Steptoe
STEPTOE & JOHNSON LLP

Tax Client Alert

Treasury, IRS Issue Expansive Proposed Regulations Impacting Related-Party Financing

April 14, 2016

Introduction

On April 4, Treasury and the IRS issued proposed regulations under section 385 (REG-108060-15) that would greatly expand the IRS's ability to recast related-party debt as equity. Although issued in conjunction with a separate regulations package addressing inversion transactions and described by Treasury and the IRS as "motivated in part by enhanced incentives for related parties to engage in transactions that result in excessive indebtedness in a cross-border context," the proposed rules apply more broadly to related-party indebtedness without regard to whether the parties are domestic or foreign or inverted companies. (The proposed regulations do not, however, apply to issuances of debt among members of a consolidated group on the theory that the policy concerns driving the regulations are not present when interest income and interest expense offset in consolidation.) The regulations propose to: (i) allow the IRS to bifurcate debt instruments into part debt and part equity; (ii) establish documentation requirements that must be satisfied in order for certain related-party debt to be respected as debt; and (iii) automatically recharacterize certain related-party debt as equity.

Treasury and the IRS state in the preamble to the proposed regulations that they intend to move swiftly to finalize the regulations. Because federal law mandates a 60-day waiting period before any major regulatory changes (30 days for minor regulatory changes) become law, Treasury and the IRS will likely work to finalize the regulations before November 20 to ensure that they become law before the next President is inaugurated. Since comments are not due until July 7, 2016, there is only about a four-month window to finalize the regulations. Commissioner Koskinen has indicated an even more optimistic schedule for releasing final regulations by Labor Day.

This update provides background on the proposed regulations, summarizes the regulations' key provisions, and offers preliminary thoughts on the potential impact of the proposed regulations.

Contact Us

Questions and comments about the Steptoe Tax Client Alert are always welcome.

Greg Kidder
+1 202 429 6755
gkidder@steptoe.com

Aaron Nocjar
+1 202 429 6211
anocjar@steptoe.com

Mark Silverman
+1 202 429 6450
msilverman@steptoe.com

Amanda Varma
+1 202 429 8116
avarma@steptoe.com

Phil West
+1 202 429 6247
pwest@steptoe.com

Lisa Zarlenga
+1 202 429 8109
lzarlenga@steptoe.com

Andrew Gordon
+1 202 429 1303
agordon@steptoe.com

Brigid Kelly
+1 202 429 1365
bkelly@steptoe.com

Background

Enacted as part of the Tax Reform Act of 1969, section 385(a) authorizes Treasury to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is treated as stock or debt for purposes of the Internal Revenue Code. Section 385(b) sets forth factors to take into account in determining whether an instrument is debt or equity. In 1989, Congress amended

section 385(a) to authorize the issuance of regulations permitting an interest in a corporation to be treated as part stock and part debt.

Treasury and the IRS's last attempt to issue regulations under section 385 was not successful; final regulations were withdrawn in 1983 without ever entering into force. Because no regulations are currently in effect under section 385, case law generally controls the characterization of an interest in a corporation as debt or equity.

In recent years, as inversion transactions increasingly faced public, media, and political scrutiny, some commentators called on Treasury and the IRS to use their authority under section 385 to target inverted companies' use of intercompany debt to generate interest deductions, and lower U.S. taxes, following inversion transactions. In 2014 and 2015, Treasury and the IRS released a pair of notices targeting inversion transactions—specifically, Notice 2014-52 (Sept. 22, 2014) and Notice 2015-79 (Nov. 19, 2015)—which stated that Treasury and the IRS were considering guidance to address strategies that avoid US tax on US operations by shifting or "stripping" US-source earnings to lower-tax jurisdictions, including through intercompany debt.

General Rules

Except for the bifurcation rule discussed below, the proposed regulations generally apply only to debt instruments between members of an "expanded group," which is defined by reference to the term affiliated group in section 1504(a) with several modifications. Specifically, an expanded group includes foreign corporations, tax-exempt corporations, life insurance companies, S corporations, regulated investment companies (RICs), and real estate investment trusts (REITs). In addition, in determining relatedness, the proposed regulations adopt the attribution rules of section 304(c)(3). This means that entities that are commonly controlled by the same individuals may be part of an expanded group. The proposed regulations treat a corporation as a member of an expanded group if 80% of the vote or value (as opposed to 80% of vote and value) is owned by expanded group members. The regulations use the term "expanded group instrument" (EGI) to refer to an instrument an issuer of which is one member of an expanded group and the holder of which is another member of the same expanded group.

The proposed regulations do not apply to instruments between members of a consolidated group. The proposed regulations treat a consolidated group as one corporation. However, instruments between a member of the consolidated group, on the one hand, and an entity owned through a partnership or a controlled foreign corporation, on the other, may be treated as EGIs.

Where the regulations recharacterize an instrument as equity, the type of stock (e.g., common stock, preferred stock, including plain-vanilla preferred stock described in section 1504(a)(4) and nonqualified preferred stock, or section 306 stock) will be determined by taking into account the terms of the instrument, such as voting rights, conversion rights, and rights relating to dividends, redemption, and liquidation. Presumably, since the EGI is structured as debt, the recharacterization will be into some form of preferred equity.

Prop. Treas. Reg. § 1.385-1 contains rules that generally prescribe the effects where purported indebtedness is deemed exchanged for stock under the proposed regulations. Under these rules, on the date the indebtedness is recharacterized as stock, the indebtedness is deemed to be exchanged, in

whole or in part, for stock with a value that is equal to the holder's adjusted basis in the portion of the indebtedness that is treated as equity under the regulations. The issuer of the indebtedness is deemed to retire the same portion of the indebtedness for an amount equal to its adjusted issue price as of that date. As a result of this rule, both the holder and issuer are generally prevented from realizing gain or loss from the deemed exchange other than foreign exchange gain or loss recognized by the issuer or holder under section 988.

IRS Ability to Bifurcate Instruments into Part Debt and Part Stock

Prop. Treas. Reg. § 1.385-1(d) authorizes the IRS to treat an EGI as part debt and part stock to the extent that "an analysis, as of the date of issuance of the EGI, of the relevant facts and circumstances . . . under general federal tax principles results in a determination that the EGI is properly treated for federal tax purposes as indebtedness in part and stock in part." For purposes of this rule, the definition of "expanded group" is modified (i.e., a "modified expanded group") to adopt a 50-percent ownership test and include certain partnerships and other persons.
The proposed regulations provide little elaboration on this standard except for providing an example in which the IRS is permitted to treat a portion of an EGI as equity because the IRS's "analysis supports a reasonable expectation that, as of the issuance of the EGI, only a portion of the principal amount of an EGI will be repaid." The bifurcation rule creates significant uncertainty since the bifurcation will not happen until an IRS audit, and, because of the discretion granted to the IRS, practitioners may have a difficult time issuing opinions. As a result, the rule is likely to lead to significant controversy.

The bifurcation rule would generally apply only to interests issued on or after the date the regulations are finalized.

Documentation Requirements

Prop. Treas. Reg. § 1.385-2 sets forth documentation requirements necessary for certain interests issued between members of an expanded group to be treated as debt for federal tax purposes. (Controlled partnerships, i.e., partnerships the capital or profits interest in which 80% is owned by members of the expanded group, are treated as expanded group members under this rule.) The documentation requirements apply only to larger affiliated groups, i.e., where: (i) the stock of any member of the expanded group is publicly traded; (ii) all or any portion of the expanded group's financial results are reported on financial statements with total assets exceeding $100 million; or (iii) the expanded group's financial results are reported on financial statements that reflect annual total revenue that exceeds $50 million.

The documentation requirements only apply to interests that are issued in the form of debt. The preamble to the regulations requests comments regarding the appropriate documentation and timing requirements for arrangements that are not debt in form.

The regulations require documentation and information to be maintained with respect to four categories:

i. A binding obligation to repay the funds advanced
ii. Creditor's rights to enforce the terms of the EGI, which must include rights superior to shareholders to share in the assets of the issuer upon liquidation or dissolution

iii. A reasonable expectation that the advanced funds can be repaid, which may be demonstrated by, for example, cash flow projections, financial statements, asset appraisals, and debt/equity ratios and
iv. Actions evidencing a genuine debtor-creditor relationship, which may include documentation of any payments (such as wire transfers or bank statements) and efforts to enforce the terms of the EGI or renegotiate the EGI in the event of nonpayment. If any member of the expanded affiliated group relied on a third-party report or analysis, it must waive any privilege in order to rely on it to document a genuine debtor-creditor relationship.

The documentation generally must be prepared no later than 30 calendar days after the date of the relevant event in the case of the first three categories (generally, the later of the date the instrument becomes an EGI or the date that an expanded group member becomes an issuer with respect to an EGI, or in the case of the third category, any later date on which a deemed issuance occurs as a result of a significant modification under Treas. Reg. § 1.1001-3). Documentation supporting the fourth category (genuine debtor-creditor relationship), however, may be prepared up to 120 calendar days after the payment, event of default, acceleration event, or similar event occurs. The proposed regulations provide special rules for revolving credit or open account obligations and cash pooling arrangements. For revolving credit or open account obligations, enabling documents must be maintained as well as documentation of any principal balance. For cash pooling arrangements, documentation governing the ongoing operation, including the relevant legal rights and responsibilities, must be maintained. All documentation and information supporting the four categories must be maintained for all taxable years that the EGI is outstanding and until the period of limitations expires for any return with respect to which the federal tax treatment of the EGI is relevant.

The documentation requirements are substantive rules, meaning that an EGI will be treated as equity if the requirements are not satisfied. However, this recharacterization is a one-way street—if the documentation requirements are satisfied, the EGI is not automatically treated as debt. General federal tax principles apply to determine whether (or the extent to which) the EGI is treated as debt, taking into account the documentation and information prepared as well as "any additional facts and circumstances."

If a taxpayer's failure to comply with the requirements is attributable to reasonable cause, "appropriate modifications may be made to the requirements" in determining whether the requirements are satisfied. The regulations do not, however, explain what these modifications might be or how they might be determined. If a taxpayer fails to satisfy the requirements of Prop. Treas. Reg. § 1.385-2 with a principal purpose of reducing the federal tax liability of any member of the expanded group, the rules of the proposed regulations do not apply. In addition, if an applicable instrument that is not an EGI is issued with a principal purpose of avoiding the purposes of Prop. Treas. Reg. § 1.385-2, the applicable instrument is treated as an EGI and will be subject to the provisions of the proposed regulations.

Prop. Treas. Reg. § 1.385-2 deviates significantly from existing debt/equity case law, which generally characterizes an instrument as debt or equity upon issuance. Instead, under the proposed regulations, an applicable instrument must be tested at the time it becomes an EGI. For example, if an instrument issued between consolidated group members ceases to be an intercompany obligation but continues to be held by an expanded affiliated group member, it becomes an EGI at that time. Conversely, if an EGI treated as stock ceases to be an EGI, it is retested at that time. Further, an EGI originally treated as debt may later be recharacterized as stock—for example, because the documentation and information cease

to evidence an ongoing debtor-creditor relationship. Taxpayers will thus have to continually monitor their outstanding applicable instruments to ensure they are not caught up in these rules.

The documentation requirements would generally apply only to interests issued on or after the date the regulations are finalized.

Certain Debt Recharacterized as Equity

Prop. Treas. Reg. § 1.385-3 provides that debt instruments in six situations are automatically recharacterized as stock—three situations under a general rule, and three situations under a funding rule. In all of these cases, debt that satisfies the documentation requirements discussed above and that would otherwise be treated as debt under general principles of tax law is nonetheless automatically treated as stock.

The general rule treats an EGI as stock to the extent it is issued by a corporation to a member of the corporation's expanded group (i) in a distribution; (ii) in exchange for expanded group stock (e.g., in a section 304 transaction), other than certain exchanges pursuant to a plan of reorganization (which are generally subject to the next prong); or (iii) in exchange for property in an asset reorganization, but only to the extent that, pursuant to the plan of reorganization, a shareholder that is a member of the issuer's expanded group immediately before the reorganization receives the debt instrument with respect to its stock in the transferor corporation (in other words, absent this rule, the EGI would be treated as boot in the reorganization). The preamble to the regulations indicates that Treasury and the IRS are concerned that such arrangements permit equity to be replaced with debt with no significant non-tax effect, potentially creating opportunities for abuse. Thus, for example, debt instruments issued for cash are not subject to recharacterization under this rule.

The funding rule treats as stock an EGI that is issued by a corporation (the funded member) with a principal purpose of funding (i) a distribution of cash or other property to a related corporation shareholder; (ii) an acquisition of affiliate stock from an affiliate; or (iii) certain acquisitions of property from an affiliate pursuant to an internal asset reorganization. Although the proposed regulations provide that whether a debt instrument is issued with a principal purpose of funding a covered distribution or acquisition is based on all facts and circumstances, in most cases, the purpose for the debt issuance will be irrelevant. This is because there is a nonrebuttable presumption that an EGI is issued with a principal purpose if it is issued by the funded member during the period beginning 36 months before the funded member makes a covered distribution or acquisition and ending 36 months after the distribution or acquisition. A covered distribution or acquisition is one of the three enumerated ones, except that they are for cash or property instead of stock of a member of the expanded group. Certain "ordinary course" debt instruments issued in connection with the purchase of property or receipt of services are excepted from this per se rule.

The per se rule imposes a significant administrative burden—all EGI and covered distributions and acquisitions will have to be carefully tracked to determine whether any EGI falls within six years of a covered distribution or acquisition.

Finally, an anti-abuse rule provides that a debt instrument is treated as stock if it is issued with a principal purpose of avoiding the application of the proposed regulations. Prop. Treas. Reg. § 1.385-3(b)(4)

includes a non-exhaustive list of examples illustrating situations where the anti-abuse rule might apply, such as a debt instrument issued to, and later acquired from, a person that is not a member of the expanded group, or a member of the expanded group is added as a co-obligor on an existing debt instrument.

Prop. Treas. Reg. § 1.385-3(c) provides three exceptions from the application of the recharacterization rules. The first exception applies to distributions or acquisitions that do not exceed current year earnings and profits (E&P). The second exception provides that an EGI will not be treated as stock if, when the debt instrument is issued, the aggregate issue price of all EGIs that otherwise would be treated as stock under the proposed regulations does not exceed $50 million. The third exception applies to certain funding of acquisitions of subsidiary stock. The preamble to the proposed regulations indicates that Treasury and the IRS thought that the E&P exception would prevent many ordinary course distributions and acquisitions from triggering the per se rule and that the E&P exception and $50 million threshold together appropriately balance the goals of preventing tax-motivated transactions among members of an expanded group and accommodating ordinary business transactions.

Prop. Treas. Reg. § 1.385-3 would become effective only when issued as a final regulation, in which case it would apply to debt instruments issued on or after April 4, 2016. However, instruments issued on or after April 4, 2016, but before the date the regulations are finalized, would not be treated as stock until 90 days after the final regulations are adopted.

Application of the Proposed Regulations to Partnerships and Disregarded Entities

The proposed regulations apply in varying ways to partnerships and disregarded entities, in an apparent effort to prevent corporations from avoiding these rules through the use of controlled pass-through entities.

In addition to the special partnership rules applicable in defining an expanded group and modified expanded group, there are varying operational rules for partnerships and disregarded entities that depend upon which set of rules in the proposed regulations applies.

If a debt instrument issued by a partnership or a disregarded entity is recharacterized as an equity interest under the documentation-maintenance rules in Prop. Treas. Reg. § 1.385-2, such equity interest is treated as issued by the relevant partnership or disregarded entity—not issued by its owners. Among many issues, this injects significant uncertainty into the tax classification of a disregarded entity that has its debt recast as equity under this subset of the proposed regulations. Does a Rev. Rul. 99-5 transaction arise? If so, when? Do the so-called deemed-conversion check-the-box regulations apply? Do lower-tier corporate members of the disregarded entity that once consolidated with the corporate owner of such disregarded entity suddenly deconsolidate due to the disregarded entity converting to a tax partnership?

In contrast, a debt instrument issued by a partnership or a disregarded entity is recharacterized as an equity interest issued by the owner or owners of such entities if the special automatic recharacterization rules in Prop. Treas. Reg. § 1.385-3 apply. Aside from some broad-brush statements of how the aggregate theory of partnerships should apply in that instance, the regulations fall short of spelling out what tax consequences should be deemed to arise in such cases.

The proposed regulations addressing partnerships raise issues of authority and interpretation. The legislative text of section 385 permits Treasury to issue regulations to address "interests in corporations" – not interests in partnerships. Although there is some generalized authority to apply an aggregate theory of partnerships in appropriate circumstances to essentially disregard the existence of the partnership as a separate entity, there already exists a detailed set of regulations (and other rules) addressing partnership liabilities, which address, among other things, what constitutes a "liability" of a partnership under an entity theory of partnerships. Those regulations treat obligations as liabilities of a partnership if certain tests are met (which are not similar to the rules in the proposed regulations), and such rules apply "without regard to whether the obligation is taken into account for purposes of the Internal Revenue Code," which naturally includes section 385 and any such regulations issued thereunder. Beyond these issues, even if such proposed regulations applied in such controlled partnership scenarios, would the partnership rules that rely upon a definition of partnership liability, including the debt-sharing rules of section 752, the disguised sale rules of section 707, and the allocation rules of section 704(b) and (c), be simply turned off? Could such debt be treated as equity for section 385 purposes but, nevertheless, as a liability for section 752 purposes (analogous to how shareholder debt to S corporations is treated under the subchapter S rules)? Transactional issues involving such partnerships also may be ensnared in these proposed regulations, particularly transactions that convert disregarded entities to controlled partnerships via Rev. Rul. 99-5 transactions (and vice versa via Rev. Rul. 99-6 transactions).

Impact on Foreign and Domestic Transaction Planning

The proposed regulations would fundamentally alter the use of related-party debt for tax planning purposes. The proposed changes in particular impact multinational corporations that use such debt in the cross-border context, irrespective of whether the multinational is domestic- or foreign-based or an inverted company.

From a domestic standpoint, the rules in the proposed regulations must be given careful consideration despite the fact that such rules are not applicable within a consolidated group. The regulations could apply to any transaction involving a non-consolidated affiliate corporation that is part of an expanded group and, therefore, have a potentially broad impact. For example, one would need to consider the application of the proposed regulations to related-party debt in transactions involving the following types of entities: (i) a consolidated group and a lower-tier corporation indirectly owned by members of such group through a partnership; (ii) separate chains of corporations that are commonly owned by an individual or a partnership; (iii) corporations that are affiliated under section 1504(a), but that may not join in consolidation under section 1504(b) (i.e., tax-exempt corporations, life insurance companies, S corporations, RICs, and REITs); and (iv) corporations that do not meet the 80-percent vote and value requirements for affiliation in section 1504(a), but that would satisfy the 80% vote or value standard for an expanded group.

Conclusion

The proposed regulations are certain to attract significant comments (which are due by July 7). It is likely that comments will address technical aspects of the regulations, including ambiguities and potential unintended consequences; the policies animating the regulations and whether those policies can be served by narrower or less burdensome provisions; and Treasury and the IRS's authority to issue the regulations.

In addition to considering whether to comment on the proposed regulations, taxpayers should take account of their existing intercompany debt arrangements and analyze whether and how they could be impacted by the proposed rules. The regulations should not apply to debt instruments issued before the release of the proposed regulations. However, instruments could become subject to the rules, for example, through a significant modification. In addition, the proposed regulations may be viewed as a roadmap for areas likely to be scrutinized by the IRS on audit. Taxpayers can begin preparing now for potential challenges, such as by strengthening documentation supporting factors key to debt treatment as well as by putting in place procedures to track EGIs and the types of transactions that trigger recharacterization.