Client Alert

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Treasury Report Proposes Substantial Revisions to Controversial Tax Regulations

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Last week, on October 2, 2017, the U.S. Department of the Treasury (the "Treasury") delivered a report to President Trump that proposes substantial revisions to eight sets of controversial U.S. federal income tax regulations (the "Report").[1]

The Report was prepared in response to Executive Order 13789, which was issued by President Trump earlier this year in April (the "Order"). The Order directed the Secretary of the Treasury to identify tax regulations issued on or after January 1, 2016 that impose an undue burden on U.S. taxpayers, add unnecessary complexity to the federal tax laws, or exceed the statutory authority of the Internal Revenue Service.[2] Following the issuance of the Order, Treasury later prepared a notice in June of this year (Notice 2017-38) that initially identified the eight sets of regulations that are the subject of the Report and that were effectively targeted for potential withdrawal or revision.[3]

This alert briefly touches on the highlights of the Report, including the potential revocation of certain aspects of the highly controversial Section 385 "debt/equity" regulations.[4]

I. KEY REGULATIONS PROPOSED TO BE REVOKED IN PART OR SUBSTANTIALLY REVISED

Partial Revocation of Final and Temporary Regulations Under Section 385

On October 13, 2016, the Treasury and IRS issued final and temporary regulations under Section 385 of the Code, which generally impose documentation requirements for certain related-party interests to be treated as indebtedness and automatically treat debt issued in certain related party contexts as equity for federal income tax purposes. These regulations were primarily comprised of (i) rules establishing minimum documentation requirements that ordinarily must be satisfied in order for purported debt obligations among related parties to be treated as debt for federal tax purposes, and (ii) rules that treat as stock certain debt that is issued by a corporation to a controlling shareholder in a distribution or in another related-party transaction that achieves an

[1] A copy of the Report is available online, at https://www.treasury.gov/press-center/press-releases/Documents/2018-03004_Tax_EO_report.pdf.

[2] *See* Executive Order 13789, available at https://www.whitehouse.gov/the-press-office/2017/04/21/presidential-executive-order-identifying-and-reducing-tax-regulatory.

[3] A copy of Notice 2017-38 is available online, at https://www.irs.gov/pub/irs-drop/n-17-38.pdf .

[4] In addition to the five sets of regulations discussed below, the Report describes three other sets of less generally applicable regulations. The Report proposes that (1) proposed regulations under Section 2704 on restrictions on liquidation of an interest for estate, gift and generation-skipping taxes be withdrawn, (2) proposed regulations under Section 103 on the definition of "political subdivision" be withdrawn, and (3) final regulations under Section 7602 on the participation of a person described in Section 6103(n) in a summons interview be withdrawn in part.

economically similar result.[5] Earlier in 2017, Treasury and the IRS released Notice 2017-36 announcing that the application of the documentation rules would be delayed until 2019. The Report states that Treasury and the IRS now believe that some requirements of the documentation regulations would create a substantial burden on corporations attempting to satisfy the tests required by the regulations. Thus, the IRS and Treasury are considering revoking the documentation regulations as issued and developing a revised set of documentation rules, with a prospective effective date that would allow time for comments and compliance, that would be simplified and streamlined to lessen their burden on U.S. corporations while requiring sufficient legal documentation and other information for tax administration purposes. The Report states that particular consideration will be given to the treatment of ordinary trade payables and modifying the requirement of a reasonable expectation of ability to pay indebtedness contained in the documentation regulations. Under the existing regulations an issuer would have been required to satisfy the documentation regulations even with respect to trade payables and any debt that was needed to finance the issuer's working capital needs.

The distribution regulations address inversions and takeovers of U.S. corporations by limiting the ability of corporations to generate additional interest deductions without new investment in the United States. The regulations were meant to achieve Treasury's policy goal "of leveling the playing field for U.S. businesses, so that they may compete freely and fairly in the global economy, and implementing tax rules that reduce the distortion of capital and ownership decisions through earnings stripping and similar practices." However, the regulations have been criticized for their complexity and breadth. The Report states that Treasury continues to support the goals underlying the distribution regulations, but Treasury believes that tax reform would be a better means of achieving those policy goals. According to the Report, Treasury believes that proposing to revoke the distribution regulations before the enactment of tax reform could exacerbate existing problems; however, the Report states, if tax reform that eliminates the need for the distribution regulations does not come to fruition, Treasury will reassess the distribution regulations and may then propose more streamlined and targeted regulations.

Regulations Under Sections 707 and 752 on Treatment of Partnership Liabilities

On October 5, 2016, the IRS and Treasury published final, temporary, and proposed regulations under Sections 707 and 752 of the Code.[6] These partnership tax regulations generally included proposed and temporary regulations governing how liabilities are allocated for purposes of disguised sale treatment, as well as proposed and temporary regulations for determining whether "bottom-dollar" guarantees create the economic risk of loss necessary to be taken into account as a recourse liability.

The Report states that the IRS and Treasury are considering whether the proposed and temporary regulations relating to disguised sales should be revoked in favor of reinstating prior regulations. However, the IRS and Treasury do not plan to make significant changes to the proposed and temporary regulations on bottom-dollar guarantees. Notably, the Report also states that Treasury and the IRS are studying ways to rationalize and lessen the burden of partnership tax regulations governing liabilities and allocations more generally.

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[5] For a more detailed discussion of the same, please see our Client Alert, available at https://media2.mofo.com/documents/161020-irs-debt-equity-regulations.pdf.

[6] For a more detailed discussion of these regulations, please see our Client Alert, available at https://media2.mofo.com/documents/161021-treasury-regulations.pdf.

Substantial Revision to Regulations Under Section 367 on Treatment of Certain Transfers to Foreign Corporations

On December 16, 2016, the IRS and Treasury published final regulations under Section 367 of the Code, which generally impose immediate or future U.S. taxation on certain transfers of tangible and intangible property, with certain exceptions. However, the regulations did not include an active trade or business exception. The Report states that the IRS and Treasury are working to develop a proposal that would expand the scope of the active trade or business exception for such transfers to include relief for outbound transfers of foreign goodwill and going-concern value attributable to a foreign branch under circumstances with limited potential for abuse. The Report states that the IRS and Treasury expect to release proposed regulations with these changes in the "near term."

Substantial Revision of Temporary Regulations Under Section 337(d) on Certain Transfers to REITs and RICs

On June 7, 2017, the Treasury and IRS released temporary regulations generally (a) expanding existing rules on transfers of property by C corporations to real estate investment trusts ("REITs") and regulated investment companies ("RICs"), and (b) providing rules relating to newly-enacted provisions of the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act").[7] The PATH Act's provisions were intended to prevent certain spinoff transactions involving transfers of property by C corporations to REITs from qualifying for non-recognition treatment. However, the Report states the Treasury and the IRS now believe temporary regulations may produce inappropriate results, such as causing a corporation to recognize too much gain in certain cases. For instance, in a case in which a smaller corporation that is party to a spin-off merges into a larger corporation in a tax-free reorganization, and the larger corporation makes a REIT election after the spin-off, the temporary regulations require immediate gain recognition with respect to all of the assets of the larger corporation. The proposed revisions in the Report would substantially reduce the immediately taxed gain of the larger corporation by limiting gain recognition to the assets of the smaller corporation.

Substantial Revision of Final Regulations Under Section 987 on Certain Income and Currency Gain or Loss

On December 7, 2016, the Treasury and IRS issued final and temporary regulations under Section 987 of the Code, generally providing rules for: (i) translating income from branch operations conducted in a currency different from the branch owner's functional currency into the owner's functional currency; (ii) calculating foreign currency gain or loss with respect to the branch's financial assets and liabilities; and (iii) recognizing such foreign currency gain or loss when the branch makes certain transfers of any property to its owner. The Report states the Treasury and the IRS believe that these regulations have proven difficult for taxpayers to apply. The Report states that, to address these difficulties, the IRS and Treasury currently expect to issue guidance that would permit taxpayers to elect to defer the application of certain aspects of these regulations until at least 2019. In addition, the Report states that the IRS and Treasury also intend to propose modifications to the final regulations to permit taxpayers to elect to adopt a simplified method of calculating Section 987 gain and loss and translating Section

[7] For a more detailed discussion of these regulations, please see our Client Alert, available at https://media2.mofo.com/documents/160615treasuryexpandsscopeofreit.pdf.

987 income and loss, subject to certain limitations on the timing of recognition of Section 987 loss. Further, the Report states the IRS and the Office of Tax Policy are considering alternative loss recognition timing limitations that would apply to electing taxpayers. Finally, the IRS and the Office of Tax Policy are considering alternatives to the transition rules in the final regulations.

II. LOOKING AHEAD

The Report states that the Treasury continues to analyze all recently issued regulations beyond the eight sets of regulations included in the Report. Specifically, the Treasury is considering possible reforms to the regulations under Section 871(m) of the Code and changes to the Foreign Account Tax Compliance Act. We will follow up with additional alerts, as appropriate, depending on how things continue to develop with the changes proposed in the Report and other regulatory developments. In the meantime, if you have questions regarding how the concepts set forth in the proposed regulatory changes in the Report may potentially affect you or your business operations please do not hesitate to contact one of the members of the Firm's U.S. federal income tax group.

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