Chapman and Cutler LLP

Chapman Client Alert

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New Proposed Regulations Address Earnings Stripping and Debt-Equity Classification

On April 4th, the U.S. Treasury Secretary (the *"Secretary"*) announced that the government would release regulations to curb inversions and reduce the ability of companies to avoid taxes through "earnings stripping;" those regulations were published in the Federal Register on April 8th. Proposed regulations were issued under Internal Revenue Code Section 7874 (relating to inversions) and Code Section 385 (relating to earnings stripping and debt-equity classification). This client alert focuses on the proposed regulations under Section 385, which the government informally has expressed a desire to adopt and implement on an unusually accelerated basis, specifically indicating a desire to promulgate final regulations as early as fall of this year.

Background on Regulations under Section 385

Section 385 was originally enacted in 1969, giving the Secretary the power to prescribe regulations to determine whether an interest in a corporation should be treated as stock or debt for purposes of the Code. The Secretary was directed by the Code to set out factors to be taken into account in the debt-equity determination, including for example, whether there is a written, unconditional promise to pay an amount certain on demand or on a specified date.

Although regulations were proposed under Section 385 between 1980 and 1982, those regulations were withdrawn by 1983. Before and since this last attempt to issue regulatory guidance, the courts have developed various and, at times, inconsistent sets of factors to distinguish whether an instrument is properly classified as debt or as equity for tax purposes.

The New Proposed Section 385 Regulations

The new regulations do not set out a list of definitive factors for debt-equity determinations. Rather, they target specific situations involving related parties which the government believes are abusive, and impose documentation requirements with respect to debt issued between such parties to impose a "discipline" it believes to be lacking.

I. Transactions that Increase Related-Party Debt Without New Investment

Under existing law prior to the new proposed regulations, a U.S. company could undergo an inversion and then issue its own debt to its new foreign parent as a dividend distribution. Then, the foreign parent could transfer this debt to a low-tax (or no-tax) foreign affiliate. As a result, the U.S. subsidiary could benefit from deducting the interest expense on its U.S. income tax return at a higher effective tax rate than the rate at which the group paid tax on interest income received by the related foreign affiliate. These tax savings encouraged foreign-parented multinationals to load up their U.S. subsidiaries with related-party debt, without investing any new capital in the U.S. operations.

The new proposed regulations respond to these transactions by treating related-party debt as equity — *i.e.*, generally as corporate stock — in certain circumstances. First, under their general rule, a debt instrument is treated as stock if it is issued by a corporation to a member of the corporation's "expanded group" (*i.e.*, the issuing corporation and a broad, specified group of related parties) in certain specified transactions, including (i) a distribution; (ii) an exchange for expanded group stock (other than in an "exempt exchange"); or (iii) an exchange for property in an internal asset reorganization (but only to the extent that, pursuant to the plan of reorganization, a shareholder that is a member of the issuer's expanded group immediately before the reorganization receives the debt

instrument with respect to its stock in the transferor corporation). An asset reorganization refers to an "A," "C," "D," "F" or "G" reorganization under Code Section 368(a)(1).

Additionally, under a "funding rule" — which is intended to prevent circumvention of the general rule — a debt instrument would also be treated as equity if it is a so-called "principal purpose debt instrument." A principal purpose debt instrument is a debt instrument that is issued by a corporation to a member of the corporation's expanded group in exchange for property with a principal purpose of funding—

- A distribution of property to an expanded group member (other than distributions of stock in certain reorganizations and spinoffs);
- An acquisition of expanded group stock by an expanded group member in exchange for property (other than in an "exempt exchange"); or
- An acquisition of property by the issuing corporation in an internal asset reorganization.

Importantly, however, the "principal purpose" prerequisite to the application of this funding rule requires no obvious taxpayer intent — *i.e.*, no tax-avoidance purpose is actually required for its application. In particular, under a "per se" rule, the regulations would create a bright line, temporal test, treating debt issued between 36 months before the date of distribution or acquisition to 36 months after that date as a principal purpose debt instrument. Moreover, this rule would establish such treatment conclusively (and not, *e.g.*, create a rebuttable presumption).

Although there is an exception to the related-party debt rules for distributions or acquisitions to the extent of *current* year "E&P" (*i.e.*, "earnings and profits," a tax concept akin to book retained earnings), it conspicuously does not apply to *accumulated* E&P — so one might expect that allowance frequently to be exceeded by larger distributions in many settings, with a resulting automatic equity recharacterization. Also, while the rules don't apply to expanded group debt with an aggregate adjusted issue price of no more than $50 million, that allowance too will likely be of little avail to a great many groups. There is also generally an "ordinary course" exception for debt instruments that arise in the ordinary course of the issuer's trade or business in connection with the purchase of property or the receipt of services. There is also an exception to the rules for the funding of an acquisition of expanded group stock (the second category of "principal purpose debt instruments" above), if the acquisition results from a transfer of property by the debt-issuing corporation to an expanded group member in exchange for stock of the debt-issuing corporation, provided that the debt-issuing corporation holds more than 50% of the stock (by vote and value) of the member for the 36 months following the issuance. The exceptions do little to narrow the relatively broad sweep of the funding rule.

A related party constituting a member of an "expanded group" within these rules is defined for these purposes as a corporation 80% owned by another corporation (by vote *or* by value). A "controlled partnership" may also be a related party included in the expanded group, if one or more members of the group directly or indirectly owns 80% of the interests in partnership capital or profits.

Although the proposed regulations under Section 385 were implemented in connection with more targeted anti-inversion provisions, they are not limited to inverters; *e.g.*, they may apply to a company that has had a foreign parent (or affiliate) for years. But on a more positive note, for purposes of these regulations, all members of a consolidated group are treated as one corporation because many of the concerns regarding related party debt are not present for debt within a consolidated group. Therefore, the rules would generally not apply to debt instruments issued among members within a consolidated group. The proposed regulations provide special rules for consolidated groups when an interest ceases to be a consolidated group debt instrument or becomes a consolidated group debt instrument.

II. Debt and Equity Bifurcation

Although Section 385(a) was amended in 1989 to authorize the issuance of regulations permitting "bifurcated" treatment — treatment of an instrument as part debt and part equity, rather than entirely one or the other — no regulations have yet been issued on this point. And in the absence of any such authorized regulations, case law generally requires the Commissioner to treat an instrument as entirely debt or entirely equity. In the view of the Treasury and the IRS, this approach does not always reflect the economic substance of related party interests issued as debt, and may create inappropriate federal tax consequences when the facts support treating an instrument as part debt and part stock.

Therefore, the proposed regulations would allow the IRS to impose bifurcated treatment on instruments issued between related parties when it determines that such treatment is appropriate. In contrast to the related party recharacterization rules discussed above, the proposed bifurcation rule would apply more broadly to parties that are related through a lower 50% (by vote or value) ownership threshold — and indeed, Treasury and the IRS have requested comment on whether bifurcation should apply even more broadly. The regulations do not currently propose to extend bifurcation treatment to related-party interests that are denominated as something other than debt, in part because of the uncertainty it would create in the capital markets.

In the sole example illustrating the application of the bifurcation rule, the regulations indicate that, if there is a reasonable expectation that only a portion of the principal amount of a debt instrument will be repaid, then the Commissioner may determine that the instrument should be treated as debt in part and stock in part. Apart from this "thin capitalization" scenario, it is far from clear when bifurcation might otherwise be deemed by the IRS to be appropriate. Further, whatever the ultimate potential for recharacterization, the issuer and the holder of the instrument (and any other person relying on the characterization of the instrument as debt) are required to treat the instrument consistently with the issuer's initial characterization.

III. Documentation Requirement

The proposed regulations indicate that it can be difficult for the IRS to obtain information to evaluate debt-equity classification, especially information that demonstrates the intent to create a genuine debtor-creditor relationship — and they further articulate the concern that related-party transactions are more susceptible to manipulation. Further, the regulations express the government's belief that the size, activities and financial complexity of corporations and their group structures have grown exponentially, and now routinely include foreign entities. Therefore, the government believes, the lack of guidance on documentation procedures for debt instruments is increasingly problematic.

Consequently, the proposed regulations require companies to undertake significant due diligence and prepare potentially burdensome documentation up front, as a condition to treating a financial instrument between related parties as debt. Such documentation, required to be prepared and maintained relatively contemporaneously (at dates specified in the regulations), relates principally to the creation of a binding obligation for the issuer to repay the principal amount borrowed, the existence and observance of creditor's rights, the presence of a reasonable expectation of repayment and evidence of an ongoing debtor-creditor relationship. Critically, meeting these documentation requirements does not assure that a taxpayer's debt classification will be respected; rather, it establishes a threshold condition that a taxpayer must meet before the instrument can be evaluated under the currently applicable debt-equity classification standards imposed by case law.

If the documentation requirement is not met, the IRS will characterize the instruments as equity for tax purposes; and while the regulations allow for "reasonable cause" principles to allow for certain failures to satisfy documentation requirements with "appropriate modifications," it is far from clear when such circumstances might be present, or what such relief might be.

IV. Possible Exclusions for Loans Not in the Form of Loans

Under certain circumstances, the bifurcation and documentation rules may not apply to loans that are not in the form of loans, such as repurchase agreements and synthetic leases. It is not clear whether the related-party debt recharacterization rules would also exclude loans that are not in the form of loans. However, the related-party rules should not apply to the deemed loan that is embedded in a swap with a nonperiodic payment, unless the swap is issued with the principal purpose of avoiding the related-party debt rules.

V. Effective Dates

The related party debt recharacterization rules (and the consolidated group rules) apply to any debt instrument issued on or after April 4, 2016 — essentially giving the proposed regulations current effect, if ultimately adopted as proposed. Those rules also apply to a debt instrument that is treated as issued before April 4, 2016 as a result of a check-the-box election that is filed on or after April 4, 2016. Generally, a distribution or acquisition relating to a principal purpose debt instrument occurring before April 4, 2016 will not be taken into account, unless the distribution or acquisition was treated as occurring before April 4, 2016 due to an entity classification filed on or after April 4, 2016. However, if the related party rules or consolidated group rules otherwise would treat a debt

instrument as stock prior to the date the regulations are finalized, the debt instrument will still be treated as debt until 90 days after the date the regulations are finalized.

The bifurcation and documentation rules apply to any debt instrument issued on or after the date the regulations are finalized. They also apply to a debt instrument that is treated as issued before the finalization date as a result of a check-the-box election that is filed on or after the date of finalization.

For More Information

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