Proposed financing regulations mean radical changes for companies in US and abroad

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The tax aspects of internal and external financing of multi-national corporations and cross-border businesses on both sides of the Atlantic are undergoing radical change.

Both the OECD, as part of its Base Erosion and Profits Shifting (BEPS) project, and the US Treasury Department, in its recently-released proposed regulations under section 385 of the Internal Revenue Code (the Proposed Regulations), have taken aim at intercompany lending transactions and the perceived abuses facilitated by such transactions.

On the US side, the Proposed Regulations take aim at these transactions through a broad and complex set of regulations representing a radical overhaul of the rules applicable to intercompany debt financing. Whereas historically under US law corporations have had significant flexibility to determine their internal capital structure, the Proposed Regulations sharply limit the circumstances under which companies can issue intercompany debt while dramatically expanding the circumstances under which intercompany debt can be recharacterised as equity.

And, while the Proposed Regulations were released the same day as another set of regulations addressing inversion transactions, they are not limited to – or even primarily focused on – inverted companies; their reach extends to all multinational enterprises that engage in nearly any form of intercompany financing.

The Proposed Regulations have three main operative provisions: (i) bifurcation rules, (ii) documentation requirements, and (iii) recharacterisation provisions. This article will focus on the last of the three, illustrating their core impact. Under current law, the characterisation of an instrument as debt or equity for US tax purposes depends on the economic terms of the instruments. The recharacterisation rules of the Proposed Regulations reject that approach, instead characterising an instrument based solely on the relationship of the parties and the circumstances under which the instrument was issued.

The recharacterisation provisions apply to all debt instruments that are issued by one entity to a member of the issuer's "expanded group" – which is generally defined as a group of corporations related through 80% ownership – subject only to a limited exception for small issuers, and an exception for debt issued between members of a US consolidated group.

Expanded group debt instruments are subject to recharacterisation under two sub-rules – the 'general rule' and the 'funding rule'. Under the general rule, a debt instrument is recharacterised as equity if it is issued in one of three specified transactions – a distribution, an acquisition of stock of an expanded group member, or an acquisition of assets of an expanded group member in a transaction that otherwise qualifies as a tax-free asset reorganization.

Under the funding rule a debt instrument is recharacterised as equity if within the 72-month period beginning 36 months before the debt issuance, the issuer engaged in one or more of those three specified transactions (the 72-month *per se* rule) or if the debt was issued with a principal purpose of funding such a transaction. Both the general rule and the funding rule are subject to an exception for distributions or stock or asset acquisitions that are not in excess of the issuer's current year earnings and profits. In addition, certain ordinary course accounts payable are excepted from the scope of the funding rule.

To illustrate the above: assume, for example, that on January 1 2017 a US subsidiary (US Sub) pays a $100 dividend to its non-US parent corporation. In addition, assume that for US Sub's 2017 taxable year it generates $25 of earnings and profits. On December 31 2019, US Sub borrows $100 from a non-US affiliate to fund an acquisition that was not contemplated at the time of the 2017 distribution. Under the 72-month *per se* rule, $75 of that $100 debt instrument is recharacterised as equity. Any interest paid on that portion of the recharacterised debt is treated as a dividend for US tax purposes, is not deductible, and is subject to any withholding tax otherwise applicable to cross-border dividend payments. Likewise, when the US Sub repays that $75 of principal, it is treated as a stock redemption, which would generally be treated as a dividend-equivalent redemption that would likewise be subject to withholding tax otherwise applicable to cross-border dividends.

The breadth of the regulations – in particular the 72-month *per se* rule – makes them applicable to nearly every intercompany lending transaction of almost any size or purpose. And because the recharacterisation provisions fully recharacterise the debt as equity – rather than simply disallowing interest deductions – their impact is far-reaching, affecting the deductibility of interest payments, withholding tax on interest and principal payments, and the availability of foreign tax credits.

By contrast, the OECD paradigm does not require a recharacterisation of the instrument or relationship itself but merely an adjustment to the deductibility for domestic tax purposes of payments or accruals in respect of the instrument or relationship. Key recommendations of Action 2 (hybrids) and Action 4 (interest deductibility) of the BEPS project seek to reach their respective goals by attacking the deduction at the root of the perceived base erosion or profit shifting situation.

The UK has been a first mover in taking steps to implement the recommendations of BEPS Actions 2 and 4. Draft anti-hybrid legislation has been published as part of the Finance Bill (expected to become law later this year), and a consultation on implementation of a net interest expense barrier set for 30% of tax EBITDA is open for comment until August 4 2016. The new measures are scheduled to take effect from January and April 2017 respectively.

More widespread implementation can be expected among OECD members, although many commentators have already remarked on the likelihood that individualised cherry-picking implementation may create avenues for similar conduct to that which the BEPS project set out to counter in the first place.

However, the opportunity to incorporate elements of tax competitiveness within implementation of BEPS Actions will, in all likelihood, be more limited for EU member states. The provisions of the Anti-Tax Avoidance Directive on which ECOFIN members agreed in principle in June 2016 will, once transposed into member states' national legislation, impose minimum implementation standards of implementation of Actions 2 and 4 by 2019. These minimum standards are, somewhat ironically, not significantly dissimilar to those referred to above which the UK is imposing on itself from 2017.

Jurisdictions implementing the recommendations of Actions 2 and 4 will have to decide for themselves whether to legislate a fiction requiring the underlying instrument or relationship (or part of it) to be recharacterised as equity-like, with the collateral consequence of attracting any domestic dividend withholding taxes to payments in respect of which deductions are not allowed or to "principal" payments. However, this would, as with the Proposed Regulations, risk leading to a highly undesirable outcome across the board. Domestic provisions reliant on equity-based ownership or control thresholds, such as the various forms of group relief in the UK, would be thrown out of kilter. The effectiveness of double tax treaties would be threatened by an increased risk of the two contracting states not recognising the payment as being of the same nature. Economic double taxation could ensue, with no deduction for the deemed dividend in the source state, potential withholding in that state, and no exemption applying to interest income in the residence state.

This final point is a common feature of both the Proposed Regulations and the UK's proposal to implement the recommendations of BEPS Action 4 (and, arguably to a lesser degree, Action 2): denial of a deduction in respect of a cross-border payment is unlikely in itself to relieve the payment from taxation in the jurisdiction of the recipient, with little prospect for recourse under most double tax treaties.

If it is desirable that implementation of the recommendations of BEPS Actions be coordinated in order to reduce future non-taxation, it is at least as desirable for

implementation of those recommendations not to give rise to a risk of increasingly significant double taxation. This is an argument which will, in the current climate, likely prove unpopular with the political classes and at best uninspiring to tax authorities. This in turn, in the authors' view, further increases the need for care and expertise in the planning and implementation of cross-border internal and external financing and funding transactions.

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