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Fact Sheet: Treasury Issues Final Earnings Stripping Regulations

10/13/2016

On April 4, Treasury issued proposed regulations to address earnings stripping by strengthening the tax rules distinguishing between debt and equity. After extensive engagement with businesses, tax experts, the public, and lawmakers, today we are announcing the final regulations.
After a corporate inversion, multinational corporations often use a technique called earnings stripping to minimize U.S. taxes by paying deductible interest to the new foreign parent or one of its foreign affiliates in a low-tax country. This commonly-used technique can generate large interest deductions without requiring a company to finance new investment in the United States. The new regulations restrict the ability of corporations to engage in earnings stripping by treating financial instruments that taxpayers purport to be debt as equity in certain circumstances. They also require that corporations claiming interest deductions on related-party loans provide documentation for the loans, similar to the common practice for third-party loans. The ability to minimize income tax liabilities through the issuance of related-party financial instruments is not, however, limited to the cross-border context, so these rules also apply to related U.S. affiliates of a corporate group.

Coupled with our previous actions to address corporate inversions, today's final regulations balance the operational needs of companies while preventing the erosion of our U.S. corporate tax base. Specifically, today's final regulations narrowly target problematic earnings stripping transactions by – transactions that generate deductions for interest payments on related-party debt that does not finance new investment in the United States – while minimizing unintended consequences for regular business activities in the following ways:

· Exempting cash pools and short-term loans: Treasury requested comments in the proposed regulations on whether special rules are warranted for cash pools, cash sweeps, and similar arrangements that multinational firms commonly use to manage cash among their affiliates. In response to thoughtful feedback, Treasury is providing a broad exemption for cash pools and other loans that are short-term in both form and substance, and therefore do not pose a significant earnings stripping risk.

o Treasury and IRS expect that the exemption will generally permit companies to continue to treat as debt short-term instruments issued among related entities in the ordinary course of a group's business.

- Providing limited exemptions for certain entities where the risk of earnings stripping is low:

- Transactions between foreign subsidiaries of- U.S. multinational corporations
  - Treasury has determined the income tax consequences of mischaracterizing equity instruments as debt in these circumstances are limited.

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- Transactions between regulated financial companies
  - These firms are already subject to supervisory and regulatory requirements that restrict their ability to issue intercompany debt.

- Transactions between regulated insurance companies
  - Like regulated financial institutions, insurance companies subject to state insurance regulation have limited ability to issue instruments inappropriately characterized as debt.

- Transactions between mutual funds (RICs) and real estate investment trusts (REITs), other than those owned by affiliated groups of companies
  - Treasury has determined that the income tax consequences of mischaracterizing equity instruments as debt for these investment vehicles are limited.

- Expanding exceptions for ordinary business transactions: Treasury has expanded the exceptions for distributions (payments made to affiliated companies), to generally include future earnings and allowing corporations to net distributions against capital contributions. Treasury is also including additional exceptions for ordinary course transactions, such as acquisitions of stock associated with employee compensation plans.

  - Such distributions out of earnings and profits will not cause debt issued by a corporation to be recharacterized as equity.

- Expanding exceptions for ordinary course transactions: Treasury is also including additional exceptions for ordinary course transactions, such as acquisitions of stock associated with employee compensation plans.

- Easing documentation requirements: Treasury has relaxed the intercompany loan documentation rules for U.S. borrowers to ease compliance burdens while still fulfilling their purpose, including by moving the deadline for required documentation to when the tax return is due. The regulations also extend the effective date of the documentation rules by one year to January 1, 2018.