Insight

Tax Topics: 385 Rules

GORDON GRAY | OCTOBER 17, 2016

On Thursday, the Department of the Treasury issued long awaited final rules relating to corporate classification of debt and equity. The Treasury proposed three new avenues of limiting the use of tax-preferred debt by 1.) allowing the Commissioner of the Internal Revenue Service (IRS) to classify some transactions between corporate entities (such as a U.S. subsidiary and a foreign partner) as being compromised of both debt and equity rather than entirely as a tax-preferred debt, 2.) requiring firms to prepare and maintain new documentation establishing a debt instrument as indebtedness for federal tax purposes, and 3.) treating as stock debt instruments used as distributions and similar transactions.[1] In general, the rules were proposed as targeting earnings-stripping, whereby multinational firms use interest payments from U.S. operations to foreign corporate affiliates to avoid high U.S. corporate taxes. Yesterday's final rules, sought to address many of the criticisms leveled at the blunt initial rules.

The initial rules were fraught with problems, and drew wide criticism during the comment period. Broadly, the initial rules were criticized for their breadth and potential for highly adverse unintended consequences. In particular, many large multinational firms rely on internal loans for cash management purposes, rather than third party banks. The rules were so broad in their application that though couched as targeting international tax avoidance, they posed potential consequences for entirely domestic firms, specifically S corporations. That the rules ensnared domestic firms is particualrly egregious given that the rules have been descried as a response to corporations moving overseas, or inverting. The initial rules also drew criticism for practical flaws, specifically its implementation date and heavy documentation requirements. Indeed, a representative of the Treasury Department conceded that its initial attempt at the rules were a "blunt instrument" and that the Treasury "might have overdone it."

The final rule addresses some of the concerns raised, but could still potentially prove burdensome, even for non-tax-motivated activities. Among other changes, the new rule

scraps entirely avenue 1.), the so-called bifurcation rule; limits the scope the potential disruption to internal cash management operations; exempts S-corporations, insurance companies, REITs, and certain other entities; and moves push back the effective date for new documentation requirements. These changes reflect many of the objections raised during the comment period. However, concerns remain that the rule could still prove disruptive to internal cash management processes. Further, the rule retains a retroactive effective date for debt instruments after April 4 of this year, despite calls for delaying the effective dates to allow firms to enter into compliance.

According to the Treasury Department, the rule would affect 6,300 firms and impose $224 million in initial compliance costs, with ongoing costs of $56 million. However, one study that examined the challenges posed by the initial rule observed that the "IRS has grossly understated the economy-wide documentation and compliance burdens," raising concern that Treasury did not adequately gauge the burdens of the new rules.

[1] The Treasury and the IRS have established four essential characteristics of indebtedness: "a legally binding obligation to pay, creditors' rights to enforce the obligation, a reasonable expectation of repayment at the time the interest is created, and an ongoing relationship during the life of the interest consistent with arms-length relationships between unrelated debtors and creditors." https://s3.amazonaws.com/public-inspection.federalregister.gov/2016-07425.pdf. The Treasury has cited fact patterns where these new regulations would apply as circumstances that are economically similar to a dividend distribution and circumstances where the transaction has limited non-tax significance. Further the Treasury also prescribed proposed regulations that would limit the use of separate related-party entities from issuing debt to fund any of the transactions targeted by these regulations through a two-step approach.