



United States Tax Alert

Treasury report proposes withdrawal, partial revocation of 2016 regulations

On October 4, 2017, the US Department of the Treasury (“Treasury”) released a report (the “Second Report”) on planned upcoming actions that it believes would reduce the burden of eight tax regulations identified in an interim report earlier this year as significant tax regulations issued on or after January 1, 2016 that (i) impose an undue financial burden on US taxpayers; (ii) add undue complexity to the federal tax laws; or (iii) exceed the statutory authority of the Internal Revenue Service (IRS). Executive Order 13789 directed the Secretary of the Treasury to identify such regulations and further directed the Secretary to submit to the President a report recommending “specific actions to mitigate the burden imposed by regulations identified in the interim report.” The Second Report, which sets forth the Secretary’s recommendations, also notes that Treasury continues to analyze all recently-issued significant regulations, apart from those identified in the interim report, and to identify all Treasury regulations, regardless of date issued, that are unnecessary, create undue complexity, impose excessive burdens, or fail to provide clarity and useful guidance.

Proposed regulations to be withdrawn in their entirety

Proposed regulations under section 2704 on restrictions on liquidation of an interest for estate, gift and generation-skipping transfer taxes

General approach: After reviewing comments, Treasury and the IRS believe that the proposed regulations’ approach to the problem of artificial valuation discounts is unworkable. In light of these concerns, Treasury and the IRS currently believe that these

proposed regulations should be withdrawn in their entirety. Treasury and the IRS plan to publish a withdrawal of the proposed regulations shortly in the Federal Register.

Proposed regulations under section 103 on definition of political subdivision

Background: Section 103 excludes from a taxpayer's gross income the interest on state or local bonds, including obligations of political subdivisions. Proposed regulations would have required a "political subdivision" to possess not only significant sovereign power, but also to meet enhanced standards to show a governmental purpose and governmental control.

General approach: After careful consideration of the comments on the proposed regulations, Treasury and the IRS now believe that regulations with the far-reaching impact of the proposed regulation on existing legal structures are not justified. Thus, while Treasury and the IRS will continue to study the legal issues relating to political subdivisions, Treasury and the IRS currently believe that these proposed regulations should be withdrawn in their entirety, and plan to publish a withdrawal of the proposed regulations shortly in the Federal Register. Treasury and the IRS may propose more targeted guidance in the future after further study of the relevant legal issues.

Regulations to consider revoking in part

Final regulations under section 7602 on the participation of a person described in section 6103(n) in a summons interview

General approach: Treasury and the IRS are looking into proposing a prospectively-effective amendment to these regulations in order to narrow their scope by prohibiting the IRS from enlisting outside attorneys to participate in an examination, including a summons interview. Under the amendment currently contemplated by Treasury and the IRS, outside attorneys would not be permitted to question witnesses on behalf of the IRS, nor would they be permitted to play a behind-the-scenes role, such as by reviewing summoned records or consulting on IRS legal strategy.

Regulations under section 707 and section 752 on treatment of partnership liabilities

Background: These partnership regulations include: (i) proposed and temporary regulations governing how liabilities are allocated for purposes of disguised sale treatment; and (ii) proposed and temporary regulations for determining whether so-called "bottom-dollar" guarantees create the economic risk of loss necessary to be taken into account as a recourse liability.

General approach:

- Treasury and the IRS believe that the temporary regulations' approach to allocating liabilities for the purpose of disguised sale treatment merits further study. Treasury and the IRS, therefore, are considering whether the proposed and temporary regulations relating to disguised sales should be revoked and the prior regulations reinstated.
- Treasury and the IRS, however, currently believe that the second set of regulations relating to bottom-dollar guarantees should be retained.

Final and temporary regulations under section 385 on the treatment of certain interests in corporations as stock or indebtedness

Background: The regulations primarily comprise (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 (the “documentation regulations”); 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 economically-similar result (the “distribution regulations”).

General approach:

- **Documentation rules:** The IRS issued Notice 2017-36 which delayed the application of the documentation regulations until 2019. (For previous coverage of Notice 2017-36, see [United States Tax Alert dated August 2, 2017](#).) As stated in the Second Report, Treasury and the IRS are considering a proposal to revoke the documentation regulations, believing that some requirements of the documentation regulations depart substantially from current practice and would require expensive new systems to satisfy the numerous tests in the regulations. Treasury and the IRS are actively considering developing revised documentation rules that would be substantially simplified and streamlined so as to lessen their burden on US corporations, while requiring sufficient legal documentation and other information for tax administration purposes. In particular, consideration is to be given to the requirement to document a reasonable expectation of ability to repay indebtedness; the treatment of ordinary trade payables is also to be reexamined. In place of any revoked regulations, Treasury and the IRS would develop and propose streamlined documentation rules with a prospective effective date that would allow time for comments and compliance.
- **Distribution regulations:** The Second Report provides that Treasury is actively working with Congress on fundamental tax reform that should prevent base erosion and fix the structural deficiencies in the current US tax system. Tax reform is expected to obviate the need for the distribution regulations, thus making it possible to revoke them. In the meantime, after careful consideration, Treasury believes that proposing to revoke the existing distribution regulations before the enactment of fundamental tax reform could make existing problems worse. If legislation does not entirely eliminate the need for the distribution regulations, Treasury will reassess the distribution rules and Treasury and the IRS may then propose more streamlined and targeted regulations.

Multistate taxation considerations: While certain states are likely to conform to the final federal documentation requirements, or at least look to them for guidance, state taxing authorities already routinely consider the existence of a written promissory note in determining whether intercompany interest can be deducted. A number of states have addback statutes which require that, for the related interest to be deductible, an intercompany debt has, among other things, business purpose, economic substance, and arm’s-length terms, among other things. As the recast rules continue to apply for the present, states that do not adopt the federal consolidated return regulations may attempt to apply them to intercompany domestic debt issuances. Furthermore, states have also attempted to use other tools to adjust cross-border interest

payments that would be unaffected by the section 385 regulations, such as the forced inclusion of certain foreign financing entities and/or subsidiaries organized in “tax haven” jurisdictions.

Final regulations under section 367 on the treatment of certain transfers of property to foreign corporation

Background: Section 367 generally imposes immediate or future US tax on transfers of tangible and intangible property to foreign corporations, subject to certain exceptions, including an exception for certain property transferred for use in the active conduct of a trade or business outside of the United States. Prior regulations provided favorable treatment for foreign goodwill and going concern value. To address difficulties in administering these exceptions, these regulations eliminated the ability of taxpayers to transfer foreign goodwill and going-concern value to a foreign corporation without immediate or future US income tax. However, no active trade or business exception was provided for such transfers.

General approach: After considering the comments and studying further the legal and policy issues, Treasury and the IRS have concluded that an exception to the current regulations may be justified both by the structure of the statute and its legislative history. Thus, to address taxpayers’ concerns about the breadth of the regulations, the Office of Tax Policy and IRS are actively working to develop a proposal that would expand the scope of the active trade or business exception described above 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 and administrative difficulties, including those involving valuation. *Treasury and the IRS currently expect to propose regulations providing such an exception in the near term.*

Temporary regulations under section 337(d) on certain transfers of property to regulated investment companies (RICs) and real estate investment trusts (REITs)

Background: These temporary regulations amend existing rules on transfers of property by C corporations to REITs and RICs generally. In addition, the regulations provide rules relating to newly-enacted provisions of the Protecting Americans from Tax Hikes Act of 2015 (the “PATH Act”). 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. Commenters criticized several aspects of the regulations.

General approach: Treasury and the IRS are considering revisions that would limit the potential taxable gain recognized in situations in which, because of the application of the predecessor and successor rule in Temp. Treas. Reg. §1.337(d)-7T(f)(2), gain recognition is required in excess of the amount that would have been recognized if a party to a spin-off had directly transferred assets to a REIT. 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 the assets of the larger corporation. The proposed revisions under consideration by Treasury would substantially reduce the immediately-taxed gain of the larger corporation by limiting gain recognition to the assets of the smaller corporation. In addition, other technical changes to further narrow the application of the rules

are currently being considered. With these contemplated changes incorporated, Treasury and the IRS believe the revised regulations would more closely track the intent of Congress.

Final regulations under section 987 on income and currency gain or loss with respect to a section 987 qualified business unit

Background: These final regulations provide 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.

General approach:

- Treasury and the IRS currently intend to amend the final section 987 regulations to defer the applicability dates. In the meantime, taxpayers can rely on Notice 2017-57 ("the Notice") regarding such proposed amendments. Specifically, the final section 987 regulations (and related temporary regulations) will apply to "taxable years beginning on or after two years after the first date of the first taxable year following December 7, 2016." For example, for calendar year taxpayers, the regulations will apply to the taxable year beginning on January 1, 2019.
- Treasury and the IRS also intend to propose modifications to the final section 987 regulations to permit taxpayers to elect a simplified method of calculating section 987 gain or loss, subject to certain limitations on the timing of recognition of section 987 loss.
- Finally, the IRS and the Office of Tax Policy are considering changes to the final section 987 regulations to allow taxpayers to elect alternative rules to transition to the new regulations. These transition alternatives and the simplified method alternatives would be elective. It appears that the regulations as currently drafted will remain the default method.

ASC 740 considerations

The release of the Second Report does not, in itself, change any existing laws or regulations. Taxpayers should consider whether the issuance of the Second Report constitutes new information with respect to any tax position they are taking or plan to take. We believe that Notice 2017-57, issued October 2, 2017, effectively establishes an administrative practice pursuant to which the required adoption date of the section 987-related regulations is deferred a year. Taxpayers should assess, in the financial reporting period that includes October 2, 2017, whether they intend to rely on the Notice to defer the applicability date of the regulations; taxpayers intending to rely on the Notice should account for any impact the deferral of the applicability date will have in the financial reporting period that includes October 2, 2017. Taxpayers should continue to monitor for subsequent actions taken by Treasury with respect to the eight regulations which are the subject of the Second Report and assess the impact of such actions in the financial reporting period that includes such actions.

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