers with additional time to implement systems and procedures necessary for compliance.

The Final Transaction-Based Recharacterization Rule. Under the proposed regulations, intercompany debt would generally have been recharacterized as stock if issued as: (i) a distribution from one expanded group member to another; (ii) consideration by one expanded group member for the stock of another; or (iii) boot in certain intragroup reorganizations. Additionally, intercompany debt would generally be recharacterized as stock when issued with a principal purpose of funding a distribution or acquisition by the funded member, regardless of whether the lending member was a party to such distribution or acquisition. A principal purpose of funding the distribution or acquisition would have been presumed on a nonrebuttable basis if the debt in question was issued within 36 months of the distribution or acquisition. Certain limited exceptions applied, including for debts issued in the ordinary course of certain types of trades or businesses or in amounts no greater than the issuer's current-year earnings and profits.

The final regulations generally implement the transaction-based recharacterization rule described in the proposed regulations, subject to a number of scope-limiting modifications, including:

- First and foremost, this rule applies only to debt issued by U.S. corporations and held by corporations that are members of the same expanded group, other than members of the U.S. consolidated group of which the issuer is a member;
- Short-term debt instruments and cash pool deposits are generally excepted;
- Regulated financial entities (including many types of banks) and insurance companies subject to risk-based capital requirements are generally excepted;
- The exception for debt issued in an amount up to the issuer's current-year earnings and profits has been expanded to include all earnings and profits accumulated by the issuer during all tax years ending after April 4, 2016; and
- An exception for related-party debt now exempts the first $50 million of all related-party debt from the transaction-based recharacterization rule.

It appears that these and many other changes are intended to focus the transaction-based recharacterization rule more closely on U.S. earnings stripping practices.

Timing and Effective Date. As described above, the documentation requirements in the final regulations are effective only for debt issued on or after January 1, 2018.

The transaction-based recharacterization rule is generally effective for related-party debt issued after April 4, 2016. However, a transition rule generally provides that any such debt issued after April 4, 2016, but before the date that is 90 days after the final regulations are published in the Federal Register (such publication date is estimated to be October 21, 2016, and the 90th day thereafter is estimated to be January 19, 2017) will not be recharacterized until immediately after such 90th day, if such debt remains outstanding at that time. This provides taxpayers with a transition period during which they can "clean up" related-party debt, although certain exceptions applicable to the transition period may limit particular methods of retiring such related-party debt.

Lawyer Contacts

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent to our "Contact Us" form, which can be found at www.jonesday.com/contactus/.

Scott M. Levine
Washington
+1.202.879.3437
smlevine@jonesday.com

Andrew M. Eisenberg
Washington
+1.202.879.5576
ameisenberg@jonesday.com

Joseph A. Goldman
Washington
+1.202.879.5437
jagoldman@jonesday.com

Edward T. Kennedy
New York
+1.212.326.3775
etkennedy@jonesday.com

Jones Day publications should not be construed as legal advice on any specific facts or circumstances. The contents are intended for general information purposes only and may not be quoted or referred to in any other publication or proceeding without the prior written consent of the Firm, to be given or withheld at our discretion. To request reprint permission for any of our publications, please use our "Contact Us" form, which can be found on our website at www.jonesday.com. The mailing of this publication is not intended to create, and receipt of it does not constitute, an attorney-client relationship. The views set forth herein are the personal views of the authors and do not necessarily reflect those of the Firm