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IRS Casting 'Wide Net' With Debt-Equity Regs, Attys Say

By **Bryan Koenig**

Law360, Washington (October 13, 2016, 4:30 PM EDT) -- In both timespan and scope, the U.S. Department of the Treasury and the Internal Revenue Service are casting a “wide net” with proposed new regulations that would treat debt between related entities in international transactions as stock not entitled to tax advantages, Mayer Brown LLP attorneys said Thursday.

In a teleconference organized by Mayer Brown to discuss the proposed regulations, tax transactions & consulting practice partners Russell Nance and Steven Garden pointed to aspects of the proposal — floated as part of a larger plan to curb corporate inversions overseas and proposed under Section 385 of the Internal Revenue Code — including that it creates a six-year window in which debt is presumed to be part of a transaction and to the types of transactions that could be ensnared that would help make the regulations far-reaching.

“As a practical matter ... in a capital markets context, the funding rule's application when trying to determine if you have a triggering transaction can be so broad in terms of both the timing and the type of transaction that could get caught, that we almost have to assume that there might be a triggering transaction,” Garden said. “Because trying to police that, particularly at the time of an issuance, can be a real challenge.”

According to Garden, the proposal is meant to nix tax advantages only for debt issued for “highly related parties” where 80 percent of an entity's “vote or value” is held by members of the group. But the IRS doesn't stop there.

The tax agency also applies attribution and ownership rules that make it “very far-reaching,” Garden said. Garden pointed to a hypothetical parent company and its third-tier subsidiary that issues debt in a transaction. Under this example, the parent company, dubbed XYZ, has a 5 percent investment in a partnership fund, which in turn owns “Portfolio Corporation” that makes an investment in buying the debt issued by that third-tier subsidiary.

“Under a first attribution rule, any stock that is owned by corporation XYZ, which would include this third-tier subsidiary, which is the issuer, because corporation XYZ is a partner in [the] fund, fund is treated as owning that stock. So fund is treated as owning the issuer,” Garden said. “And then under a second attribution rule, that does apply as a follow-on, because fund owns Portfolio Corporation, Portfolio Corporation is treated as owning whatever stock fund owns. And because the fund now owns the issuer under that first attribution rule, Portfolio Corporation is treated as owning the issuer.”

That puts both Portfolio and the issuer under an expanded group, Garden said, meaning that when Portfolio bought the issued notes, it becomes “related-party debt” subject to the proposed rules.

The proposal, Nance added, “could create a spider web of potential relationships” under which ensnared debt could trigger the stock treatment.

“That's very broad and potentially unknowable here in the marketplace,” he said. It could be very difficult to know of entity relations that could trigger the rule, he added.

The IRS's net, Nance said, extends to three years before the transaction — either distribution or acquisition — and three years after, under which the tax agency is looking to create a “per se rule” counting debt instruments as part of the deal.

“Treasury has really cast a wide net on this part of the transaction,” he said.

Floated in April as a means of combatting earnings stripping — when foreign related companies saddle domestic affiliates with debt and take a U.S. tax deduction on the interest — the proposal also seeks to allow the IRS to move beyond an all-or-nothing characterization of debt as stock or not, Garden noted, so the tax agency could treat part of a transaction as debt and part as stock. New documentation and reporting requirements are also envisioned that would treat debt instruments without sufficient documentation as stock instead.

Originally planned for finalization by Labor Day, Nance and Garden said they expect the regulation relatively soon and still largely intact, despite criticism and concerns that it could also create new tax compliance burdens at the state level for wholly domestic transactions.

Critics include business and trade groups, as well as both Democrats and Republicans, who've called out the proposal as overly broad and beyond the Treasury Department’s authority, while also contending it's been rushed through without proper consideration for public comments.

Just one day after the Treasury Department announced its anti-inversion package, the U.S. pharmaceutical giant Pfizer Inc. and its Irish rival Allergan PLCcalled off their intended $160 billion merger, saying their decision was “driven by the actions announced by the U.S. Department of Treasury.”

The proposed rules are also facing a legal challenge in Texas federal court brought by the U.S. Chamber of Commerce, which is alleging the Treasury Department is violating administrative procedures by circumventing Congress instead of fixing the underlying tax issues that have U.S. companies looking overseas.

--Additional reporting by Vidya Kauri, Braden Campbell, Eric Kroh, Chuck Stanley and Chelsea Naso. Editing by Jack Karp.

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