Expansive Debt/Equity Regulations Finalized with Modifications from Proposed Regulations

November 21, 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. [See our Alert dated May 2, 2016]. Although highly publicized as intending to curb inversion transactions and earnings stripping arrangements, the proposed regulations also upended decades of relatively settled debt/equity concepts. They threatened 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. After considerable comments (more than 29,000) from the business community and professionals, and public hearings, on October 13, 2016, Treasury issued final and temporary regulations (the "final regulations") that, with Treasury's accompanying explanation, concisely provide guidance in approximately 127 pages. This Alert summarizes the key features of the final regulations and compares them to the proposed regulations.

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 Treasury to issue regulations governing whether "for a particular factual situation whether a debtor-creditor relationship exists or a corporate-shareholder relationship exists." In prior years, Treasury previously issued proposed regulations, but they were withdrawn before they became final.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 Final Regulations and a Comparison to the Proposed Regulations

Like the proposed regulations, the final 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 final regulations apply to intercompany instruments among an expanded group of related companies (an "Expanded Group"), and such instruments are called "Expanded Group Instruments" or "EGIs." The final regulations modify the proposed regulations' definition of Expanded Group by adding certain exclusions and revising the rules for determining the relationship necessary for members. S corporations, non-controlled RICs and non-controlled REITs are now excluded.

Another significant change from the proposed regulations is the exclusion of foreign issuers of debt. 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.

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. The proposed regulations would have allowed the IRS to bifurcate an instrument into debt and equity components if it determined that the substance of the instrument was best treated as part debt and part equity. The final regulations eliminate the bifurcation rule. Therefore, the IRS is generally still required to use an all-or-nothing approach to treat an instrument as either entirely debt or equity.

Stringent Documentation and Substantiation Requirements

The proposed regulations introduced 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.

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. The final regulations retain the above documentation requirements. Under the proposed regulations, failure to satisfy all of the above four factors caused automatic treatment as equity. However, the final regulations are more lenient and instead create a rebuttable presumption that the instrument is equity and not debt. The taxpayer can rebut this presumption by demonstrating that it is otherwise "highly compliant" with the new documentation rules. This requires proof that either at least 90 percent of its EGIs comply with the documentation requirements or the non-compliant instruments are "not material" according to specified mathematical tests. Under the proposed regulations, required documentation had to 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. The final regulations extend these time periods by requiring preparation of necessary documentation no later than the due date for the issuer's federal tax return (including extensions) for the tax year that includes the relevant date.

The first two documentation 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. In addition, the regulations provide a safe harbor that allows taxpayers to satisfy the requirements to document an unconditional obligation to pay and the existence of typical creditor's rights by using documentation customarily used in third-party transactions.

However, it is unclear 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. Taxpayers 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. A Treasury official has indicated that acceptable documentation could include cash flow projections, financial statements, business forecasts, relevant financial ratios and other information relevant to lenders. On a positive note, the final regulations provide that documentation establishing a reasonable prospect of repayment may assume that the principal amount of an EGI could be satisfied with a refinancing, provided that such assumption is reasonable. Regardless, compliance with these documentation 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 traditional federal case law principles.

Certain Instruments Automatically Deemed to be Equity

The final regulations generally retain the proposed regulations' automatic treatment of certain EGIs as equity in all cases, even if the instrument meets the regulatory and case law definitions of debt. However, the final regulations include significant new exceptions that reduce the application of the rules to certain ordinary business transactions.

The "General Rule"

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 Expanded Group member 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 internal 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.

The "Funding Rule"

Any debt instrument issued to fund any of the above "general rule" types of 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 affect many typical business transactions. The proposed regulations contained an exemption for certain transactions occurring in the ordinary course of business, intended to apply to routine intercompany purchases of goods and services where payment was funded with intercompany debt. The final regulations expand this ordinary course exemption to include short-term funding arrangements, ordinary course loans, interest-free loans, cash pool arrangements, and acquisition of stock associated with employee compensation plans. A principal purpose rule applies to transactions occurring outside the six-year window.

The final regulations exempt debt issued by certain regulated entities such as insurance companies (not captive ones) or financial institutions. The final regulations also modify the computation of the issuer's earnings and profits for purposes of a limitation exception.

The final regulations generally retain the general anti-abuse rule of the proposed regulations which allows the IRS to treat as equity any debt issued with a principal purpose of avoiding the regulations, even if the taxpayer had other principal purposes for the transaction.

Effective Dates

The above documentation rules will generally apply prospectively to debt issued on or after January 1, 2018. However, the per se stock rules applicable to certain transactions will apply to debt issued and transactions entered into on or after April 5, 2016 (the day after the day the proposed regulations were filed in the federal register). For purposes of the funding rule, distributions and acquisitions occurring before April 5, 2016, are disregarded.

Conclusion

Although the final regulations were issued as part of a broader attempt to curb corporate inversions and cross-border tax avoidance, like the proposed regulations these regulations go much further and could have an impact on general financial transactions of many corporations, including a wide array of wholly domestic transactions. For example, as discussed above, garden-variety decisions to capitalize a related entity with debt will require consideration of these rules and, if the company is public or meets specified financial thresholds, will require compliance with the documentation and substantiation rules. Fortunately, the final regulations contain broader exemptions (e.g., normal intercompany cash pooling arrangements will not be re-characterized). In the private equity world, the final 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.

Comments on the final regulations are due by January 19, 2017. It remains to be seen whether the new Trump administration will push for further revisions to these regulations.

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

Attorneys

Robert W. Nelson

Practice Areas

Taxation