Implications of Proposed Debt/Equity Regulations Extend Far Beyond Anti-Inversion Measures

May 2, 2016

Introduction

On April 4, 2016, Treasury released proposed regulations under Section 385 of the Internal Revenue Code ("Code") governing when intercompany debt will be treated as equity for federal tax purposes. Although highly publicized as intending to curb inversion transactions and earnings stripping arrangements, the proposed regulations also would upend decades of relatively settled debt/equity concepts. They threaten the tax treatment of debt instruments in a broad range of domestic and foreign related party transactions, running from private equity investments to leveraged ESOP structures to the ordinary capitalization of subsidiaries with debt and equity and common intercompany cash pooling arrangements.

Prior Law

The issue of whether instruments denominated as debt are to be treated as true debt for tax purposes has vexed the IRS for many years. Use of intercompany debt has been a favored way to strip earnings out of the United States and send them to affiliates in low tax jurisdictions. To do this, U.S. corporations borrow money from foreign parents or related entities, or simply distribute promissory notes to related companies located in low-tax jurisdictions. Because of tax treaties and local jurisdiction tax rates, the interest payments are deductible by the U.S. debtor, but subject to little or no tax when received by the related party lender.

Code Section 385(a), enacted in 1969, authorizes the Treasury to issue regulations to govern whether "for a particular factual situation whether a debtor-creditor relationship exists or a corporate-shareholder relationship exists." The Treasury previously issued proposed regulations, but they were withdrawn before they became final. The issue was left to the courts, and a facts and circumstances test developed from a series of cases enumerating a seemingly unending list of common law factors to be considered. The uncertain nature of the analysis has led to much litigation, and the IRS has vigorously pursued these cases.

The Proposed Regulations

The proposed regulations mark a sea-change in the treatment of intercompany debt instruments, and, while not completely displacing the former debt/equity concepts, set forth additional detailed rules for when an instrument denominated as debt will be recharacterized as equity for federal tax purposes. The consequences of treating purported debt as equity are extremely significant. "Interest" paid on the debt would not be deductible by the payer, and would be treated by the recipient as returns of capital or dividends. If a recipient is foreign, the payments may be subject to U.S. withholding tax. In situations involving a tax treaty, the usually higher withholding tax rate on dividends would apply rather than the treaty rate on interest payments, which often is zero. "Principal" repayments would be redemptions or additional distributions.

The proposed regulations apply to intercompany instruments among an expanded group of related companies, and such instruments are called "Expanded Group Instruments" or "EGI." An Expanded Group includes not only affiliated entities as defined in Code Section 1504(a), but also includes all domestic, foreign and tax-exempt related corporations. An Expanded Group also includes indirectly held corporations, such as corporations held through partnerships. Finally, an Expanded Group includes corporations connected by ownership of 80 percent of vote *or* value, rather than the usual vote *and* value. However, an Expanded Group does not include affiliated corporations filing a consolidated return, because members of a consolidated group are treated as a single corporation.

The proposed regulations fall into three main parts:

IRS Ability to Bifurcate An Instrument Into Part Debt and Part Stock.

Congress has long authorized Treasury to develop regulations treating an instrument as part equity and part debt. However, until now Treasury has not done so and relevant case law has generally treated an instrument as either entirely debt or entirely equity. However, for instruments issued on or after the date the proposed regulations are finalized, the proposed regulations will allow the IRS to bifurcate an instrument into debt and equity components if it determines that the substance of the instrument is best treated as part debt and part equity. The proposed regulations do not incorporate specific standards for making this determination, and therefore continue the uncertainty associated with prior debt/equity determinations.

The IRS' power to bifurcate applies to corporations that are connected by common ownership of 50 percent of vote or value, rather than the 80 percent standard that applies to the rest of the proposed regulations. If the IRS bifurcates an instrument, it will characterize the equity portion based on the terms of the instrument and the facts and circumstances, including conversion rights, voting rights, and rights related to liquidation, redemption and dividends, and the borrower's ability to repay the debt.

Stringent Documentation and Substantiation Requirements.

The proposed regulations impose stringent new contemporaneous documentation and substantiation requirements that must be met for an intercompany instrument to be treated as debt. The parties must document:

1. an unconditional and legally binding obligation to repay the debt principal, either on demand or on one or more fixed payment dates;
2. that the holder had typical rights of a creditor to enforce the obligation;
3. sufficient financial analysis to establish that as of the date of issuance the debtor had a reasonable prospect of repaying the loan; and
4. evidence of timely repayment or, if payments were missed, evidence that the holder acted with reasonable diligence as a creditor.

Documentation must generally be prepared no later than 30 days after the instrument is issued or, for requirements related to events after issuance (such as a payment or missed payment), within 120 days of the event. These requirements apply only to Expanded Groups which (i) include a member with publicly traded stock or (ii) have more than $100 million in assets or more than $50 million in annual revenue, as reported on certain specified financial statements as of the time the instrument is an EGI. If the documentation and substantiation requirements are not fulfilled, the relevant instrument will automatically be deemed to be equity.

The first two requirements listed above may be fulfilled through careful drafting of the debt instrument, and it should not be difficult to create and maintain evidence of timely repayment. However, it is not clear how much detail is required for a financial analysis demonstrating a reasonable prospect of repayment, or what will constitute reasonable diligence as a creditor when payments are missed. Lenders might consider using the types of analysis and documentation used by commercial lenders in underwriting loans and when negotiating work-out terms with distressed borrowers. Compliance with these requirements does not guarantee debt treatment, but simply fulfills a threshold requirement for debt treatment. Covered instruments are still subject to debt/equity analysis under federal case law principles.

Certain Instruments Automatically Deemed to be Equity.

The proposed regulations treat certain EGIs as equity in all cases, even if the instrument meets the regulatory and case law definitions of debt. First, any distribution of a debt instrument to a member of the issuing corporation's Expanded Group is treated as equity. This includes distributions previously held to be valid debt under *Kraft Foods v. Commissioner*, 232 F.2d 118 (2nd Cir. 1956). If a U.S. subsidiary distributes a note to its parent, the note will be treated as equity and any payments as dividends (or a return of capital if there are no earnings and profits). This is significant because, among other things, interest is generally subject to lower withholding tax rates than dividends under various tax treaties. The U.S. subsidiary would be denied interest deductions.

Second, any note issued to acquire stock of an affiliate will be treated as equity. The purpose of this rule is to eliminate certain tax-advantaged triangular reorganizations. The rule goes further though, and applies to all instruments issued for affiliate stock. The rule even applies to Code Section 351 transactions where no stock is issued.

Third, debt issued as boot in an asset reorganization is treated as equity if the debt is issued to a corporation that was a member of the issuing corporation's Expanded Group immediately before the reorganization. This rule is aimed at "cash D" reorganizations, but, like all of these rules, applies more generally.

Fourth, any debt instrument issued to fund any of the above transactions is deemed to be equity. Whether an instrument is issued to fund such a transaction is determined based on all facts and circumstances. However, there is an irrebuttable presumption that an instrument is issued to fund a transaction if it is issued any time from 36 months before the transaction occurs to 36 months after it occurs. This presumption is very broad, and could even affect such things as standard cash pooling operations. For example, if a member of an Expanded Group borrows from a group cash pool (a frequent occurrence), and then issues a dividend either 36 months before or after the borrowing date, the loan is treated as equity, and the repayment is treated as a Code Section 302 redemption of stock. While there are certain exceptions to the application of these rules, some general intercompany finance operations will have to be carefully reviewed.

Finally, the proposed regulations contain a general anti-abuse rule which allows the IRS to treat as equity any debt issued with a principal purpose of avoiding the other proposed regulations.

Effective Dates

The above bifurcation and documentation rules would generally apply prospectively to debt issued on or after the date final regulations are issued. However, the per se stock rules applicable to certain transactions would apply to debt issued and transactions entered into on or after April 4, 2016, the date the proposed regulations were filed in the federal register.

Conclusion

Although a main focus of the proposed regulations is to reduce cross-border earnings stripping transactions, they also apply to a broad array of wholly domestic transactions. For example, as discussed above, garden-variety decisions to capitalize a related entity with debt and equity will require consideration of the bifurcation rules and, if the company is public or meets specified financial thresholds, require compliance with the documentation and substantiation rules. Also, as discussed above, normal intercompany cash pooling arrangements can inadvertently be transformed into equity transfers and stock redemptions. This threatens to impose a significant burden on multinationals that use cash pooling and other internal financing arrangements to manage liquidity and minimize outside borrowing. In the private equity world, the proposed regulations may affect some standard financing structures for portfolio companies and debt-financed mergers and acquisitions. The inclusion of corporations held by partnerships within the Expanded Group rules could affect private equity finance entities, and the bifurcation rule with its lower 50 percent common ownership threshold could have an especially broad impact.

Even things as far afield as leveraged S corporation ESOP transactions could be affected. If such a transaction involves an intercompany loan, in theory, that loan could be bifurcated and treated as part equity, possibly resulting in a second class of stock and thereby potentially threatening the corporation's status as an S corp. Thus, although the proposed Section 385 regulations were issued as part of a broader attempt to curb corporate inversions and cross-border tax avoidance, these few examples show that the proposed regulations go much further, and could have an impact on general financial transactions of many corporations.

If you have any questions regarding consequences of the proposed regulations, please contact Jeff Goldman (jgoldman@dykema.com), Steve Grob (sgrob@dykema.com), Robert Nelson (rnelson@dykema.com) or your Dykema relationship attorney.

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