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Pitfalls Remain Despite Easing Of IRS Debt-Equity Rules

By **Vidya Kauri**

Law360, New York (October 18, 2016, 7:11 PM EDT) -- The U.S. Department of the Treasury recently introduced several exemptions in final rules intended to recharacterize debt as equity following bipartisan backlash and scores of comments from business groups, but experts say compliance with the complex regulations will remain burdensome for multinational companies.

Originally introduced in April as part of a larger plan to curb corporate inversions aimed at lowering U.S. taxes, the Section 385 regulations drew the ire of Democrats, Republicans and trade groups, including the National Retail Federation and the U.S. Chamber of Commerce, who said the proposed rules were overly broad, affecting ordinary business transactions that lacked tax avoidance motives. The critics also accused Treasury and the Internal Revenue Service of exceeding their constitutional authority in promulgating the rules.

On Thursday, the IRS heeded concerns from business groups and tax practitioners by making exceptions for foreign subsidiaries of U.S. multinationals, S-corporations, mutual funds, real estate investment trusts and transactions between banks.

The sheer volume of the regulations — 518 pages in all — means that it could take weeks or even months to fully understand their full scope and identify areas of concern. But reactions from experts suggest that while the final rules are more reasonable and more thorough than they initially were, foreign parents lending to U.S. subsidiaries are still subject to the rules, and it is not always clear when debt may be treated as equity.

“The rules are complicated. So, just figuring out when they apply and when they don’t is going to be a burden,” Sam Kaywood of Alston & Bird LLP said. “It will cause problems and cause tax where tax wouldn’t otherwise be due. It’s going to cause a lot of compliance efforts.”

The final regulations could still be perceived as being overly broad because they may catch other legitimate transactions that are not intended to be inversions, experts said.

For example, the inclusion of a “per se” rule, which essentially recharacterizes an intercompany loan as equity if the transaction took place within 36 months of a reorganization, could unnecessarily curb bona fide restructuring efforts, according to Friedemann Thomma of Venable LLP.

“The impact of recharacterization of debt into equity could be very detrimental even if the underlying transaction has nothing to do with an inversion,” Thomma said. “There is a fundamental nonunderstanding of the inappropriateness of the per se rule. In my opinion, the per se rule should not be there, period.”

Even if the rules ultimately don’t apply to certain transactions, businesses still have to “go through a very lengthy, technical analysis” to determine if the rules apply, Thomma said.

Tax practitioners are also troubled by the IRS’ refusal to adopt comments requesting that the agency disregard repayments on purported debt instruments recharacterized as stock. Commenters had expressed concerns about the so-called cascading effects of recharacterizing debt in which the reclassification of one debt instrument could lead to other debt instruments also getting treated as equity.

Mark Leeds, a tax transactions and consulting partner at Mayer Brown LLP, explained that the effects of the cascading recharacterizations means that not only will an entity lose out on interest deductions, but debt principal repayments will be treated as distributions with respect to equity as well. In effect, there will be some level of tax due on amounts recharacterized as dividends in contrast with loan repayments that are nontaxable events, he said.

“The repayment of that portion of the instrument that’s recharacterized as equity is going to be treated as a distribution potentially taxable as a dividend. That dividend can have withholding tax consequences, as well as being taxable in other contexts,” Leeds said.

The rules could also create additional burdens and documentation requirements if states decide to adopt the federal regulations, but it is too early to tell if and how states may implement these rules, according to Kaywood.

“If states get involved, then loans within the U.S. within a consolidated group all of a sudden becomes subject to the rules at the state level, and that’s where it could really get nightmarish,” he said.

In addition, there are still questions about whether Treasury had the constitutional authority to promulgate these rules and whether they are in line with congressional intent, experts said.

Certain types of transactions will always be treated as stock no matter what, and one could argue that it is not up to Treasury to attack these transactions when Congress had previously tried, but failed, to reduce the amount of deductible interest paid to foreign, related parties, Kaywood said.

“They’re really just trying to disallow a deduction especially in the case of a U.S. company paying interest to a foreign, related lender. And so, that’s where they [may be] trying to basically make law that didn’t exist,” Kaywood said, adding that this could give rise to lawsuits years down the road if a corporation suffers inadvertent consequences as a result of the rules and the stakes are large enough.

Treasury’s willingness to seriously consider and accommodate the numerous comments it received in response to its initial proposals, including pushing back the effective date of several aspects of the rules from April 2016 to January 2018, could dissuade any legal challenges to the regulations in the near future, Leeds said.

“Given the reduced impact and the fact that the regulations are prospective as opposed to retroactive — which they were under the proposed regulations, I’m not saying it couldn’t happen, but I’d be surprised if people continued to press forward with constitutional challenges,” Leeds said.

--Editing by Christine Chun and Kelly Duncan.

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