Proposed Treasury Regulations on Debt-Equity Classification Change the Landscape for Related Party Financings

Executive Summary

On April 4, 2016, the U.S. Treasury Department and the Internal Revenue Service ("IRS") proposed new regulations that, if finalized, would dramatically change how debt instruments issued between related parties are treated and analyzed (the "Proposed Regulations").[1] The Proposed Regulations are part of an effort to make so-called "inversion" transactions less attractive to U.S. corporations seeking to combine with a foreign-parented group, and were issued at the same time as other significant regulations specifically addressing inversions.[2] The Proposed Regulations go well beyond inverted companies, however, and apply broadly to many other related taxpayers and commercial arrangements, both cross-border and domestic. The Proposed Regulations are so far-reaching that, if finalized in their current form, they likely will affect the way every multinational corporate group with a U.S. presence does business. In addition, the IRS has requested comments as to whether the Proposed Regulations should be further expanded to reach other types of related party debt and even equity transactions, such as debt issued by so-called "blocker" corporations commonly used by investment partnerships, and certain preferred equity issued by corporate controlled partnerships.

The Proposed Regulations apply broadly to many related taxpayers and commercial arrangements, both cross-border and domestic and, if finalized in their current form, will likely affect the way every multinational group with a U.S. presence does business.

Historically, whether an instrument is treated as debt or equity for tax purposes has generally been determined at issuance based on all facts and circumstances. A significant body of case law has developed over several decades around this question, with courts focusing on numerous factors including (i) the terms of the instrument, (ii) evidence of the parties' intent, (iii) the instrument's subordination or preference in relation to other securities of the issuer, (iv) the issuer's debt-to-equity ratio (or other financial metrics), (v) presence of a conversion feature, and (vi) other factors evidencing the ability of the borrower to repay the debt and supporting a genuine debtor-creditor relationship. If treated as debt at issuance, an instrument normally would be respected as debt for the remainder of its life (unless significantly modified).

The Proposed Regulations upend existing law in several important ways. In particular, as further discussed below:

- A debt instrument issued between certain related entities in certain types of transactions will be treated upon issuance (or in some cases recharacterized in the future) as per se equity, whether or not the instrument otherwise qualifies as indebtedness under existing law (see 2. below). This provision is generally effective for debt issued on or after April 4, 2016.

- The Proposed Regulations impose significant new record creation and retention policies with respect to debt instruments issued between many types of related entities, with failure to satisfy these requirements generally resulting in automatic equity treatment from and after the time of the failure (see 3. below). This rule is generally effective prospectively for debt issued after the regulations are finalized.

- The Proposed Regulations authorize the IRS to treat a debt instrument between related parties (based on a more expansive concept of relatedness) as debt in part and equity in part, based on an analysis of the facts and circumstances at issuance under general U.S. federal tax principles and taking into account the foregoing new record creation and retention rules (see 4. below). This provision is generally effective prospectively for debt issued after the regulations are finalized.

- The Proposed Regulations modify the current rules regarding consistent reporting of the tax characterization of debt instruments (see 5. below).

The Proposed Regulations would (i) recharacterize certain related party debt as per se equity, (ii) impose new record creation and retention requirements on related party debt issuances as a condition to debt treatment, and (iii) give the IRS authority to bifurcate a debt instrument into debt in part and equity in part.

Once a debt instrument covered by the Proposed Regulations is characterized as equity, affected taxpayers may face significant U.S. tax consequences including the following:

- interest on the debt would not be deductible by the issuer;

- repayments of debt principal may be treated as taxable dividends in whole or in part, rather than as tax-free return of debt basis;

- interest payments would normally be treated as dividends rather than interest which, if the holder is foreign, could have adverse withholding tax consequences depending on the applicability of a treaty or other exemption;

- there could be important consequences under the foreign tax credit rules (on which the IRS has requested comments) and the rules governing the dividends received deduction; and

- if the issuer is a subsidiary of a U.S. consolidated group and the holder is a foreign affiliate or a partnership, deconsolidation of the U.S. subsidiary could result if the deemed equity interest represents more than 20% of vote or value of the subsidiary's "stock" (as defined for purposes of determining consolidation).

In addition, other rules turning on equity ownership thresholds (e.g., the REIT rules) are implicated by the Proposed Regulations.

The Proposed Regulations are complex and far-reaching and raise many questions. Particularly given the April 4, 2016 effective date for some of these rules, their impact on both cross-border and domestic financing arrangements involving related parties (as broadly captured by the Proposed Regulations), including arrangements previously considered to be non-controversial from a tax perspective, should be considered closely. The following sections provide additional detail on key provisions in the Proposed Regulations.

Well-advised taxpayers must consider the impact of the new rules in any intercompany financing arrangement that is not confined within a U.S. consolidated group.

1. Debt Instruments Covered by the Proposed Regulations

The rules described in 2 below (per se equity treatment) and 3 below (documentation and information requirements) generally apply to any debt instrument that is issued between members of an "expanded group" (an "expanded group instrument" or "EGI"). An "expanded group" generally means a corporate parent and all other corporations (whether domestic or foreign, and including REITs, regulated investment companies, S-corporations and tax-exempt corporations) in which the parent directly or indirectly (including through partnerships or as a result of the application of constructive ownership rules) owns 80% or more of the stock by vote or by value. For purposes of the Proposed Regulations, however, all members of a U.S. consolidated group are treated as a single corporation and, accordingly, intercompany obligations between members of a U.S. consolidated group are not subject to the Proposed Regulations unless and until (i) either debt party ceases to be a member of the consolidated group or (ii) the obligation is otherwise transferred outside of the consolidated group.

The Proposed Regulations define "expanded group" using broad ownership attribution principles which can lead to unexpected results.

> *Example:* A partnership directly owns 100% of the stock of two standalone U.S. corporations. The Proposed Regulations treat the two U.S. corporations as an expanded group (with each treated as owing 100% of the other through attribution). Since they are not a consolidated group, intercompany obligations between them will be treated as EGIs under the Proposed Regulations.

As further described in 4 below, the rules granting the IRS authority to treat a debt instrument as debt in part and equity in part apply to debt issued between members of a "modified expanded group," which is even more broadly defined to include 50%-related persons.

Since various portions of the Proposed Regulations implicate all sorts of intercompany obligations, including revolving credit lines, cash pooling arrangements and contractual rights in addition to traditional promissory notes, well advised taxpayers must consider the impact of the rules in any intercompany financing arrangement that is not confined within a consolidated group.

2. Debt Instruments that are Treated As Per Se Equity

The government concluded that obligations issued between related corporations in certain transactions raise such significant policy concerns that they should automatically be treated as equity, regardless of their status under general tax principles. In particular, with limited exceptions, the Proposed Regulations treat a debt instrument as equity if it is issued by one expanded group member to another (1) in a distribution (whether or not characterized as a dividend for tax purposes), (2) in exchange for stock of a group member, or (3) in exchange for property in an intercompany asset reorganization if, pursuant to the reorganization, a group member receives the debt instrument with respect to its stock in the transferor (each of the foregoing, a "distribution or acquisition").

> *Example:* Foreign corporation (FC) owns all the stock of U.S. corporation (USCo). If USCo issues debt to FC in exchange for cash, then (assuming the "Funding Rule," described in the next paragraph, does not apply) the debt would be respected as debt for tax purposes if it would be so treated under general tax principles. However, if USCo distributes the note to FC for no consideration, the Proposed Regulations would treat the debt as equity for tax purposes.

Additionally, the Proposed Regulations generally treat a debt instrument as equity if it is issued by one expanded group member to another member in exchange for cash or other property with "a principal purpose" of funding one of the foregoing types of distributions or acquisitions (the "Funding Rule"). Subject to a narrow ordinary course exception for certain debt issued for property or services, the Proposed Regulations treat a principal purpose as existing if the debt is issued during the period beginning 36 months before, and ending 36 months after, the distribution or acquisition. Outside this 72 month window, a facts and circumstances analysis applies to determine whether an obligation is issued with a principal purpose of funding such a distribution or acquisition. Multiple debt instruments may be subject to the Funding Rule, and a single debt instrument may be treated as funding multiple distributions or acquisitions.

> *Example:* FC owns all the stock of USCo and of foreign subsidiary (FS). USCo issues debt to FS in exchange for cash and distributes the cash to FC. The Funding Rule treats the debt as equity.

The breadth of the Funding Rule means that a multinational firm with U.S. operations must carefully examine all decisions with respect to cross-border funding. For instance, if a foreign-parented group has a non-U.S. treasury center, a loan to a U.S. subsidiary could be treated as equity if the U.S. subsidiary has engaged (or later engages) in a covered distribution or acquisition. Similar concerns arise for a U.S.-parented group with a U.S. finance subsidiary that lends to a foreign subsidiary.

There are three limited exceptions to these per se equity rules:

(i) In applying the per se rules to EGIs issued by an expanded group member for a taxable year, the aggregate amount of the distributions or acquisitions made by that member that would otherwise be subject to the per se rules is reduced by that member's current year earnings and profits (E&P), with the reduction based on the order in which the distribution or acquisition occurs. Unfortunately, this exception may have little practical use, since E&P for a year are not determinable until the year has ended, and therefore E&P could only be estimated (at the taxpayer's peril if actual E&P turns out to be lower) for financing decisions that must be made during the course of the year.

Debt issued by one expanded group member to another will be treated as per se equity if issued (i) in a distribution, (ii) in an acquisition of stock of an expanded group member, or (iii) in exchange for property in an intercompany asset reorganization where a group member receives the debt with respect to its stock in the transferor, or with a principal purpose of funding any such transaction.

There are three limited exceptions to the per se equity rules that, among other things, permit distributions of a member's current year's E&P and limit application of the rules to smaller taxpayers with limited inter-company debt.

(ii) An EGI is not treated as equity under the per se rules if, immediately after it is issued, the aggregate adjusted issue price of EGIs held by group members that would be subject to these rules in the absence of this exception does not exceed $50 million. Once this $50 million threshold is exceeded, however, the exception no longer applies and all EGIs that would be subject to the per se equity rules absent this exception will be deemed exchanged for stock of the issuer (valued at the adjusted issue price of the instrument and not its fair value) at such time (unless the issuance and the crossing of the threshold occur in the same year, in which case the debt instrument will be treated as equity from the date of issuance). The $50 million threshold is applied by taking into account all EGIs held by group members, regardless of the extent to which any portion of the aggregate amount of those EGIs may qualify for another exception.

> *Example:* FC owns all of the stock of USCo and of FS. In a taxable year in which USCo has $10 million of current earnings and profits, USCo issues $55 million of debt to FS in exchange for cash and distributes the cash to FC. The $55 million debt constitutes the only EGI held by any member of the FC expanded group. Although $10 million of the $55 million debt issued by USCo is exempted from the per se rule by reason of the E&P exception, the remaining $45 million is not eligible for the $50 million exception and is therefore treated as equity under the Funding Rule.

(iii) An acquisition of expanded group stock by a member (a "funded member") that issues an EGI to another member in exchange for property is not subject to the Funding Rule if the funded member holds (directly or indirectly) more than 50 percent of the total combined vote and value of the issuer's stock for the 36-month period immediately following the stock issuance and the issuer of the stock does not itself make an acquisition or distribution that, if made by the funded member, would have caused the EGI to be treated as equity under the Funding Rule. If the funded member ceases to own 50 percent of the vote and value of the issuer within this period, the stock issuance becomes subject to the Funding Rule at such time, and the related EGI is deemed exchanged for stock at such time (unless the debt issuance and failure to qualify occur in the same year, in which case the debt instrument is treated as equity from its issuance).

A debt instrument that is subject to these per se equity rules generally is treated as equity from the time of issuance. However, if an instrument properly characterized as debt is issued in one tax year, and a distribution or acquisition triggers the application of the Funding Rule in a subsequent tax year, then the debt is deemed to be exchanged for stock when the subsequent distribution or acquisition occurs. In addition, if the issuer and holder of a debt instrument that is treated as equity under the per se rules cease to be members of the same expanded group (because either the debt is transferred to someone other than a group member, or the issuer or holder leaves the group), (i) the debt ceases to be treated as equity, (ii) the issuer is deemed to issue a new debt instrument to the holder for its adjusted issue price immediately before the issuer and holder cease being members of the same group, and (iii) all other debt instruments of the issuer not currently treated as stock are retested to determine whether the Funding Rule should cause any of them to be recharacterized as equity at such time.

The Proposed Regulations impose the severe penalty of automatically treating expanded group debt as equity upon failing to timely prepare and maintain required documents or to provide such information to the IRS on request.

For purposes of these per se rules, if at least 80% of the capital or profits interests in a partnership are owned, directly or indirectly, by members of an expanded group (a controlled partnership), the partnership is treated as an aggregate of its members. For example, if a controlled partnership with respect to an expanded group issues debt to a group member, each group member that is a partner of the partnership is treated as issuing its proportionate share of such debt for purposes of applying the foregoing rules.

Since members of a consolidated group are treated as one corporation for purposes of the Proposed Regulations, the Proposed Regulations also address the consequences of a debt instrument that is an EGI ceasing to be, or becoming, a consolidated group debt instrument, and related considerations.

The per se equity rules generally apply to any debt instrument (i) issued on or after April 4, 2016 or (ii) treated as issued before such date as a result of an entity classification election made on or after such date, except that if the per se equity rules would treat a debt instrument as stock before the date final Regulations are published, the debt is treated as debt until 90 days after such publication, at which time it is deemed exchange for stock. A distribution or acquisition occurring before April 4, 2016 (unless treated as occurring as a result of an entity classification election made on or after such date) is not taken into account under the principal purpose rule.

3. Documentation and Information Requirements

To facilitate IRS determination of the proper tax characterization of an EGI as debt or equity, the Proposed Regulations impose new record-keeping requirements on certain taxpayers with respect to EGIs and their tax classification.[3] While well-advised taxpayers would normally maintain much of this information in the ordinary course even without the Proposed Regulations, the Proposed Regulations impose the severe penalty of automatic treatment of the EGI as equity for failure to timely prepare and maintain the required documents or failure to provide required information to the IRS upon request.[4]

These information rules are limited to larger taxpayers. That is, they generally apply to an EGI only if (i) the stock of any member of the expanded group is publicly traded, or (ii) all or a portion of the expanded group's assets or revenue is included on an "applicable financial statement" that shows either total assets exceeding $100 million or annual total revenue exceeding $50 million. An "applicable financial statement" is generally a financial statement prepared in the three years preceding issuance of the EGI for a substantial non-tax purpose, including one that is filed with the SEC, prepared for creditors, shareholders or partners, provided to a governmental agency, or that has been audited by an independent auditor.

The information requirements, which the Proposed Regulations describe in detail, include initial documentation prepared at the time of issuance, and ongoing documentation prepared over the life of the EGI. The initial documentation generally must evidence a binding obligation to repay the funds, the creditor's rights to enforce the terms of the instrument, and a "reasonable expectation" of the borrower's ability to repay the EGI on its terms. This must be prepared within 30 days of an obligation becoming an EGI (whether or not it was an EGI when issued). The ongoing documentation must evidence a continuing and genuine debtor/creditor relationship, including payments of interest and principal (e.g., wire transfers or bank statements) and, if applicable, enforcement actions upon default. This ongoing documentation must be prepared within 120 days of the action. All information must be maintained for all years in which the EGI is outstanding and until the expiration of the statute of limitations with respect to any year that the obligation is relevant.

The Proposed Regulations grant the IRS the authority to treat a debt instrument between members of a broadly defined "modified expanded group" as debt in part and equity in part.

These information rules could be a significant trap for the unwary. In particular, where an instrument becomes an EGI in the future, e.g., (1) as a result of a check-the-box election or an acquisition, or (2) where the lender does not take appropriate enforcement actions, the rules apply from and after that future event. In addition, the exact requirements to record the ongoing relationship between the parties in common arrangements such as cash pooling arrangements that are settled through net book entry are not clear. Although there is a reasonable cause exception, the penalty (recharacterization as equity from and after that point) is severe.

These information requirements apply to debt instruments issued or deemed issued on or after the date final Regulations are published (or issued or deemed issued before such date as a result of a check-the-box election made after publication).

4. IRS Authority to Treat Debt Instruments Partly As Debt and Partly As Equity

In addition to the rules discussed above concerning expanded group instruments, the Proposed Regulations grant the IRS the authority to treat a debt instrument between members of a "modified expanded group" as debt in part and equity in part, based on the IRS's analysis of the facts and circumstances at issuance under general U.S. federal tax principles and taking into account the new record creation and retention policies described in 3. above. A "modified expanded group" means an expanded group broadened to include (i) all corporations related by 50% ownership, (ii) a partnership 50% or more owned by group members, and (iii) a partnership or any other person owning at least 50% of the stock of any group member (in each case using broad attribution rules). Such part-debt/part-equity characterization is a novel approach that is authorized by the statute but previously has rarely been adopted by the courts.

This characterization rule applies to debt instruments issued or deemed issued on or after the date final Regulations are published (or issued or deemed issued before such date as a result of a check-the-box election made after publication).

5. Consistent Reporting Requirement

If the issuer of a related party debt instrument (whether an EGI or a debt between members of a "modified expanded group") treats the instrument as debt for tax purposes, the issuer, the holder, "and any other person relying on the characterization of an EGI as indebtedness" must treat the EGI consistent with the issuer's initial characterization. Thus, in contrast to current law, persons other than the issuer may no longer disclose on their tax returns an inconsistent position with respect to such instruments. This consistency rule does not apply if the per se rule treats a debt instrument (e.g. in the hands of the holder) as stock.

In contrast to current law, an issuer of a related party debt instrument and a holder of such instrument must treat the instrument consistently with the issuer's initial characterization.

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1 The Proposed Regulations are issued under section 385 of the U.S. Internal Revenue Code of 1986, which authorizes the IRS to prescribe regulations "necessary or appropriate" to determine whether an interest in a corporation should be treated for tax purposes as debt or equity (or partly as debt and partly as equity).

2 A *Kirkland Alert* describing the temporary regulations specifically addressing inversions is available here.

3 For the limited purpose of these documentation rules, any partnership in which expanded group members own 80% of the capital or profits (applying broad attribution rules) is considered a member of the expanded group, so that a debt instrument between the partnership and another group member is treated as an EGI.

4 The rules specifically require delivering to the IRS upon request all third party analyses on which the taxpayer relied, including any purportedly privileged documents. Any documents withheld on the basis of privilege do not count towards satisfying these regulatory information requirements, thus creating exposure to this penalty.

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