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Proposed Regulations Addressing Treatment of Certain Interests in Corporations as Stock or Indebtedness

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On April 4, 2016, the United States Treasury and the IRS published broadly applicable proposed regulations under section 385 of the Internal Revenue Code (REG-108060-15, the "Proposed Regulations") that would (i) authorize the IRS to treat certain related-party interests as part stock and part debt for federal tax purposes; (ii) establish contemporaneous documentation requirements that must be satisfied for certain related-party debt to be respected for federal tax purposes; and (iii) treat certain related-party debt as stock for all purposes of the Code when issued in connection with certain distributions and acquisitions.

The Proposed Regulations have complex effective date provisions. Specifically, the contemporaneous documentation requirements are proposed to be effective prospectively when finalized. By contrast, the Proposed Regulations state that the rules treating as equity certain related-party instruments issued in connection with certain distributions apply to instruments issued on or after April 4, 2016. However, these instruments will not be subject to such automatic characterization until 90 days after the Proposed Regulations are finalized. Until such time, these instruments would be entitled to debt treatment if they would qualify as such under current law. Treasury has stated that it intends to "move swiftly" to finalize the Proposed Regulations.

While ostensibly intended to limit the earnings stripping benefits of corporate inversion transactions, the Proposed Regulations, if adopted in their present form, apply well beyond inversions, and are also intended to apply to a broad range of related-party transactions; consequently, they would significantly impact many ordinary business transactions and restructurings of domestic and foreign corporations. In general, the Proposed Regulations do not apply to instruments issued between members of an affiliated group that files a consolidated return. In general, and subject to the contemporaneous documentation requirement and the bifurcation of instruments as part-debt and part-equity provisions, cash-funded, related-party debt generally would not be subject to the Proposed Regulations, provided that the cash is not used for certain specified distributions or acquisitions (unless such cash-funded, related-party debt is a funding, as described below). On the other hand, related-party debt issued in a distribution (such as a section 301 distribution or a section 302 redemption); in exchange for related party stock (such as a section 304 transaction or debt issued for stock in

triangular reorganizations); or in certain asset reorganizations (such as debt issued to a target shareholder in a cash-D reorganization) would be treated as "stock" under the Proposed Regulations.

Cash-funded, related-party debt may nonetheless be subject to the Proposed Regulations under a "funding rule" and so treated as stock if such cash is used in one of the foregoing distributions or acquisitions to which the Proposed Regulations apply. Under this funding rule, discussed below, a refinancing of existing debt might be treated as stock, depending on the circumstances. Moreover, the refinancing of existing debt, i.e. debt in place prior to April 4, 2016, would initially be treated as "good" debt, even if the existing debt had funded such a distribution or acquisition, because the new debt would not itself have been issued to fund such a distribution or acquisition. However, any new related-party debt (including debt "deemed" reissued under Treas. Reg. §1.1001-3) would need to be tested under the funding rule, which adopts a non-rebuttable presumption that if the debtor made such a distribution or acquisition during the 36-month period prior to the issuance of the new related-party debt or the 36-month period subsequent to its issuance, that new debt runs afoul of the Proposed Regulations and would be characterized as stock. There is no need for the IRS to actually trace the proceeds of the debt to such a distribution or acquisition. Accordingly, prior to undertaking any refinancing or significant modifications of existing related-party debt, an analysis of the impact of such actions under the Proposed Regulations should be undertaken.

Background

Historically, the determination of whether an interest in a corporation is debt or equity for federal tax purposes has been based on all the relevant facts and circumstances. Courts have developed multi-factor tests to determine whether an instrument is debt or equity in its entirety. In 1969, Congress enacted section 385, authorizing Treasury to issue regulations to determine whether an instrument should be classified as debt or equity for federal tax purposes. No such regulations are currently in effect. Recently, related-party debt has come under increased scrutiny in the context of inversions and other cross-border situations.

In response to inversion transactions, Treasury and the IRS issued Notice 2014-52 and Notice 2015-79. These notices provide that Treasury and the IRS expect to issue guidance that limits the benefits of post-inversion transactions. The notices state, in particular, that Treasury and the IRS are considering guidance to address strategies that avoid U.S. tax on U.S. operations by shifting or "stripping" U.S.-source earnings to lower-tax jurisdictions, including through intercompany debt. For a discussion of the temporary regulations implementing the notices, also issued on April 4, 2016, see the U.S. International Tax Alert dated April 6, 2016.

Proposed Regulations

The Proposed Regulations would permit the IRS to bifurcate certain related party debt into part stock and part debt. They also would establish new contemporaneous documentation requirements that must be satisfied in order for the related party debt to be treated as debt for federal tax purposes. Finally, and most significantly, the Proposed Regulations would automatically reclassify certain related party debt as stock for all federal tax purposes. While the Proposed Regulations contain a broad exception for debt between members of a consolidated group, we are also considering the extent to which these new rules would apply from a state tax perspective.

Permit Commissioner to bifurcate related party debt

Under current law, an instrument is debt or equity in its entirety. The Proposed Regulations would provide that the Commissioner may treat a debt instrument between members of a "modified expanded group," a so-called "expanded group instrument" (EGI), as part debt and part stock to the extent that an analysis of the relevant facts and circumstances concerning the EGI results in a determination that it is properly treated for federal tax purposes as part debt and part stock. For this purpose, a modified expanded group means an affiliated group (as defined in section 1504(a)) determined without regard to the exclusions set forth in section 1504(b), and by modifying the ownership requirement to be ownership of 50% of the vote *or* value and taking into account direct and indirect ownership (including through attribution under section 304(c)(3)). The modified expanded group also includes certain partnerships that are wholly owned by members of the modified expanded group. Notwithstanding the ability of the Commissioner to bifurcate an EGI, the issuer and any other person relying on the characterization of the EGI as debt for federal tax purposes must treat the EGI consistently with the issuer's initial characterization (i.e. the ability to bifurcate cannot be used affirmatively by a taxpayer). No specific standard or criteria is provided to elucidate how the IRS will make the determination to bifurcate.

Contemporaneous documentation and information requirement for certain interests issued between members of an expanded group

The Proposed Regulations provide that with respect to an EGI between two members of an "expanded group," the EGI is treated as stock for federal tax purposes unless the taxpayer satisfies certain documentation and information requirements in respect of the EGI, subject to a reasonable cause exception. For this purpose, an expanded group has the same meaning as for the modified expanded group, except that only corporations that are owned 80% by vote *or* value are included in an expanded group. These requirements are intended to permit the IRS to determine whether an EGI is appropriately treated as stock or debt for federal tax purposes. Satisfying the documentation and maintenance requirement does not establish that an EGI is debt; it merely serves as a minimum standard that enables the determination of the proper characterization of the instrument under general federal tax principles. If the documentation requirements are satisfied, general federal tax principles apply to determine the proper characterization of the EGI as debt for federal tax purposes. Taxpayers, however, cannot apply the rules affirmatively, i.e. the rules do not apply if the failure to satisfy the documentation requirements has a principal purpose of reducing the federal tax liability of any member of the expanded group or any other person relying on the characterization of the EGI for federal tax purposes.

To satisfy the documentation and information requirements, the taxpayer must document and maintain information in respect of the EGI, including executed copies of all instruments, agreements and other documents evidencing the material rights and obligations of the parties relating to the EGI, and any associated rights and obligations of other parties such as guarantees and subordination agreements. The documentation and information must include written documentation establishing that (i) the issuer has an unconditional and legally binding obligation to pay a sum certain on demand or at one or more fixed dates; (ii) the holder has the rights of a creditor to enforce the obligation; and (iii) the issuer's financial position supports a reasonable expectation that the issuer intended to, and would be able to, meet its obligations under the terms of the EGI. This documentation generally must be prepared no later than 30 days after the

date on which a member of the expanded group becomes an issuer of a new or existing EGI. In respect of (iii), if a disregarded entity is the issuer of an EGI, and the owner of such entity has limited liability, only the assets and the financial position of the disregarded entity would be taken into account. In the event that subsequent actions evidence the debtor-creditor relationship of the issuer and holder of an EGI, such as the payment of interest or an event of default, the taxpayer must prepare, generally within 120 days, evidence of such actions, e.g. a wire transfer for a payment or evidence supporting the holder's reasonable exercise of the diligence and judgment of a creditor. Special documentation requirements apply with respect to revolving credit agreements and cash pool arrangements. It appears that these new rules would apply to every intercompany account between members of an expanded group. Taxpayers must maintain the required documentation for all taxable years that the EGI is outstanding and until the applicable statute of limitations expires for any return with respect to which the treatment of the EGI is relevant.

The documentation and information requirements apply to an EGI only if (i) the stock of an expanded group member is publicly traded on an established financial market; (ii) the expanded group's total assets exceed $100 million on certain applicable financial statements, as of the date the instrument first becomes an EGI; or (iii) the expanded group's annual total revenue exceeds $50 million on certain applicable financial statements, as of the date the instrument first becomes an EGI.

Treatment of instruments becoming or ceasing to be an EGI

The Proposed Regulations generally provide that when an EGI treated as stock due to the failure to meet the documentation requirements ceases to be an EGI, e.g. it is transferred to a person outside the expanded group, the instrument is characterized at that time under general federal tax principles. If, under such principles, the instrument is properly characterized as debt, the issuer is treated as issuing a new instrument to the holder in exchange for the EGI immediately before the transaction that causes the instrument to cease to be an EGI. Similar rules apply when an EGI originally characterized as debt is recharacterized as stock based on the actions of the issuer or holder after issuance. More generally, the Proposed Regulations provide that if an EGI is deemed to be exchanged, in whole or in part, for stock, the holder is treated as having a realization event in respect of the portion of the instrument subject to the deemed exchange into stock, and the issuer is treated as having retired such portion of the instrument for federal tax purposes. The amount realized in the deemed exchange to the holder generally is the holder's basis, and the amount paid by the issuer is the adjusted issue price of the debt.

Treatment of certain distributions and stock acquisitions with debt instruments

The Proposed Regulations provide that, subject to certain exceptions, an EGI otherwise treated as debt for federal tax purposes and held by a member of the issuer's expanded group will be treated as stock for all federal tax purposes in certain circumstances described below. Whether the stock is "preferred" stock (including nonqualified preferred stock or section 306 stock) or "common" stock will be based on the terms and conditions of the debt instrument (e.g. participation or conversion rights, term, voting, etc.).

General rule

Under the "general rule," an EGI is treated as stock to the extent that the debt instrument is issued by a corporation to a member of its expanded group:

(1) in a distribution, defined as any distribution made with respect to stock;

(2) in exchange for expanded group stock (other than an exempt exchange); and

(3) in exchange for property in an 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 example of (1) would be a simple distribution of a note as a dividend. An example of (2) would be a section 304 purchase of a controlled corporation for a note or the purchase of a parent corporation's stock for a note to be used in a "triangular" B reorganization. An example of (3) would be the issuance of a note by the acquiring corporation as consideration in whole or in part for the assets of the transferor corporation in a cash-D reorganization.

The Proposed Regulations provide two exceptions to the general rule (as well as the funding rule described below). First, the aggregate amount of a distribution or acquisition subject to the general rule is reduced to the extent of the relevant member's current year earnings and profits. This exception also applies in respect of the funding rule, described below. Second, an EGI is not treated as stock under the general rule if, immediately after the debt instrument is issued, the aggregate adjusted issue price of debt instruments held by expanded group members otherwise subject to the general rule or the funding rule does not exceed $50 million.

The Proposed Regulations provide several other rules, including timing rules for determining when an EGI is treated as stock, rules governing the consequences of instruments being subject to the rules and ceasing to be subject to the rules (e.g. rules for debt instruments treated as stock that leave the expanded group), and rules for the treatment of partnerships. In addition, taxpayers cannot apply the rules affirmatively.

Special rules for "principal purpose debt instruments"

The Proposed Regulations provide that a debt instrument not otherwise subject to the general rule is treated as stock to the extent that it is a "principal purpose debt instrument" (the "funding rule"). For this purpose, a principal purpose debt instrument is an EGI issued by a member of the expanded group (the "funded member") to another member of its group, in exchange for property, with a principal purpose of permitting the funded member to undertake a distribution or an acquisition otherwise described in items (1) – (3) of the general rule above. An example of this rule would be a loan of cash by one member of the expanded group to the funded member of the expanded group, which then distributes the cash to a shareholder that is also a member of the expanded group. However, if the expanded group member that holds the loan distributes the loan to its shareholder that is also a member of the expanded group, then that loan would not appear to be subject to the general rule or the funding rule.

The Proposed Regulations provide that an EGI shall be treated as issued with a principal purpose of funding a distribution or acquisition if it is issued during the 72-month period beginning 36 months before the date of the distribution or

acquisition, and ending 36 months after the date of the distribution or acquisition.[1] This per se rule does not apply, however, to the extent that the EGI either (i) meets one of the exceptions described under the general rule, or (ii) arises in the ordinary course of the issuer's trade or business in connection with the purchase of property or receipt of services, e.g. generally trade payables, provided that the outstanding amount does not exceed the amount that would be ordinary and necessary to carry on the trade or business if the issuer were unrelated to the lender. A third exception applies to an acquisition of expanded group stock if the acquiring member acquires stock of the issuer for property and holds, directly or indirectly, more than 50% of the total voting stock and value of the issuer for the 36-month period immediately following the issuance of the stock.

The Proposed Regulations provide several examples discussing the application of the funding rule.

Anti-abuse rules

The Proposed Regulations also provide that an EGI is treated as stock if it is issued with a principal purpose of avoiding the application of the rules, including the rules applicable to consolidated groups. For example, the anti-abuse rule may apply if a debt instrument is issued to, and later acquired from, a person that is not a member of the issuer's expanded group when such issuance and acquisition has a principal purpose of avoiding the application of the rules. In addition, certain instruments that are not debt for federal tax purposes, such as nonperiodic swap payments, also are treated as stock if issued with a principal purpose of avoiding the application of the rules.

The Proposed Regulations also include a rule that permits the IRS to treat an EGI as debt even if used for an otherwise prohibited distribution or acquisition, if a principal purpose for issuing the EGI was to reduce U.S. federal income tax.

Treatment of consolidated groups

The Proposed Regulations treat members of a consolidated group as one corporation for purposes of applying the operative rules. Generally, the Proposed Regulations do not apply to issuances of interests and related transactions among members of a consolidated group, because the concerns addressed therein generally are not present when the issuer's deduction for interest expense and the holder's corresponding interest income offset each other in the group's consolidated federal income tax return. Special rules apply, however, when a debt instrument becomes, or ceases to be, a consolidated group debt instrument, or a consolidated group member that is a party to a debt instrument becomes, or ceases to be, a consolidated group member.

Effective Date

In general, the Proposed Regulations have grandfathered from their application all related-party debt instruments issued prior to April 4, 2016, regardless of the purpose of those debt instruments or the use of their proceeds. However, exchanges, or deemed exchanges, of such grandfathered instruments under Treas. Reg. §1.1001-3 could cause the Proposed Regulations to apply.

[1] It should be noted that for the 36-month look-back period, the rule would not appear to look back to distributions or prohibited acquisitions completed prior to April 4, 2016, the effective date for the proposed rules (see below).

The Proposed Regulations contain several effective dates for their operative provisions. For the IRS's ability to bifurcate related-party debt and the contemporaneous documentation and information requirements, the Proposed Regulations generally are proposed to be effective for any EGI issued or deemed issued on or after the date the regulations are published as final (except to the extent the instrument was deemed issued as a result of an entity classification election that is filed on or after the date the regulations are issued in final form). The Proposed Regulations treating as stock certain EGI issued in certain distributions (including distributions of notes) or stock acquisitions (including section 304 exchanges or triangular B reorganizations involving debt) are proposed to be effective for any debt instrument issued on or after April 4, 2016 (and for any debt instrument issued before April 4, 2016 as a result of an entity classification election filed on or after April 4, 2016). However, where the Proposed Regulations otherwise would treat an EGI as stock in such transactions prior to the date the Proposed Regulations are issued in final form, the EGI would be treated as debt (and would not be recharacterized as stock) until the date that is 90 days after the date the Proposed Regulations are issued in final form.
