Client Update
Treasury's Sweeping Proposed Regulations Attack Related-Party Debt

NEW YORK
Gary M. Friedman
gmfriedman@debevoise.com

Peter A. Furci
pafurci@debevoise.com

Vadim Mahmoudov
vmahmoudov@debevoise.com

Burt Rosen
brosen@debevoise.com

Peter F.G. Schuur
pfgschuur@debevoise.com

On April 4, 2016, the Treasury Department and Internal Revenue Service issued proposed regulations under section 385 of the Internal Revenue Code (the "Proposed Regulations") that, if applicable, would treat certain debt instruments issued between related parties as stock for U.S. federal income tax purposes. Although issued in conjunction with temporary regulations targeting inversion transactions, the Proposed Regulations have a far broader scope. In addition to covering certain "earnings stripping" transactions that frequently accompany an inversion, the Proposed Regulations cover many other transactions, such as cross-border lending among members of multinational groups and "debt pushdowns" in connection with mergers and acquisitions.

These rules in the Proposed Regulations, taken together, represent a dramatic departure from the current facts and circumstances approach to determining whether a particular instrument is treated as debt or equity for tax purposes. Some of the new rules are proposed to be effective to debt instruments issued on or after April 4, 2016.

Importantly, instruments issued between members of a U.S. consolidated tax group are generally not covered by the Proposed Regulations. The Proposed Regulations appear primarily designed to limit the ability of a foreign parent to reduce the taxable income of its U.S. subsidiaries with interest deductions by capitalizing these subsidiaries with related-party debt. In addition, treatment of such debt instruments as equity may result in U.S. dividend withholding taxes (at a 30% rate, unless a lower rate is available under a treaty) applying to payments of interest and principal made on such instruments by U.S. borrowers to their non-U.S. related party creditors.

The Proposed Regulations generally (i) treat related-party debt instruments issued in certain transactions as equity interests, (ii) establish documentation and information maintenance requirements, certain of which must be satisfied

throughout the life of a related-party debt instrument in order for such instrument to be respected as debt, and (iii) authorize the IRS to bifurcate certain related-party instruments and treat them as debt in part and stock in part.

DEBT DISTRIBUTIONS AND THE LIKE

The Proposed Regulations recharacterize as stock certain debt instruments of a corporation that are held by a member of such corporation's "Expanded Group." Generally, an Expanded Group is a group of corporations, connected through stock ownership with a common parent corporation, in which 80% of the vote or value of the stock of each member is owned directly or indirectly by other members of the group (including through certain partnerships). A debt instrument issued by an Expanded Group member and held by another Expanded Group member is referred to as an "EGI."

Generally, an EGI will be treated as stock, *even though it would otherwise be treated as debt under general tax principles*, if it is issued (i) in a distribution (broadly defined as any distribution made by a corporation with respect to its stock), (ii) in exchange for stock of an Expanded Group member, or (iii) in exchange for property in certain asset reorganizations involving members of the Expanded Group. Thus, common techniques previously used by foreign parent companies to lever up their U.S. subsidiaries, such as dividend distributions of intercompany notes or internal "D" reorganizations in which assets are transferred to subsidiaries in exchange for intercompany notes, would no longer succeed in creating debt respected as such for U.S. federal income tax purposes.

In addition, an EGI issued for cash or other property will be treated as stock if it is issued with the principal purpose of funding (i) a distribution of property by the Expanded Group member issuing the EGI (the "funded member") to another Expanded Group member, (ii) an acquisition of stock of an Expanded Group member by the funded member in exchange for property other than stock of an Expanded Group member, or (iii) an acquisition of property by the funded member from another Expanded Group member in an asset reorganization (each a "distribution" or "acquisition"). The principal purpose test is broadly defined and is determined based on all relevant facts and circumstances. However, an EGI will be treated as having a principal purpose of funding a distribution or acquisition when such EGI is issued by the funded member during the period beginning 36 months before the date of the distribution or acquisition and ending 36 months after the date of the distribution or acquisition (the "per se rule"). The per se rule generally will not apply to debt issued in the ordinary course of the issuer's trade or business in connection with the purchase of property or the receipt of services.

In practice, the per se rule is likely to add significant complexity to the analysis of any EGI's tax treatment. For example, an EGI initially treated as debt may be recharacterized as equity due to subsequent events (such as a dividend by the borrower) that cause the per se rule to apply.

There are three exceptions to each of the rules above. First, the rules will not apply if the aggregate adjusted issue price of all EGIs held by members of an Expanded Group that would otherwise be recharacterized as equity does not exceed $50 million. Second, the rules will not apply to distributions and acquisitions that do not exceed the Expanded Group member's current year "earnings and profits." Third, the rules will not apply to certain debt-funded acquisitions of stock of a subsidiary if, for the 36-month period immediately following the transaction, the acquirer holds, directly or indirectly, more than (i) 50% of the total voting power of all classes of stock and (ii) 50% of the total value of the stock of the issuer of the stock.

These rules are proposed to be effective to debt instruments issued (or deemed issued) on or after April 4, 2016, but include a transition rule under which an EGI that would be treated as stock pursuant to the Proposed Regulations will continue to be treated as debt for 90 days following the issuance of final regulations. This gives taxpayers a limited "grace period" to unwind problematic transactions. Significantly, there is no "grandfathering" exception for EGIs issued on or after April 4, 2016 in connection with transactions that were already signed on or before April 4 but were not yet closed.

DOCUMENTATION REQUIREMENTS

The Proposed Regulations prescribe new documentation requirements with respect to certain EGIs, the satisfaction of which is necessary for taxpayers to treat such EGIs as indebtedness for U.S. federal tax purposes. These requirements are intended to apply only to large taxpayer groups and therefore only apply to an EGI if (i) the stock of any member of the Expanded Group is publicly traded or (ii) a financial statement of any member (or members) of the Expanded Group shows (a) total assets exceeding $100 million or (b) annual total revenue exceeding $50 million.

An issuer of an EGI subject to the documentation requirements must timely prepare and maintain written documentation with respect to the following four characteristics of the EGI:

- ***Unconditional Obligation to Pay a Sum Certain***: The written documentation must establish an EGI issuer's unconditional and legally binding obligation to pay a sum certain on demand or on one or more fixed dates.
- ***Creditor's Rights***: The written documentation must establish that the holder of an EGI has the "rights of a creditor" to enforce the terms of such EGI. The Proposed Regulations provide that the rights of a creditor must include a right, superior to the rights of shareholders, to share in the assets of the issuer in the event of the issuer's dissolution. The Proposed Regulations note that the rights of a creditor typically include the right to trigger an event of default or acceleration of the EGI for non-payment of interest or principal when due, but are not completely clear whether an interest that lacks an acceleration right is per se equity.
- ***Reasonable Expectation of Repayment***: The written documentation must establish that, considering all relevant circumstances as of the date of issuance of an EGI, the EGI issuer was reasonably expected to meet its obligations under such EGI. The documentation may include cash flow projections, financial statements, business forecasts and the like.
- ***Debtor-Creditor Relationship Actions***: Going forward, the written documentation must evidence payments of principal and interest, or, if such payments are not made in accordance with the terms of an EGI, evidence of the EGI holder's reasonable exercise of a creditor's diligence and rights.

In general, this documentation must be prepared no later than 30 days after the "relevant date", generally defined as the later of the date that an instrument becomes an EGI or the date that an Expanded Group member becomes an issuer with respect to an EGI. However, with respect to the debtor-creditor relationship actions, documentation must generally be prepared no later than 120 days from each date on which a principal and interest payment is due or each date on which a default or acceleration event occurs.

Pursuant to the Proposed Regulations, a debt instrument could be subject to continuous testing throughout its life (e.g., if the creditor fails to enforce its rights after borrower fails to pay), and a taxpayer's failure to provide the required documentation to the IRS upon request would result in the characterization of certain EGIs as stock for all U.S. federal tax purposes. If finalized in their current form, the Proposed Regulations would likely result in burdensome and costly debt analyses and recordkeeping procedures.

These rules are proposed to be effective for instruments issued, or deemed issued, on or after the date the Proposed Regulations are published in final form.

INSTRUMENTS TREATED AS DEBT IN PART AND EQUITY IN PART

While the IRS has generally been required to treat an interest as entirely debt or entirely equity, the Proposed Regulations give the IRS the authority to treat a single related-party debt instrument as partly debt and partly equity. The Proposed Regulations adopted this approach to combat scenarios in which "all-or-nothing" characterizations proved problematic, such as when the facts and circumstances provided only slightly more support for the classification of the entire interest as debt rather than equity. However, the Proposed Regulations do not permit issuers and related holders of the debt to treat an instrument in a manner that is inconsistent with the issuer's initial characterization. This eliminates the possibility of related holders and issuers taking contrary positions as to the tax treatment of an instrument.

The test for relatedness in this context is generally defined in a similar manner to an Expanded Group, but adopting a lower 50% ownership threshold.

These rules are proposed to be effective for instruments issued, or deemed issued, on or after the date the Proposed Regulations are published in final form.

OTHER POINTS OF INTEREST

- The Proposed Regulations create multiple opportunities for the tax treatment of an instrument as debt or equity to be retested under the Proposed Regulations framework after the instrument's initial issuance. For example, related parties may become unrelated, or vice versa. Alternatively, an EGI may be transferred out of the Expanded Group. Finally, as discussed above, the parties may fail to demonstrate a debtor-creditor relationship during the life of the instrument, or other events following the issuance may trigger the per se rule. The Proposed Regulations generally treat such a change in tax status as a deemed exchange of debt for equity (or vice versa), which may cause taxpayers to recognize taxable gain in certain cases.
- As currently drafted, the Proposed Regulations are unlikely to apply to transactions between a private equity fund and its portfolio companies (other than a fund with a controlling corporate investor or feeder entity, or certain structures with multiple tiers of blocker corporations), because an Expanded Group requires a common parent corporation. However, the preamble to the Proposed Regulations notes that the Treasury is requesting comments on "whether certain indebtedness commonly used by investment partnerships, including indebtedness issued by certain "blocker" entities, implicate similar policy concerns as those motivating the Proposed

Regulations, such that the scope of the Proposed Regulations should be broadened."

- Although the main target of the Proposed Regulations seems to be cross-border related-party debt, certain purely domestic structures will also be affected. For example, a surplus note of a non-consolidated life insurance company issued to its U.S. corporate parent, or a REIT capitalizing its wholly-owned taxable corporate subsidiary with debt, could be swept up by the Proposed Regulations.

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Please do not hesitate to contact us with any questions.