Proposed Treasury Regulations Revolutionize Tax Rules Governing Intercompany Financing Transactions

06 / 28 / 16

If you have any questions regarding the matters discussed in this memorandum, please contact **Moshe Spinowitz**, moshe.spinowitz@skadden.com, 617.573.4837 or call your regular Skadden contact.

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

500 Boylston Street
Boston, Massachusetts 02116
617.573.4800

Four Times Square
New York, NY 10036
212.735.3000

skadden.com

Recently proposed Treasury regulations, which will likely be finalized this year,[1] promise to alter the tax treatment of a wide range of intercompany financing transactions dramatically, upending nearly a century of law regarding the tax treatment of related-party debt. The regulations, which the Internal Revenue Service and Treasury Department released on April 4, 2016, will force multinational enterprises to rethink corporate activities ranging from external borrowing and M&A structuring to internal financing and strategies available to efficiently allocate and return capital within a multinational enterprise. Given the regulations' broad reach, they already have received significant attention and generated concern within the tax and business communities.

Commonly referred to as the "385 Regs" after the relevant section of the tax code, the proposed regulations would recharacterize rules that treat debt as equity when issued to a related party as part of or in connection with (defined as broadly as "within three years of") a wide range of transactions, including distributions, and certain intercompany acquisitions of stock or assets.

These regulations represent a marked departure from long-standing tax law, which historically has allowed taxpayers to choose their capital structure, and has based the tax treatment of capital on the terms of the relevant instrument. To distinguish debt from equity, tax law has focused on the economics of the instrument — fundamentally, whether the investor has placed its capital at the risk of the business, with the expectation of participating in the ups and downs of the enterprise (equity capital), or whether the investor provided capital to the business with relative confidence in having the investment repaid and with limited exposure to the vicissitudes of the business (debt capital). Within these bounds, taxpayers generally were free to choose their capital structures — a principle that Congress reaffirmed as recently as 2010 when the choice of capital structure was identified as one of the types of decisions not subject to the then-recently enacted "economic substance doctrine."

This flexibility in turn allowed taxpayers to achieve predictable — and potentially advantageous — results that flowed from the differential tax treatment of debt and equity capital. For example, while interest generally is deductible, dividends are not; and while debt repayment generally is tax-free, stock redemptions are generally taxable transactions that in the related-party context often are treated as dividends. A host of corollary consequences flow from this differential treatment, including the imposition of withholding taxes, the availability of foreign tax credits, and the magnitude and location of tax attributes.

Under the new rules, every intercompany lending transaction within a corporate group (generally defined as corporations and their 80 percent-owned affiliates) can potentially be recharacterized as equity if the debt is issued as part of a distribution or intercompany stock or asset acquisition, or where the borrower has undertaken such a transaction (*e.g.*, paid a dividend) within three years preceding or following the borrowing. Internal borrowing — whether to fund a major acquisition or day-to-day working capital needs — now can be recharacterized as equity, with potentially adverse and unpredictable consequences when such loans are serviced and repaid.

By potentially recharacterizing intercompany lending, the regulations create a significant bias in favor of external debt. Centralized external borrowing with intercompany on-lending becomes increasingly difficult. While direct external borrowing to fund acquisitions is untouched, the internal restructuring (and intercompany borrowing) that

[1] Comments on the proposed regulations are due by July 7, 2016.

commonly follows acquisitions will be impacted greatly. Ultimately, the regulations impact all aspects of corporate finance, forcing multinational enterprises to scrutinize and carefully monitor their approaches to acquisition structuring, external financing and internal treasury functions.

The proposed regulations generally will not be effective until finalized (in some respects with an additional 90-day grace period), although at that point they would generally apply to debt instruments issued on or after April 4, 2016. **Comments on the proposed regulations are due by July 7, 2016**. Treasury officials have indicated that they aim to finalize the regulations by the end of the summer, requiring multinational enterprises to begin preparing now, though there have been indications that finalization may be delayed until closer to the end of the year. Whether the scope of the regulations is narrowed remains to be seen. If allowed to stand as proposed, these regulations will require companies to take great care in navigating this new terrain.