Client Alert

April 12, 2016

Proposed IRS Debt-Equity Regulations: Aimed at Post-Inversion "Earnings Stripping," But May Also Impact Ordinary Related-Party Debt

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On April 4th, the Internal Revenue Service ("IRS") issued proposed regulations (the "Proposed Regulations")[1] under Section 385[2] which could dramatically change how related-party indebtedness is treated for federal income tax purposes. In general, the Proposed Regulations provide for the automatic treatment of related-party debt instruments as equity if the parties fail to comply with burdensome recordkeeping requirements or if the instruments are issued under circumstances the IRS has deemed abusive, resulting in a disallowance of interest deductions on the instruments. In addition, the Proposed Regulations would give the IRS new authority to treat certain related-party debt as part debt and part equity for tax purposes.

The Proposed Regulations were unexpected and have been immediately controversial. Treasury had previously indicated that it was studying earnings stripping as an area for potential guidance, but it was widely expected that any such guidance would be limited to corporate groups that had previously undertaken an inversion transaction (generally, the migration of a domestic corporation abroad in a transaction that the government views as tax-motivated).[3] Alternatively, there had been some resignation to the idea that Treasury might tighten the restrictions on related-party interest deductions under the earnings-stripping rules contained in Section 163(j).

Instead, the Proposed Regulations propose a sweeping change that, at least in certain circumstances, would abandon a long-standing multifactor approach to reclassifying instruments as equity that have been denominated as debt, and instead examine the relationship of the parties to the instrument, the context in which it was issued, and the relevant documentation to determine whether there is sufficient support for the claim of debt treatment. In addition, the Proposed Regulations also abandon long-standing practice and authority that treats an instrument as either debt or equity in its entirety and introduces the possibility that an instrument may now be characterized as part debt, part equity.

Although the current Section 385 regulations were proposed in conjunction with temporary regulations targeting inversion transactions, it is important to note that the Section 385 regulations are not limited to the inversion context. Instead, the Proposed Regulations have the potential to apply to any multinational group that uses

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[1] REG–108060–15.

[2] All section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

[3] The Treasury simultaneously with the debt-equity regulations issued additional guidance on corporate inversions. See TD 9761 for final and temporary regulations under Sections 367 and 7874. We will be issuing a client alert on this guidance in the immediate future. In the meantime, for additional information about inversions, please see our client alert, available at http://www.mofo.com/~/media/Files/ClientAlert/2014/07/140721InversionCraze.pdf.

intragroup financing in its structure. The Proposed Regulations also have the potential to impact financing structures that are common for private equity portfolio companies and debt-financed mergers and acquisitions, potentially making those transactions much more expensive and rendering some transactions no longer viable after the formerly available tax benefits are taken out of the calculus.

If the Proposed Regulations are adopted substantially as proposed, the ability of the government to recharacterize certain debt instruments would be significantly bolstered, with dramatic effects to taxpayers. Not only would the issuer lose its interest deductions for debt that is recharacterized as equity under the Proposed Regulations; the issuer apparently could also have a withholding tax obligation with respect to its payments that in many instances would not have applied were the instrument respected as debt.

Given the dramatic impact of the proposals and the inevitable questions of regulatory authority on the part of the Treasury, we expect the Proposed Regulations to provoke extensive comments and lobbying. Nevertheless, Treasury has stated its intention to move quickly to finalize the Proposed Regulations. In the meantime, however, portions of the Proposed Regulations would apply to debt instruments issued on or after April 4, 2016, although the Proposed Regulations will take effect only once they are finalized.

BACKGROUND

Section 385 was originally enacted by Congress in 1969 and gives the Treasury Department broad authority to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated as stock or indebtedness (or as part stock and part indebtedness). Section 385(b) provides further that the regulations shall set forth factors that are to be taken into account in determining, with respect to a particular factual situation, whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. Section 385(c) provides that the issuer's classification of an interest in a corporation as stock or indebtedness is binding on the issuer and the holders. However, a holder can treat the instrument inconsistently if it discloses the inconsistent treatment on its tax return.

A set of final regulations under Section 385 was issued in the early 1980s but were subsequently withdrawn without ever coming into force, due to concerns that they were too vague and opened up the possibility of manipulation by the taxpayer. Small businesses, in turn, were concerned the regulations would turn many common debt instruments into equity for federal income tax purposes. There were no subsequent attempts made to utilize the authority granted by Section 385, and as a result prior to the current proposals (almost 50 years after enactment of the underlying statute) there were no final or proposed regulations under Section 385 in effect. In lieu of regulations, case law has continued to evolve and control the characterization of an interest as debt or equity for U.S. federal income tax purposes.

SCOPE

The purpose of the Proposed Regulations is to address concerns that the IRS believes exist when an interest is issued to a related party. Therefore, except for the rule described below permitting the IRS to recharacterize an instrument as part debt and part equity, the Proposed Regulations only address instruments (Expanded Group Instruments or "EGIs") labeled as indebtedness between members of the same "expanded group." An issuer's expanded group is a chain of corporations (including foreign corporations and tax-exempt entities) with a common parent connected by ownership of 80% of the vote or value of each member. Indirect ownership of corporations is also taken into account by attributing ownership through related entities.

Although the impetus for the issuance of the Proposed Regulations in general was the issuance of cross-border debt instruments, the preamble states that indebtedness between domestic parties likewise can be used to reduce or eliminate federal income tax liability. Therefore, the Proposed Regulations apply to and must be considered in wholly domestic transactions.[4] However, members of a single consolidated group generally are treated as one corporation for purposes of the Proposed Regulations with the effect that intercompany indebtedness within a consolidated group ordinarily is disregarded.

As further explained below, the Proposed Regulations generally enumerate situations in which EGIs are automatically treated as equity for federal income tax purposes. Even if an EGI is not automatically treated as equity under the Proposed Regulations, the EGI is still subject to scrutiny under general tax principles to determine its proper characterization for tax purposes. Therefore, compliance with the Proposed Regulations is a necessary, but not sufficient, requirement for an instrument to be respected as debt.

If all or part of an EGI is recharacterized as equity for federal income tax purposes, the Proposed Regulations provide the recharacterized portion of the EGI is treated as being retired for an amount of stock equal to the debt's adjusted issue price as of the date of the recharacterization. In general, both the holder and the issuer will not realize gain or loss on the deemed exchange.

PARTIAL DEBT/EQUITY TREATMENT

The Proposed Regulations authorize the IRS (but not taxpayers) to recharacterize a single instrument as equity in part and indebtedness in part, if warranted by the facts and circumstances. For example, if an analysis of an EGI demonstrates that the issuer cannot reasonably be expected to repay more than 60% of the principal amount, the IRS may treat the EGI as 60% indebtedness and the remaining 40% as equity. This approach is a departure from existing law, where courts have generally adhered to the practice of treating an instrument as wholly debt or wholly equity. According to the IRS, this all-or-nothing approach frequently fails to reflect the economic substance of related-party amounts that are cast in the form of indebtedness.

The IRS is granted a broader authority to treat an instrument as part debt and part equity than in the rest of the Proposed Regulations. Thus, the IRS gives itself such authority for "modified expanded groups." A modified expanded group is one that meets the expanded group definition, but substituting a 50% ownership threshold for 80% and making certain other modifications.

Unfortunately, the Proposed Regulations are vague on what happens after the IRS "treats" an instrument as part equity and part debt. Does the provision simply give the IRS the ability to assert in an audit that an instrument is part debt and part equity?[5] Is the taxpayer simply allowed to challenge this assertion in court? Or did the IRS intend to create a new substantive rule of law? Under this latter view, once the IRS decides that a purported debt

[4] For example, the Proposed Regulations could recharacterize a REIT's debt interest in its taxable REIT subsidiary.

[5] According to the preamble, "the proposed rule merely permits the Commissioner to treat a purported debt instrument as in part indebtedness and in part stock consistent with its substance."

instrument is actually part debt and part equity, then this treatment would be mandated for federal income tax purposes.[6] The IRS would adjust the taxpayer's income accordingly, e.g., by disallowing a portion of prior interest deductions claimed by the taxpayer. If the taxpayer challenges this treatment in court, the IRS would assert that the part debt, part equity classification is entitled to deference and that a court can reverse the government's classification only if the exercise of its rule-making power was "arbitrary or capricious" under relevant administrative law.[7] It is hard to imagine a more fundamental difference in interpretation and even more surprising that the Proposed Regulations are not clear on the point.

This grant of authority is effective for EGIs issued or deemed issued on or after the date the Proposed Regulations become final, and to instruments deemed issued before the date the Proposed Regulations become final as a result of an entity classification election that is filed on or after the date the Proposed Regulations become final.

DOCUMENTATION REQUIREMENTS

The Proposed Regulations establish new documentation requirements that must be met to keep the IRS from automatically recharacterizing an instrument as equity. Significantly, as proposed, the documentation requirements only apply to instruments that are debt in form. However, Treasury expressly requests comments on a lengthy list of topics, among them how to implement documentation and timing requirements for transactions that do not take the form of debt but that are treated as debt under general tax principles (e.g., repurchase agreements). In a further restriction that may be of very limited practical utility, the documentation requirements only apply if a member of the relevant expanded group is publicly traded, or if on the date the instrument first becomes an EGI the group's total assets or total annual revenues exceed $100 million or $50 million, respectively.

Meeting the documentation requirements is a threshold requirement to keep the IRS from automatically characterizing an instrument as equity under the Proposed Regulations, but does not itself establish that a related-party instrument is indebtedness. Instead, the documentation requirement only acts as a preliminary test for the possibility of indebtedness treatment after the determination of an instrument's character is made under federal tax principles developed under applicable case law. Failure to maintain the required documentation or to provide it upon request by the IRS results in automatic equity characterization of the instrument, subject to a reasonable cause exception.

The Proposed Regulations require that the following four categories of documentation and information be prepared and maintained by the issuer. For these purposes, the issuer of an EGI means a person that is obligated to satisfy any material obligations created under the terms of the instrument, even if such person is not the primary obligor. A guarantor, however, is generally not treated as an issuer unless the guarantor is treated as the primary obligor under general tax principles (for example, on substance over form grounds). Furthermore, controlled partnerships (i.e., partnerships in which the expanded group owns an interest in 80 percent of the capital or profits) are treated as part of the expanded group for these purposes.

[6] The Proposed Regulations dealing with automatic equity classification (Prop. Reg. §1.385-3) specifically say this: "To the extent a debt instrument is treated as stock under [the automatic equity classification rules] it is treated as stock for all federal tax purposes." There is no similar statement for the part debt, part equity portion (Prop. Reg. §1.385-2) of the Proposed Regulations.

[7] Administrative Procedures Act §7, 5 U.S.C. §706.

Each of the four requirements described below is meant to reflect an essential characteristic of indebtedness for federal tax purposes.

1. Binding Obligation to Repay.

Evidence must be maintained that the lending represents a binding legal obligation to repay a sum certain on demand or at one or more fixed dates.

2. Creditor's Rights to Enforce Terms.

The documents must establish that the creditor/holder has the legal rights of a creditor to enforce the terms of the EGI. At a minimum, the rights of a creditor must include a superior right to shareholders to share in the assets of the issuer in the case of dissolution. Other examples in the Proposed Regulations include the right to trigger default and the right to accelerate payments.

3. Reasonable Expectation of Repayment.

The documents must evidence a reasonable expectation that the issuer could in fact repay the amount of the proposed loan. The documentation might include cash flow projections, financial statements, business forecasts, asset appraisals, determination of debt-to-equity and other relevant financial ratios of the issuer. The Proposed Regulations include special rules for disregarded entities issuing EGIs.

4. Genuine Debtor-Creditor Relationship.

The documents must evidence an ongoing debtor-creditor relationship, which can come in two forms. First, in the case of an issuer that complied with the terms of the EGI, documentation must include evidence of any payments on which the taxpayer relies to establish debt treatment under general federal tax principles. In the alternative, if the issuer did not comply with the terms of the EGI (by not making required payments or otherwise suffering an event of default under the EGI), to show a genuine debtor-creditor relationship there must be documentation showing the holder's reasonable exercise of the diligence and judgment of a creditor.

Generally, the Proposed Regulations require that the documentation be prepared no later than 30 calendar days after the date of a relevant event, which will generally be the date the EGI was issued or the date the issuer became an expanded group member. In the case of documentation of the debtor-creditor relationship (category four above), the Proposed Regulations allow the documentation to be prepared up to 120 calendar days after a payment or relevant event occurs. Special rules apply to revolving credit, cash pooling, and similar arrangements.

Under the Proposed Regulations, the documentation and information for each category must be maintained for all taxable years that an EGI is outstanding and until the period of limitations expires for any return with respect to which the tax treatment of the EGI is relevant. The preamble states that the IRS intends for taxpayers to have flexibility in determining how the requirements of the four categories above are satisfied, and thus the Proposed Regulations do not specify where and in what manner records must be kept.

Taxpayers are expressly prohibited from affirmatively using the documentation requirements to recharacterize as equity instruments that are denominated as debt. Issuers and holders (but not the IRS) must treat instruments denominated as debt consistently with their form.

The documentation requirement suffers from the same vagueness about the consequences as the part of the Proposed Regulations that permits the IRS to recast an instrument as part debt and part equity. Presumably the IRS intends to create a substantive rule: "If the requirements . . . are not satisfied . . . the EGI will be treated as stock." The preamble to the Proposed Regulations echoes this ("If the requirements . . . are not satisfied the purported indebtedness would be recharacterized as stock"). Taxpayers will presumably argue that the IRS has overstepped its rule-making bounds by tying a taxpayer's ability to claim an interest deduction to a lack of proper documentation.

The documentation requirements are effective for EGIs issued or deemed issued on or after the date the Proposed Regulations become final, and to instruments deemed issued before the date the Proposed Regulations become final as a result of an entity classification election that is filed on or after the date the Proposed Regulations become final.

AUTOMATIC EQUITY TREATMENT

Certain debt instruments that satisfy the above documentation requirements will nevertheless automatically be treated as equity under the Proposed Regulations if they are issued in any of the situations described below. In general, the IRS views the situations described below as having limited non-tax effect because the debt issuance does not result in the transfer of capital or assets in a significant way. The IRS therefore adopts the view that respecting the instrument as debt in these situations produces inappropriate results.

For the purposes of these rules, controlled partnerships are treated as aggregates of their members, i.e., each member is treated as owning its proportionate share of the partnership's assets and is treated as issuing its share of the partnership's debt.

1. Debt instrument issued in a distribution

   The Proposed Regulations treat as equity a debt instrument issued by a corporation to a member of the corporation's expanded group in a distribution. The term "distribution" is broadly defined as any distribution by a corporation to a member of the corporation's expanded group with respect to the distributing corporation's stock, and therefore includes a redemption.

2. Debt instrument issued in exchange for affiliate stock

   The Proposed Regulations treat a debt instrument as equity if it is issued by a corporation to a member of the corporation's expanded group in exchange for expanded group stock, subject to an exception for certain asset reorganizations. The IRS views such a transaction as similar to the issuance of a debt instrument in a distribution. According to the IRS, such transactions have limited non-tax significance because they do not change the ultimate ownership of the affiliate and introduce no new capital to either party. One example is the purchase of "hook stock" from a parent in exchange for a debt instrument.

3. Debt instrument issued pursuant to an internal reorganization

The Proposed Regulations treat as equity a debt instrument issued as consideration received by a member of the expanded group in certain tax-free asset reorganizations occurring within the group. Again, the IRS expresses concern that these transactions have limited non-tax significance while creating the potential for significant U.S. tax benefits. This rule does not apply to debt instruments exchanged for securities or other debt interests in the reorganization, because such an exchange does not increase the overall debt within the group.

An example of an issuance that would be treated as equity under this rule is illustrated by the following scenario: A foreign parent owns two U.S. subsidiaries. In a tax-free reorganization under Section 368(a)(1)(D), the parent transfers its stock in the first subsidiary to the second subsidiary in exchange for a note issued to the parent, following which the first subsidiary liquidates. The transaction is a (tax-free) transfer of the first subsidiary's assets to the second subsidiary. Under the Proposed Regulations, the note would be treated as equity.

4. Debt instrument issued with a principal purpose of funding certain distributions and acquisitions

The Proposed Regulations treat as equity a debt instrument issued for property (including cash) when the debt instrument is issued to a member of the issuer's expanded group with a principal purpose of funding (1) a distribution of cash or other property to a member of the expanded group, (2) an acquisition of the stock of a member of the expanded group, or (3) the acquisition of property from a member of the expanded group in an intragroup asset reorganization similar to that described immediately above.

The purpose of this rule is to prevent a taxpayer from circumventing the other automatic equity rules by using multi-step transactions. For example, this rule treats as equity a transaction in which, instead of a subsidiary distributing a note to its parent corporation in a distribution, the subsidiary borrows cash from the parent and later distributes the cash to the parent in a transaction claiming to be independent from the borrowing.

The Proposed Regulations subject a debt instrument to these funding rules regardless of whether the lender is a party to the funded transaction. This prevents an expanded group from borrowing money from a sister corporation and then distributing funds to the common parent to circumvent the automatic equity rules.

The facts and circumstances determine whether a debt instrument is issued with a principal purpose of funding one of the above distributions or acquisitions. A principal purpose is irrebuttably presumed to exist if the instrument is issued during a period beginning 36 months before and ending 36 months after the distribution or acquisition. The irrebuttable presumption does not apply to a debt instrument issued in the ordinary course of the issuer's trade or business in connection with the purchase of property or receipt of services, provided the amount of the obligation at no time exceeds the amount that would be ordinary and necessary if the issuer were unrelated to the lender. The preamble to the Proposed Regulations emphasizes that this "ordinary course" exception to the presumption is not available for debt arising in the context of capital expenditures, intragroup financing or treasury center activities.

The Proposed Regulations include three exceptions to the automatic equity rules discussed above. First, distributions or acquisitions that do not exceed the current year's earnings and profits of the distributing or acquiring corporation are not treated as distributions or acquisitions under these rules. Second, a debt instrument will not be treated as equity if the aggregate issue price of all of the expanded group's debt instruments that would otherwise be treated as equity under the Proposed Regulations does not exceed $50 million. If the expanded group's debt instruments that would otherwise be treated as equity later exceeds $50 million, then the entire amount of the expanded group's debt instruments would be treated as equity (including the first $50 million). Third, with respect to the second prong of the funding rule, an acquisition of expanded group stock does not include an acquisition that results from a transfer of property by the issuer of a debt instrument to an expanded group member in exchange for stock of the expanded group member if, for 36 months following the issuance, the issuer of the debt instrument holds (directly or indirectly) more than 50% of the total combined vote and value of the stock of the expanded group member.

Finally, the Proposed Regulations include an anti-abuse rule of uncertain, and potentially very broad, reach. An instrument (including an instrument that is not denominated as debt) is treated as equity if it is issued with a principal purpose of avoiding the application of the automatic equity rules. The anti-abuse rule may apply where, with the principal purpose of avoiding the application of the automatic equity rules, (i) a debt instrument is issued, and later acquired from, a person that is not a member of the issuer's expanded group, (ii) a debt instrument is issued to a person that is not a member of the issuer's expanded group but later becomes a member of the issuer's expanded group, (iii) a debt instrument is issued to an entity that is not taxable as a corporation, or (iv) a member of the issuer's expanded group is substituted as a new obligor or added as a co-obligor on an existing debt instrument. The Proposed Regulations do not provide any clarity on how it is determined that a principal purpose of an issuance was the avoidance of the automatic equity rules; as a result, the scope of the anti-abuse rule is unclear.

The automatic equity rules are effective for debt instruments issued on or after April 4, 2016, and that are deemed issued after April 4, 2016 as a result of an entity classification election that is filed on or after April 4, 2016. If the Proposed Regulations would treat a debt instrument as stock prior to the date the Proposed Regulations become final, the debt instrument would not be treated as stock until at least 90 days after the date the Proposed Regulations become final. In addition, for purposes of determining whether a debt instrument was issued with a principal purpose of funding the distributions and acquisitions described above, a distribution or acquisition that occurs before April 4, 2016, is generally not taken into account.

LOOKING FORWARD

Some final observations about the Proposed Regulations. First, the automatic equity provisions, which if finalized would apply to debt instruments issued after April 4, 2016, will have a chilling effect on the transactions within their ambit. Many if not most taxpayers will try to avoid issuing debt in situations that could trigger automatic equity treatment. Second, corporate taxpayers in consolidated groups will not much worry about the Proposed Regulations. They are basically exempted. Third, corporations that would be subject to the part debt and part equity and documentation requirements when or if the Proposed Regulations are adopted will likely review their debt documentation and procedures currently even though the rules would be prospective only. Finally, we expect criticism of the Proposed Regulations to match the criticism of the 1980 proposed Section 385 regulations (which were ultimately withdrawn) in their volume and fervor. Whether the Proposed Regulations will suffer a similar fate as those 1980 regulations is an open question.

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