CLIENT MEMORANDUM

The Treasury Department and Internal Revenue Service Issue Final and Temporary "Earnings-Stripping" Regulations

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On October 13, 2016, the Treasury Department and Internal Revenue Service released final and temporary regulations under section 385 relating to the classification of certain intercompany loans as equity for U.S. federal income tax purposes. The regulations adopt portions of regulations on the same topic that were proposed in April 2016, but they also make a number of significant modifications to the proposed regulations. Many of the modifications relax the application of the proposed regulations.

The regulations adopt the basic approach of the proposed regulations, including imposing new documentation requirements on intercompany debt and providing that loans in certain intercompany transactions are "per-se stock." However, the final and temporary regulations made substantial changes to the proposed regulations, including (i) eliminating the so-called "bifurcation rule" pursuant to which the IRS would be able to treat intercompany debt in part as debt and in part as equity, (ii) expanding the types of intercompany loans and identity of issuers that are exempt from the rules and (iii) generally delaying the effective dates of the regulations to allow taxpayers time to comply with the regulations.

This memorandum briefly summarizes certain of the most significant changes from the proposed regulations.

- Regulations Only Apply to U.S. Borrowers – One of the most significant changes is that the final and temporary regulations now only apply to U.S. borrowers. The regulations reserve on the application of the rules to debt issued by foreign corporations.

- Elimination of "Bifurcation Rule" – The final regulations removed the portion of the proposed regulations that gave the government the authority to treat applicable intercompany loans as part-debt and part-equity for U.S. tax purposes.

- Exemption from Regulations for Certain Types of Issuers – The regulations exclude, among others, debt issued by S-corporations, regulated investment companies (RICs) and real estate investment trusts (REITs) from the application of the rules.

- Significant Changes to Documentation Requirements – The final and temporary regulations provide some welcome relief to the documentation requirements, including:

  - Extension of period for timely preparation – The final regulations eliminate the proposed regulations' 30-day timely preparation requirement and instead will treat documentation (including financial analysis) as timely prepared if it is prepared by the time that the issuer's federal income tax return is filed (including extensions).

  - Delayed implementation – The final regulations' documentation requirements only apply to debt instruments issued on or after January 1, 2018.

  - Rebuttable presumption based on compliance with documentation requirements – The final regulations provide that, if an expanded group has otherwise generally complied with the documentation requirements, a rebuttable presumption (rather than per-se recharacterization as stock, which is what the proposed regulations had provided) applies in the event of a documentation failure.

  - Relaxed rules for certain debt issued by regulated entities – Although the regulations do not provide a general exception to the documentation rules for regulated financial companies and regulated insurance companies, a debt instrument issued by such entities will not fail the documentation rule merely because the issuer must receive approval of the regulator prior to making payments of principal or interest, as long as at the time of issuance it is expected that the debt instrument will be paid in accordance with its terms.

- Significant Changes to the Per-Se Stock Rule – The final regulations retain the basic construct of the proposed regulations with respect to so-called "per-se stock" transactions. Specifically, an intercompany debt instrument issued in a distribution, in an acquisition of stock of an expanded group member or in exchange for property in an asset reorganization is treated, per se, as stock for tax purposes. As a backstop to this rule, the final regulations also retain the so-called "funding" rule pursuant to which intercompany debt is treated as stock to the extent it

funds a distribution or acquisition within the six-year period surrounding the issuance of the debt instrument. However, the final regulations provide a variety of new exceptions and relax certain provisions of the proposed regulations. Among the most significant changes are:

- Exclusion for debt issued by regulated entities – Debt instruments issued by regulated financial entities and regulated insurance companies that are subject to a specified degree of regulation are exempt from the per-se stock rule.

  Specifically, with respect to insurance companies, the debt issued is not subject to the per-se stock rule if the insurance company is (i) subject to tax under subchapter L of the Code, (ii) domiciled or organized under the laws of a state or the District of Columbia, (iii) licensed, authorized or regulated by one or more states or the District of Columbia to sell insurance, reinsurance or annuity contracts to unrelated persons and (iv) engaged in regular issuances of (or subject to ongoing liability with respect to) insurance, reinsurance or annuity contracts with unrelated persons. Thus, a section 953(d) company – i.e., a foreign corporation that elects to be treated as a U.S. corporation for U.S. federal income tax purposes – as well as certain captive insurance companies would not benefit from this exemption. Also, a non-insurance subsidiary of a qualifying insurance company will not qualify for the insurance company exception.

- Exclusion for short-term cash management and cash pooling arrangements – The regulations generally exclude from the per-se stock rule deposits to cash management arrangements, as well as certain loans that finance short-term liquidity needs.

- Expanded exclusion for ordinary course loans – A debt instrument issued to acquire property, other than money, in the ordinary course of the issuer's trade or business that is reasonably expected to be repaid within 120 days is excluded from the rule.

- Changes to $50 million exception – The regulations remove the "cliff effect" of the $50 million threshold exception so that all taxpayers can now exclude the first $50 million of indebtedness that otherwise would be recharacterized.

- Earnings and profits exception – The regulations expand the earnings and profits exception, which offsets intragroup distributions and/or acquisitions that could otherwise cause a recharacterization of debt as equity, to include all earnings and profits of a corporation that are accumulated while the company is a member of the expanded group in taxable years ending after April 4, 2016.

- Equity compensation exception – The regulations provide an exception for debt issued in exchange for the acquisition of stock delivered to employees, directors and independent contractors as consideration for the provision of services.

- New effective date – The per-se stock rule now applies to taxable years ending on or after January 19, 2017 with respect to debt instruments issued after April 4, 2016. Thus, taxpayers have a 90-day window to unwind instruments issued after April 4, 2016, which instruments might otherwise be caught by these rules without adverse effect.

The regulation package itself is over 500 pages long and contains other significant changes not addressed here (e.g., rules regarding debt issued by controlled partnerships and disregarded entities) and more detail on the changes highlighted in this memorandum.

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