



International Tax ADVISORY ■

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Treasury Would Overhaul 2016 Regulatory Guidance

In a [report released October 2](#), the Treasury Department recommends actions to reduce regulatory burdens on taxpayers. This latest report follows a June 22 report that identified eight sets of regulations for review pursuant to Executive Order 13789, which had directed Treasury to pinpoint regulations issued after January 1, 2016, that (1) impose undue financial burdens; (2) add undue complexity to the tax laws; or (3) exceed the IRS's statutory authority to regulate.

Among other rules identified in the June 22 report were three sets of regulations with clear cross-border implications:

- Final and temporary regulations under Section 385 concerning the treatment of certain interests as debt or equity.
- Final regulations under Section 367 relating to outbound property transfers to foreign corporations.
- Final regulations under Section 987 on income and currency gain or loss for Section 987 "qualified business units."

Treasury's latest report recommends partial revocation of the Section 385 rules and substantial reworking of the 2016 regulations under Sections 367 and 987.

Section 385 Rules on Debt-Equity Classification

The regulations under Section 385 address the classification of certain related-party debt as debt or equity for U.S. federal income tax purposes. (See our [prior advisory](#) on the final and temporary Section 385 regulations.) Shortly after its June report, Treasury issued Notice 2017-36 to delay application of the documentation rules under Section 1.385-2 until 2019. The latest report says that Treasury and the IRS may revoke entirely the documentation rules as written and consider developing simplified rules that ease taxpayers' compliance burden while facilitating proper tax administration. Particular consideration, according to the October report, is being given to modifying the "reasonable expectation of ability to pay indebtedness" requirement and the treatment of ordinary trade payables.

The October report recommends retention, pending tax reform, of the "distribution regulations" under Section 385. Found in Sections 1.385-3 and -3T, these regulations are aimed at restricting earnings stripping, including in the context

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of inversions and other corporate transactions. Treasury believes that these rules, while “blunt,” maintain “safeguards against earnings-stripping and diminishing incentives for inversions and foreign takeovers.” Meanwhile, Treasury is working with Congress on fundamental tax reform “expected to obviate the need for the distribution regulations and make it possible for [them] to be revoked.”

Section 367 Regulations on Outbound Transfers to Foreign Corporations

In general, Section 367 requires gain recognition on the transfer of property by U.S. persons to foreign corporations, subject to specific exceptions such as property transferred for use in an active business outside the U.S. Before 2016 guidance in this area, regulations afforded favorable treatment for foreign goodwill and going concern value. Regulations finalized in December 2016 eliminated this favorable treatment. (See our [prior advisory](#) on the Section 367 regulations.)

Treasury now believes that the structure of Section 367 and its legislative history justify extending the active business exception to foreign goodwill and going-concern value attributable to foreign branches in certain circumstances. The October report indicates that the Office of Tax Policy and the IRS are working to issue a proposal in the near term to expand the carve-out in cases with limited potential for abuse and administrative hassle, including issues with valuation.

Section 987 Regulations on Foreign Branch Income and Foreign Currency Gain or Loss

The final regulations under Section 987 provided rules for (1) translating income from branch operations conducted in a currency different from the branch owner’s functional currency into the owner’s functional currency; (2) calculating the foreign currency gain or loss as to the branch’s financial assets and liabilities; and (3) recognizing such foreign currency gain or loss upon certain transfers from the branch to its owner.

The recent report notes that many commenters disparaged the regulations’ transition rules as unduly burdensome for disregarding previously calculated but unrecognized foreign currency losses while other commenters lamented the regulations’ gratuitous complexity. In response, Treasury and the IRS expect to issue guidance allowing taxpayers to defer application of Sections 1.987-1 through 1.987-10 until at least 2019, depending on the taxpayer’s tax year. In the meantime, the Office of Tax Policy and the IRS are studying alternatives to the current regulations’ transition rules.

Treasury also intends to offer taxpayers the ability to elect a simplified method for calculating Section 987 gain and loss and translating Section 987 income and loss, subject to limits on loss recognition. One method being considered would look to harmonize the Section 987 rules with financial accounting principles (as well as the 1991 proposed Section 987 regulations). The Office of Tax Policy is currently considering alternative loss recognition limitations in this connection.

Conclusion

Treasury’s latest report emphasizes reduction and simplification, in line with the Administration’s general approach to government regulation. For regulations not marked for elimination or ameliorated with a near-term quick fix, Treasury seems comfortable with a delay-and-defer strategy. Given the looming prospect of more comprehensive tax reform, this wait-and-see approach may be the safest course, however uncertain.

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