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May 2017

Final U.S. Rules for Related-Party Debt

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On October 13, 2016, the U.S. Treasury Department and the IRS issued final and temporary regulations under Internal Revenue Code Section 385. These regulations offer some relief to the provisions of the proposed regulations which were issued on April 4, 2016. For details of the proposed regulations, see Collins Barrow - U.S. Tax Alert, U.S. Proposes New Rules for Related-Party Debt.

Changes to Proposed Regulations

Limited Applicability

The final regulations target inbound related-party U.S. financing. Generally speaking, these rules apply to a non-U.S. parent loan to its U.S. subsidiary. The final regulations now limit applicability of these regulations to U.S. borrowers. Foreign to foreign and U.S. to foreign loans would not be covered by these rules. In addition, S corporations and Real Estate Investment Trusts (REIT) are excluded from these rules. Furthermore, loans between members of a U.S. consolidated group would likewise be excluded.

Documentation Requirements Relaxed

The documentation requirements apply to all “in-form” debt, including trade accounts payable, and debt that is only evidenced by journal entries. The new rules avoid requiring new loan agreements for each new borrowing by allowing for master loan agreements. The master loan agreement must be substantiated by material documentation, such as legal agreements, board resolutions or credit agreements. The “ability-to-pay” test for a master loan agreement must be made on an annual basis rather than each time a loan is made under the agreement.

The new rules replace the “30 day rule” for documenting a debt and the “120 day rule” for documenting a payment of interest or principal, with the date of the timely filing of the federal income tax return, including extensions. Under the proposed regulations, failure to satisfy the documentation requirements would cause a debt to be reclassified as stock. Under the final regulations, where taxpayers are “highly compliant” with the documentation requirements, they may be able to rebut the presumption that an undocumented debt is stock.

Exception for Qualified Short-Term Debt Instruments

The final regulations kept the “General Rule” which provide for the automatic re-characterization of a debt instrument to equity when the instrument is issued in specific types of transactions. The final regulations also kept the “Funding Rule” which treats a debt instrument that is issued with the principal purpose of funding any of the transactions covered by the General Rule as stock. However, the final regulations exclude from these rules, “qualified short-term debt instruments” which are:

1. short-term funding arrangements, a) with short-term interest rates and in an amount not exceeding “specified” current assets, or b) with a short-term interest rate and the borrower is a net borrower from the lender for less than 270 days during the taxable year;
2. ordinary course loans which are issued to acquire property in the ordinary course of the issuer’s trade or business that are expected to be repaid within 120 days;
3. interest-free loans (e.g., intercompany receivables which do not require interest to be charged); and
4. certain cash-pooling loans.

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Expanded E&P Exception

The proposed rules excluded debt instruments from the General Rule or the Funding Rule to the extent of the borrower's current Earnings and Profits ("E&P"). The final regulations exempt debt instruments to the extent of the borrower's E&P accumulated after April 5, 2016 and while the borrower was a member of the same expanded group.

Elimination of the Cliff Effect

Under the proposed regulations, indebtedness would not be classified as stock, under either the General or Funding Rules, provided such amounts do not exceed US$ 50 million in the aggregate. The proposed regulations do provide, however, that once the US$ 50 million threshold is exceeded, all debt instruments which would be treated as equity under the General or Funding Rules would be recharacterized as stock. Therefore, under the proposed regulations, once the amount of debt which would be recharacterized under the General Rules or Funding exceeds US$ 50 million, all of the taxpayer's debt subject to these rules would be recharacterized as stock. Under the final regulations, only to the extent that the total amount of all debts issued exceeds US$ 50 million, which would otherwise be subject to recharacterization under the General or Funding Rules, will a debt be recharacterized as stock.

Bifurcation Rule Eliminated

The final regulations eliminate the "bifurcation rule" which would have granted the IRS the ability, based on their analysis of the facts and circumstances, to split a debt instrument into part debt and part equity. The final regulations eliminate this ability, and return to the prior all-or-nothing approach to reclassifying a debt as equity.

Effective Date

The final and temporary regulations are effective as of October 21, 2016 and apply to taxable years beginning on or after January 19, 2017. The final documentation requirements only apply to debt instruments issued on or after January 1, 2018. The effective date for the General and the Funding rules are unchanged and still apply to debts issued on or after April 4, 2016 with effect on January 19, 2017.

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