New proposed "debt-equity" regulations

April 2016

kpmg.com

No. 2016-162
April 6, 2016

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The Treasury Department and IRS on April 4, 2016, issued proposed regulations under section 385 of the Internal Revenue Code that, if finalized, would dramatically change the treatment of intercompany debt issued among the members of certain corporate groups. Although the associated Treasury Department press release described the regulations as designed to "reduce the benefits of and limit the number of corporate tax inversions, including by addressing earnings stripping", the proposed regulations would have their greatest impact outside the inverted company context.

The proposed regulations were issued as part of a broader package that included temporary regulations addressing transactions that are structured to avoid the purposes of sections 7874 and 367 and certain post-inversion tax avoidance transactions.

Overview of the proposed regulations

The proposed section 385 regulations would, in certain circumstances, recharacterize debt instruments issued between affiliates as stock for U.S. federal income tax purposes. In most cases, the stock will be viewed as preferred equity for U.S. tax purposes.

In general, the proposed regulations would recharacterize an intercompany debt instrument as stock unless the intercompany debt is issued in exchange for cash or other non-stock property that increases the non-stock gross assets of the issuer, taking into account related transactions.

For example, if an issuer were to issue a debt instrument to its owner with respect to its stock, the proposed regulations would generally recharacterize that debt as preferred equity. Similarly, intercompany debt would generally be recharacterized as preferred equity if the debt were issued in exchange for stock of an affiliate.

The proposed regulations are drafted broadly to address similar transactions that might achieve the same economic result as the transactions described above. For example, intercompany debt would be partially or entirely recharacterized as stock if the intercompany debt were issued for money—which itself is an acceptable transaction—and, as part of a related transaction, the issuer transfers money or other nonstock property to an affiliate either as a distribution with respect to stock or as an acquisition of stock of an affiliate.

Although the question of whether a distribution or acquisition of stock is related to the intercompany debt issuance is a "facts and circumstances" test, the proposed regulations provide a “per se” rule by which a debt instrument is automatically recharacterized as equity to the extent of distributions or acquisitions of stock of affiliates by the issuer during the 36-month period before and after the date of distribution or acquisition, (the 72-month period).

What is the authority for these regulations?

The proposed regulations are issued under the authority of section 385, which authorizes the Treasury Department to prescribe any regulations necessary or appropriate to determine whether an interest in a corporation is to be treated as stock or indebtedness.

Section 385 also indicates that “the regulations prescribed under this section shall set forth factors which are to be taken into account….”, and

> *[t]he factors so set forth in the regulations may include among other factors:*
>
> *(1) whether there is a written unconditional promise to pay a demand or on a specified date a sum certain in money in return for an adequate consideration in money or money’s worth, and to pay a fixed rate of interest,*
>
> *(2) whether there is subordination to or preference over any indebtedness of the corporation,*
>
> *(3) the ratio of debt to equity of the corporation,*
>
> *(4) whether there is convertibility into the stock of the corporation, and*
>
> *(5) the relationship between the holdings of stock in the corporation and holdings of the interest in question.*

Importantly, the proposed regulations, in characterizing certain intercompany debt instruments as equity, rely solely on factor (5)—the relationship between the holdings of stock in the corporation and the holdings of the interest in question—and exclude consideration of all of the other factors, such that debt issued in certain circumstances (e.g., a distribution) is automatically characterized as equity due solely to “the relationship between the holdings of stock in the corporation and holdings of the interest in question” (i.e., the debt is issued between members of an expanded group).

The proposed regulations also exercise authority granted by section 385 to permit the Commissioner to treat a debt instrument issued between related parties as in part debt and in part stock for U.S. federal income tax purposes.

What types of instruments are subject to these rules?

A debt instrument is subject to recharacterization under these rules if it is issued in certain transactions between members of an expanded group as defined in the proposed regulations. For this purpose, an expanded group is an affiliated group as defined in section 1504(a) (generally corporations connected by 80% ownership of vote and value) except that (1) the nonincludable corporations listed in section 1504(b) (including non-US corporations) are included therein, (2) the common parent need not own 80% of another member directly, but it can own it indirectly as well, and (3) the group need be connected by ownership of stock constituting 80% of vote **or** value of a member, rather than vote <u>and</u> value.

All instruments or contractual arrangements that (1) constitute indebtedness for U.S. federal income tax purposes, (2) are issued between members of an expanded group, (3) pursuant to certain transactions are subject to recharacterization under these rules. For example, a sale-leaseback or sale-repurchase agreement that is treated as debt for U.S. federal income tax purposes would be subject to recharacterization under these rules if the other conditions are met.

What issuers are subject to these rules?

The proposed regulations are not limited to debt instruments of issuers that are U.S. persons and would recharacterize, for U.S. tax purposes, the intercompany debt instruments of a non-U.S. issuer, such as a controlled foreign corporation, as well assuming it was part of the expanded group.

The rules are not limited to debt of corporations and can also apply to debt instruments of disregarded entities if their owner is part of an expanded group and a controlled partnership, defined as a partnership with respect to which at least 80% of the interests in partnership capital or profits are owned, directly or indirectly, by one or more members of an expanded group.

If the debt instrument of a disregarded entity or controlled partnership is recharacterized as equity under the foregoing rules, the recharacterized instrument is not viewed as equity of the disregarded entity or the partnership itself, but rather as equity of its owner or owners that are members of the expanded group. In the case of a controlled partnership, the proposed regulations state that the partnership and its partners must make appropriate conforming adjustments to reflect this treatment.

What is the effect of a recharacterization of intercompany debt under these rules?

If intercompany debt is recharacterized as equity under the proposed regulations then (1) the issuer will not be entitled to a deduction for interest payments on the debt and (2) interest payments will be characterized as dividends for all U.S. tax purposes.

Moreover, if the counterparty is a non-U.S. person, the recharacterization provided for in the proposed regulations will of course not affect the characterization under non-U.S. law and, as such, accruals or payments of interest are likely to be subject to taxation in that jurisdiction. Further, if a U.S. corporation is a creditor with respect to the recharacterized debt, the instrument may be viewed as a hybrid instrument in the debtor jurisdiction, potentially affecting the deductibility of interest payments in the debtor jurisdiction.

What is the effective date of these proposed regulations, and when are they likely to be finalized?

The proposed regulations would apply with limited exceptions to debt instruments issued on or after April 4, 2016. Under the proposed regulations, the intercompany debt instruments subject to recharacterization would continue to be treated as debt for 90 days after the issuance of final regulations and would thereafter by viewed as exchanged for equity.

Given that the president has made public remarks about this package as targeting corporate inversions, it is clear they are a priority of the Obama Administration. We expect Treasury and the IRS to try to finalize the package before the end of the Obama Administration.

What are examples of debt instruments that seem to be subject to recharacterization (or not subject to recharacterization) under these rules?

Examples of debt instruments that would generally be recharacterized as equity under the proposed regulations would include the following:

- Intercompany debt issued to an affiliate as a distribution with respect to stock (for example, as a dividend or a return of capital),

- Certain intercompany debt issued in exchange for affiliate stock (for example, as part of a so-called “Section 304” transaction“ or certain “triangular B reorganizations”). For example, if US issues debt to its non-US parent, FP, to acquire FP stock and uses the FP stock to acquire assets or stock of a third-party, the debt would generally be recharacterized as equity,

- Certain intercompany debt issued as part of an asset reorganization (for example, certain debt issued as part of a reorganization described in section 368(a)(1)(D)), and

- Any intercompany debt to the extent the issuer of the debt either makes a distribution of property with respect to its stock or an acquisition of affiliate stock if the debt issuance occurred within the 72 month period beginning 36 months before the date of the distribution or acquisition.

Examples of debt instruments that seem not to be recharacterized as equity under the proposed regulations would include the following:

- Third-party debt instruments without regard to the manner in which the proceeds are used (e.g., proceeds could be distributed with respect to stock, transferred in exchange for affiliate stock, or transferred as part of an asset reorganization),

- Debt instruments issued between U.S. members of an expanded group that have elected to file a consolidated return for U.S. federal income tax purposes (members of a consolidated group are treated as a single corporation for purposes of the regulations),

- Intercompany debt issued in exchange for property (subject to the recharacterization rule that would treat debt as stock to the extent of certain distributions and affiliate stock purchases within the 72-month period described above). For example, an intercompany loan to an affiliate, whether funded by a third-party borrowing or funds on hand, to acquire stock or assets of an unrelated party would generally be respected subject to the 72-month recharacterization rule described above,

- Refinancings and significant modifications of debt instruments that occur on or after April 4 even if the debt was issued before April 4 in a transaction that otherwise would have caused it to be recharacterized as equity (subject again to the same 72-month recharacterization rule described above),

- Any intercompany debt to the extent the total amount of group debt subject to recharacterization under the proposed regulations does not exceed $50 million. If the $50 million safe-harbor is exceeded by the group, then then safe-harbor is no longer applicable, and

- An amount of intercompany debt issued in the tax year to the extent of the issuer's current earnings and profits for that year. If the issuer's total intercompany debt for the tax year exceeds the current earnings and profits for the year, then the excess is subject to recharacterization. This exception is applied in the order to which the intercompany debt is issued.

What are the other aspects of these proposed regulations?

The proposed regulations also include a "preparation and maintenance of documentation and information" requirement for intercompany debt between members of an expanded group that is not reclassified under the rules set forth above. These documentation requirements would apply to debt between members of an expanded group (and not reclassified under the rules above) that is issued or deemed issued on or after the date the proposed regulations are published as final.

If these documentation and information requirements are not satisfied on a timely basis, then the instrument will also be treated as equity for U.S. federal income tax purposes. The documentation and information that must be prepared on a timely basis to satisfy the requirements of this section include written documentation establishing:

- That the issuer has entered into an unconditional and legally binding obligation to pay a sum certain on demand at one or more fixed dates,
- That the holder has the rights of a creditor to enforce the obligation,
- That, as of the date of issuance of the instrument and taking into account all the relevant circumstances, the issuer's financial position supported a reasonable expectation that the issuer intended to, and would be able to, meet its obligations pursuant to the terms of the instrument,
- Evidence of payments of principal and interest, and in the event payments were not made, the holder's efforts to assert its rights as a creditor.

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