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New Debt-Equity Rules May Have Gone Too Far

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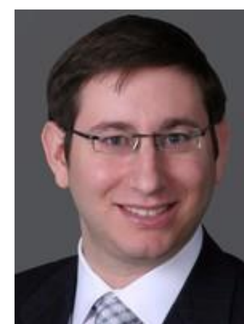
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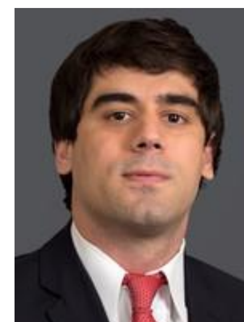
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On April 4, 2016, the U.S. Treasury Department and the Internal Revenue Service issued extensive proposed and temporary regulations under Sections 367, 385, 7874 and other provisions of the Internal Revenue Code of 1986. Although these regulations have been publicized as targeting inversions, much of the inversion-related guidance takes the form of temporary regulations simply implementing the changes previously outlined by the Treasury in Notices 2014-52 and 2015-79 (the "notices"). In contrast, proposed regulations under Section 385, which relate to characterization of interests in corporations as stock or indebtedness, would overturn the long-standing treatment of certain intercompany debt arrangements and could have far-reaching effects on U.S. and foreign companies. The proposed regulations are not limited to companies that would be considered inverted companies under Section 7874, but rather would generally apply to all debt instruments issued between affiliated entities.

The Treasury indicated that it intends to move swiftly to finalize the temporary regulations and the proposed regulations, parts of which apply to instruments issued on or after April 4, 2016. IRS Commissioner John Koskinen stated, "Usually when there is a change of administration major regulations aren't issued after Labor Day, so we're going to complete as much of the guidance plan as we can between now and August."

Whether the nod to "as much of the guidance plan as we can" means the IRS realizes that at the very least portions of the proposal will require more time than the summer to benefit from proper public reflection and feedback — or not — remains to be seen. The Treasury will accept comments on these proposals through July 7, 2016.

Highlights of the Section 385 Proposed Regulations

The Treasury's press release used the phrase "earning stripping" when describing the concern addressed by these proposed regulations. However, the proposed regulations do not address interest deductibility under Section 163(j) (commonly referred to as the "earnings stripping rules"), but rather take on the broader threshold issue of whether certain related-party loans are in fact indebtedness for U.S. federal income tax purposes. The proposed regulations also are not limited to "inbound" transactions, but rather apply generally to transactions between certain related parties, without regard to whether the parties are domestic or foreign. Given the

broad scope of the proposed regulations, it could be inferred that the Treasury is attempting to achieve through regulation some of the policy goals it has not achieved in its failed attempts to get Congress to modify Section 163(j).

Section 385 governs the treatment of corporate interests as stock or indebtedness. Its content is primarily limited to authorizing the secretary to prescribe regulations as necessary for determining whether an instrument is properly treated as stock or indebtedness, or part stock and part indebtedness. Prior attempts to issue regulations under Section 385 have been unsuccessful.

The proposed regulations can be viewed as establishing three new sets of rules: (1) rules allowing for bifurcation by the IRS of instruments that it determines to be indebtedness in part but not in whole ("bifurcation rules"); (2) rules imposing documentation requirements for certain debt instruments; and (3) rules requiring the recharacterization of debt instruments as stock in specified intercompany transactions ("recharacterization rules"). The proposed regulations also contain anti-abuse rules and provisions preventing the affirmative use of the rules by taxpayers.

The preamble to the proposed regulations acknowledges that these proposals mandate outcomes that depart from long-standing debt-equity precedents. As a matter of administrative law, agencies are not necessarily precluded from creating new regulations that effectively overturn prior case law. However, regulations must be the product of reasoned decision-making under the Administrative Procedure Act and represent a permissible interpretation of the statute they implement under the U.S. Supreme Court's two-step Chevron standard.

Documentation Requirements for Related-Party Indebtedness

In the preamble to the proposed regulations, the Treasury identifies the inconsistent sets of factors considered by the courts, and inconsistent weight given to such factors, in determining whether an instrument is treated as debt or as equity for U.S. federal income tax purposes as the reason for Congress' delegation to the Treasury of authority under Section 385. However, the proposed regulations do not clarify or provide guidance on the application of the historic multifactor tests, but rather impose additional hurdles that must be cleared to obtain debt treatment for certain related-party instruments, even if the facts-and-circumstances analysis supports debt treatment. In so doing, the new documentation requirements appear to be targeted at administrative concerns, allowing the IRS to analyze intercompany debt instruments without receiving "vast amounts of irrelevant documents and material" or dealing with "the inadvertent omission of necessary documents."

The proposed regulations set forth four categories of documentation requirements that must be satisfied in order for a debt instrument issued and held within an "expanded group" to be treated as indebtedness. An "expanded group" is defined as one or more chains of corporations (including foreign corporations and tax-exempt corporations) connected through stock ownership with a common parent corporation that owns directly or indirectly (including through partnerships) 80 percent of vote or value of the corporation.

If the documentation requirements are not satisfied, the instrument is treated as stock. However, even if the documentation requirements are satisfied, the IRS may still recharacterize the instrument as stock based on its analysis of the U.S. federal tax principles developed under applicable case law.

The documentation requirements only apply to an expanded group where: (1) the stock of any member of the expanded group is traded on an established financial market; (2) total assets exceed $100 million on any applicable financial statement; or (3) annual total revenue exceeds $50 million on any applicable

financial statement.

In general, the proposed regulations require that the taxpayer's documentation:

(1) establishes the issuer has an unconditional and legally binding obligation to pay a sum certain;

(2) establishes the holder has creditor rights (such as the right to trigger an event of default for nonpayment and to sue to enforce payment, and a superior right to shareholders in case of dissolution);

(3) contains financial information (e.g., cash-flow projections, financial statements, business forecasts, asset appraisals, debt-to-equity ratios and other financial metrics of the issuer in relation to industry averages) establishing a reasonable expectation that the issuer intended to and is able to repay the debt; and

(4) evidences post-issuance actions consistent with a debtor-creditor relationship, such as records of payment and documentation evidencing the holder's efforts to assert its rights or otherwise renegotiate upon nonpayment.

Generally, documentation satisfying the first three requirements must be prepared no later than 30 days after the "relevant date," and documentation satisfying the fourth requirement must be prepared no later than 120 days after the "relevant date." The relevant date (or, in some instances, dates) depends on the applicable requirement and the manner in which an instrument becomes subject to these rules.

While these documentation requirements are consistent with documentation commonly in place for many existing intercompany loan arrangements, the proposed regulations' automatic equity recharacterization significantly increases the stakes with respect to documentation of intercompany loans. And in a particularly stark break from current law, debt will be recharacterized as equity after issuance (subject to a reasonable cause exception) in certain instances, such as where documentation is not provided to the IRS upon request, certain post-issuance debtor-creditor relationship compliance is not satisfied, reasonable expectation of issuer's repayment documentation is not prepared in connection with a deemed reissuance under Treasury Regulations Section 1.1001-3 or documentation is not maintained.

Bifurcation of Related-Party Indebtedness

The proposed regulations permit the IRS to treat an instrument as in part indebtedness and in part stock to the extent that the IRS' analysis under general U.S. federal tax principles results in such a determination. The Treasury acknowledges in the preamble that this bifurcation breaks with general historic practices that treat an interest in a corporation as either wholly indebtedness or wholly equity. Under the proposed regulations, if the IRS concludes that as of the issuance date it is only reasonable to expect that $3 million in principal amount of a $5 million debt instrument will be repaid, the IRS may treat the instrument as part debt ($3 million) and part stock ($2 million). Taxpayers may consider using tranched loans or similar arrangements to attempt to proactively address the bifurcation issue.

The IRS' bifurcation right applies to debt instruments for which the issuer and holder are members of a "modified expanded group." The definition for "modified expanded group" follows the expanded group definition, but with a 50 percent ownership measurement as opposed to an 80 percent ownership measurement.

Recharacterization Rules for Specified Transactions

The recharacterization rules under the proposed regulations are particularly complex and work to automatically recharacterize debt as stock for federal income tax purposes where debt is issued in certain transactions between members of an expanded group. The Treasury intends for this recharacterization to eliminate the tax benefits associated with transactions that create interest deductions or facilitate the repatriation of untaxed earnings, in particular where the transactions introduce no new capital into the group. The recharacterization may also have various ramifications (e.g., interest payments on the instrument would be recharacterized as dividends, potentially subject to U.S. withholding tax).

Under the proposed regulations, debt instruments issued between members of an expanded group in certain specified transactions are automatically recharacterized as stock. The general recharacterization rule is that a debt instrument is treated as stock if it is issued between expanded group members in: (1) a distribution; (2) an exchange for stock other than in certain asset reorganizations; or (3) an exchange for property in certain asset reorganizations.

Under this rule, for example, when a domestic subsidiary of a foreign company distributes a note to its foreign parent (whether or not in exchange for stock), that note is automatically treated as stock regardless of its terms and characteristics, and the transaction is treated as a distribution of stock. Likewise, when foreign subsidiaries of a U.S.-parented group engage in what would otherwise be a Section 304 transaction or Section 368(a)(1)(D) reorganization in which a member's debt instrument is issued as consideration, that debt instrument is treated as stock for purposes of analyzing the transaction and subsequent payments on the instrument.

The proposed regulations also provide a "funding rule" under which a debt instrument of an expanded group member that is issued with a "principal purpose" of funding one of the transactions described above (subject to certain modifications) will be treated as stock. Recharacterization of an instrument as equity under the funding rule does not result in recharacterization of the distribution or acquisition that is treated as funded by the instrument.

Although described as a "principal purpose" test, the funding rule includes a nonrebuttable presumption that a debt instrument is issued with a principal purpose of funding an applicable distribution or acquisition if the instrument is issued by the funding member during the period beginning 36 months before the funded member makes an applicable distribution or acquisition and ending 36 months after the applicable distribution or acquisition. This "72-month period" rule is subject to a limited exception for certain debt instruments arising in the ordinary course of the issuer's trade or business.

Third-party debt instruments will generally not be subject to recharacterization under these rules, regardless of how the loan proceeds are used (subject to an anti-abuse exception for cases where a debt instrument is issued to, and later acquired from, an unrelated person with a principal purpose of avoiding the application of the recharacterization rules). These recharacterization rules are subject to certain other exceptions, including: (1) an exception for distributions and acquisitions that do not exceed current-year earnings and profits of the distributing or acquiring corporation; and (2) a de minimis exception where the aggregate issue price of all expanded group debt instruments that otherwise would be treated as stock under these rules does not exceed $50 million. Various other rules are also provided on the ordering of transactions, coordination between the general rule and the funding rule, treatment of predecessors and successors, the timing of the recharacterization as stock and the deemed exchange of debt for stock resulting from such recharacterization.

Consolidated Group, Disregarded Entities and Partnerships

Members of a consolidated group (an affiliated group filing a consolidated U.S. federal tax return) are treated as one corporation for purposes of the proposed regulations. As a result, an instrument that is both issued and held by members of the same consolidated group is exempted from the documentation requirements and the specified transaction recharacterization rules. The proposed regulations also contain rules addressing the treatment of instruments that change status as a result of members departing or joining a consolidated group.

Disregarded entities and partnerships with corporate members are also covered by the rules, subject to certain modifications. Interestingly, an instrument issued by a controlled partnership or a disregarded entity recharacterized as equity due to a failure in the documentation requirements results in equity of such issuer, while an equity recharacterization under the recharacterization rules results in equity of the relevant expanded group member(s).

Effective Dates of the Proposed Regulations

The proposed regulations contain different effective dates depending on the specific rules at issue.

- Documentation requirements and bifurcation rules: These provisions apply only to related party instruments issued or deemed issued on or after the date the regulations are finalized.

- Recharacterization rules: These provisions apply to instruments issued on or after April 4, 2016, but there is a transition rule that would characterize such instruments otherwise treated as stock by the regulations as valid indebtedness until 90 days after the date the regulations are finalized.

As noted, the proposed regulations provide that the documentation requirements and bifurcation rules apply to debt instruments deemed issued (e.g., as a consequence of a “significant modification” under general tax principles to a debt instrument) on or after the date the regulations are finalized, but the proposed regulations do not provide that the recharacterization rules apply to debt instruments deemed issued on or after April 4, 2016. This implies that debt instruments issued prior to April 4, 2016, are not subject to the recharacterization rules as a result of a deemed reissuance after that date, however, it is not particularly clear.

Regulations Implementing the Inversion Notices

The temporary regulations generally incorporate, with certain changes, the rules previously announced in the notices with respect to the anti-inversion rules under Section 7874. We highlight below a couple of new rules that were not part of the notices.

The Multiple Domestic Entity Acquisition Rule (or “Serial Inversions” Rule)

The Treasury and the IRS voiced their concern that a single foreign acquiring corporation may avoid the application of Section 7874 by completing multiple acquisitions of domestic entities — each below the 60 percent or 80 percent thresholds for the Section 7874(a)(2)(B(ii) percentage (the “ownership percentage”) — where Section 7874 would otherwise have applied if the acquisitions had been made

simultaneously or pursuant to a common plan.

The concern is that each time the foreign acquiring corporation issues stock in connection with the acquisition of a domestic entity, the foreign corporation increases its value, thereby potentially providing a platform to complete larger future domestic acquisitions without exceeding the ownership percentage thresholds. According to the preamble to the temporary regulations, the Treasury and the IRS believe that the application of Section 7874 in these circumstances should not depend on whether there was a demonstrable plan to undertake subsequent acquisitions of domestic entities at the time of a prior domestic acquisition.

As such, for purposes of calculating the ownership percentage, the temporary regulations exclude from the fraction's denominator any stock of the foreign acquiring corporation attributable to certain acquisitions of domestic entities completed 36 months prior to the signing date of the domestic acquisition under analysis (regardless of whether the prior acquisition occurred pursuant to the same plan or was otherwise related to the subsequent domestic acquisition). Stock issued by the foreign acquiring corporation in prior domestic acquisitions would generally not be disregarded under this rule if: (1) the ownership percentage for the prior domestic acquisition was less than 5 percent; and (2) the value of the stock received by the former domestic entity's shareholders in the prior domestic acquisition did not exceed $50 million.

The temporary regulations provide that this "serial inversions" rule applies to acquisitions of domestic entities completed on or after April 4, 2016, regardless of when the prior domestic acquisition was completed. As such, acquisitions of domestic entities completed on or after April 4, 2016, may be subject to the "serial inversions" rule even with respect to domestic acquisitions completed by the same foreign acquiring corporation prior to April 4, 2016. The temporary regulations provide that this rule will expire on April 4, 2019.

The Multiple-Step Acquisition Rule

Another new rule introduced by the temporary regulations addresses certain successive acquisitions where (1) a foreign corporation (the "initial acquiring corporation") undertakes an acquisition of a domestic entity that does not result in the initial acquiring corporation being treated as a domestic corporation under Section 7874 (e.g., the ownership percentage is less than 80 percent), and (2) pursuant to that same plan, another foreign corporation (the "subsequent acquiring corporation") acquires the initial acquiring corporation (the "subsequent acquisition").

In that case, the subsequent acquisition will itself be treated as the acquisition of a domestic entity and, when calculating the ownership percentage, the stock of the subsequent acquiring corporation received by the former shareholders of the initial acquiring corporation in the first transaction will be treated as "bad stock" (i.e., as stock held by reason of holding stock in the acquired domestic corporation). The temporary regulations provide that this rule will expire on April 4, 2019.

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