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Treasury Targets Related-Party Debt with Proposed Regulations to Treat Debt as Equity

Proposed regulations would establish a sweeping framework to treat debt as equity in an effort to curb the use of "excessive" related-party debt.

On April 4, 2016, the US Department of the Treasury (Treasury) and the Internal Revenue Service (the IRS) announced proposed regulations (the Proposed Regulations) under Section 385[1] to address certain related-party debt transactions perceived as producing significant tax benefits but lacking meaningful non-tax significance. These transactions include "earnings stripping" techniques and repatriation planning that remove certain intragroup payments from the US federal income tax net. Section 385, enacted almost 50 years ago and largely dormant since an amendment in 1992, grants Treasury the authority to prescribe regulations to determine whether an interest in a corporation is properly treated as debt or stock. Regulations were issued in the early 1980s, but their effective date was delayed several times and the regulations were finally withdrawn without ever entering into force. Although the Proposed Regulations were issued as part of a package related to inversion and post-inversion transactions (for more detail regarding those regulations, please see the concurrently published Latham & Watkins *Client Alert* "Treasury Issues Stringent Inversion Regulations, Proposes Far-Reaching Related-Party Debt Rules"),[2] the Proposed Regulations extend beyond the inversion context, applying generally to taxpayers in both the cross-border and even the purely domestic context.

The Proposed Regulations, as drafted, would attempt to achieve Treasury's and the IRS' policy objectives by treating as stock:

- Certain related-party debt issued in connection with specific types of transactions
- Certain related-party debt for which specific documentation requirements are not met
- Entirely or in part, certain other related-party instruments that, although styled as debt, are perceived to be more appropriately characterized, at least partially, as stock

In general, the Proposed Regulations would apply to instruments in the form of debt issued (or deemed issued) and held by members of the same "expanded group," although in some cases, discussed below, their scope is broader. An expanded group, which would consist of corporations that are connected directly or indirectly by 80% ownership (by vote or value) is similar to an affiliated group that files a consolidated federal income tax return (a consolidated group), but would also include entities ineligible to be part of a consolidated group. These entities include foreign corporations, real estate investment trusts (REITs) and corporations held indirectly through partnerships. As described below, however, the

Proposed Regulations would generally not apply to instruments issued and held by members of the same consolidated group.

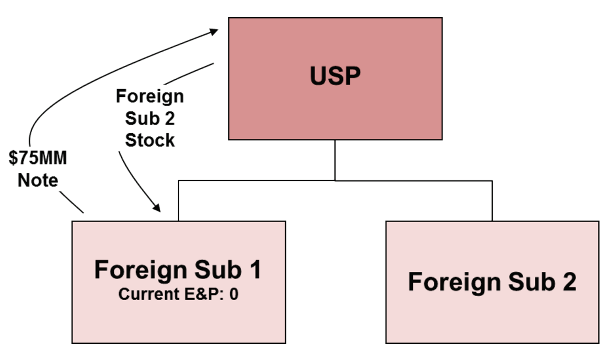
One clear result of recasting debt as stock in the three circumstances listed above is that deductible interest payments become non-deductible dividends. In addition, in the cross-border context, dividend payments may be subject to withholding tax at higher rates than those applicable to interest payments. Moreover, principal payments on recast debt may be treated as dividends potentially subject to withholding tax. Unexpected results could also arise under many other circumstances where the distinction between debt and equity results in materially different US federal income tax consequences. The Proposed Regulations would also impose significant monitoring and documentation burdens on multinational and domestic groups with common cash management arrangements, or that regularly engage in intercompany debt issuances and distributions.

I. Related Party Debt Issued in Connection with Certain Transactions

Subject to certain exceptions, including the exception for transactions among members of a consolidated group, as described above, the Proposed Regulations would treat as stock a debt instrument issued to a member of the issuer's expanded group in connection with specified transactions. Importantly, under these rules, the terms of the debt instrument itself are irrelevant in determining whether debt treatment applies, as the instrument would be subject to treatment as stock even if the documentation requirements described below are satisfied and, under traditional debt-equity analysis, the instrument would otherwise be treated as debt.

- **<u>General Rule:</u>** Subject to certain exceptions described below, the "general rule" would treat as stock a debt instrument issued to a member of the issuer's expanded group if the debt instrument were 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).

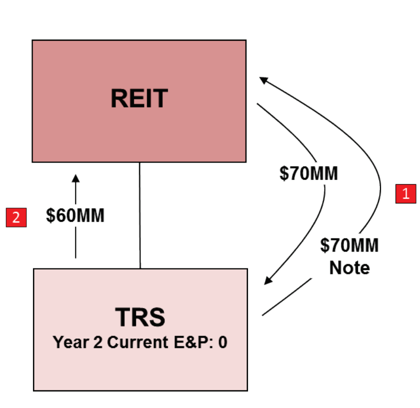
    - **Example 1:**[3] US parent (USP) sells one foreign subsidiary (Foreign Sub 2) to another foreign subsidiary (Foreign Sub 1, which has zero current-year earnings and profits, or E&P) in exchange for a US$75 million note. In the absence of the Proposed Regulations, this transaction would be subject to Section 304, and the note would generally be treated as distributed to USP by Foreign Sub 1. Under the Proposed Regulations' general rule, following the transaction, USP would not be treated as holding a note issued by Foreign Sub 1, but instead be treated as holding additional stock (with features different from Foreign Sub 1's stock that USP already held).

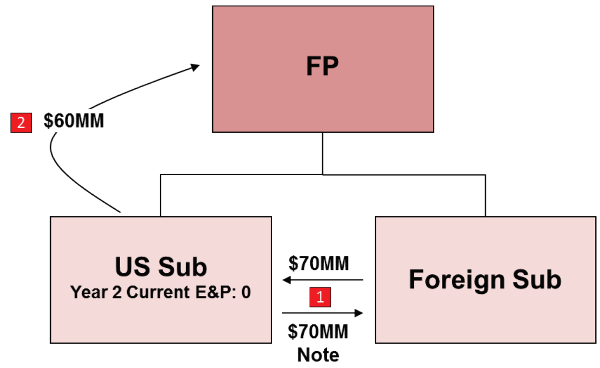


- **<u>Funding Rule:</u>** The Proposed Regulations also target multi-step transactions that implicate policy concerns similar to those that transactions subject to the general rule raise. Subject to certain exceptions, under the "funding rule," a debt instrument issued for property, including cash, (a funded debt instrument) will nonetheless be characterized as stock if a member of the expanded group (a funded member) issues a funded debt instrument to another member of the expanded group in a separate transaction with a principal purpose of using the debt proceeds to fund one or more distributions or acquisitions described in the general rule (a principal purpose debt instrument). The funding rule generally would not apply to treat debt instruments issued on or after April 4, 2016, as funding a distribution or acquisition that occurred before such date. Subject to the "per se rule" described below, whether such principal purpose exists would be determined based on all facts and circumstances.

  - **Per se rule**: The most significant feature of the funding rule is a non-rebuttable presumption (the per se rule) that, subject to certain exceptions described below, treats certain funded debt instruments as principal purpose debt instruments, whether or not a principal purpose actually exists to fund a general rule transaction. Under the per se rule, a funded debt instrument would be treated as stock if the instrument were 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. Certain "ordinary course" debt would be exempt from the per se rule. However, this exception is limited and would not apply to activities many large multinationals view as ordinary course, including intercompany financings and treasury activities. Thus, the per se rule would create a significant risk of foot-faults with drastic consequences: transactions completely unrelated to a funded debt issuance (and meaningfully separated from the issuance by time) could cause such debt to be treated as stock. The per se rule would not create a safe harbor by implication. Accordingly, debt issued outside of the six-year presumption period would remain subject to treatment as stock based on a facts-and-circumstances determination of whether the debt was a principal purpose debt instrument.

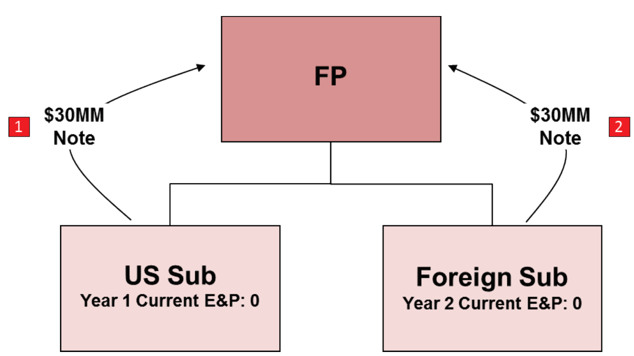
  - **Example 2:** Loans from a REIT (or in some cases, from an operating partnership in an UPREIT structure) to a taxable REIT subsidiary (a TRS) could be subject to treatment as stock under the Proposed Regulations as a result of distributions from the TRS occurring in the 36 months before or after the loan (even if the distribution and loan occurred in connection with unrelated transactions). In Year 1, REIT loans TRS US$70 million and receives a note (TRS Note). In Year 2, TRS distributes US$60 million to REIT, and TRS has zero current-year E&P in Year 2. Under the per se rule, TRS Note would be treated as a principal purpose debt instrument because of the US$60 million distribution from TRS to REIT in Year 2. At the time of the distribution, REIT would be treated as exchanging US$60 million of TRS Note for TRS stock, and the remaining US$10 million would be treated as debt. The same result would follow if, for example, rather than a REIT, the parent were a foreign corporation and the subsidiary a domestic corporation.





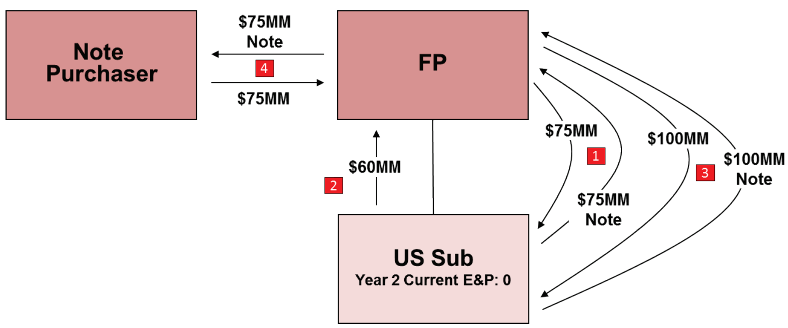
- **<u>Exceptions to the General Rule and the Funding Rule:</u>** The Proposed Regulations specify certain exceptions to the general rule and the funding rule. For example, debt would not be subject to these rules to the extent the debt was issued in distributions or acquisitions not exceeding the issuer's current-year E&P. In addition, under the "threshold exception," a debt instrument that would otherwise be treated as stock under the general rule or the funding rule would not be treated as such if, immediately after issuance, the aggregate adjusted issue price of all such debt instruments held by members of the expanded group did not exceed US$50 million. The threshold exception, however, might have limited application in practice as all debt instruments that would be recast as stock under the general rule or the funding rule (even those with both non-US issuers and holders) would count against the US$50 million threshold. Moreover, a debt instrument that qualified as debt upon issuance solely by reason of the threshold exception could subsequently be treated as stock if the expanded group's applicable debt instruments subsequently exceed the threshold.

  - **Example 3:** Prior to Year 1, an expanded group consisting of foreign parent (FP), a US subsidiary (US Sub) and a foreign subsidiary (Foreign Sub) have no intragroup debt that would be treated as stock but for the threshold exception. In Year 1, US Sub distributes a US$30 million note (US Note) to FP, and US Sub has zero current-year E&P in Year 1. Under the threshold exception, US Note would be treated as debt. In Year 2, Foreign Sub distributes a US$30 million note (FS Note) to FP, and Foreign Sub has zero current-year E&P in Year 2. At the time of Foreign Sub's distribution, the adjusted issue price of US Note is US$30 million. The threshold exception would no longer apply because the aggregate adjusted issue price of US Note and FS Note is greater than US$50 million. Thus, in Year 2, FP would be treated as exchanging US Note for US Sub stock, and FS Note would be treated as stock.



- **<u>Timing of Recharacterization:</u>** A debt instrument recast 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 debt instrument would be treated as stock under the funding rule and the funded transaction occurs in a tax year after the debt issuance, the debt would be treated as stock when the funded transaction occurs. In addition, if debt treated as stock leaves the expanded group, the debt would cease to be treated as stock at such time. Importantly, a change in an instrument's character would require retesting of other debt instruments issued among members of the expanded group.

  - **Example 4:** In Year 1, foreign parent (FP) loans its US subsidiary (US Sub) US$75 million and receives a note (US Sub Note A). In Year 2, US Sub distributes US$60 million, and US Sub has zero current-year E&P in Year 2. For reasons described in Example 2 above, at the time of the distribution, FP would be treated as exchanging US$60 million of US Sub Note A for US Sub stock, and the remaining US$15 million would be 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 would not be treated as stock under the per se rule and funding rule because US Sub Note A would be treated as fully funding the prior Year 2 US$60 million distribution. In Year 3, FP sells US Sub Note A to a non-expanded group member. As a result, no part of US Sub Note A would continue to be treated as stock. However, US Sub Note B would be retested to determine whether it would be required to be treated as stock in whole or part from that time forward. Under the per se rule and the funding rule, FP would be treated as exchanging US$60 million of US Sub Note B for US Sub stock, and the remaining US$40 million would be treated as debt.



- **<u>Anti-Avoidance Rules and No Affirmative Use:</u>** Consistent with the intended broad reach of the Proposed Regulations, an anti-abuse provision would operate to treat as stock debt instruments issued with a principal purpose of avoiding the general rule, the funding rule or the rules relating to consolidated groups (discussed below). The Proposed Regulations provide a non-exhaustive list of transactions perceived as abusive, such as where a debt instrument is issued to an entity that was not a member of the expanded group at issuance, but later becomes a member of the group. To prevent avoidance through the use of partnerships, a partnership that is 80% controlled by members of an expanded group would be treated as an aggregate of its partners, which would therefore be treated as owning their proportionate share of partnership assets and as issuing their proportionate share of partnership debt. In addition, taxpayers would not be able to use these rules affirmatively to reduce tax liability by treating debt as stock, because the rules would not apply to a transaction if a principal purpose of the transaction were to have debt treated as stock in order to reduce tax liability.

- **Effectiveness:** The general rule and funding rule would apply, generally, to debt issued (or deemed issued) on or after April 4, 2016. However, a transition rule would apply to debt instruments that are issued before the regulations are finalized and would be treated as stock under these rules. Such debt instruments would continue to be treated as debt until 90 days after final regulations are issued. At the end of the transition period, a holder of such debt would be deemed to exchange the debt for stock, if the holder is a member of the issuer's expanded group at such time.

II. Documentation Requirements

In general, the Proposed Regulations would require contemporaneous documentation and financial analysis to support the treatment of certain related-party debt as debt. These requirements are intended to cause related parties to produce, with respect to such debt, the documentation and financial analysis typical of transactions involving unrelated parties. Compliance with these requirements would be necessary but not sufficient to treat debt instruments issued and held by members of the same expanded group (expanded group instruments or EGIs) as debt. Failure to comply with these requirements would, therefore, generally result in the EGI being treated as stock.

- **Scope:** In general, the documentation requirements would apply to EGIs issued, or deemed issued, by large taxpayer groups after the regulations are finalized. Large taxpayer groups are expanded groups with members whose stock is publicly traded or with "applicable financial statements" showing US$50 million in annual revenue or US$100 million in assets. Applicable financial statements are, generally, financial statements prepared for a substantial non-tax purpose that include the assets, a portion of the assets or the annual total revenue of any member of the expanded group.

- **Requirements:** The Proposed Regulations would require producing documentary evidence that the IRS could review to determine whether an EGI was appropriately treated as debt. The documentation would need to establish that: (i) the issuer was under an unconditional and legally binding obligation to pay a sum certain on demand or on fixed dates; (ii) the holder had creditor's rights to enforce the issuer's obligations under the EGI; (iii) as of the date of the EGI's issuance, the issuer's financial position supported the reasonable expectation that the issuer intended and would be able to satisfy its obligations under the EGI; and (iv) the ongoing conduct of the EGI's issuer and holder was consistent with an arm's-length relationship between an unrelated debtor and creditor. The documentation would need to be maintained for the period during which the EGI remains outstanding and until the expiration of the period of limitations for any return to which the treatment of the EGI was relevant.

III. Analysis of the Purported Debt; Potential for Partial Recast

As discussed above, the Proposed Regulations would cause certain related-party debt instruments to be treated as stock by application of the general rule or the funding rule, or through the issuer or holder's failure to satisfy applicable documentation requirements. Such treatment would not, except as specifically set forth in the documentation requirements, be based on the characteristics of the instrument itself nor on the issuer's financial position, which would only become relevant once the rules and requirements discussed above were satisfied. If these threshold requirements were satisfied, the IRS would still be empowered to apply general US federal income tax principles to treat certain related-party instruments in the form of debt as stock, either entirely or in part. For instance, if upon analysis the IRS were to determine that there was a reasonable expectation that only a portion of an EGI's principal would be repaid, the IRS would be able to treat the excess principal as stock. In addition, under the Proposed Regulations, the IRS' authority to partially or entirely recast an instrument in the form of debt as stock would extend beyond EGIs to instruments issued, or deemed issued, in the form of debt to members of the same "modified expanded group" as the issuer. A "modified expanded group" is similar to an expanded group, but the ownership requirement would be reduced from 80% to 50%.

IV. Consolidated Groups

The Proposed Regulations generally would treat members of a consolidated group as the same corporation for purposes of applying the rules described above. Therefore, a debt instrument issued and held by members of the same consolidated group (a consolidated group debt instrument) would, generally, not be subject to the Proposed Regulations. When the issuer or holder of a consolidated group debt instrument ceases to be a member of the consolidated group, but remains in the expanded group (or modified expanded group), the Proposed Regulations' requirements would apply to the debt instrument. Similarly, a consolidated group debt instrument that was transferred outside of the consolidated group to a holder that is a member of the expanded group (or modified expanded group) would be subject to the Proposed Regulations.

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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 further discussion, please refer to: Latham & Watkins *Client Alert* No. 1956 (Apr. 21, 2016), Treasury Issues Stringent Inversion regulations, proposes Far-Reaching Related-Party Debt Rules *available at* https://www.lw.com/thoughtLeadership/treasury-issues-stringent-inversion-regulations.

3 For purposes of Examples 1 through 4, each note is assumed to be issued with adequately stated interest.