IRS Issues Proposed Regulations That Would Recast Certain Debt Instruments as Equity

On April 4, 2016, the IRS and U.S. Treasury Department issued proposed Treasury Regulations designed to curb the ability of large multinational companies to reduce their U.S. taxable income by engaging in "earnings stripping" practices (the "Proposed Regulations").[1] If finalized, these rules, promulgated under section 385 of the Internal Revenue Code, would significantly impede several tax-planning options available to large multinationals.

Notwithstanding the ominous implications, the Proposed Regulations are subject to three major limitations. First, they apply only to related-party debt—specifically, so-called "expanded group instruments," or "EGIs."[2]. Second, they will impact only large corporations.[3] Third, as Proposed Regulations, the new rules do not yet have the force of law and generally will go into effect no earlier than the date on which ultimately finalized.[4]

One of the key features of the Proposed Regulations is the requirement that affected taxpayers contemporaneously document related-party debt. Under this rule, taxpayers would generally be required to document both the commercial terms of the lending and an analysis of the creditworthiness of the debtor within 30 days of the lending, as well as satisfy certain ongoing maintenance requirements. Another key feature includes rules that recharacterize debt instruments issued in certain related-party transactions as equity. The Proposed Regulations also provide that

---

[1] 81 Fed. Reg. 20912 (proposed Apr. 8, 2016). The Proposed Regulations were issued at the same time as Temporary Regulations, T.D. 9761, 81 Fed. Reg. 20857 (April 4, 2016), which in large part target so-called "inversion" transactions. These Temporary Regulations have already gained notoriety by single-handedly thwarting the $160 billion Pfizer-Allergan merger. The Proposed Regulations, on the other hand, cover an even wider scope, targeting earnings stripping practices both within and without the context of inversion transactions.

[2] Under Prop Reg. § 1.385-2(a)(4)(ii), an expanded group instrument, or EGI, is an applicable instrument the issuer of which is one member of an expanded group and the holder of which is another member of the same expanded group. For these purposes, an "expanded group" is a chain of related corporations within the meaning of section 1504(a), without regard to the various restrictions under section 1504(b)(1) through 1504(b)(8), such as, importantly, the rule in section 1504(b)(3) that would otherwise exclude a foreign corporation from the group.

[3] There are effectively two thresholds involved: one which applies to the documentation requirements of the Proposed Regulations and one which applies to the debt instruments themselves, both of which substantially restrict the ambit and effect of the Proposed Regulations. The documentation requirements apply to expanded groups (defined below) if either (1) the stock of a member of the expanded group is publicly traded or (2) financial statements of the expanded group or its members show total assets exceeding $100 million or annual total revenue exceeding $50 million. The other debt recharacterization rules apply to the extent that, when issued, the aggregate issue price of all expanded group debt instruments that would otherwise be treated as stock under the new rules exceeds $50 million. Prop. Reg. § 1.385-2(a)(2); Prop. Reg. § 1.385-3(c)(2).

[4] Prop. Reg. § 1.385-3(h)(1) provides a transitional rule which will render only debt instruments that are issued on or after April 4, 2016 subject to potential recharacterization as equity.

the IRS on exam (but not the taxpayers) may bifurcate a single financial instrument issued between related parties between a combination of debt and equity. This portion of the rules will therefore affect common financial transactions, including for instance, cash pooling and treasury management activities.

The Proposed Regulations cast an extremely wide net and, if finalized, would easily be among the most ambitious and aggressive tax provisions promulgated by the Treasury in recent memory. Given the high stakes, while many practitioners doubt the Proposed Regulations will survive the review and comment process, there can be no doubt that if the Proposed Regulations fail, they will not fail due to any lack of initiative or creativity on the part of Treasury.[5]

I. Earnings Stripping – Background

As mentioned, the goal of the Proposed Regulations is to prevent multinationals from saving U.S. tax by way of earnings stripping.

A. What is "earnings stripping?"

"Earnings stripping" is the process of reducing (or "stripping") the taxable income of a U.S. taxpayer through deductible payments. In a typical earnings stripping structure, a foreign entity in a low tax jurisdiction lends to an affiliated U.S. corporation, allowing for the U.S. debtor corporation to reduce its taxable income by paying deductible interest expense to its foreign creditor. Although the foreign creditor will presumably recognize taxable interest income in the foreign country, to the extent that the U.S. tax rate exceeds the foreign tax rate, the U.S. deduction will result in tax savings for the group as a whole.

Current rules under Section 163(j) of the Internal Revenue Code provide a limitation on this practice. When interest expense is paid from a U.S. person to a person who is not a U.S. taxpayer[6] and the debt-to-equity ratio of the U.S. debtor exceeds 1.5 to 1, the amount of the U.S. debtor's deductible interest expense will be limited to 50% of the debtor's adjusted taxable income.[7] However, because this limitation is based on income,[8] if the U.S. debtor is an operating entity generating substantial earnings, a significant amount of interest expense may remain deductible and therefore allow for significant earnings stripping, notwithstanding the section 163(j) limitation.

B. Section 385

[5] The Treasury Department website indicates that it intends to act quickly to finalize the Proposed Regulations. https://www.treasury.gov/press-center/press-releases/Pages/jl0404.aspx.

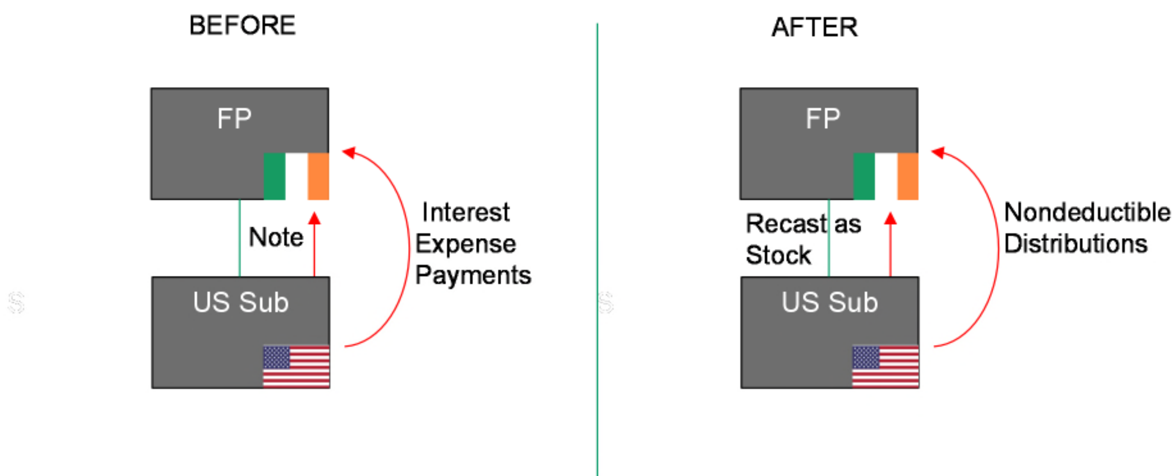
[6] This could be either a foreign person or a U.S. tax-exempt entity.

[7] Effectively, the concept of adjusted taxable income under section 163(j) approximates the accounting/financial concept of earnings before interest, tax, depreciation and amortization (EBITDA).

[8] This limitation is in contrast to the anti-earnings stripping provisions of many foreign jurisdictions, which focus entirely on a maximum permissible debt-to-equity ratio.

In addition to section 163(j), section 385 is a potential weapon at Treasury's disposal to combat earnings stripping. This is the mechanism adopted by the Proposed Regulations. Section 385 allows Treasury to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated as stock or indebtedness (or as stock in part and indebtedness in part). Under such a rule, the Proposed Regulations would thereby be able to disregard the label explicitly assigned to a debt instrument by a taxpayer and treat the instrument instead as equity in whole or in part. There are currently no regulations in effect on earnings stripping under section 385,[9] so debt versus equity determinations heretofore have been largely the product of case law and other informal IRS guidance.

The potential effect of characterizing debt as equity under the Proposed Regulations is illustrated below. For purposes of the example, assume that FP is an Irish corporation taxed at 12.5% on all corporate income and that U.S. Sub is its wholly-owned subsidiary corporation, which is subject to corporate tax of 35% on all income. In the example, U.S. Sub distributes a Note to FP as a dividend:



Prior to the Proposed Regulations, U.S. Sub would be able to deduct interest expense payments on the Note issued to FP, while FP takes into account interest income, which is taxed at the Irish corporate tax rate of 12.5%. The income that is effectively "shifted" by U.S. Sub to FP results in a savings of 22.5% (i.e., the 35% U.S. corporate rate minus the 12.5% Irish rate) to the FP-U.S. Sub group. Contrast this with the result after finalization of the Proposed Regulations, as depicted on the right side of the diagram. With the Note recast as equity, the payments from U.S. Sub to FP are recast as dividend distributions and are therefore not deductible to U.S. Sub.

[9] On March 24, 1980, Treasury and the IRS published a notice of proposed rulemaking in the Federal Register (45 FR 18959) under section 385 relating to the treatment of certain interests in corporations as stock or indebtedness. LR-1661, 45 Fed. Reg. 18959 (proposed March 24, 1980). Final regulations were published in the Federal Register on December 31, 1980, which were subsequently revised three times in 1981 and 1982. T.D. 7747, 45 Fed. Reg. 86438 (December 31, 1980). Finally, the Treasury Department and the IRS completely withdrew the section 385 regulations. T.D. 7920 Fed. Reg. 48 Fed. Reg. 50711 (July 6, 1983).

Accordingly, no earnings stripping or erosion of the U.S. tax base is possible, and all corresponding tax savings are denied to the expanded group.[10]

II. The Proposed Regulations (Prop. Reg. § 1.385-1 through Prop. Reg. § 1.385-4)

The Proposed Regulations are organized into four sections which provide (1) general provisions (including, for example, rules that under certain circumstances recharacterize only a portion of a debt instrument as equity),[11] (2) contemporaneous documentation requirements,[12] (3) special consolidated group rules,[13] and, most importantly, rules which implement the recharacterization of debt as equity in the situations described in the following paragraph.[14] The Proposed Regulations are effective for debt instruments issued on or after the date the Proposed Regulations are finalized, although the recharacterization rules described below are proposed to apply to debt instruments issued on or after April 4, 2016 (with such instruments continuing to be treated as indebtedness during an additional 90-day grace period after finalization).[15]

---

[10] In this sense, an anti-earnings stripping provision under Section 385 would seem to impose a more failproof combatant of earnings stripping than, for example, simply increasing or otherwise strengthening the limitation under section 163(j). The section 385 approach will also bring about withholding tax consequences, under which (1) dividends may be taxed at a different rate than interest expense under an applicable treaty and (2) a greater portion of payments may be subject to US tax by virtue of the inability to characterize a portion of payments as repayments of principal.

[11] These provisions, included in Prop. Reg. § 1.385-1, include both definitions and specific mechanics involved in recharacterizing debt as equity for tax purposes.

[12] Prop. Reg. § 1.385-2

[13] Prop. Reg. § 1.385-1(e); Prop. Reg. § 1.385-4.

[14] Prop. Reg. § 1.385-3.

[15] Prop. Reg. § 1.385-3(h)(3) provides that when recharacterization would otherwise take effect prior to the date the Proposed Regulations are finalized, the debt instrument will be treated as indebtedness until the date that is 90 days after the date the Proposed Regulations are finalized. The transitional rule, which imposes the April 4 bright-line issuance date, is included in Prop. Reg. § 1.385-3(h)(1) and Prop. Reg. § 1.385-3(h)(2).

Because the United States has one of the highest corporate tax rates in the world,[16] there is an almost ever-present incentive in a multinational structure to saddle U.S. member entities with as much debt as possible, regardless of what other jurisdictions are involved. Given capital constraints, it is therefore common for a U.S. company (as depicted in the illustration above) to simply distribute a note to a foreign related party in order to jumpstart the earnings stripping process, even when the only purpose of such indebtedness is to create tax savings. The Proposed Regulations evidence Treasury's belief that this practice is abusive,[17] and would use the authority granted by section 385 to recast purported indebtedness as equity in the following specific cases when:

- Debt is "pushed down" into U.S. subsidiaries by causing U.S. subsidiaries to directly distribute a note to new foreign parent as a distribution with respect to their stock (e.g., a dividend);
- Debt is pushed down into U.S. subsidiaries through a two-step process whereby a U.S. subsidiary borrows cash from a related company and then makes a distribution with respect to its stock (e.g., a dividend) to its foreign parent; and
- A U.S. purchaser acquires stock of a related foreign company using debt, creating the same effect as if it had distributed a note as a dividend distribution.

To summarize, where large taxpayers have issued related-party debt, the Proposed Regulations provide three hurdles the debt must "clear" in order to survive recharacterization as equity: (1) the new documentation requirements, (2) the new transactional requirements recasting debt as equity, and (3) traditional debt versus equity principles. As can be seen, the old test involved one hurdle, while the new test has three. Accordingly, a failure to satisfy any one of the three separate tests will result in the issued debt being recast as equity.[18] As elaborated below, a host of consequences, some anticipated and many perhaps not, are sure to follow.

A. New Documentation Requirements (Prop. Reg. § 1.385-2)

1. Summary of Preparation and Maintenance Requirements

---

[16] As of 2015, the United States has, along with Puerto Rico, the third highest corporate tax rate in the world, exceeded only by the United Arab Emirates and Chad, neither of which are in the OECD's group of 34 industrialized nations. At an effective rate (factoring in state and local tax) of approximately 39%, the U.S. rate is also 16 percentage points higher than the worldwide average of 22.8%. OECD Tax Database, Table II.1 – Corporate income tax rates: basic/non-targeted, May 2015, http://www.oecd.org/tax/tax-policy/tax-database.htm.

[17] The Proposed Regulations recognize that introducing debt into a structure for business purposes is not indicative of this abuse, and there is therefore an exception for infusion of debt in the ordinary course of business.

[18] To the extent debt is recharacterized as equity, there is a deemed exchange whereby the holder is treated as having realized an amount equal to the holder's adjusted basis in that portion of the debt as of the date of the deemed exchange (and as having basis in the stock deemed to be received equal to that amount), and the issuer is treated as having retired that portion of the debt for an amount equal to its adjusted issue price as of the date of the deemed exchange. Prop. Reg. § 1.385-1(c). The mechanics of this deemed exchange are similar to those described under section 108(e)(6) in the context of a related-party debt instrument evidencing debt owed by a subsidiary to its parent and which is retired by way of a contribution to capital. When applicable, no income would be recognized (including cancellation of indebtedness) on the deemed exchange, except any foreign currency gain under section 988.

The most immediate impact of the Proposed Regulations may be the result of the new documentation and diligence requirements. Unlike similar requirements under other provisions of tax law, under which documentation requirements are purely procedural in nature, the documentation procedures under the Proposed Regulations serve as a substantive element that must be met in order for an EGI to be respected as debt. That is, a mere failure to meet the documentation requirements alone will be grounds for recasting the EGI as equity even if the instrument would otherwise qualify as debt, subject only to a reasonable cause exception.[19] To this end, there are two main categories of documentation requirements: (1) a preparation requirement and (2) a maintenance requirement.

As stated above, the saving grace for many taxpayers will be that only large taxpayers are targeted by these new rules. Specifically, the documentation requirements are only applicable to taxpayers (1) any member of the expanded group of which is publicly traded, or (2) whose assets are reported on financial statements with either total assets exceeding $100 million or total revenue exceeding $50 million.[20]

2. Preparation Requirement

Under the preparation sub-requirement of the documentation requirements, documentation must be prepared to reflect four major categories indicative of legitimate indebtedness: (1) a binding obligation to repay the borrowed funds, (2) creditor's rights to enforce the terms of the purported lending, (3) reasonable expectation that the debt will be repaid, and (4) actions evidencing a genuine debtor-creditor relationship ("the four categories").[21] Documentation referencing the first three of these four categories (i.e., the "binding obligation," "creditor's rights," and "reasonable expectation" elements) must be prepared no later than 30 calendar days after the applicable relevant date, while documentation referencing a genuine debtor-creditor relationship may be prepared within 120 days of the applicable relevant date.[22] For these purposes, which "relevant date" will apply depends on which of the above four categories the documentation falls into.[23] Similarly, if debt is recharacterized as equity by virtue of failing any of these requirements,

[19] If the specified documentation is not provided to the Commissioner upon request, the Proposed Regulations provide that the Commissioner may treat the applicable requirements as not satisfied and thus may treat the instrument as stock for federal tax purposes. Prop. Reg. § 1.385-2(b). Note that this provision is more or less unprecedented under current law and has already been criticized as likely to cause overly harsh and inappropriate results. A more measured rule would perhaps consider failure to keep such documentation as a relevant factor in an appropriate facts and circumstances analysis.

The reasonable cause exception provides only that if reasonable cause exists with respect to a failure to meet applicable documentation requirements, modifications may be made to the applicable documentation requirements in determining whether such requirements have been met. No further explanation is provided. Prop. Reg. § 1.385-2(c).

[20] Prop. Reg. § 1.385-2(a)(2)(i).

[21] Prop. Reg. § 1.385-2(b)(2).

[22] Prop. Reg. § 1.385-2(b)(3).

[23] For example, for documentation pertaining to the issuer's unconditional obligation to repay and establishment of the holder's creditor's rights, the relevant date is the date on which a member of the expanded group becomes an issuer of a new or existing EGI. For documentation relating to reasonable expectation of issuer's repayment (except

the effective date of such recharacterization depends on which category gave rise to the failure—for example, an instrument that was an EGI as of issuance and that is recharacterized as stock under the "binding obligation," "creditor's rights," and "reasonable expectation" elements will be recharacterized as of the date of issuance, whereas such an EGI that is recharacterized by virtue of actions failing to evidence a debtor-creditor relationship will be recharacterized as of the time the facts and circumstances regarding the behavior of the issuer or holder cease to evidence a debtor-creditor relationship.[24] While the four categories apply separately to each EGI, it is possible for the same documentation to satisfy one or more of the categories with respect to more than one EGI.[25]

Under each of the four categories, the documentation prepared must include "executed copies of all instruments, agreements and other documents evidencing the material rights and obligations of the issuer and the holder relating to the EGI, and any associated rights and obligations of other parties, such as guarantees and subordination agreements." [26]

Specifics as to the requirements of documentation pertaining to the four categories are as follows:

a. Legally Binding Obligation to Repay Borrowed Funds

The Proposed Regulations explicitly provide that there must be written documentation establishing that the issuer has entered into an unconditional and legally binding obligation.[27]

b. Creditor's Rights to Enforce Terms of Purported Lending

Written documentation must also establish that the creditor has rights to enforce the obligation, including, for example, (1) the right to cause or trigger an event of default or

---

in the case of certain special financial arrangements, such as cash pooling arrangements), the relevant dates are the dates on which a member of the expanded group becomes an issuer with respect to the EGI and any later date on which an issuance is deemed to occur under Reg. § 1.1001-3. In the case of an instrument that becomes an EGI subsequent to issuance, the relevant day is the day on which the applicable instrument becomes an EGI and any other relevant date after such date. With respect to documentation relating to payments of principal and interest, each date on which principal or interest payments are due, taking into account additional time permitted under the EGI's terms prior to default, is a relevant date. With respect to documentation and information pertaining to events of default and similar events, relevant dates include each date on which an event of default, acceleration event or similar event occurs under the terms of the EGI (e.g., relevant dates for an EGI that required maintenance of certain financial ratios would include any date on which the issuer fails to maintain the specified financial ratio). In the case of special financial arrangements, including cash pooling arrangements, the relevant dates include the date of execution of legal documents governing the EGI and the date of any amendment to such documents providing for an increase in the permitted maximum principal amount. Prop. Reg. § 1.385-2(b)(3)(ii).

[24] Prop. Reg. § 1.385-2(b)(3)(ii).

[25] Prop. Reg. § 1.385-2(b)(1).

[26] Prop. Reg. § 1.385-2(b)(2). Additional documentation may be provided as well, but cannot serve as a substitute for documentation otherwise required.

[27] Prop. Reg. § 1.385-2(b)(2)(i).

acceleration of the EGI (when not automatic) for non-payment of interest or principal when due under the terms of the EGI, (2) the right to sue to enforce payment, and (3) a right to share in the assets of the issuer upon dissolution that is superior to the rights of shareholders.[28]

c. Reasonable Expectation of Repayment

Timely prepared documentation must evidence that the issuer's financial position supports a reasonable expectation of repayment, considering all relevant circumstances (including, for example, all other obligations incurred or reasonably expected to be incurred by the issuer).[29] Such documentation includes, but is not limited to, cash flow projections, financial statements, business forecasts, asset appraisals, determination of debt-to-equity ratios and other relevant financial ratios of the purported issuer.[30] Where the issuer of the obligation is a disregarded entity for tax purposes, and where the entity's owner has limited liability, only the assets of the disregarded entity will be taken into account for these purposes, whereas disregarded entities with full liability owners may also take into account the assets and financial position of the owners.[31] Moreover, to the extent any member of the expanded group relied on any third party report or analysis in analyzing whether the issuer would be able to meet its obligations under the EGI's terms, such documentation must include such report or analysis, unless the report or analysis is subject to a privilege or other asserted protection.[32]

d. Actions Evidencing a Genuine Debtor-Creditor Relationship

Documentation of actions evidencing a genuine debtor-creditor relationship are also required and are subject to specific rules pertaining to (1) payments of principal and interest and (2) events of default or similar events.

i. Payments of Principal and Interest

If payments of interest or principal on an EGI (whether or not made according to the terms of the EGI) are claimed to support the "debt status" of the EGI, documentation must include written

[28] Prop. Reg. § 1.385-2(b)(2)(ii).

[29] Prop. Reg. § 1.385-2(b)(2)(iii).

[30] *Id.*

[31] While the existence of disregarded entities is usually ignored for federal income tax purposes, where the issuer of an EGI is a disregarded entity, and where the owner of the disregarded entity has limited liability within the meaning of Reg. § 301.7701-3(b)(2)(ii), special rules apply. Under these special rules, for the limited purpose of establishing whether the issuer's financial situation supports a reasonable expectation of servicing the debt under the documentation requirements of the Proposed Regulations, only the assets and financial position of the disregarded entity will be considered. Conversely, if the owner does not have limited liability under Reg. § 301.7701-3(b)(2)(ii), the assets and the financial position of both the disregarded entity and its owner will be taken into account. Prop. Reg. § 1.385-2(b)(2)(iii). Presumably, this would mean that with respect to a disregarded entity that is an LLC or LLC equivalent, only the assets of the disregarded LLC could be considered for this purpose.

[32] Prop. Reg. § 1.385-2(b)(2)(iii).

evidence of such payment, which could include, for example, a wire transfer record or a bank statement reflecting the payment.[33]

ii. Events of Default and Similar Events

If the issuer has not made payments of interest or principal that have become due and payable, or if any default or similar event has occurred with respect to the EGI, there must be written documentation evidencing the holder's reasonable exercise of diligence and judgment of a creditor.[34] Such documentation may include evidence of efforts to assert rights under the EGI's terms, including efforts by the parties to renegotiate such terms or mitigate breach of one of the obligations thereunder, including any applicable documentation detailing decisions by the holder to refrain from pursuing any actions to enforce payment.[35]

3. Maintenance Requirement

Under the maintenance sub-requirement of the documentation requirements, the documentation and information in the four categories mentioned above must be maintained for all taxable years that the EGI is outstanding and until the period of limitations expires for any return with respect to which the federal tax treatment of the EGI is relevant.[36] Taxpayers are afforded flexibility to determine where or in what manner to keep these records.[37]

a. Impact on Revolving Credit Agreements and Cash Pooling Arrangements

Special rules provide additional documentation necessary with respect to revolving credit agreements, cash pooling arrangements, and similar agreements.

i. Revolving Credit Agreements and Similar Agreements

In arrangements under which, for example, an increase in the initial principal balance of an EGI does not trigger issuance of a new note (such as in the case of a revolving credit agreement or an omnibus agreement governing open account obligations), documentation referencing the first preparation requirement (i.e., the requirement to evidence an unconditional sum certain) must include all relevant enabling documents, including, for example, board of directors' resolutions, credit agreements, omnibus agreements, security agreements, or agreements prepared in connection with the execution of the legal documents governing the EGI as well as any relevant

---

33 Prop. Reg. § 1.385-2(b)(2)(iv)(A).

34 Prop. Reg. § 1.385-2(b)(2)(iv)(B).

35 *Id.*

36 Prop. Reg. § 1.385-2(b)(4).

37 The Preamble to the Proposed Regulations provides that "The Treasury Department and the IRS intend that taxpayers have flexibility to determine the manner in which the requirements of (Prop. Reg. § 1.385-2) are satisfied.

documentation executed with respect to an initial principal balance or increase in the principal balance of the EGI.[38]

ii. Cash Pooling Arrangements

For EGIs issued under cash pooling arrangements, such as internal banking service issuances, account sweeps, revolving cash advance facilities, overdraft set-off facilities, operational facilities, or similar features, documentation referencing the first of the four categories (i.e., the requirement to evidence an unconditional sum certain) must include material documentation governing the ongoing operations of the arrangement, including any agreements with entities that are not members of the expanded group. The documentation must contain the relevant legal rights and responsibilities of any entities (both members and nonmembers of the expanded group) in conducting operations of the arrangement.[39]

In the case of cash pooling arrangements, the prospect of having to provide and maintain documentation for each separate loan made pursuant to the arrangement may be daunting at best and inadministrable at worst. Moreover, in the case of an expanded group member acting as a treasury center, similar concerns apply. Not surprisingly, the Preamble to the Proposed Regulations requests that comments be provided to help create either new provisions or amendments to the Proposed Regulations that would make the documentation requirements more administrable to taxpayers with these alternative profiles.[40]

B. New Transactional Requirements Causing Recharacterization of Debt as Equity

Under the new transactional provisions of Proposed Regulations § 1.385-3, debt that is properly documented under the rules above may nonetheless be recast as equity under either (1) a "General Rule" or, failing that, (2) a "Funding Rule." Debt which passes both tests (that is, debt that is still respected as debt after considering application of both the General and Funding Rules) must of course still pass muster under traditional debt/equity principles of tax law.

1. The General Rule (Prop. Reg. § 1.385-3(b)(2))

The General Rule provides that an EGI is recharacterized as stock to the extent issued by a corporation to another member of its expanded group in three cases:

- The EGI is transferred in a distribution;
- The EGI is exchanged for expanded group stock (other than an exempt exchange[41]); or

[38] Prop. Reg. § 1.385-2(b)(3)(iii)(A).

[39] Prop. Reg. § 1.385-2(b)(3)(iii)(B).

[40] Preamble.

[41] An "exempt exchange" is defined in Prop. Reg. § 1.385-3(f)(5) as an acquisition of expanded group stock in which the transferor and transferee of the stock are parties to an asset reorganization and either: (1) section 361(a) or (b) applies to the transferor of the expanded group stock and the stock is not transferred by issuance; or

- The EGI is exchanged for property in an asset reorganization (but only to the extent a shareholder that is a member of the group receives the EGI in a transaction with respect to its stock in the transferor corporation).

In defining the term "expanded group," the Proposed Regulations adopt the section 1504(a) definition of an affiliated group, thereby espousing what the Preamble refers to as an "highly-related party" standard.[42]

2. The Funding Rule (Prop. Reg. § 1.385-3(b)(3))

Under the Funding Rule, an EGI that is a "principal purpose debt instrument" will be recast as equity. The Proposed Regulations provide two situations under which a debt instrument will be treated as a principal purpose instrument: (1) the facts and circumstances test and (2) in certain specific transactions specified in the Proposed Regulations. With respect to the former test, as the Proposed Regulations provide no specific guidance, the traditional principles of debt versus equity would seem to apply.[43] With respect to the latter, the Proposed Regulations provide three types of presumptively abusive transactions, the mere existence of which will cause an EGI to be considered a principal purpose instrument. Specifically, an EGI is a principal purpose instrument under this rule to the extent issued by an expanded group member entity in exchange for property in order to fund:

- A distribution of property by one member (the funded member) to another member of the expanded group (other than in an asset reorganization distribution described in section 354, 355, or 356 (not counting "other property," or "boot," within the meaning of section 356));
- An acquisition of expanded group stock; and
- An acquisition of property by a funded member in an asset reorganization but only to the extent of other property (boot) received.[44]

For these purposes, the definition of property in section 317(a) is adopted, which provides that property does not include stock in the corporation treated as making the distribution in the transaction.[45] Moreover, a special nonrebuttable presumption applies, known as the "per se rule." Under the per se rule, a principal purpose to fund a transaction described above will be deemed to

---

(2) section 1032 or § 1.1032-2 applies to the transferor of the expanded group stock and the stock is distributed by the transferee pursuant to the plan of reorganization.

[42] Prop. Reg. § 1.385-1(b)(3). Note that, as mentioned above, this restrictive standard of relatedness applies throughout the Proposed Regulations, except with respect to instruments that are recast as equity in part and debt in part under Prop. Reg. § 1.385-1(d), under which a more expansive "modified" relatedness standard applies, adopting a 50%, rather than an 80%, threshold.

[43] The Preamble to the Proposed Regulations provides a summary of this history. These considerations include, for example, the 16 factor debt vs. equity test discussed in *Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968) and the 13 factor analysis considered in *Estate of Mixon v. United States,* 464 F.2d 394 (5th Cir. 1972).

[44] Prop. Reg. § 1.385-3(b)(3)(ii).

[45] Prop. Reg. § 1.385-3(f)(10).

exist to the extent debt 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.[46] Under the Proposed Regulations, the only exception to this nonrebuttable presumption is the so-called "ordinary course exception," which provides that the per se rule does not apply to a debt instrument:

> that arises in the ordinary course of the issuer's trade or business in connection with the purchase of property or the receipt of services to the extent it reflects an obligation to pay an amount that is currently deductible by the issuer under section 162 or currently included in the issuer's cost of goods sold or inventory, provided the amount of the obligation outstanding at no time exceeds the amount that would be ordinary and necessary to carry on the trade or business of the issuer if it was unrelated to the lender.[47]

3. Exceptions

There are three exceptions from the application of the foregoing rules:[48] The first is for distributions that do not exceed current earnings and profits. The second is for debt where the aggregate adjusted issue price of debt instruments held by members of the expanded group does not exceed $50 million. The third is for funded acquisitions of subsidiary stock in exchange for stock of the issuer.

Additionally, where an EGI that is recharacterized as stock is subsequently transferred outside of the expanded group, and thereby loses its "EGI" status, the EGI reverts to status as indebtedness.[49]

4. Anti-Abuse Rule

Notwithstanding the rules above, a debt instrument is also treated as stock if issued with a principal purpose of avoiding application of the Proposed Regulations.[50] The Preamble to the Proposed Regulations mentions possible examples of this, including: (1) where a debt instrument

---

[46] Prop. Reg. § 1.385-3(b)(3)(iv)(B)(1). Importantly, the per se rule does not act as a safe harbor. Debt that is issued outside of the applicable 72 month period is not presumed "innocent," so to speak, as such debt may still be seen as having been issued with a principal purpose of funding a related distribution or acquisition.

[47] Prop. Reg. § 1.385-3(b)(3)(iv)(B)(2).

[48] Prop. Reg. § 1.385-3(c)(1),(2) and (3).

[49] Prop. Reg. § 1.385-3(d)(2). The Proposed Regulations provide that "immediately before the transaction that causes the holder and issuer of the debt instrument to cease to be members of the same expanded group, the issuer is deemed to issue a new debt instrument to the holder in exchange for the debt instrument that was (initially recharacterized) as stock…" Moreover, at this point in time, all other debt instruments of the issuer that are not currently treated as stock must be re-tested to determine whether such instruments must be recast as equity under the Funding Rule. As can be imagined, in complicated leveraged structures, implementation and tracking of these rules and their implications could prove challenging for taxpayers.

[50] Prop. Reg. § 1.385-3(b)(4).

is issued to a person outside an expanded group and that person later joins the group, (2) a debt instrument is issued to an entity that is not taxable as a corporation (such as a grantor trust that is beneficially owned by an expanded group member), or (3) a member of the issuer's expanded group is substituted as an obligor (or added as co-obligor) on an existing debt instrument.[51] Moreover, the anti-abuse rule may recharacterize as stock instruments that not only constitute debt, but also certain non-debt instruments, such as contracts to which section 483 applies and nonperiodic swap payments.[52]

5. Debt in Part and Equity in Part

The Proposed Regulations reject a traditional "all or nothing" approach to the debt versus equity analysis and also allow for debt to be bifurcated into both debt in part and equity in part in certain situations.[53] The Proposed Regulations provide only one example of a situation in which such bifurcation would be appropriate—specifically, a case in which the Commissioner's analysis supports a reasonable expectation that, as of the issuance of the EGI, only a portion of the principal amount of the EGI will be repaid.[54] In such cases, only the portion of the EGI for which repayment is expected would retain debt treatment, with the balance recast as equity.[55] Moreover, specifically for the limited purposes of this rule, the definition of an EGI uses a "modified expanded group" approach, extending relatedness to an expansive 50% threshold.[56]

6. Examples

The diagrams below illustrate transactions which trigger application of the transactional debt vs equity recharacterization rules described above. In all examples, assume that FP is a foreign corporation which owns 100% of the stock of foreign subsidiary FS and U.S. subsidiaries USS2 and USS1. USS1 in turn owns 100% of the outstanding stock of lower-tier U.S. subsidiary DS and lower-tier foreign subsidiary CFC. For illustrative purposes only, FP is depicted as an Irish corporation, FS is depicted as a Dutch corporation, and CFC is depicted as a Canadian corporation. For purposes of the examples, the jurisdictions depicted have no independent significance beyond mere status as foreign (non-U.S.) jurisdictions.

Example 1: Note Issued as Distribution Recast as Stock.

---

[51] Preamble.

[52] *Id.*

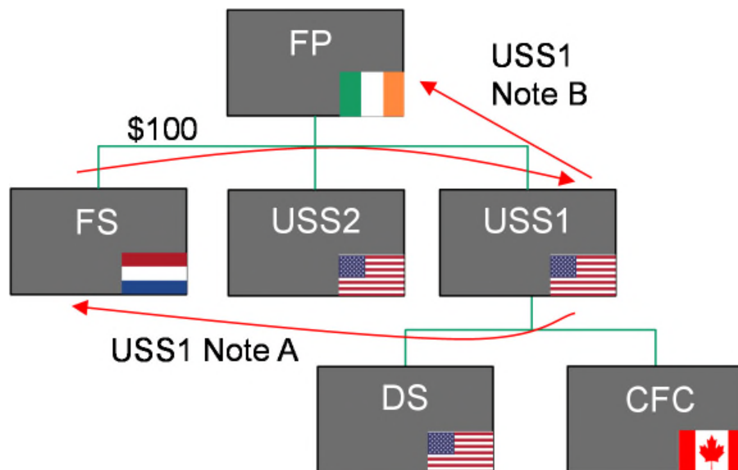
[53] Prop. Reg. § 1.385-1(d)(1). Note that this is a power reserved by statute in section 385 itself, which provides that regulations may be issued to determine when an interest in corporation is to be considered debt and or equity in part for federal income tax purposes.

[54] Prop. Reg. § 1.385-1(d)(1).

[55] *Id.*

[56] Prop. Reg. § 1.385-1(d)(2).

In Year 1, FS lends $100x to USS1 in exchange for USS1 Note A. In Year 2, USS1 issues Note B (valued at $100x) to FP in a distribution. Under the General Rule, Note B is an EGI transferred in a distribution to an expanded group member and is therefore recast as stock of USS1 immediately as of its issuance. USS1 Note A, on the other hand, is not recast as equity under the Funding Rule because Note B, which is a newly recast equity instrument, is no longer considered property under section 317(a).[57] Therefore, Note A is not treated as funding the issuance of property by one expanded group member to another within the meaning of the Funding Rule.



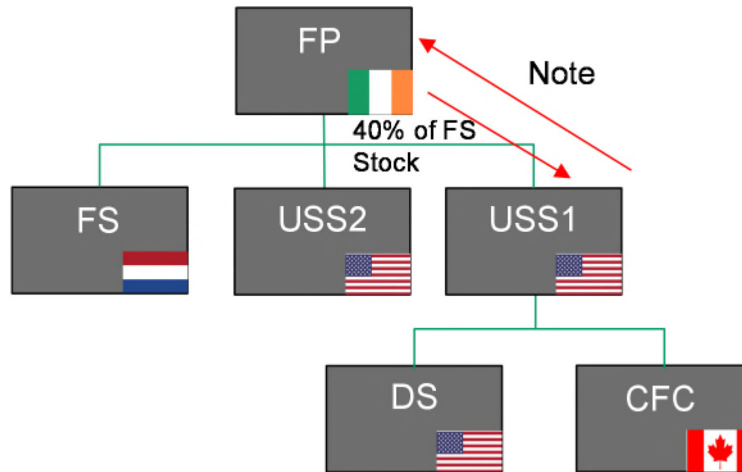
EXAMPLE 1

Example 2: Note Recast as Stock When Issued in Exchange for Stock of Other Member of Expanded Group

In Year 1, USS1 issues a Note to FP in exchange for 40% of FP's FS stock.[58]

[57] Under section 317(a), stock distributed by an entity to its shareholder is not treated as property.

[58] This example appears in the Proposed Regulations as Prop. Reg. § 1.385-3(g)(3) Example 3.



EXAMPLE 2

Under the General Rule, because the exchange is not pursuant to an asset reorganization,[59] and therefore is not an exempt exchange under Proposed Regulations § 1.385-3(f), the Note is recast as stock as of the date of its issuance. The transaction is not subject to deemed redemption treatment under section 304 because the Note is recast as stock of the entity transferring the Note as a distribution, and therefore is not property within the meaning of section 317(a).

Absent the Proposed Regulations, USS1 would be treated as distributing the Note as a dividend to FP, triggering U.S. withholding tax to FP to the extent of USS1's earnings and profits.[60] Despite this initial tax, on a prospective basis, USS1 would be treated as debtor with respect to the Note issued to FP, and could substantially reduce its taxable income by paying deductible interest expense.[61] Meanwhile, the interest income on the note would be taxed at a significantly lower rate in Ireland.[62] At the end of the day, the FP multinational group would have substantially reduced

---

[59] The Proposed Regulations confine "exempt exchange" treatment to asset reorganizations. It is unclear from a policy standpoint why the Proposed Regulations treat transfers in connection with asset reorganizations (i.e., reorganizations described in section 368(a)(1)(A), (C), (D), or (F) of the Code) differently from their stock reorganization counterparts under section 368(a)(1)(B). See Prop. Reg. § 1.385-3(f)(5).

[60] This result obtains under section 304(a)(1), which would recast FP's sale of FS stock to USS1 in exchange for the Note as though USS1 simply distributed the Note to FP in redemption of a portion of its stock. As a distribution that would not effect a meaningful reduction in FP's proportionate interest in USS1 (FP would still hold 100% of USS1 after the distribution), the distribution would be recast as a taxable dividend to the extent of the combined earnings and profits of USS1 and FS. Withholding tax would be imposed at the source by USS1 as the U.S. withholding agent under the rules of section 1441.

[61] This of course is classic earnings stripping. Moreover, USS1, having acquired only 40% of FS, would not be a U.S. shareholder with respect to FS for purposes of section 951(b), and therefore would also avoid application of the Subpart F anti-deferral regime.

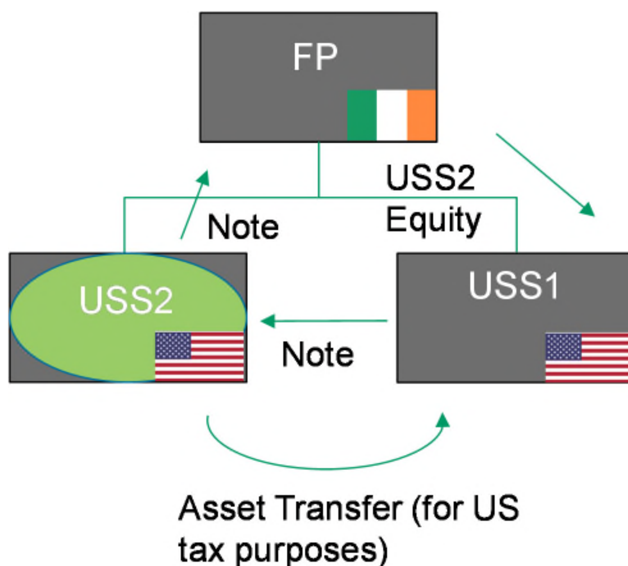
[62] The Irish corporate tax rate on such income would likely be either 25% or 12.5%, depending on whether the income qualifies as active "trading profits" for Irish tax purposes. Of course, either way, the group has engaged in tax arbitrage.

its tax bill without having introduced any additional capital into the structure or otherwise altered the structure of the group in an economically significant way.[63]

By recharacterizing the Note as equity, the Proposed Regulations prevent the group from eroding the U.S. tax base at the level of USS1. The silver lining, however, is that under the Proposed Regulations, the distribution of the Note may not give rise to withholding tax.[64]

Example 3: Notes Issued in Asset Reorganizations

Prior to the Proposed Regulations, tax-free reorganizations were an effective means of pushing debt into the United States in a tax-efficient manner. In Example 3 below, USS2 converts to an LLC in connection with the transfer and therefore becomes a disregarded entity for U.S. purposes. FP then (effectively) sells the membership interests in USS2 to USS1 in exchange for a Note (although according to the form of the transaction, the Note is transferred to USS2 first and ultimately distributed by USS2 to FP in a liquidating distribution). The transaction is cast as a type "D" reorganization for U.S. federal income tax purposes, which prior to the Proposed Regulations, would allow debt to be pushed down into the U.S. with minimal tax cost (that is, the only tax cost would the built-in gain portion of FP's USS1 stock by virtue of section 356) and pave the way for future earnings stripping of USS1.



EXAMPLE 3

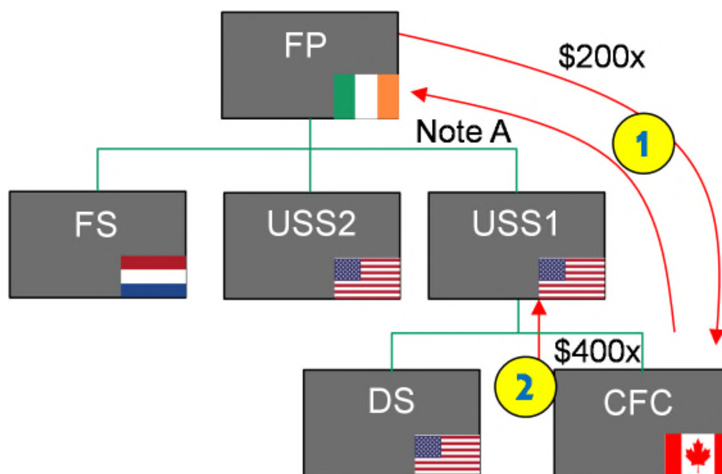
[63] This is the primary abuse targeted by the "general rule" of Prop. Reg. § 1.385-3(b)(2). The Preamble mentions the abuse in the context of multinational structures in which the structure is merely rearranged in an superficial (noneconomic) manner in order to garner tax benefits: "lack of new money can be a significant factor in holding a purported indebtedness to be a capital transaction, particularly when the facts otherwise show that the purported indebtedness was merely a continuation of the stock interests allegedly converted."

[64] This would depend on the application of section 305(a), which exempts certain stock dividends from tax.

The Proposed Regulations would recast Note as equity of USS1, resulting in both the prevention of any future earnings stripping capabilities and the imposition of what is likely to amount to additional U.S. withholding tax imposed on FP.[65]

Example 4: Funding Rule.

Example 4 below illustrates application of the Funding Rule.[66] The effect of the Proposed Regulations is to recast Note A as equity, rather than as indebtedness, of CFC.



On Date 1 in Year 1, FP lends $200x to CFC in exchange for Note A. On Date 2 in Year 2, CFC distributes $400x to USS1 in a distribution. Note A is presumed under the per se rule to be a principal purpose instrument[67] because Note A was issued to a member of the FP expanded group during the applicable 72 month period determined with respect to CFC's distribution to USS1.[68] Note A is therefore recast as stock by virtue of the Funding Rule.

Although Note A, which is issued in exchange for cash of $200x rather than distributed as a dividend, is not immediately recast as equity, the related distribution made by CFC to USS1, made within the per se rule period of 72 months, causes the recharacterization as of the date the note was issued.

---

[65] Assuming eligibility for benefits of the US-Ireland Income Tax Treaty, the U.S. withholding rate on dividends is 5%, compared with a 0% withholding rate with respect to interest payments.

[66] This example appears in the Proposed Regulations as Prop. Reg. § 1.385-3(g)(3) Example 4.

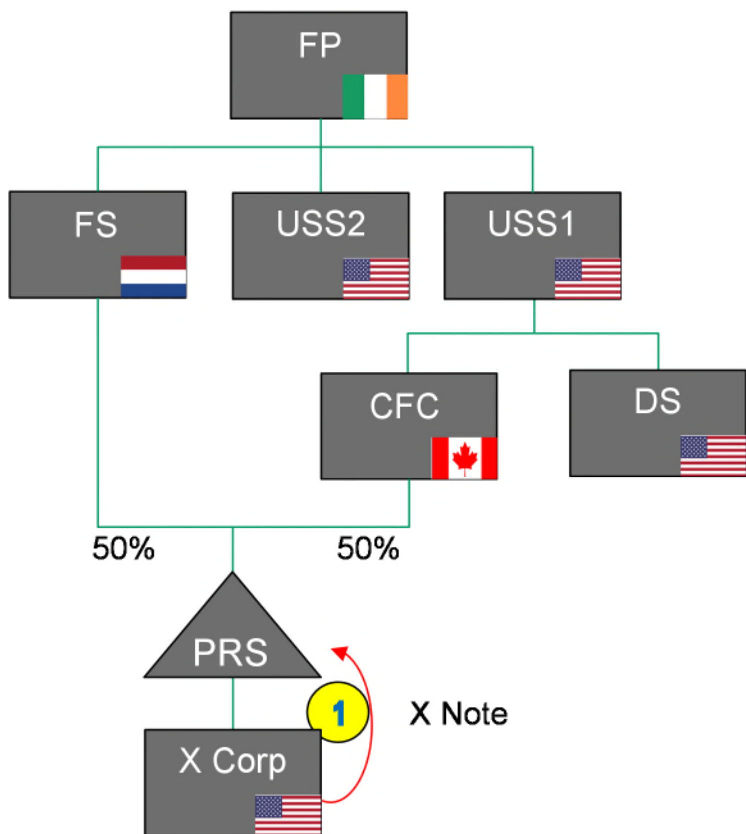
[67] That is, an instrument issued with a principal purpose of funding the $400x distribution by CFC to USS1 in Year 2.

[68] Recall that under Prop. Reg. § 1.385-3(b)(3)(iv)(B)(1), this period begins 36 months prior to the issuance of Note A and ends 36 months after such issuance.

The immediate ramifications of this recast may not be obvious. After all, even absent the Proposed Regulations, the distribution of $400x would be a taxable dividend to USS1 to the extent of CFC's earnings and profits. However, to the extent CFC generates both positive earnings and subpart F income, there is a tax savings in allowing CFC to deduct interest expense and reduce those earnings in order to limit potential future subpart F inclusions.[69] The Proposed Regulations eliminate this planning possibility.

Example 5: Treatment of Partnerships

As illustrated below, the Proposed Regulations adopt an aggregate (as opposed to an entity) approach to partnerships. Assume that PRS is a partnership, the capital and profits interests of which are held equally by FS and CFC. Also assume that PRS holds 100% of the outstanding stock of X Corp, a U.S. corporation. On Date 1 in Year 1, X Corp issues an X Note to PRS in a distribution.



EXAMPLE 5

For purposes of Prop. Reg. § 1.385-2, controlled partnerships are treated as members of an expanded group, and the term "controlled partnership" is defined as any partnership the capital or profits interest in which is 80 percent owned by members of the expanded group. For purposes of

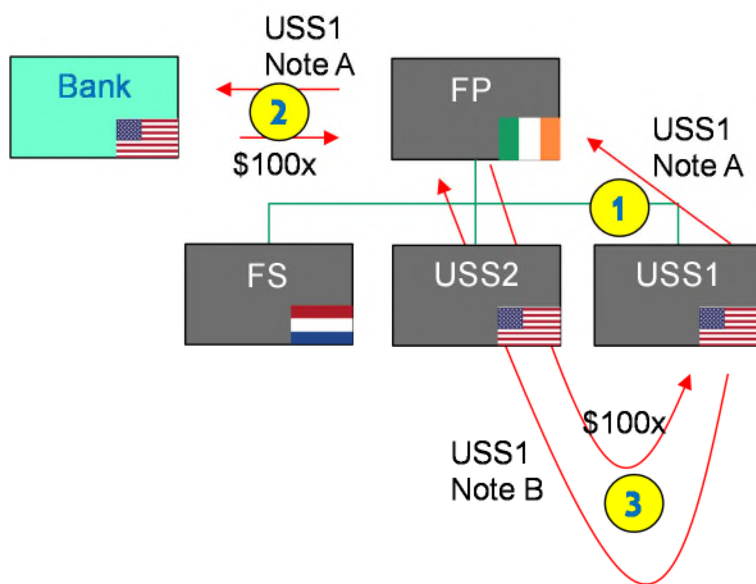
[69] Section 952(c) limits subpart F inclusions to earnings and profits of the applicable CFC.

determining whether X Corp is a member of the FP expanded group, CFC and FS are each treated as holding 50% of the X Corp stock held by PRS. Because 100% of the X Corp stock is treated as held by CFC and FS, PRS is a controlled partnership and X Corp is treated as a member of the expanded group.

Solely for purposes of Prop. Reg. § 1.385-3, when X Corp issues the X Note to PRS, proportionate shares of the X Note are treated as issued in a distribution to FS and CFC, such that 50% of the X Note is treated as issued and distributed to each partner as debt for purposes of Prop. Reg. § 1.385-3, and immediately recast as stock of X Corp. For other purposes of the Internal Revenue Code the X Note is treated as stock in X Corp that is held by PRS.

Example 6: Anti-Avoidance Rule: Debt Respected as Debt Under Proposed Regulations Recast as Equity If Issued for Tax Avoidance Purpose

Debt issued for the sole purpose of avoiding application of the Proposed Regulations will also be subject to recharacterization under the anti-abuse rule, even when the strict technical provisions of the Proposed Regulations mandate otherwise.[70]



EXAMPLE 6

On Date 1 in Year 1, USS1 issues USS1 Note A, valued at $100x, to FP in a distribution. On Date 2 in Year 1, with a principal purpose of avoiding application of the rules of Proposed Regulations § 1.385-3, FP sells USS1 Note A to unrelated Bank for $100x and proceeds to lend $100X to USS1 in exchange for USS1 Note B.

USS1 Note A is a debt instrument issued by and distributed to an expanded group member of USS1. Therefore it is treated as stock under the General Rule of Prop. Reg. § 1.385-3(b)(2) as

[70] This example appears in the Proposed Regulations as Prop. Reg. § 1.385-3(g)(3) Example 18.

of the date of issuance on Date 1 in Year 1. Accordingly, USS1 is treated as distributing USS1 stock to FP. Because USS1 Note A is treated as stock, it is not property within the meaning of section 317(a).

USS1 Note A however ceases to be treated as stock when sold outside the group to Bank on Date 2.[71] Immediately before the sale, USS1 is deemed to issue a debt instrument to FP in exchange for USS1 Note A. Under the Proposed Regulations, USS1 Note B would not ordinarily be treated as stock because USS1, as the funded member, has not made a distribution of property. However, because the transactions occurring on Date 2 of Year 1 have been carried out for a tax avoidance purposes, USS1 Note B is recast as stock as of its issuance on Date 2 of Year 1.

FP in this example seeks to take advantage of two rules in the Proposed Regulations: (1) a loan taken out from a related party for cash will not be immediately recast as equity and (2) a debt instrument initially recast as equity under the Proposed Regulations will revert back to debt status once transferred outside of the group. As indicated above, although Note A is immediately recast as equity under the General Rule, it becomes debt again once acquired by the third party Bank in exchange for $100x. Because FP has simply sold Note A in order to prevent Note B from being recharacterized as debt upon the subsequent issuance, Note B is treated as a principal purpose instrument notwithstanding the form of the transaction.

7. Treatment of Consolidated Groups

Prop. Reg. § 1.385-4 provides special rules to address the treatment under the Proposed Regulations of consolidated groups. Essentially, the Proposed Regulations recognize that intra-consolidated group debt does not raise the same concerns present as to members of the same expanded (but not consolidated) group, and therefore these rules treat all members of a consolidated group as a single corporation (effectively disregarding the existence of all intercompany obligations).[72] Notwithstanding the above, purported intercompany debt may be recast as equity when distributed outside of the group to a member of the expanded group.[73]

C. Conclusion and Ripple Effects

The Proposed Regulations may bring about a host of either unintended or unexpected consequences, including the following, to name a few:

- Disqualification of entities subject to certain special tax regimes (e.g., REITs, RICs, S Corps[74])

---

[71] Prop. Reg. § 1.385-3(d)(2).

[72] This is presumably due to the fact that under section 1504(b), a consolidated group can only include taxpaying U.S. corporations, whereas an expanded group may include foreign corporations that are not subject to U.S. tax.

[73] Prop. Reg. § 1.385-4(b).

[74] REITs, RICS, and S Corps are entities which receive special flow-through treatment (or the effective equivalent thereof) under the Code. With the tax favorable treatment comes stringent equity ownership and classification requirements. See generally §§ 856, 851, 1361.

- Deconsolidation of entities in consolidated groups and related income recognition triggers (e.g., ELAs, deferred intercompany gain, intercompany obligations)
- Section 382 ownership changes (provides limitation on a loss corporation's use of losses after a 50% change in stock ownership during a three-year testing period with respect to various shifts in ownership of corporate equity)
- Controlled foreign corporation status: recharacterization of debt instruments under the Proposed Regulations could cause a foreign corporation to either become or cease to be a CFC
- Application to publicly traded or syndicated debt in leveraged structures
- Debt of a disregarded entity recharacterized as equity could cause a deemed creation of a partnership under Revenue Ruling 99-5 and cause possible gain recognition events for debt treated as equity retroactively under the disguised sale rules of section 707(a)(2)(B)
- Qualification for treaty benefits under limitation on benefits provisions (many LOB clauses require a certain equity percentage of resident owners in a treaty jurisdiction)
- Foreign exchange gain under section 988[75]
- Significant modifications and resultant deemed exchanges of debt instruments under Reg. § 1001-3
- Considerations related to otherwise non-abusive intercompany transactions within a consolidated group which may unwittingly trigger the Funding Rule[76]
- SALT concerns, particularly in the consolidated return context in which federal consolidated groups are not always recognized[77]
- Considerations related to publicly traded debt[78]

While it remains to be seen whether the Proposed Regulations will ultimately be finalized, two points seem clear: (1) the potential impact is far reaching and is likely to have a significant

[75] Prop. Reg. § 1.385-1(c). The Proposed Regulations explicitly state that "the rules of Reg. § 1.988-2(b)(13) apply to require the holder and the issuer of a debt instrument or EGI that is deemed to be exchanged in whole or in part … to recognize any exchange gain or loss, other than any exchange gain or loss with respect to accrued but unpaid qualified stated interest that is not taken into account … at the time of the deemed exchange."

[76] Because the Proposed Regulations treat consolidated group members as one entity, debt issued by one member is treated as issued by all members. Therefore, in the event intercompany debt leaves a group, a distant sister company of the actual issuer for legal purposes may unwittingly implicate the "per se" rule of the Funding Rule provisions, rendering what would otherwise be an unrelated distribution subject to the purview of the new rules.

[77] Some states do not recognize section 1501 (i.e., consolidated returns) elections. In cases where such states may choose to adopt the Proposed Regulations, it must be determined how documentation requirements under Prop. Reg. § 1.385-2 and the special consolidated returns rules of Prop. Reg. § 1.385-1(e) and Prop. Reg. § 1.385-4 will apply. Needless to say, incongruities between federal and state law with respect to the new rules could create administrative nightmares for taxpayers, particularly those with complicated leveraged structures.

[78] The Proposed Regulations have fallen under criticism for not accounting for debt issued within an expanded group and then later sold into public markets, which is not uncommon in securitization transactions where immediate placement of the debt is not possible. Many practitioners therefore believe that the Proposed Regulations should offer a broad exception for publicly traded debt.

“chilling” effect with respect to common tax planning practices within international structures, and (2) even though the Proposed Regulations are likely to be met with substantial criticism and complaints of the potential for “collateral damage,” the current political climate is such that the possibility of finalization of the Proposed Regulations within the near term cannot be ignored.

For more information, please contact the authors:

Peter Connors
pconnors@orrick.com
212.506.5120

Barbara Spudis de Marigny
bdemarigny@orrick.com
713.658.6700

Michael Robert Rodgers
mrodgers@orrick.com
713.658.6473