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New Guidance Rewrites Debt/Equity Rules and Further Limits Inversions

The IRS and Treasury Department released a package of temporary and proposed regulations on April 4, 2016 ostensibly aimed at further curbing corporate "inversion" transactions. The regulations cover a wide range of tax issues related to inversions but the newly proposed rules governing debt/equity characterization also apply to transactions completely unrelated to inversions. The expansive scope of the new debt/equity rules will have a significant impact on many taxpayers. We expect that the Treasury Department will seek to finalize the regulations before the change in administrations in January 2017.

This memorandum summarizes some of the key aspects of the regulations. We will follow up with a more detailed discussion of the regulations in a subsequent memorandum.

Debt/Equity Regulations

The IRS and Treasury Department resurrected Section 385 of the Internal Revenue Code (the "Code") in order to target certain uses of related-party debt. Section 385 authorizes the Treasury to issue regulations for the purpose of classifying financial instruments issued by a corporation as debt, equity or in part as debt and in part as equity. Long considered a dead-letter provision due to the lack of regulations and the existence of a substantial body of case law in the area, the issuance of new regulations under Section 385 is an aggressive and somewhat unexpected byproduct of the government's focus on protecting the U.S. corporate tax base. With the increased focus on base erosion and corporate expatriation reaching a fever pitch, several prominent commentators and academics have been urging the government to exercise its broad authority under the dormant, nearly fifty-year-old Code provision. The Treasury Department and the IRS responded in a resounding fashion, with the introduction of rules that some are calling the most significant in years.

Prior to the issuance of these regulations, taxpayers could rely on well-established case law and IRS guidance respecting related-party debt for tax purposes if it satisfied certain minimum standards. Under the proposed regulations, debt issued in a variety of circumstances could be recharacterized as equity, or as part debt and part equity, where the issuer and the holder are related (with relatedness generally determined for this purpose using an 80% affiliated ownership standard). This is a radical departure from current debt/equity tax law and could have very significant tax consequences for many taxpayers.

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Debt recharacterized as equity in whole or in part under the proposed regulations generally would be treated as equity for all federal income tax purposes. Accordingly, payments of "interest" would not be deductible by the payor and, in the case of payments to foreign related parties, would be treated as nondeductible distributions potentially subject to U.S. withholding taxes as dividends. Further, repayment of "principal" on the instrument would be treated as a redemption, or as a distribution with respect to stock, for federal income tax purposes.

Subject to certain exceptions, the regulations will recharacterize as equity an instrument that is debt in form, to the extent it is issued to a related party in a distribution or in certain other transactions that the Treasury Department has identified in the proposed regulations as having an effect similar to a distribution. This rule specifically targets certain debt issuances that do not result in the creation of any new capital.

The proposed regulations also permit the IRS, in the context of an audit, to take the unprecedented approach of bifurcating a financial instrument issued between related parties (using a modified 50% affiliated ownership standard for this purpose), treating the instrument as part debt and part equity. Although 1989 amendments to Section 385(a) authorized the Treasury Department to write rules under which an instrument could be treated in part as debt and in part as equity, no such regulations have been enacted and courts have not typically taken this approach. This bifurcation rule is intended to avoid supposed distortions arising from the current "all-or-nothing" approach generally used in classifying financial instruments.

The proposed regulations also impose new documentation and substantiation requirements that must be met in order for a debt instrument issued between related parties to be treated as indebtedness for federal income tax purposes. Among other things, the parties must document that (i) there is a binding obligation to repay the principal amount of the debt, (ii) the holder has creditors' rights permitting it to enforce the terms of the instrument, and (iii) there is a reasonable expectation of repayment of the debt. The parties must also prepare and maintain certain documentation evidencing a genuine, ongoing debtor-creditor relationship. A taxpayer is not entitled to rely on any report or analysis for this purpose if the taxpayer asserts its disclosure is privileged. Failure to produce and maintain the required documentation would result in the instrument being characterized entirely as equity. Furthermore, while such documentation is necessary in order to allow for treatment as debt, it is not sufficient to ensure that result. The documentation requirements described above generally apply only to debt instruments issued within expanded groups of corporations or other entities that have total assets exceeding $100 million, annual total revenue exceeding $50 million, or that have a member with publicly traded stock.

The proposed regulations generally would not apply where the issuer and the holder of the purported debt instrument are members of the same affiliated group filing consolidated U.S. federal income tax returns.

Should these proposed regulations be finalized without revision, the provisions described above generally would apply to instruments issued on or after the date the regulations are published as final regulations. However, the rule described above which would treat as equity a purported debt instrument issued to a related party in a distribution (or a transaction having an effect similar to a distribution) will apply to instruments issued on or after April 4, 2016. If the application of this rule mandates that an instrument be treated as equity, the instrument will nonetheless continue to be treated as debt until 90 days after the Treasury Department issues its final regulations. At the expiration of that period, the debt will be treated as if it had been exchanged for equity.

Inversion Regulations

The Treasury Department also released temporary regulations under Code Sections 7874 and 367 (the "Inversion Regulations"). These regulations are generally consistent with guidance previously issued by the IRS via notices in 2014 and 2015, and in certain significant respects expand on those prior efforts to combat corporate inversions. In general terms, corporate inversions are business combination transactions involving a foreign entity and a U.S.-parented multinational group that are structured to result in the creation of a new group with a foreign parent company. Ever

since the IRS has made it more difficult to realize the expected benefits of inversions in transactions that trigger the application of Section 7874 (the Code's primary anti-inversion provision), these transactions have typically been structured in a manner that avoids the provision completely by ensuring that former shareholders of the "inverting" U.S. company own less than 60% of the new foreign parent corporation. Many of these transactions have produced significant tax benefits by facilitating tax-efficient repatriations of cash from foreign subsidiaries and the implementation of various "earnings stripping" structures. According to a Treasury Department release, "the primary purpose" of an inversion transaction typically is "to reduce taxes, often substantially."

The Inversion Regulations include several new rules that are intended to further discourage inversions by strengthening Section 7874 and by reducing tax benefits associated with post-inversion restructuring. The Inversion Regulations generally apply to acquisitions completed on or after April 4, 2016.

The most significant new rule in the Inversion Regulations is aimed at foreign companies that avoid Section 7874 by acquiring multiple U.S. target companies over a period of time. In the preamble to the Inversion Regulations, Treasury and the IRS state that foreign companies may be engaging in these "serial inversions" to increase their value with each acquisition in which foreign company stock is used as consideration. Accordingly, foreign companies have been able to acquire progressively larger U.S. companies without triggering the application of Section 7874. In order to discourage these transactions, the Inversion Regulations disregard foreign company stock that is attributable to acquisitions of U.S. companies during a 36-month look-back period for purposes of applying the ownership thresholds of Section 7874 (which makes it more likely that an inversion transaction will be subject to Section 7874).

In addition to the rule targeting serial inversions described above, the Inversion Regulations also provide rules (i) targeting certain other "multiple-step" transactions engaged in by companies to avoid the application of Section 7874, (ii) requiring a controlled foreign corporation (CFC) to recognize gain on certain transfers of assets to a related foreign person that is not a CFC, and (iii) implementing the anti-inversion guidance contained in Notices 2014-52 and 2015-79.

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