Proposed Treasury Regulations Dramatically Alter Existing Debt/Equity Law

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On April 4, 2016, the Internal Revenue Service (IRS) and Treasury Department proposed new Treasury regulations that, if finalized, would become retroactively effective to April 4, 2016, and dramatically alter the tax landscape for most companies' capital structures, internal financing and cash management — including real estate investment trusts (REITs). The proposed regulations apply to all U.S. corporations (and even some partnerships) and are not limited to U.S. subsidiary groups owned by foreign corporations or foreign subsidiaries owned by U.S. corporations. Although lending within a consolidated group is exempt, such exemption may not apply at the state level. As a practical matter, taxpayers must now consider the proposed regulations when issuing any intercompany debt due to the retroactive effective date of certain provisions. Although described as an effort to address inversion transactions and repatriation-related tax planning, the proposed regulations would fundamentally rewrite existing law concerning the tax classification of intercompany debt instruments of a wide variety of issuers. The current facts-and-circumstances test (including factors such as loan-to-value ratio and ability to pay) would effectively become irrelevant for a broad swath of instruments. The proposed regulations represent a radical departure from traditional debt/equity analyses because, in many cases, they classify instruments as debt or equity based not on the attributes of the instrument but on the identity of the holder and the circumstances of its issuance.

Under current law, if a corporation borrowed $100 from an unrelated lender and $100 from a related lender using identical *pari passu* loan documents, the $200 of debt instruments would be classified entirely as debt or entirely as equity, and that classification would apply equally to both lenders. Under the proposed regulations, the $100 debt instrument held by the unrelated lender could be classified as debt for tax purposes while all or a portion of the $100 debt instrument held by the related lender could be classified as equity, even though both debt instruments are identical and the lenders share in payments on a *pari passu* basis. Surprisingly, the $100 debt instrument held by the related lender could be classified as equity even if the related lender's debt claim is senior to the unrelated lender's claim. Thus, a senior mortgage loan might be reclassified as equity even though a junior mezzanine loan on the same collateral is classified as debt simply because the senior loan is held by a related party lender.

The proposed regulations can broadly be divided into two categories. First, in rules that are prospective only (applicable to debt instruments issued after the proposed regulations are finalized), the proposed regulations introduce significant new administrative burdens for most intercompany debt instruments and establish certain per se requirements that must be satisfied in order for an intercompany debt instrument to be classified as debt for tax purposes. These prospective rules also allow the IRS to treat any instrument as part debt and part equity, a clear departure from current law.

Second, in a regime that, once finalized, will have an effective date of April 4, 2016, the IRS introduced new rules that would treat certain instruments as equity regardless of whether all debt/equity requirements of current law and all documentation requirements of the proposed regulations are satisfied. The rules would wash away decades of debt/equity tax law, rewriting the economic arrangements between borrowers and lenders (even where the form of lending was dictated by nontax business reasons, such as priority in bankruptcy).

Per Se Recharacterizations

The proposed regulations introduce a series of new rules under which a debt instrument issued by a member of an "expanded group" (broadly speaking, an 80 percent commonly owned group of corporations or partnerships headed by a corporation, but

excluding consolidated groups and certain small, privately held groups) to another member (or among one or more partnerships that are part of an expanded group) will be recharacterized — except to the extent of current-year earnings and profits — as equity if the debt instrument is issued:

- in a distribution;
- in exchange for stock of an expanded group member (with certain limited exceptions); or
- in exchange for property in an asset reorganization, so long as the debt instrument is received pursuant to the reorganization by an expanded group member.

In addition, any debt instrument issued within an expanded group with a principal purpose of facilitating a cash transfer in the foregoing types of transactions also will be recharacterized as equity. With very limited exceptions, any debt instrument issued within three years before or after the distribution, acquisition or reorganization will be treated as issued with such a principal purpose.

While these per se rules would apply to any instrument issued after April 4, 2016, the instrument would be deemed exchanged for an equity instrument 90 days after the proposed regulations are finalized.

This per se equity recharacterization applies even if interests in the debt also are held by third-party lenders and are classified as debt for tax purposes in the hands of such third party. An instrument with the same CUSIP[1] could be treated as equity in the hands of one party and debt in the hands of another.

Threshold Debt Requirements

The proposed regulations provide new threshold requirements that must be satisfied for substantially all debt instruments issued within an expanded group. The proposed regulations would establish the following new inflexible requirements for all debt instruments issued between expanded group members:

- an unconditional obligation to pay a sum certain;
- creditor's rights (including the right to trigger an acceleration or default for nonpayment, the right to sue to enforce payment and superiority over equity holders in liquidation);
- a reasonable expectation of repayment (which may include cash flow projections, asset appraisals, debt/equity ratios of comparable borrowers, etc.);
- timely payment of principal and interest; and
- if nonpayment (or another event of default) occurs, the holder's exercise of reasonable diligence and judgment as a creditor.

While many of these requirements are factors in the debt/equity analysis under current law, the proposed regulations require each of them to be met and to be fully documented with supporting information within a short period of time after issuance of the instrument, or the instrument will be treated as equity even if all of the substantive requirements are satisfied. However, the proposed regulations provide that even if the debt instrument satisfies these requirements, it may still be treated as equity.

Bifurcation

The proposed regulations also will allow the IRS to assert that an instrument issued between "modified expanded group" members (generally, an expanded group applying a 50 percent rather than an 80 percent standard, and including groups with a partnership or other noncorporate parent) should be treated as part debt and part equity. This is a significant change from current law, where an instrument can be found to be debt or equity but not both.

Examples

The broad application of the foregoing rules would appear to change fundamentally not just the treatment of debt issued for repatriation planning or for "earnings stripping" but also for more run-of-the-mill intercompany financing arrangements. The following examples illustrate a few such arrangements:

Debt/Equity Funding Followed by Dividend

Parent corporation forms a new nonconsolidated subsidiary to invest in a business line, either organically or through an acquisition of an unrelated target. Parent capitalizes the subsidiary with a mix of 40 percent debt and 60 percent equity, for a total of $1,000x. The subsidiary successfully operates the new business for the next 2 1/2 years, and the value of the business appreciates to $3,000x. Parent decides to recover a portion of its investment by having the subsidiary pay a $500x dividend (either out of cash on hand or out of third-party borrowings). Under the proposed regulations, to the extent that this $500x exceeds the subsidiary's current-year earnings for Year 3, the debt from subsidiary to parent would be recharacterized as equity, meaning that future interest payments (and potentially principal) would be treated as nondeductible dividend payments. Although not explicitly addressed, this rule may apply even in the event of a deemed dividend (*e.g.*, through a transfer pricing adjustment or other intercompany transaction).

[1] CUSIP is an acronym for Committee on Uniform Security Identification Procedures and refers to the nine-digit alphanumeric numbers that are used to identify securities.

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REIT/TRS Leverage

Parent REIT owns a taxable REIT subsidiary (TRS), which conducts certain activities that parent REIT would be barred from conducting. TRS is capitalized with a mix of debt and equity, with the debt secured by real property. As TRS grows in value, parent REIT receives a dividend from TRS (designed in part to limit the size of TRS for purposes of REIT qualification). To the extent that the distribution happens within three years of the debt capitalization and exceeds TRS' current earnings and profits of the year in which the distribution occurs, TRS' debt to parent REIT would be recharacterized as equity, increasing the taxable income of TRS on an ongoing basis and converting payments on the debt from "good" REIT income to "nonqualifying" REIT income.

Integration Planning

Parent (a U.S. multinational) acquires target (also a U.S. multinational) in a half-cash, half-stock merger transaction. Parent finances the cash consideration through external borrowings. To integrate target's operations into parent's existing structure, parent transfers a U.K. subsidiary of target to parent's existing U.K. controlled foreign corporation (CFC). Parent makes the transfer 50 percent in exchange for a note and 50 percent in exchange for additional equity in its U.K. CFC, with a goal of moving an appropriate amount of leverage down to parent's U.K. CFC, in part to provide cash to service its external debt. Under the proposed regulations, the debt from U.K. CFC to parent will be recharacterized as equity.

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These examples illustrate that the proposed regulations may change the results of many transactions that would traditionally be viewed as nonabusive intercompany financings, irrespective of a debtor member's ability to service the debt. The proposed regulations alter decades of tax law that has essentially been in place since the inception of the corporate income tax, creating instead a complex framework of analysis and producing often arbitrary results. Given the April 4, 2016, effective date for certain of these rules, taxpayers are advised to carefully review the potential application of these rules to their individual situations.

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