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International Tax Alert

New US Section 385 regulations would treat certain related-party corporate interests as stock, rather than debt, for federal tax purposes

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Executive summary

On 4 April 2016, the US Treasury Department and the Internal Revenue Service (IRS) released proposed regulations (REG-108060-15) under Section[1] 385 (the Proposed Regulations). The Proposed Regulations would:

- Treat as stock certain related-party interests that otherwise would be treated as indebtedness for federal tax purposes
- Authorize the Commissioner of the IRS (the Commissioner) to treat certain related-party interests in a corporation as indebtedness in part and stock in part for federal tax purposes
- Establish extensive documentation requirements in order for certain related-party interests in a corporation to be treated as indebtedness for federal tax purposes

As described below, the Proposed Regulations would have far-reaching consequences for corporations that issue debt instruments to related corporations and partnerships.

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Detailed discussion

Background

Section 385(a) authorizes the Treasury Department to issue regulations that may be necessary or appropriate to determine whether an interest in a corporation is treated as stock or indebtedness for federal tax purposes. As the preamble to the Proposed Regulations notes, when Congress enacted Section 385 in 1969, it authorized the Treasury Department and the IRS to establish factors to indicate "for a particular factual situation whether a debtor-creditor relationship exists or a corporate-shareholder relationship exists."

There are no regulations currently in effect under Section 385.

The Proposed Regulations

The Proposed Regulations provide rules for when certain related-party interests in a corporation may be treated, for federal tax purposes, in whole or in part, as stock rather than debt. The preamble states that the Proposed Regulations were motivated in part by policy concerns relating to transactions that result in excessive debt between related parties in the cross-border context. Nevertheless, the preamble goes on to state, because transactions that result in excessive debt between related parties in the domestic context can implicate similar policy concerns, the Proposed Regulations would generally apply to foreign and domestic related parties alike. The Proposed Regulations would not apply, however, to issuances of debt and related transactions between members of a consolidated group; the policy concerns addressed in the Proposed Regulations, the preamble explains, are not present in those cases, because the issuer's interest expense is offset by the holder's interest income.

With an important exception, discussed immediately below, the Proposed Regulations would generally apply only to debt instruments between members of an "expanded group." The term "expanded group" is defined by reference to the term affiliated group in Section 1504(a), with three key modifications. First, an expanded group includes foreign and tax-exempt corporations, as well as corporations held through controlled partnerships. Second, the attribution rules of Section 304(c)(3) would apply for purposes of determining relatedness. Third, the Proposed Regulations would treat a corporation as a member of an expanded group if 80% of the vote *or* value (not vote *and* value) is owned by expanded group members.

a. Treatment of a debt instrument as indebtedness in part and stock in part

In contrast to current law, under which an interest is generally treated as either wholly debt or wholly equity, Prop. Reg. Section 1.385-1 would authorize the Commissioner to treat a related-party interest in a corporation as indebtedness in part and as stock in part, consistent with its substance. For example, under Prop. Reg. Section 1.385-1, if it is determined that the issuer of a related-party interest that is denominated as a US$5 million debt instrument cannot reasonably be expected to repay more than US$3 million of the principal amount as of the issuance of the interest, the Commissioner may bifurcate the interest into a US$3 million debt instrument and a US$2 million stock instrument. In such a case, the type of stock (e.g., common or preferred) that the instrument would be treated as for federal tax purposes is determined on the basis of the terms of the instrument.

This proposed rule would apply to in-form debt instruments issued between parties that meet a 50% threshold for relatedness rather than the 80% threshold for expanded group membership otherwise applicable to other rules contained in the Proposed Regulations. The Proposed Regulations reserve rules dealing with interests that are not in the form of a debt instrument (e.g., repurchase transactions).

In general, Prop. Reg. Section 1.385-1 would apply to certain related-party interests issued on or after the date the Proposed Regulations are issued as final regulations.

b. Documentation requirements – Prop. Reg. Section 1.385-2

Prop. Reg. Section 1.385-2 would establish documentation requirements that must be satisfied for certain related-party interests in a corporation to be treated as indebtedness for federal tax purposes. The stated purpose of these documentation requirements is to provide the IRS with information necessary to analyze the nature of an instrument for federal tax purposes. As the preamble acknowledges, Prop. Reg. Section 1.385-2 would require "a degree of discipline in the nature of the necessary documentation, and in the conduct of financial diligence indicative of a true debtor-creditor relationship, that exceeds what is required under current law."

Prop. Reg. Section 1.385-2 would generally apply only to interests that are issued in the form of debt. Furthermore, Prop. Reg. Section 1.385-2 is intended to apply only to "large taxpayer groups." Thus, a related-party debt instrument is not subject to Prop. Reg. Section 1.385-2 unless: (i) the stock of any member of the expanded group is publicly traded; (ii) all or any portion of the expanded group's financial results are reported on financial statements with total assets exceeding US$100 million; or (iii) all or any portion of the expanded group's financial results are reported on financial statements that reflect annual total revenue that exceeds US$50 million.

The central provisions of Prop. Reg. Section 1.385-2 are the set of requirements concerning the type of documentation and other information that must be prepared and maintained with respect to a related-party debt instrument. Under Prop. Reg. Section 1.385-2, a taxpayer seeking to establish that a purported debt instrument is indebtedness for federal tax purposes would have to provide documentation establishing: (i) a binding obligation to repay the funds advanced; (ii) creditor's rights to enforce the terms of the debt; (iii) a reasonable expectation that the funds advanced can be repaid (e.g., cash flow projections or other relevant financial data); and (iv) after the instrument is issued, actions evidencing an ongoing genuine debtor-creditor relationship. With respect to the fourth category, the form of the documentation would depend on whether the issuer complies with the terms of the debt. If it does, the documentation would have to include timely prepared documentation of any payments supporting the treatment of the debt instrument as indebtedness for federal tax purposes. On the other hand, if the issuer fails to comply with the terms of the debt (e.g., fails to make one or more required payments), the documentation would have to include evidence of the holder's reasonable exercise of the diligence and judgment of a creditor, including the parties' efforts to renegotiate the terms of the debt. As a practical matter, this means that, if a debtor company is unable to make a scheduled payment, the parties must promptly document the creditor's agreement to extend the time for the payment and to provide for interest on the deferred payment consistent with an arm's-length debtor-creditor relationship.

In general, the required documentation must be prepared no later than 30 calendar days after the date that the debt instrument comes to be held by an expanded group member. In the case of documentation of the debtor-creditor relationship, however, the regulations allow the documentation to be prepared up to 120 calendar days after the payment or relevant event occurred.

Prop. Reg. Section 1.385-2 would generally apply to an interest at the time it becomes held by an expanded group member (an expanded group instrument or EGI), and would cease to apply to the instrument when it is no longer held by an expanded group member. Accordingly, if a debt instrument that was characterized as stock under the rules of Prop. Reg. Section 1.385-2 ceased to be subject to Prop. Reg. Section 1.385-2, the character of the instrument at the time of the cessation would be determined by applying general tax principles. If, under general tax principles, the interest were treated as indebtedness, the issuer would be treated as issuing a new debt instrument to the holder in exchange for the debt instrument (previously characterized as stock) immediately before the transaction that caused the instrument to cease to be subject to Prop. Reg. Section 1.385-2.

If an EGI issued by an entity that would otherwise be a disregarded entity were treated as equity under Prop. Reg. Section 1.385-2, the EGI would be characterized as an equity interest in the entity issuing the instrument. Similarly, if a controlled partnership issued an EGI that was treated as equity under Prop. Reg. Section 1.385-2, the EGI would be characterized as an equity interest in the controlled partnership.

Prop. Reg. Section 1.385-2 would not apply if there were a failure to satisfy the requirements of that Section with a principal purpose of reducing the federal tax liability of any member or members of the expanded group of the issuer and holder of the EGI or any other person relying on the characterization of an EGI as indebtedness for federal tax purposes.

Prop. Reg. Section 1.385-2 would generally apply to related-party interests in a corporation issued on or after the date the Proposed Regulations are issued as final regulations. For this purpose, an issuance includes a deemed issuance as a result of an entity classification election and presumably also includes a deemed reissuance under Reg. Section 1.1001-3.

c. Certain distributions of debt instruments and related transactions – Prop. Reg. Section 1.385-3 and -4

Prop. Reg. Section 1.385-3 provides rules that would treat as stock certain related-party debt instruments that otherwise would be treated as indebtedness for federal tax purposes, if the instruments are issued as part of certain related-party transactions. As discussed below, under these rules, the nature of whether a related-party debt instrument is treated as stock for federal tax purposes would turn on the relationship of the holder to the issuer and how the holder acquired the interest, not the terms of the instrument itself. These rules thus constitute a significant departure from the multifactor balancing test traditionally applied by the courts.

i. General rule

As the preamble notes, Treasury and the IRS identified three types of transactions that they believe raise significant policy concerns and therefore should be addressed under Section 385: (1) distributions of debt instruments by corporations to their related corporate shareholders; (2) issuances of debt instruments by corporations in exchange for stock of an affiliate (e.g., in connection with a Section 304 sale); and (3) certain issuances of debt instruments as consideration in an exchange pursuant to an internal asset reorganization. According to Treasury and the IRS, the foregoing transactions involve circumstances in which equity is replaced with debt with no significant non-tax effect, and therefore can create opportunities for abuse. For example, foreign-parent groups generally and inverted groups in particular can use these transactions to create interest deductions that offset US-source income without investing fresh capital in the US. Furthermore, the US-parented groups can use these transactions to avoid US tax on the repatriation of untaxed earnings and profits of controlled foreign corporations. To address these concerns, Prop. Reg. Section 1.385-3 contains a general rule that would treat related-party debt instruments issued in any of the foregoing transactions as stock, subject to certain exceptions.

ii. Funding rule

According to the preamble, the policy concerns implicated by the transactions described in the general rule also arise when a corporation issues a debt instrument to a related party with a principal purpose of funding a distribution or an acquisition described in the general rule. Accordingly, Prop. Reg. Section 1.385-3 includes a funding rule, which treats as stock certain related-party debt instruments that are issued with such a purpose.

The determination as to whether a debt instrument is issued with a principal purpose of funding a distribution or an acquisition is based on all the facts and circumstances. However, Prop. Reg. Section 1.385-3 would establish a non-rebuttable presumption that an expanded group debt instrument is issued with such a principal purpose if it is issued by the funded member during the period beginning 36 months before the funded member makes a distribution or acquisition and ending 36 months after the distribution or acquisition. In the preamble, Treasury and the IRS justify this per se rule on the grounds that money is fungible and that it is difficult for the IRS to divine the principal purpose of internal transactions.

Prop. Reg. Section 1.385-3 provides an exception to the per se rule for ordinary course debt instruments. This exception is intended to cover debt instruments that arise in connection with the purchase of property (e.g., inventory) or the receipt of services between members of the same expanded group or in the ordinary course of the purchaser's or recipient's trade or business. But, significantly, it is not intended to cover intercompany financing or treasury center activities.

iii. Anti-abuse rule

Prop. Reg. Section 1.385-3 sets forth an anti-abuse rule, under which a debt instrument is treated as stock if it is issued with a principal purpose of avoiding the application of the Proposed Regulations. Prop. Reg. Section 1.385-3 also includes a non-exhaustive list of examples showing the circumstances in which the anti-abuse rule might apply. Conversely, Prop. Reg. Section 1.385-3 and -4 (discussed below) contain a prohibition against the affirmative use of the rules of Prop. Reg. Section 1.385-3 and -4 "to the extent a person enters into a transaction that otherwise would be subject to these rules with a principal purpose of reducing the federal tax liability of any member of the expanded group that includes the issuer and the holder of the debt instrument by disregarding the treatment of the debt instrument that would occur without regard to this section."

d. Exceptions

There are three exceptions from the application of the foregoing rules:

1. *Exception for current-year earnings and profits*. Distributions or acquisitions described in the general rule or the funding rule that do not exceed current earnings and profits are not treated as distributions or acquisitions for purposes of the general rule or the funding rule.

2. *Threshold exception*. A related-party debt instrument will not be treated as stock if, when the debt is issued, the aggregate adjusted issue price of all other related-party debt instruments that would be treated as stock does not exceed US$50 million.

3. *Exception for funded acquisitions of subsidiary stock by issuance*. An acquisition of expanded group stock would not be treated as an acquisition described in the second prong of the funding rule if: (i) the acquisition results from a transfer of property by a funded member (the transferor) to an issuer in exchange for stock of the issuer, and (ii) for the 36-month period following the issuance, the transferor holds, directly or indirectly, more than 50% of the total combined voting power of all classes of stock of the issuer entitled to vote and more than 50% of the total value of the stock of the issuer.

Presumably, certain types of financing activity to effect an external acquisition (e.g., a loan of cash from a foreign parent corporation to a US subsidiary, used to acquire a US target corporation) would not be affected. However, many popular post-acquisition debt "push down" strategies involving a subsidiary's distribution of a note to its parent would likely be subject to Prop. Reg. Section 1.385-3(b).

e. Leaving or entering a consolidated group

Prop. Reg. Section 1.385-4 provides rules for applying Prop. Reg. Section 1.385-3 to a consolidated group when an interest ceases to be a consolidated group debt instrument or becomes a consolidated group debt instrument. For example, a proposed rule provides that, when a corporation ceases to be a member of the consolidated group but continues to be a member of the expanded group (a departing member), a debt instrument that is issued or held by the departing member may be treated as stock if the instrument was not treated as stock solely because all members of a consolidated group are treated as a single taxpayer.

f. Effective date

Significantly, although Prop. Reg. Section 1.385-3 becomes effective only when issued as a final regulation, it would generally apply to debt instruments issued on or after 4 April 2016. The rules of Reg. Section 1.385-3, however, would treat as stock a debt instrument issued prior to the date the final regulations only after the 90-day period following the adoption of the final regulations. Thus, during this period, taxpayers may avoid the application of the rules of Reg. Section 1.385-3 by repaying or otherwise eliminating related-party debt instruments that would otherwise be treated as stock. Similar effective date rules apply for purposes of Prop. Reg.Section 1.385-4.

Implications

These proposed regulations reflect some of the same concerns that motivated the Organisation for Economic Co-operation and Development project on base erosion and profit shifting (BEPS) and the Section 163(j) earnings stripping rules. And, like BEPS, if finalized in their current form, the proposed regulations would dramatically affect a wide range of mergers and acquisitions (M&A) transactions and ordinary course corporate finance and tax operations. The proposed regulations reach well beyond the inversion transactions that may have been their primary impetus; they extend to routine financing transactions for both non-US-based and US-based multinational corporations, for some majority-owned subsidiaries, for private equity funds and their portfolio companies, and for taxable real estate investment trust subsidiaries. In many of these situations, every financing of the subsidiary would need to be documented in accordance with the standards set forth in Prop. Reg. Section 1.385-2(b). Otherwise, such "debt" would not be treated as debt for federal income tax purposes.

In addition, the proposed regulations would dramatically affect many commonplace subchapter C nonrecognition transactions. For example, a note issued by an acquiring corporation that has historically been treated as "boot" under Section 356 may now be treated as stock of the acquiring corporation (even if the note is formalized and complies with the "writing" requirement of Prop. Reg. Section 1.385-2(b)). Relatedly, a note issued by a related acquiring corporation to the seller of a corporation, in a transaction otherwise described in Section 304, would not be considered "property," and thus Section 304 would not apply. Other provisions of the Code that look to a corporation's indebtedness would also be affected. Moreover, not all of the aforementioned alterations of traditional federal tax treatment would be limited to "internal" M&A transactions; common structures for acquiring a corporate group from an unrelated person, with debt financing placed in appropriate operating subsidiaries, especially for inbound US investors, would be affected too.

Many questions about the operation of the proposed regulations will arise. For example, would these regulations apply to an S corporation with a domestic or foreign subsidiary? What are the consequences of creating a springing partnership when a disregarded entity's debt is recharacterized as equity? Will regulated entities be treated as issuers of hybrid instruments (e.g., a loan to an insurance company in a life-nonlife consolidated group that its regulator sees as debt but which could be treated as equity for federal tax purposes under the proposed regulations)?

We understand that the Government expects to finalize these regulations quickly. Taxpayers that are potentially affected by them should take steps now to ensure that they are prepared to comply. As noted above, although the proposed regulations would not apply to debt instruments that are now outstanding, such instruments could easily become subject to the regulations through an entity classification election or a significant modification of the instrument. Taxpayers should take an inventory of all debt they hold or have issued where the holder and the issuer are related parties but not members of the same affiliated group. (This includes any amounts existing under a cash pooling or receivables financing program). Next, taxpayers should review the documentation related to the debt to determine whether it would pass muster under Prop. Reg. Section 1.385-2(b). Finally, taxpayers should begin considering how to establish that the issuers of those debt instruments have the capacity to pay the interest and principal due thereon.

Endnote

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.

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