

AN ALERT FROM THE BDO INTERNATIONAL TAX PRACTICE

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INTERNATIONAL TAXATION



SUBJECT

EARNINGS STRIPPING REGULATIONS UNDER SECTION 385 FINALIZED

SUMMARY

On October 13, 2016, the Department of the Treasury (“Treasury”) and the Internal Revenue Service (“Service”) issued final and temporary regulations under Section 385 of the Internal Revenue Code (the “Final and Temporary Regulations”).

DETAILS

Background

Internal Revenue Code 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 Internal Revenue 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.

On April 4, 2016, the Treasury and the Service issued proposed regulations under Internal Revenue Code Section 385 (the “Proposed Regulations”) addressing the characterization of certain related party debt instruments as debt or equity for United States tax purposes.

The Proposed Regulations addressed three primary areas relating to debt/equity classification. The Proposed Regulations:

1. Permitted the Service to re-characterize an instrument as part debt and part equity (the “Bifurcation Rule”);

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2. Required timely documentation to support debt classification of related party indebtedness (the “Documentation Rules”);¹ and
3. Provided specific rules to characterize debt instruments as stock with respect to certain distributions, reorganization transactions and certain other types of transactions (the “Recast Rules”).

Additionally, the Proposed Regulations provided specific rules relating to the treatment of consolidated groups.

The general Recast Rule in the Proposed Regulations provided that a debt instrument can be treated as stock to the extent it is issued by a corporation to a member of the corporation’s expanded group (1) in a distribution, (2) in exchange for expanded group stock (subject to a limited exception), or (3) in exchange for property in certain asset reorganizations.

The “Funding Rule” in the Proposed Regulations targeted debt instruments issued with a principal purpose of funding a transaction described in the general Recast Rule. The Funding Rule contained a non-rebuttable presumption of a principal purpose within a 72-month period surrounding the distribution or acquisition. The Funding Rule in the Proposed Regulations applied if the instrument was issued by a member during the period 36 months before the distribution or acquisition and ending 36 months after the distribution or acquisition. The Proposed Regulations included an exception to the non-rebuttable presumption rule for certain ordinary course debt instruments (as defined in the Proposed Regulations).

The Proposed Regulations included several operating rules (rules for defining when members of the group are related for purposes of applying the rules, certain threshold exceptions, and specific exceptions relating to the application of the rules, anti-abuse rules, anti-avoidance rules, etc.).

The Proposed Regulations are discussed in more detail in our Tax Alert, *“Internal Revenue Service and Treasury Release Proposed Regulations Addressing Debt/Equity Classifications for US Tax Purposes,”* dated April 2016.

Final and Temporary Regulations

After the Proposed Regulations were issued, the Treasury and the Service received numerous written comments in response to the Proposed Regulations. Many of these comments criticized the broad application of the rules. In addition, many of the comments expressed concern that the Proposed Regulations would impose compliance burdens and result in collateral consequences that were not justified by the stated policy objectives of the Proposed Regulations. In response to the comments received, the Final and Temporary Regulations substantially revise the Proposed Regulations. The Final and Temporary Regulations significantly reduce the scope and breadth of the rules by including several important exclusions and exceptions relating to the application of the rules.

The changes significantly reduce the number of taxpayers and transactions affected by the Final and Temporary Regulations. As narrowed, many issuers are entirely exempt from the application of §§1.385-2 (the Documentation Rules) and 1.385-3 (the Recast Rules). Moreover, with respect to the large domestic issuers that are subject to §1.385-3, that section has been substantially revised to better focus on extraordinary transactions that have the effect of introducing related-party debt without financing new investment in the operations of the issuer.

Summary of Key Changes

The Final and Temporary Regulations included the following important changes to the Proposed Regulations.

Changes to the overall scope of the regulations include the following:

- ▶ The Final Regulations make some modifications to the definition of an Expanded Group for purposes of applying the rules.
- ▶ The Final Regulations reserve on all aspects of their application to foreign issuers; as a result, the Final Regulations do not apply to foreign issuers significantly reducing the number of taxpayers affected by these rules. The Final and

¹ The Proposed Regulations provided that an instrument is not subject to the Documentation Rules unless one of the following conditions is met: (1) the stock of any member of the expanded group is publicly traded, (2) all or any of the portion of the expanded group’s financial results are reported on financial statements with total assets exceeding U.S. \$100 million, or (3) the expanded group’s financial results are reported on financial statements that reflect annual total revenue that exceeds U.S. \$50 million. The Final Regulations include this threshold.

Temporary Regulations achieve this result by creating a new term, “covered member,” which is defined as a member of an expanded group that is a domestic corporation, and reserves on the inclusion of foreign corporations, including with respect to U.S. branches of foreign issuers.

- ▶ S corporations and non-controlled regulated investment companies (“RIC”) and real estate investment trusts (“REIT”) are exempt from all aspects of the Final Regulations. However, the Final Regulations continue to treat a RIC or REIT that is controlled by members of the expanded group as a member of the expanded group.
- ▶ The Final Regulations do not include a general bifurcation rule.

Changes to the documentation requirements in §1.385-2 include the following:

- ▶ The Final Regulations eliminate the Proposed Regulations’ 30-day and 120-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).
- ▶ The Final Regulations provide that, if an expanded group is otherwise generally compliant with the Documentation Rules, then a rebuttable presumption, rather than *per se* re-characterization as stock, applies in the event of a documentation failure with respect to a purported debt instrument. For this rebuttable presumption to apply, the taxpayer must demonstrate a high degree of compliance with the Documentation Rules.
- ▶ The Documentation Rules apply only to debt instruments issued or deemed issued on or after January 1, 2018.
- ▶ The Final Regulations clarify the ability of expanded group members to satisfy the documentation rules for EGIs issued under revolving credit agreements, cash pooling arrangements, and similar arrangements by establishing overall legal arrangements (master agreements).

Changes to the rules regarding distributions of debt instruments and similar transactions under §1.385-3 include the following:

- ▶ 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.
- ▶ The Final and Temporary Regulations generally exclude from the scope of §1.385-3 deposits pursuant to a cash management arrangement as well as certain advances that finance short-term liquidity needs when certain requirements are satisfied.
- ▶ The Final and Temporary Regulations narrow the application of the Funding Rule by preventing, in certain circumstances, the so-called “cascading” consequence of re-characterizing a debt instrument as stock. To prevent inappropriate duplication under the Funding Rule, §1.385-3(b)(6) of the Final Regulations clarifies that once a covered debt instrument is re-characterized as stock under the Funding Rule, the distribution or acquisition that caused that re-characterization cannot cause a re-characterization of another covered debt instrument after the first instrument is repaid.
- ▶ The Final and Temporary Regulations expand the earnings and profits exception detailed in the Proposed Regulations 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. Special rules apply when there is a change in control.
- ▶ 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 re-characterized.²
- ▶ 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.

² The Proposed Regulations provided that the threshold exception would not apply to any debt instruments once the \$50 million threshold was exceeded.

- ▶ 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, if certain requirements are satisfied.
- ▶ The Final and Temporary Regulations provide that an expanded group partner's share of a controlled partnership's assets is determined in accordance with the partner's liquidation value percentage.
- ▶ 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 so that any debt instrument that is subject to re-characterization but that is issued on or before the date 90 days after the date of publication in the Federal Register, will not be re-characterized until immediately after the date 90 days after the date of publication in the Federal Register.

Effective/Applicability Dates

The Final and Temporary Regulations apply to taxable years ending on or after the date 90 days after the date on which the regulations are published in the Federal Register.³

The Documentation Rules in the Final Regulations under §1.385-2 do not apply to interests issued or deemed issued before January 1, 2018.

The Recast Rules in Final and Temporary Regulations under §§ 1.385-3 and 1.385-3T grandfather debt instruments issued before April 5, 2016 (rather than before April 4, 2016, as was provided in the Proposed Regulations). The Final and Temporary Regulations in §1.385-3(b)(3)(viii) also grandfather distributions and acquisitions occurring before April 5, 2016, for purposes of applying the Funding Rule.

Debt instruments that are issued between April 5, 2016, and 90 days after the publication of the Final Regulations in the Federal Register that would be re-characterized as stock under the Recast Rules are deemed to be exchanged for stock immediately after the date 90 days after the publication of the Final Regulations in the Federal Register.

See above regarding the expansion of the 90-day delay for re-characterization.

For more details regarding the dates of applicability, see §§ 1.385-1(f), 1.385-2(i), 1.385-3(j), 1.385-3T(k), 1.385-4T(g) and 1.752-2T(l)(4).

For more details on these rules and changes see the [Final and Temporary Regulations](#).

³ The Final and Temporary Regulations are scheduled to be published on October 21, 2016.

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