

Treasury Issues Final and Temporary Regulations on Related-Party Debt Instruments

Seeking to curb “excessive” use of related-party debt, Treasury and IRS retain basic framework, but significantly narrow the scope, of the Proposed Regulations.

On October 13, 2016, the US Department of the Treasury (Treasury) and the Internal Revenue Service (the IRS) issued final and temporary regulations under Section 385¹ (the Regulations) regarding the US federal income tax treatment of certain related-party debt transactions. The Regulations, which maintain much of the fundamental framework of the April 2016 proposed regulations on the subject, will continue to reclassify intercompany debt as equity and to impose detailed documentation and other compliance requirements with respect to certain intercompany debt transactions. At the same time, the Regulations introduce various changes that will reduce the impact on many common intercompany transactions of multinational groups, particularly US-based multinationals.

After briefly summarizing some of the Regulations' key elements, this *Client Alert* illustrates — using fact patterns — how the Regulations apply to US and foreign multinational groups.

Introduction

Treasury and the IRS issued proposed regulations under Section 385 in April 2016 (the Proposed Regulations). In issuing the Proposed Regulations, the government aimed to curb certain related-party debt transactions, including “earnings stripping” and some repatriation techniques, that it viewed as generating tax benefits but lacking a meaningful non-tax significance. The government framed the Proposed Regulations largely as a tool to address corporate “inversions” in which US corporations relocate to lower-tax jurisdictions abroad. But, as we discussed in our previous Latham & Watkins [Client Alert](#), the Proposed Regulations reached well beyond inversions, applying to taxpayers not just in the cross-border context but even in a purely domestic setting.

The controversial Proposed Regulations prompted considerable criticism from the business and tax communities and some political quarters. Perhaps reflecting both an effort to protect the Regulations from legal challenges and a response to recent criticism of the IRS (including from courts) for failing to address taxpayer comments during the regulatory process, the Regulations include a lengthy preamble setting forth the government's reasons for accepting or rejecting numerous submitted comments. In the end, the Regulations address many of the concerns taxpayers expressed about various aspects of the Proposed Regulations, limiting their application in certain respects and reserving several issues for possible future guidance.

Highlights of the Regulations include, but are not limited to, the following:

- **Funding rule exception for ordinary course short-term debt and cash pooling arrangements.** The Regulations provide a welcome exception to the funding rule (as described below) for certain obligations issued on a short-term basis, including in connection with cash pooling arrangements.
- **Bifurcation rule eliminated.** The Regulations remove the Proposed Regulations' bifurcation rule, which would have authorized the IRS to apply general US federal income tax principles to treat certain related-party instruments in the form of debt as part debt and part stock. The preamble to the Regulations states Treasury and the IRS will continue to study the bifurcation approach.
- **Limited to US issuers of debt.** The Regulations apply to debt issued (or treated as issued) by domestic corporations (or entities treated as domestic corporations under US federal income tax law) that are members of an expanded group, while reserving on whether to apply the Regulations to debt issued by non-US corporations. As such, for now, they do not apply to debt of non-US issuers, such as controlled foreign corporations (CFCs). An expanded group means, very generally, a group of entities with a common corporate parent that are 80% owned (by vote or value) by that parent or other group members. Notably, because expanded groups must have a common corporate parent, an expanded group would not include separate portfolio companies owned by a common private equity sponsor partnership.
- **Reclassification generally applies for all federal income tax purposes.** Under the Regulations, debt reclassified as stock generally is treated as stock for all US federal income tax purposes, subject to certain exceptions (e.g., to prevent deconsolidation of an affiliated group under Section 1504 and to prevent changes in the classification of disregarded entities (DREs)).
- **Key dates.** The Regulations delay the effective dates of several provisions. Key dates relevant under the Regulations include:
 - **April 4, 2016:** Debt instruments issued (or deemed issued due to a modification of the debt) after this date could be subject to the general rule or the funding rule (discussed below), and earnings and profits (E&P) accumulated in taxable years ending after this date count for purposes of the E&P Exception (discussed below).
 - **January 19, 2017:** Any debt instruments that would be reclassified under the general rule or the funding rule will not be reclassified until immediately after this date.
 - **January 1, 2018:** The documentation requirements under the Regulations apply only to debt instruments issued on or after this date.

Documentation Requirements

Highlights

- **Obligations of partnerships and non-US corporations exempt.** The documentation requirements apply only to certain related-party obligations issued by US corporations and their DREs. This removes application of the documentation requirements to many common planning techniques used by US-based multinationals with respect to CFCs.
- **Obligations between members of the same consolidated group exempt.** The documentation requirements apply only to obligations held by members of the issuer's expanded group (or a

controlled partnership, as defined below, of such group) that are not members of the issuer's consolidated group (e.g., obligations issued by a US corporation to a non-US affiliate).

- **Applicable to a broad array of related-party obligations.** The documentation requirements apply to traditional notes and loans as well as revolving credit facilities, cash pooling arrangements, internal banking services, trade payables and other forms of related-party obligations. Moreover, unlike the reclassification rules discussed below, there are no exceptions for short-term or ordinary course obligations.
- **Some relief for compliance failures.** In general, related-party obligations that are not compliant with the documentation requirements are treated as stock for all federal income tax purposes. However, exceptions to this per se treatment as stock may apply for otherwise highly compliant expanded groups, for failures due to reasonable cause and for certain ministerial or immaterial failures discovered and rectified by the taxpayer.

Note: If an obligation satisfies the documentation requirements, the obligation may still be treated as stock either in accordance with federal income tax principles or pursuant to the reclassification rules discussed below.

Small private expanded groups exempt

The documentation requirements apply only to obligations among the members of an expanded group if (i) a member of the expanded group has publicly traded stock or (ii) the expanded group has either US\$100 million in assets or US\$50 million in annual revenue.

Requirements

- **In general.** The Regulations identify four factors that are significant and must be taken into account (along with other relevant factors) in determining whether an obligation subject to the documentation requirements (an expanded group interest, or EGI) is debt or stock for federal income tax purposes. With respect to each of its EGIs, an expanded group must timely prepare and maintain documentation and information supporting debt treatment under each of the four specified factors discussed immediately below.
 - **Unconditional obligation to pay a sum certain.** The written documentation must establish a legally binding obligation to pay a fixed or determinable sum certain on demand or on one or more fixed dates. The Regulations contain a market-standard documentation safe harbor permitting the use of documentation customarily used in comparable third-party transactions (e.g., documentation used with unrelated parties for trade payables).
 - **Creditor's rights.** The written documentation must establish creditor's rights to enforce the obligation (e.g., trigger an event of default or acceleration, or permit foreclosing on collateral). These rights may arise from local law, but the documentation must reference such law. The market-standard documentation safe harbor discussed immediately above applies to this documentation requirement as well.
 - **Reasonable expectation of repayment.** The written documentation must establish that, as of the date of issuance of an EGI, the issuer's financial position supported a reasonable expectation that the issuer intended and would be able to meet its obligations (e.g., cash flow projections, financial statements, business forecasts, asset appraisals, documentation of financial ratios, evidence of the availability of third-party loans on substantially similar terms). In this regard, the

Regulations specifically provide that repayment by way of a refinancing can be taken into account so long as such refinancing is reasonably expected. An annual credit analysis of an issuer may satisfy this documentation requirement for multiple EGIs issued by an issuer. Following certain material credit events, the annual credit analysis must be updated.

- **Actions demonstrating a debtor-creditor relationship**. The written evidence must demonstrate that payments of interest and principal were timely made with respect to the EGI and, if an event of default has occurred (*e.g.*, payments were not timely made, or financial covenants were breached), demonstrate either (i) the reasonable exercise of the holder's creditor's rights or (ii) the reasonableness of not exercising such creditor's rights.
- **Timely preparation of documentation**. In general, the expanded group must prepare documentation with respect to an event (*e.g.*, the issuance of an EGI, or an annual credit analysis) no later than the time for filing the issuer's federal income tax return (taking into account applicable extensions) for the year in which the event occurred.

Cash pooling, revolving credit and similar arrangements

While cash pooling arrangements, revolving credit facilities, internal banking services and similar arrangements are subject to the documentation requirements, certain special rules apply. Expanded groups may establish master agreements governing these types of arrangements (which must comply with the documentation requirements), and use an annual credit analysis establishing a reasonable expectation that the issuer will be able to repay all amounts permitted under the master agreement.

Other considerations

- **Regulated financial and insurance companies**. The Regulations treat the EGIs of certain regulated financial and insurance companies as satisfying the documentation requirements if the (i) EGI contains terms required by the regulator (*e.g.*, terms satisfying regulatory capital requirements or requiring regulatory approval prior to making payments) and (ii) issuer and holder expect, at the time of issuance, that the issuer will make interest and principal payments in accordance with the EGI's terms.
- **Disregarded entities**. If an EGI of a DRE is treated as stock due to a failure to satisfy the documentation requirements, then the EGI is treated as stock of the entity's regarded corporate parent (*i.e.*, the DRE does not become a partnership for federal income tax purposes).
- **Certain "debt" exempt**. Certain obligations otherwise treated as debt pursuant to federal income tax law (*e.g.*, production payments, or REMIC "regular interests") are not subject to the documentation requirements.

Reclassification Rules

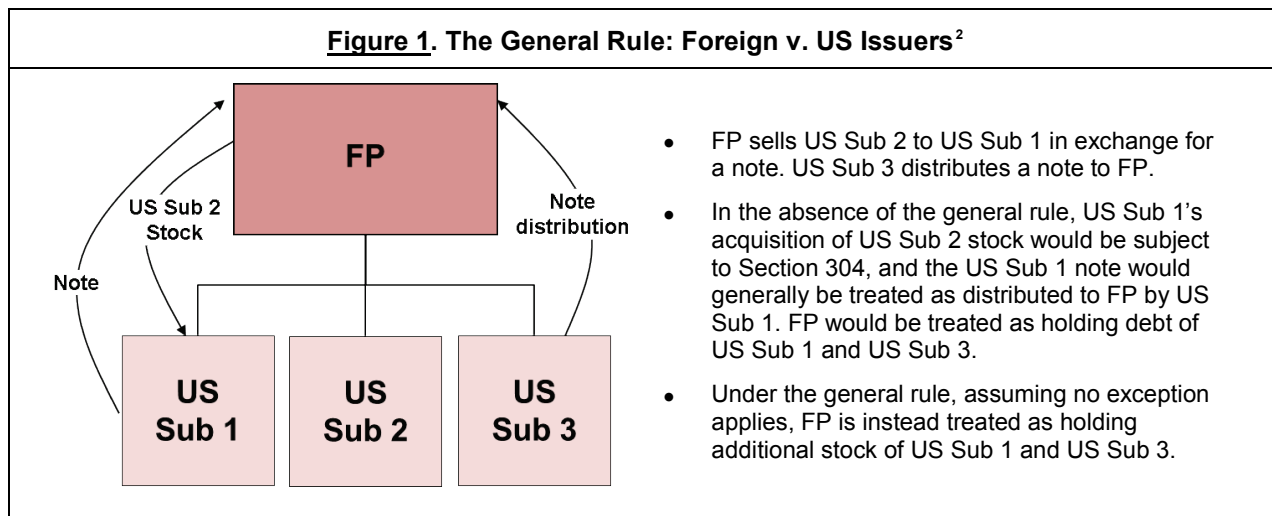
Highlights

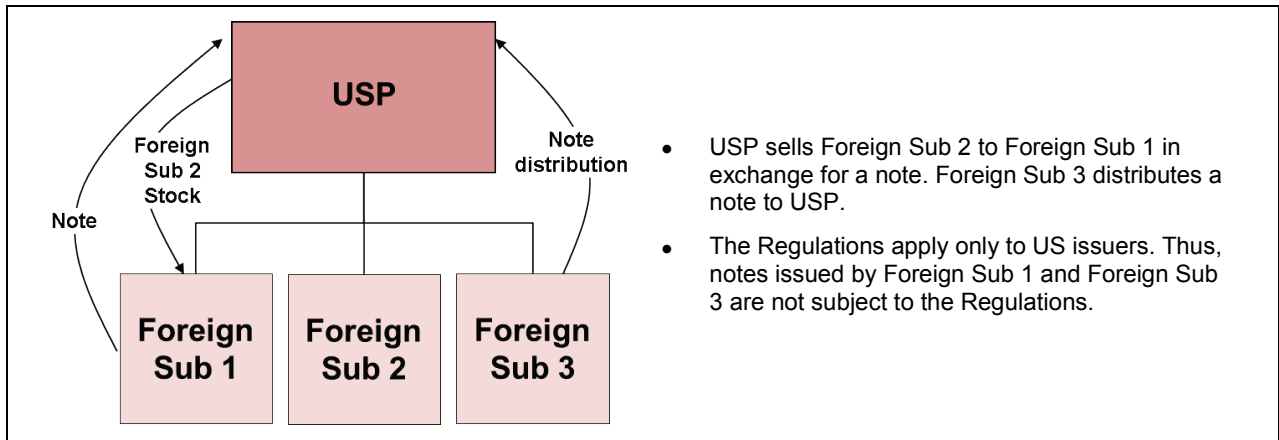
The Regulations generally adopt the basic framework of the Proposed Regulations, including the funding rule and the per se rule (described below). Thus, subject to certain exceptions, a debt instrument issued after April 4, 2016, by a US member of an expanded group to another member (a covered debt instrument) may be reclassified as stock. However, the Regulations include a number of welcome modifications to the Proposed Regulations that significantly limit the scope of the reclassification rules. Highlights of notable limitations include:

- **US issuers only.** The reclassification rules apply only to debt issued by US members of an expanded group. This change from the Proposed Regulations significantly reduces the application of the reclassification rules to US-based multinational groups.
- **Ordinary course short-term debt and cash pooling arrangements.** Certain short-term obligations and certain deposits in connection with cash pooling arrangements are disregarded for purposes of the funding rule.
- **Reduction for accumulated E&P.** Distributions and acquisitions would not cause a debt instrument to be reclassified as stock to the extent such distributions or acquisitions do not exceed the issuer's E&P accumulated in taxable years ending after April 4, 2016, and while the issuer was a member of the expanded group.
- **US\$50 million threshold exception.** The reclassification rules do not apply to the first US\$50 million of expanded group debt that would otherwise be reclassified as stock. Only the portion in excess of US\$50 million would be subject to reclassification.
- **Set-off for qualified capital contributions.** Qualified contributions of property made to an expanded group member during a specified period offset distributions and acquisitions by such member, thus limiting the scope of reclassification to the reduction in such member's "net equity."
- **Consolidated group affiliation.** Debt reclassified as stock under the reclassification rules will not be treated as stock for purposes of determining membership in an affiliated group filing a consolidated federal income tax return.

General rule

Subject to certain exceptions, the "general rule" reclassifies a covered debt instrument as stock if the instrument is issued (i) in a distribution; (ii) to acquire stock of a member of the issuer's expanded group (e.g., in a transaction that would otherwise be subject to Section 304); or (iii) as consideration in certain internal asset reorganizations (e.g., in a "D" reorganization).





Funding rule

The “funding rule” treats a covered debt instrument issued for property (a funded debt instrument) as stock to the extent a principal purpose of the issuance is to fund one or more distributions or acquisitions described in the general rule (a principal purpose debt instrument). Although determining whether such principal purpose exists is based on all facts and circumstances, the funding rule includes a non-rebuttable presumption (the per se rule) under which, subject to certain exceptions, a funded debt instrument is deemed to have such principal purpose, whether or not such principal purpose actually exists. Under the per se rule, a funded debt instrument is reclassified as stock if the instrument is issued during the six-year period beginning 36 months before, and ending 36 months after, the issuer engages in a distribution or acquisition described in the general rule. The per se rule does not create a safe harbor. Accordingly, a covered debt instrument issued outside of the six-year presumption period remains subject to reclassification as stock based on a facts-and-circumstances determination of whether the debt instrument is a principal purpose debt instrument.

If a covered debt instrument is “significantly modified,” the modified instrument generally is treated as issued on the date the original instrument was issued. However, such modified instrument would be treated as issued on the deemed exchange date if there is (i) a substitution of an obligor, (ii) a deletion or addition of a co-obligor or (iii) an extension of the instrument’s term that materially defers scheduled payments under the instrument.

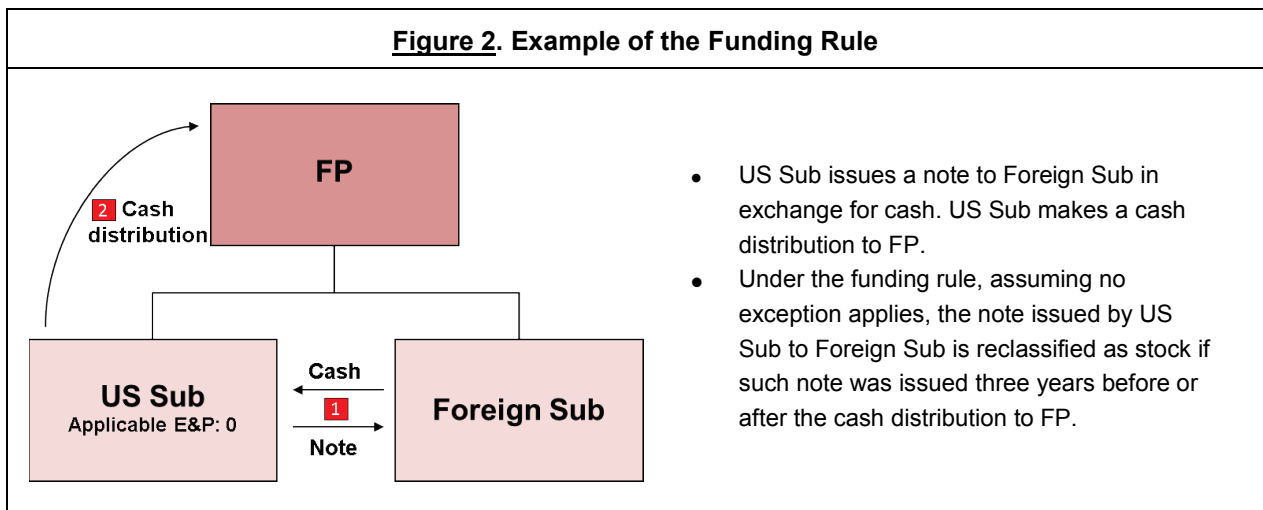
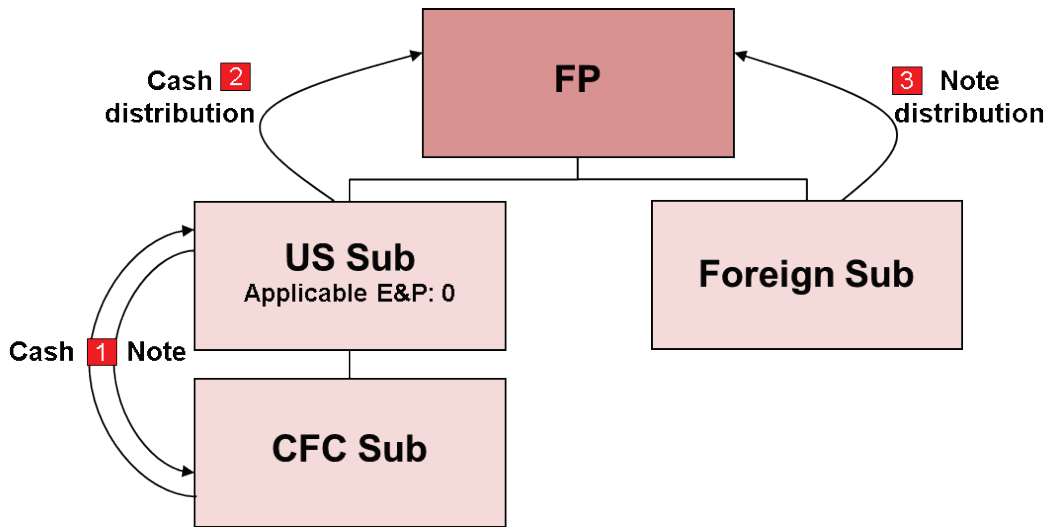


Figure 3. Example of the Funding Rule and Comparison of Distributions from US Sub and Foreign Sub

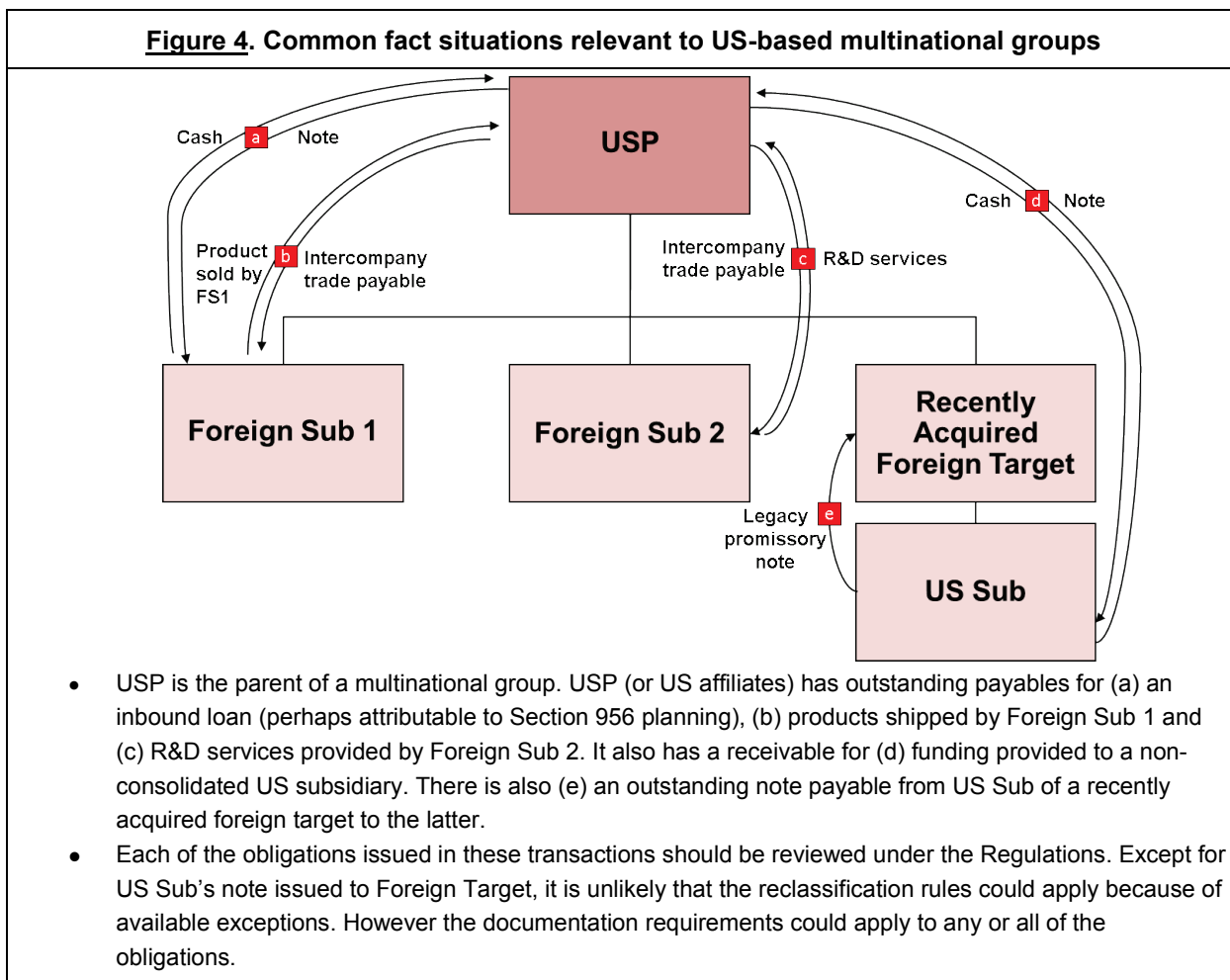


- In Year 1, US Sub issues a note to CFC Sub in exchange for cash. In Year 2, US Sub makes a cash distribution to FP, and Foreign Sub distributes a note to FP.
- Absent an exception to the funding rule, the cash distribution from US Sub to FP is deemed to have been funded by the loan from CFC Sub. Thus, the note issued by US Sub is reclassified as stock.
- The note distributed by Foreign Sub to FP is not reclassified as stock because Foreign Sub is not a US issuer.

Considerations for US multinational groups

As noted, the Regulations limit the documentation requirements and the reclassification rules to US corporate issuers. Practically speaking, this means that a large portion of a US-based multinational group’s international structuring is not subject to the Regulations because debt issued by foreign subsidiaries, including CFCs, is not covered. Thus, typical debt pushdown transactions taken as part of a foreign acquisition (e.g., outbound Section 304 and cash “D” transactions) are not subject to the Regulations, although such transactions remain subject to a host of other rules in the international tax arena. Nevertheless, a number of common fact patterns applicable to, and structures employed by, a US-based multinational group will be subject to the Regulations, absent any exceptions.

Figure 4 below shows several situations requiring analysis of the Regulations for a US-based multinational group.



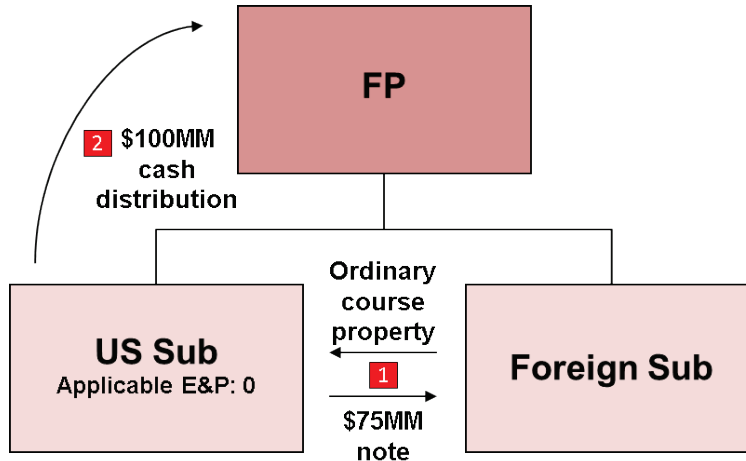
Exceptions to the general rule and the funding rule

As noted above, the general rule and the funding rule apply only to debt issued (or treated as issued) by a US member of an expanded group. Several other notable exceptions to the general rule and the funding rule are described below and illustrated with examples.

- **Short-term debt and cash pooling arrangements (Short-Term Debt Exception).** The funding rule does not apply to covered debt instruments that are “qualified short-term debt obligations,” which are any of the following:
 - Demand deposits with a “qualified cash pool header” pursuant to a “cash-management arrangement.” This exception does not apply to a loan *from* a qualified cash pool header, however.
 - Loans that do not provide for interest (stated or original issue discount) in circumstances in which interest is not required to be imputed or charged under the Code.
 - Loans made in the ordinary course in consideration for property (other than money) and expected to be repaid within 120 days of issuance.
 - Loans that are “short-term funding arrangements.”

A loan is a short-term funding arrangement if it satisfies either the “current asset test” or the “270-day test,” each as defined in the Regulations. However, an issuer cannot claim the benefit of both the current asset test and the 270-day test for the same taxable year.

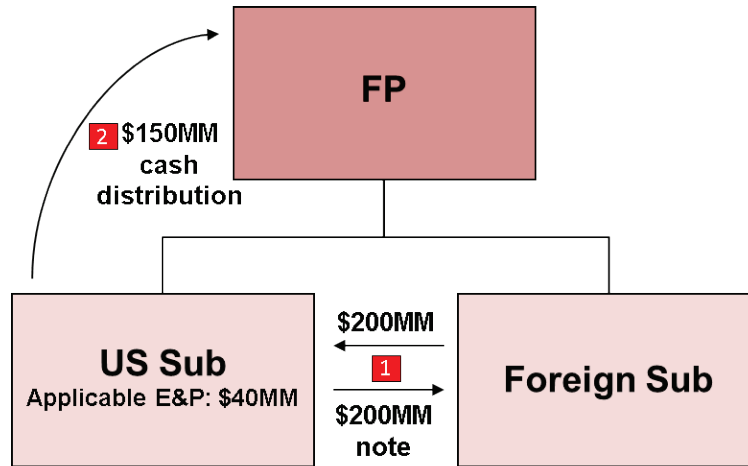
Figure 5. Example of short-term debt instrument exception for ordinary course loans



- US Sub issues a US\$75 million note to Foreign Sub in consideration for property in the ordinary course of US Sub’s trade or business. US Sub and Foreign Sub reasonably expect that US Sub will repay the note within 120 days of issuance. US Sub makes a US\$100 million cash distribution to FP.
- Assuming no exception applies, the US\$75 million note issued to Foreign Sub is subject to potential reclassification as stock under the funding rule when US Sub makes a cash distribution of US\$100 million. However, the Short-Term Debt Exception applies, and the note is not reclassified as stock.

- **Reduction for accumulated E&P (E&P Exception).** The general rule and the funding rule do not apply to the extent distributions and acquisitions do not exceed an issuer’s E&P accumulated in taxable years ending after April 4, 2016, and while the issuer was a member of the expanded group.
- **US\$50 million exception (Threshold Exception).** The first US\$50 million (measured by aggregate adjusted issue price) of an expanded group’s covered debt instruments that would otherwise be reclassified as stock is exempt from the general rule and the funding rule, and only the amount of covered debt instruments in excess of the US\$50 million threshold is subject to reclassification.

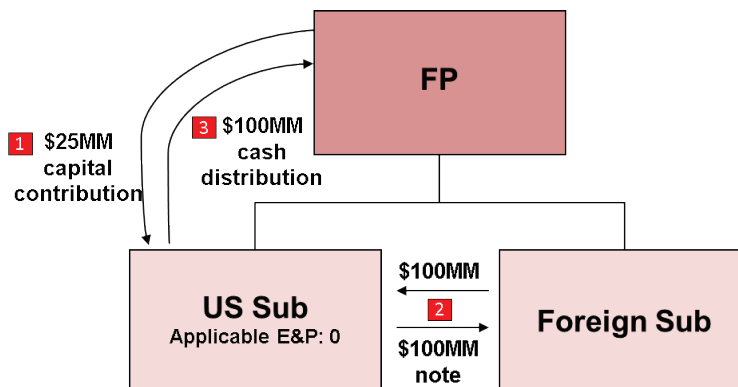
Figure 6. Example of E&P Exception and Threshold Exception



- US Sub issues a US\$200 million note to Foreign Sub in exchange for US\$200 million cash. The next year, US Sub distributes US\$150 million cash to FP. US Sub has US\$40 million of E&P accumulated in taxable years ending after April 4, 2016, and while US Sub was a member of the expanded group. No other covered debt instruments are outstanding among the expanded group.
- The distribution from US Sub triggers the funding rule, and therefore US\$150 million of the US\$200 million note issued to Foreign Sub is subject to potential reclassification as stock. However, under the E&P Exception, the amount of the note subject to reclassification is reduced to US\$110 million. In addition, the Threshold Exception further reduces the amount of the note that is reclassified as stock to US\$60 million.

- **Set-off for qualified capital contributions (Net Equity Exception).** Distributions and acquisitions by a member of an expanded group are offset by the aggregate fair market value of the stock it issues to other members in qualified contributions it receives generally during the six-year period beginning 36 months before, and ending 36 months after, the member engages in a distribution or acquisition subject to the funding rule or the general rule. A qualified contribution does not include, among other things, a contribution of expanded group stock or property acquired by the member in an internal asset reorganization.

Figure 7. Example of Net Equity Exception

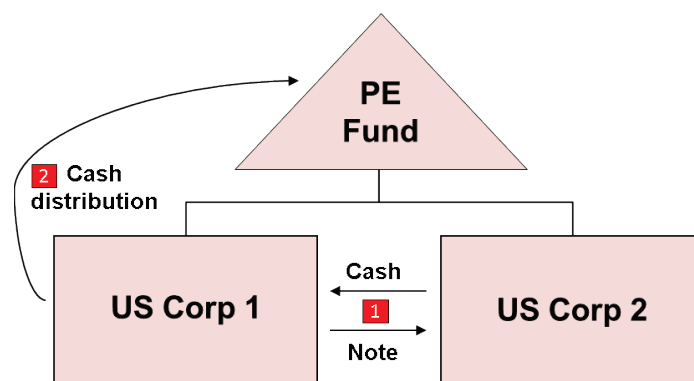


- FP contributes US\$25 million cash to US Sub. The next year, US Sub issues a US\$100 million note to Foreign Sub in exchange for US\$100 million cash and, subsequently in that year, US Sub distributes US\$100 million cash to FP. US Sub has zero E&P accumulated in taxable years ending after April 4, 2016. The expanded group has covered debt instruments outstanding with an aggregate adjusted issue price exceeding US\$50 million.
- The distribution from US Sub to FP triggers the funding rule, subjecting the US\$100 million note issued to Foreign Sub to potential reclassification as stock. However, under the Net Equity Exception, the amount of the note subject to reclassification is reduced to US\$75 million.

Application to controlled partnerships

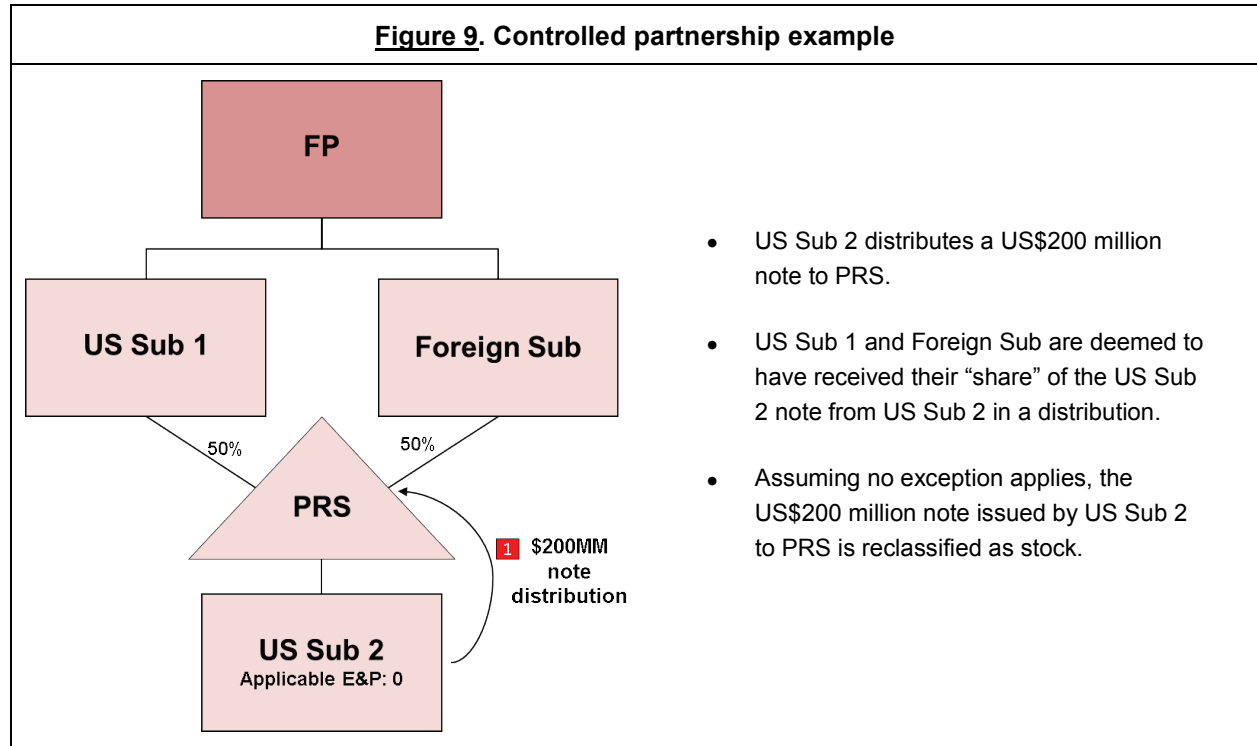
The general rule and funding rule apply only to partnerships that are “controlled partnerships.” A partnership is a controlled partnership with respect to an expanded group if members of the expanded group directly or indirectly own 80% or more of the interests in the partnership’s capital or profits. Therefore, the general rule and funding rule generally do not apply to debt between a non-controlled partnership (e.g., a private equity fund) and its subsidiaries (e.g., portfolio companies).

Figure 8. Private equity fund example



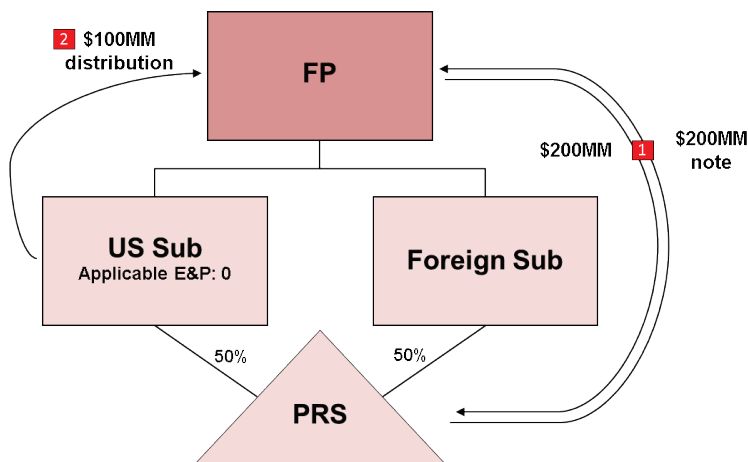
- PE Fund is not a controlled partnership. As a result, the issuance of the note by US Corp 1 and the cash distribution to PE Fund do not implicate the funding rule.

The Regulations adopt an aggregate, or look-through, approach to controlled partnerships. Thus, the Regulations generally treat a controlled partnership's expanded group partners as (i) owning their "share" of the controlled partnership's property (e.g., expanded group stock or debt instruments) and (ii) issuing their "share" of the controlled partnership's debt. The Regulations determine an expanded group partner's share of controlled partnership property in accordance with liquidation value and its share of controlled partnership debt in accordance with the allocation of interest expense.



As shown above in Figure 9, a distribution of a note to a controlled partnership is deemed issued to its partners, and can thus trigger a reclassification under the general rule. In addition, as shown below in Figure 10, a borrowing by a controlled partnership, combined with a distribution or acquisition by an expanded group partner of such controlled partnership, could also trigger the funding rule; however, the Regulations adopt a deemed transfer approach in lieu of a reclassification approach in such instance. Accordingly, in the event a note issued by a controlled partnership is subject to the funding rule, the expanded group debt holder is deemed to contribute the covered debt instrument (or a portion thereof) to the applicable expanded group partner in exchange for stock of the expanded group partner. The expanded group partner, therefore, is deemed to be the holder of the covered debt instrument (or a portion thereof) issued by the controlled partnership and, because controlled partnership debt is shared by expanded group partners in accordance with the allocation of interest expense, the expanded group partner's interest income is offset by its distributive share of the controlled partnership's interest expense.

Figure 10. Controlled partnership example



- PRS issues a US\$200 million note to FP in exchange for US\$200 million cash. The next year, US Sub distributes US\$100 million cash to FP.
- The note issued by PRS is attributed up to the PRS partners, US Sub and Foreign Sub.
- As a result of the distribution of US\$100 million by US Sub, US\$100 million of the PRS note would be subject to the funding rule, assuming no exception applies.
- Under the special rules for covered debt instruments issued by controlled partnerships, the PRS note is not reclassified as stock; rather, FP is deemed to transfer US\$100 million of the PRS note to US Sub in exchange for US Sub stock.

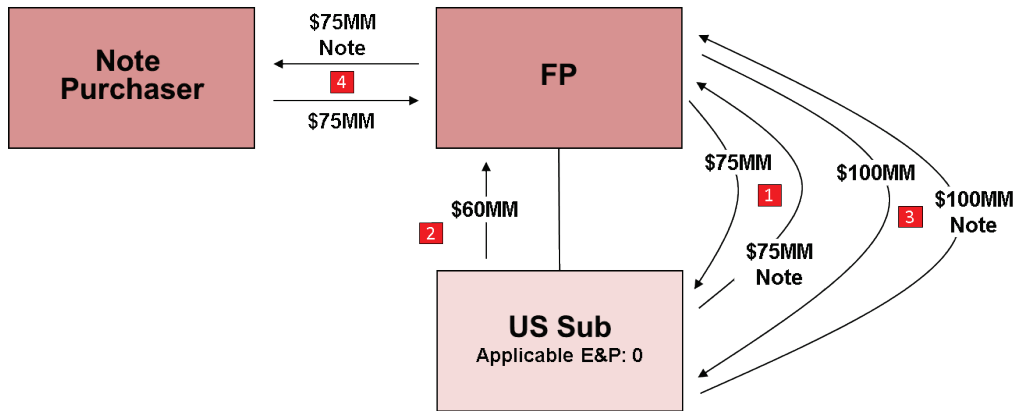
Application to DREs

A covered debt instrument issued by a DRE that would be reclassified under the general rule or funding rule is treated as stock in the DRE's regarded owner rather than as an equity interest in the DRE itself. Thus, the reclassification rules do not result in the DRE becoming a regarded partnership for federal income tax purposes.

Timing of reclassification

A covered debt instrument reclassified as stock would generally be treated as stock as of the debt issuance. Additional rules address circumstances where an instrument's character may change because of subsequent transactions or changes with respect to the holder or issuer of the debt. For example, if a transaction triggers the funding rule to reclassify a covered debt instrument issued in a prior tax year, the instrument is treated as stock as of the time of the triggering transaction. In addition, if a covered debt instrument treated as stock leaves the expanded group, the instrument ceases to be treated as stock at such time. Importantly, a change in an instrument's character would require retesting of an expanded group's other covered debt instruments.

Figure 11. Example of timing of reclassification

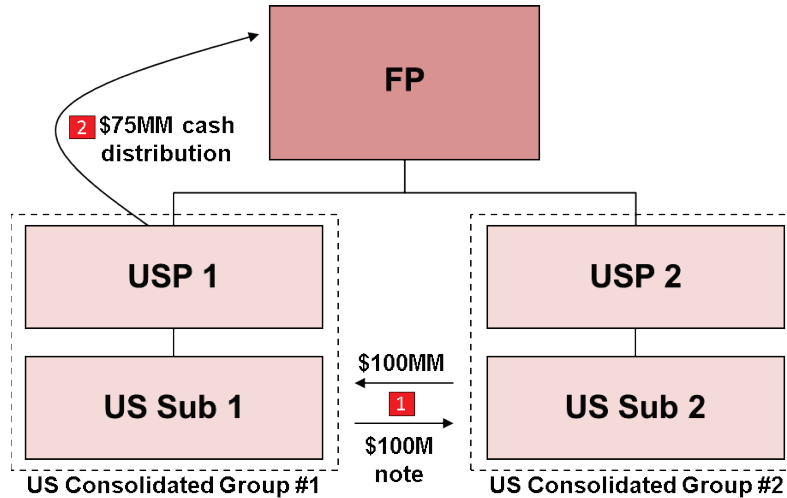


- In Year 1, FP loans US Sub US\$75 million and receives a note (US Sub Note A).
- In Year 2, US Sub distributes US\$60 million to FP. Assuming no exception applies, under the funding rule, FP is treated as exchanging US\$60 million of US Sub Note A for US Sub stock in Year 2, and the remaining US\$15 million is treated as debt.
- Later in Year 2, FP loans US Sub an additional US\$100 million and receives a note (US Sub Note B). US Sub Note B is not treated as stock under the funding rule because US Sub Note A fully funded the prior Year 2 US\$60 million distribution.
- In Year 3, FP sells US Sub Note A to a non-expanded group member, and therefore US Sub Note A ceases to be treated in part as stock. US Sub Note B must be retested under the funding rule. As a result, FP is treated as exchanging US\$60 million of US Sub Note B for US Sub stock, and the remaining US\$40 million is treated as debt.

Treatment of Consolidated Groups

The Regulations generally treat members of a consolidated group as one corporation. Thus, debt issued between members of the same consolidated group (consolidated group debt instruments) are not subject to the documentation and reclassification rules described above. However, transactions between members of separate consolidated groups that are together part of the same expanded group are subject to the Regulations.

Figure 12. Consolidated groups example



- In Year 1, US Sub 1 issues a US\$100 million note to US Sub 2 in exchange for US\$100 million cash. In Year 2, USP 1 distributes US\$75 million cash to FP.
- Because US Sub 1 and USP 1 are members of the same consolidated group, US Consolidated Group #1 is treated as having both issued the note and distributed the cash to FP. Assuming no exception applies, the cash distribution from USP 1 to FP is treated as having been funded by the note issued by US Sub 1. Therefore, such note is reclassified as stock up to the amount of the distribution to FP (US\$75 million).

Further Special Provisions

The Regulations contain additional rules affecting certain specific types of taxpayers, including:

- **S corporations.** By excluding S corporations from treatment as members of an expanded group (departing from the Proposed Regulations), the Regulations exempt S corporations entirely.
- **Real estate investment trusts (REITs) and regulated investment companies (RICs).** Similarly, the Regulations exclude REITs and RICs from treatment as expanded group members, unless the REIT or RIC is controlled by members of the expanded group.
- **Certain regulated entities.** The Regulations limit the application of the reclassification rule by excluding debt instruments issued by certain regulated financial companies, financial groups and regulated insurance companies, on the ground that these entities face regulatory oversight with respect to their capital structures. The Regulations also clarify the documentation requirements' application to certain interests issued by regulated financial services entities and insurance companies that must contain particular terms as required by regulators.

Conclusion

While substantially scaled back in certain respects from the Proposed Regulations, the Regulations still contain numerous hazards and complexities. Taxpayers should review the Regulations carefully and take great care in planning their future transactions.

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Endnotes

¹ All references to "Section" refer to sections of the Internal Revenue Code of 1986, as amended (the Code).

² For purposes of the illustrations throughout this *Client Alert*, each note is assumed to be issued with adequately stated interest.