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Treasury Reveals Plans Regarding Certain 2016 Tax Rules, Including Disguised Sale and Debt/Equity Regulations

On October 2, 2017, the United States Department of the Treasury submitted its highly anticipated final report to President Trump announcing its plans to pare back eight tax regulations that it had previously identified in June of 2017 under Executive Order 13789 as "burdensome." This memorandum describes four of the eight regulations we believe will be of particular interest to our clients.

Final and Temporary Regulations under Section 385 on the Treatment of Certain Interests in Corporations as Stock or Indebtedness—Controversial Debt/Equity Rules Remain Unchanged

These regulations under Section 385 were issued due to concerns relating to transactions resulting in excessive debt among related parties in the international context. They are comprised of (i) rules establishing minimum documentation requirements (the "documentation regulations") and (ii) rules that treat as stock certain debt issued by a corporation to a controlling shareholder in a distribution or in another related-party transaction that achieves an economically similar result (the "distribution regulations"). As Treasury notes in its report, these two aspects of the Section[1] 385 regulations are very different in purpose, scope and application and, thus, Treasury currently plans to take different approaches to the two parts of these regulations.

- **Documentation Regulations**: The documentation regulations were intended to establish minimum guidelines that must be satisfied in order for purported debt obligations among related parties to be treated as debt for federal tax purposes. Treasury is now considering a proposal to revoke the documentation regulations and instead may develop revised rules that would be "substantially simplified and streamlined in a manner that will lessen their burden on U.S. corporations . . . ."

- **Distribution Regulations**: Prior to the adoption of the distribution regulations, a U.S. corporation could create intercompany debt owing to its foreign parent by distributing a debt obligation as a dividend (often free of withholding tax because of applicable tax treaties), thereby sheltering a portion of its U.S. earnings by taking interest deductions on the debt. These rules were in the first instance intended to address inversions by limiting the ability of corporations to generate additional interest

[1] All Section references herein are to the U.S. Internal Revenue Code of 1986, as amended and the regulations thereunder, as applicable.

deductions without new investment in the United States. However, these rules went well beyond their initial purpose and have been criticized for their complexity and breadth, particularly the funding rule that addresses multiple-step transactions and the burdens of tracking multiple transactions among affiliated companies over long periods of time. Following the election, particularly given Republican criticism of these rules, there was some thought that the new administration might revoke or modify these regulations. Treasury has decided to retain these rules for now, as it believes that the best option is to wait for tax reform, noting that Congress is best equipped to effectively address the "distortions and base erosion caused by excessive earnings stripping." The report notes that if legislation does not entirely eliminate the need for the distribution regulations, Treasury may then propose more streamlined and targeted regulations at that time.

Regulations under Section 707 and Section 752 on the Treatment of Partnership Liabilities Relating to Leveraged Partnerships and Disguised Sales—Leveraged Partnership Redux?

Under prior rules, taxpayers were able to conduct so-called "leveraged partnership" transactions, in which the "sale" of a substantial portion of an interest in a business could effectively be accomplished on a tax-deferred basis through the formation of a partnership with the buyer. These transactions took advantage of an exception to the disguised sale rules for transactions in which a partner contributes property to a partnership and receives a debt-financed distribution of cash from the partnership. Under prior rules, if such debt was treated as recourse to the contributing partner, the transaction would effectively be treated as if the partner had simply borrowed against his own assets, ordinarily a tax-free transaction. One of the ways that this debt was treated as recourse was through so-called "bottom-dollar" guarantees, where the partner agreed to repay certain partnership debt only if the lender collected less than the guaranteed amount from the partnership. This technique allowed partners to guarantee the payment of otherwise nonrecourse debt up to the amount of the distribution, but only after all of the equity in the partnership's assets had been applied to the liability.

Although such transactions had become quite common, particularly in connection with UP-REIT acquisitions, Treasury came to the view that they were abusive, because the outcome was inconsistent with economic substance. To address such perceived abuses, the new Section 707 regulations rejected the treatment of bottom dollar guarantees, but went beyond that to treat all partnership debt as "nonrecourse" for purposes of the disguised sale rules, thus allocating all partnership debt in accordance with the partner's share of partnership profits. Accordingly, it was no longer possible to disproportionately allocate partnership debt to a distributee partner, even, for example, if the partner bore "first dollar" risk for the debt.

In its report, Treasury notes that while the new regulations under the disguised sale rules merit further study, such a dramatic change should be studied methodically and thus Treasury is considering whether to abandon the new rules and reinstate the prior, more favorable regulations. If Treasury were to revoke these rules, other kinds of allocations under Sections 707 and 752 (including third tier allocations of "excess nonrecourse debt" and allocations of recourse debt where there is real economic risk of loss) would likely come back into play.

However, Treasury believes that the new regulations relating to bottom-dollar guarantees should be kept, as such guarantees allowed sophisticated taxpayers to artificially create basis without meaningful economic risk, which goes against the main principles underlying the allocation of recourse liabilities. Therefore, Treasury has stated that it does not plan to propose substantial changes to the temporary regulations on bottom-dollar guarantees. While Treasury's plans in this area may leave room for certain kinds of leveraged partnership transactions, it appears that such transactions involving bottom-dollar guarantees will remain a thing of the past.

Final Regulations under Section 367 on the Treatment of Certain Transfers of Property to Foreign Corporations—Goodwill Will be a Good Asset

Although U.S. corporations are generally taxable under Section 367(a) on the transfer of assets to a foreign corporation, there is an exception for transfers of assets constituting a foreign trade or business. Prior regulations had provided favorable treatment for foreign goodwill and going-concern value by excluding such assets from Section 367 treatment altogether. However, due to concerns about abusive valuation practices, the final Section 367 regulations issued in December 2016 eliminated the ability of taxpayers to make such transfers without immediate or future U.S. income tax and, significantly, limited the scope of property that is eligible for the active business exception to certain tangible property and financial assets. As a result, transfers of goodwill and going-concern value would either be taxed under Section 367(a), requiring immediate gain recognition, or Section 367(d), providing for gain recognition over the life of the property transferred.

After studying the legal and policy issues, Treasury now concedes that "an exception to the current regulations may be justified . . . ." As a result, the Office of Tax Policy and the IRS are working toward a proposal that would bring back the active trade or business exception with respect to foreign goodwill and going-concern value under certain circumstances. Treasury expects to propose regulations providing such an exception in the near term.

Temporary Regulations under Section 337(d) on Certain Transfers of Property to Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs)—REIT Spin Rules Rationalized

Prior to the enactment of the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act"), a C corporation could place its real estate assets in a REIT and engage in a Section 355 tax-free spinoff of the REIT stock. Although the PATH Act limited some of these transactions, it did not prevent the spinoff of a C corporation followed by other types of transactions, such as a merger, into a pre-existing REIT. The temporary regulations under Section 337(d) were meant to close this gap by extending the prohibition of a REIT election following an otherwise tax-free spinoff to other types of "conversion" transactions, including mergers of the spinco with an existing REIT. Under these rules, such a merger would subject the taxpayer to immediate gain recognition for the pre-conversion unrecognized gain on the assets of the C corporation that was a party to the merger.

But Treasury, upon further consideration, believes that these rules may have gone too far. In particular, where a smaller corporation that is a party to a spinoff merges into a larger corporation in a tax-free reorganization, and the larger corporation makes a REIT election after the spinoff. Under the temporary regulations, there is an immediate gain recognition related to the larger corporation's assets.

Treasury is considering revisions that would limit the potential taxable gain recognized in such situations to the amount that would have been recognized if a party to a spinoff had directly transferred the assets to a REIT. Treasury notes in its report that its revisions would substantially reduce the immediately taxed gain of the larger corporation by limiting gain recognition to the gain in the assets of the smaller spinco. The report also notes that other technical changes to narrow further the application of these rules are currently being considered.

Other "Burdensome" Regulations and Future Plans

In addition to its plans regarding the above four sets of regulations, Treasury also intends to: (1) withdraw entirely proposed regulations (a) under Section 2704, restricting the ability to take valuation discounts on transfers of closely-held business interests, for estate, gift and generation-skipping transfer tax purposes, and (b) under Section 103 on the definition of political subdivision, (2) consider revoking in part final regulations under Section 7602 on the participation of a person described in Section 6103(n) in a summons interview, and (3) consider substantially revising final regulations under Section 987 on income and currency gain or loss with respect to a Section 987 qualified business unit.

Treasury is also continuing to evaluate all recently issued significant regulations and has further initiated a comprehensive review of all regulations, regardless of when they were issued. This review has already identified over 200 regulations that the IRS Office of Chief Counsel believes should be repealed, most of which have been outstanding for many years. Treasury expects to begin the rulemaking process for repealing these regulations in the fourth quarter of 2017.

We will continue to follow developments in this area and report as matters progress.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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