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The final debt-equity regulations: planning to comply

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On October 13 the US Treasury Department released final debt-equity regulations to address "earnings stripping" and deter multinationals from shifting income out of the United States to lower-tax jurisdictions. The impact of these new rules on MNEs with operations in the United States will be significant and companies should develop plans to ensure both tax and financial reporting compliance.

Background

In general, corporations can raise capital by issuing debt or stock. US tax rules provide an incentive for corporations to issue debt because the interest expense is deductible for US tax purposes while dividends are not. In the marketplace, economic and legal constraints limit corporations' ability to issue debt.

When the parties to the transaction are highly related, however, these constraints are not effective. In the view of the US government this can lead to over-leveraging, resulting in tax arbitrage and a negative impact on the US tax base. In recent years, an increase in debt issued by US corporations to foreign parent corporations has created significant economic and revenue costs to the United States, which the government has decided to address.

On April 4 the US Treasury Department proposed debt-equity regulations under Internal Revenue Code Section 385 intended to address this problem by creating rules that would treat certain instruments issued to related parties as stock.

The government received over 30,000 comments to these proposed rules, heard testimony from business and tax professionals, and consulted with members of Congress. Most of these comments attacked the proposed regulations on the grounds that they would have a negative impact on transactions entered into in the ordinary course of business, be costly for corporations to implement, and create unintended consequences in the tax law.

Final debt-equity regulations

The final regulations – which are extremely complex and detailed – narrow the impact on corporations compared to the proposed regulations. First, they apply only to domestic US C corporations that are either (i) publicly traded, (ii) have revenue greater than $50 million, or (iii) have assets over $100 million. They will not apply to instruments issued by foreign corporations, certain entities that are fiscally transparent, or certain short-term instruments—including instruments issued in connection with ordinary cash management techniques.

In addition, the rules will not apply to instruments issued by members of a US consolidated tax group and held by another member of the consolidated group (although there may be state tax consequences in states that do not allow for the filing of consolidated tax returns). Further, the effective dates of several portions of the final debt-equity regulations have been delayed somewhat to give companies more time to comply. The regulations also include a number of exemptions, special rules, anti-abuse rules, and transition rules.

The final regulations contain two major substantive rules: rules requiring documentation of related-party instruments, and rules dealing with certain types of "tainted" transactions that the government considers abusive. For the rest of this article we will focus exclusively on the debt-equity regulation documentation requirements and their implementation.

Under the final regulations, any instrument issued by a domestic C corporation to a related party can be considered to be debt for US federal income purposes only if there is written documentation establishing:

- ***A written promissory note***—a binding legal obligation to repay a fixed or determinable sum certain on demand or at one or more fixed dates;
- ***Creditor's rights***—the creditor/holder has the legal rights of a creditor to enforce the terms of the instrument;
- ***Creditworthiness***—as of the issue date and taking into account all relevant circumstances, the issuer's financial position supports a reasonable expectation that the issuer intended to, and would be able to, meet its obligations under the terms of the interest; and
- ***Payment or exercise of remedies***—that the debtor-creditor relationship is ongoing, with written proof that either—
  - All payments required by the instrument are being made under the terms of the instrument, or
  - In the event of a default, the holder takes actions that an ordinary, reasonable, third party lender would take (for example, acceleration of the debt, foreclosure on security, renegotiation, or a reasoned decision to forgo exercise of its rights at that time).

Failure to timely prepare the documentation creates a presumption (which the company may overcome) that the instrument is stock. The documentation must be completed no later than the due date of the issuer's tax return (including extensions) for the relevant taxable year.

The documentation requirements will generally take effect for calendar-year taxpayers beginning in 2017. While the final regulations will expressly apply to a significantly reduced number of companies when compared to the proposed regulations, they set forth guidelines and best practices that all companies should be following.

Meeting the documentation requirements

To meet the documentation requirements, all MNEs with activities in the United States should develop a detailed action plan to ensure compliance both for existing instruments and for those issued in the future. In general, an implementation plan should include three major components: risk analysis, process and procedures development, and monitoring and reassessment.

Risk Analysis. Every company that may be subject to the new rules should perform an immediate risk analysis for all related-party loans within its multinational group, as well as examine its existing processes to understand potential exposures. The MNE should create a complete inventory of its related party loans, followed by a review of all current documentation supporting those transactions and any policies and procedures already in place.

If an MNE had conducted a risk analysis previously under the proposed regulations, it should reassess the conclusions in light of the final debt-equity regulations. In any event, a company should identify and remedy gaps between current documentation and the requirements of the regulations, as well as consider potential impacts to its tax provision and ASC 740. Steps that can be taken immediately may include eliminating or reducing intercompany balances or converting problematic entities into disregarded entities.

Processes and Procedures. Once a risk analysis has been completed and the immediate issues have been identified, the company should develop and test processes and procedures regarding creation, documentation, and management of all future related party advances (including cash management methods, trade receivables and payables, transfer pricing adjustments, and other situations).

The company should identify and designate a "process owner" as part of the design process. The process owner provides accountability to the parties and to management and can serve as the direct point of contact within the organization for all matters connected to documentation.

The design process should involve all internal and external stakeholders with both direct (senior management, legal, treasury, tax) and indirect (IT, accounts payable/receivable, internal and external audit and/or outside advisors) involvement to minimize impact to the business. Only after understanding the impact to the various stakeholders within the organization, should the company design, test, and implement repeatable processes and procedures to mitigate risk and comply with the regulations.

Each step in the documentation process should be clearly identified so that there is no ambiguity or confusion about what needs to be done and who is responsible for it. Specific control and review procedures should be designed to ensure that the process is performed accurately. The process owner should maintain all documentation in a central location to help encourage uniformity and completeness in reporting and make review and monitoring activities much easier.

Implementation is often the most challenging aspect of the action plan. Training is a critical element of any successful implementation. Procedures may be designed with the best intentions, but if they aren't implemented uniformly, directions are not clear, or the correct stakeholders are not involved, the result may be failure. All stakeholders must be aware of the designated process owner so that they receive a clear and consistent message and know where to turn if they have questions.

Throughout this phase, the MNE should give careful consideration to communication and the accessibility of timely and accurate information. Periodic meetings, creation of a distribution list, and the use of a dedicated internal website can ensure that all stakeholders can successfully participate in and own the entire process.

Monitoring and Reassessment. After implementation, the MNE should perform monitoring activities—including periodic assessment of the processes and procedures—at least annually. While this review should focus on compliance with and performance by the stakeholders of the processes, it is also important to understanding where improvements can be made or where law changes may need to be incorporated. As always, timely communication will be critical.

Compliance with the new regulations will be challenging and require involvement from multiple parties both within and outside your organization. Nevertheless, a clearly-defined action plan and a strategy focusing on both the immediate and future needs of the business will prepare your organization to conquer this challenge successfully.