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200 DTR G-3

Earnings Stripping

Final Debt-Equity Rules Ease Impact on U.S. Multinationals

By Alison Bennett

Oct. 14 — U.S. multinationals can generally breathe a sigh of relief over the final version of controversial earnings-stripping rules, tax practitioners said.

A series of broad carveouts—headlined by a widely praised exception for transactions between foreign subsidiaries of multinationals based in the U.S.—takes most U.S. multinationals largely out of the reach of the rules (T.D. 9790), the practitioners told Bloomberg BNA Oct. 14.

Snapshot

- Broad foreign-to-foreign exception welcome
- Some praise measured

The guidance, intended to stop companies from shifting income out of the U.S. via loans to offshore subsidiaries, caused consternation across a huge swath of companies, industries and business groups when it was first proposed. As proposed, it allowed the government to broadly recharacterize the loans as expensive equity, split debt instruments into part debt and part equity, and impose tight documentation rules. Taxpayers predicted dire economic consequences without major changes.

Generous carveouts for cash pooling, Subchapter S corporations, regulated financial companies, regulated insurance companies, regulated investment companies and real estate investment trusts, among others, eased most of those concerns, practitioners said.

The exception for cash pooling, which covered short-term loans and other short-term financing structures, was laid out in proposed rules (REG-130314-16) accompanying the final rules (T.D. 9790). The proposed rules are effective for three years (see related story in this issue).

'Constellation of Exceptions.'

Although some questions remain, "I think overall the regulation package is positive," said Wade Sutton, a principal in the Mergers & Acquisitions group at PricewaterhouseCoopers LLP. "Most U.S. multinationals will no longer have problems under these rules, especially with cash management activities. I like the approach they've taken, with a constellation of exceptions. You should be able to fit into one of those categories."

The extensive exception for foreign-to-foreign transactions brings relief across a wide range of financial activities, said David Golden of Ernst & Young LLP. "It's not even really a foreign-to-foreign exception," he said. "It's foreign-to-anybody. Foreign issuers are simply carved out. For U.S. multinationals, that's huge."

Treasury said in the rules that it allowed the relief as a way to "achieving a better balance between minimizing the burdens placed on taxpayers" and going after abuse.

The rules expand exceptions for ordinary business transactions, such as distributions, to generally include future earnings and allowing corporations to net distributions against capital contributions. The rules also provide exceptions for ordinary course transactions such as stock acquisitions associated with employee compensation plans.

In a move that's been widely praised, the rules extend the effective date for tough documentation requirements by one year, to take effect Jan. 1, 2018.

Measured Praise

Some of the praise was measured, however.

Practitioners across the board said it was clear the Treasury had listened carefully to hundreds of comments on the rules and made changes that tried to address many of those concerns. But Golden said the end result, in many cases, was complex and would take a lot of work to implement.

"In some respects they almost listened too carefully," he said. Noting that the final rules "are about four times longer and pick up 80 percent fewer transactions" than the proposed rules, Golden said, "Some of the exceptions are incredibly complicated and it remains to be seen, in the real world, how useful they will be."

Brian Kittle, a tax partner with Mayer Brown LLP, said it remains unclear whether the way the IRS addressed those concerns is enough. He said it is still possible, if not likely, that taxpayers could challenge both the government's authority to issue the rules and the question of whether the rules represent a reasonable interpretation of the law under the Administrative Procedure Act (see related story in this issue).

The Organization for International Investment said despite the changes, it is still worried the rules might deter foreign businesses and taxpayers from bringing their money to the U.S.

Disagreement on Costs

One issue Treasury addressed in the preamble to the final rules was the question of their cost. Dozens of taxpayers wrote to Treasury complaining that compliance with the proposed rules would carry a high price tag, arguing the government hadn't adequately taken that into account when writing the guidance.

The government said in the preamble to the rules that it disagreed, contending that the rules are a "necessary and appropriate" exercise of authority and it had conducted an adequate analysis of the costs and benefits.

Treasury said even at their broadest application, the rules will impact only 6,300 of the roughly 1.6 million C corporations in the U.S.

The total start-up expenses for these affected taxpayers is estimated to be $224 million in 2016 dollars, Treasury said, with ongoing annual compliance costs estimated to be $56 million in 2016 dollars, or an average of $8,900 per company.

By comparison, Treasury said, the rules would raise about $600 million a year in taxes from shutting down avoidance.

Targeted Rules

Both Paul Schmidt, chair of tax at BakerHostetler LLP, and Joe Calianno, partner and international technical tax practice leader at BDO USA LLP, said the rules show Treasury's effort to narrow the proposed guidance to go after troublesome earnings-stripping transactions.

"These regs are much more targeted to the initial earnings stripping concerns that they had," Calianno told Bloomberg BNA.

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