IRS and Treasury Issue Final Debt/Equity Regulations

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If you have any questions regarding the matters discussed in this memorandum, please call your regular Skadden tax contact.

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Overview

On October 13, 2016, the Internal Revenue Service (IRS) and the Treasury Department (Treasury) issued temporary and final Treasury regulations under Section 385 of the Internal Revenue Code of 1986, as amended (the Final Regulations).[1] These regulations implement the rules contained in the proposed regulations that were issued by the IRS and the Treasury on April 4, 2016 (the Proposed Regulations). The Final Regulations retain much of the general approach and structure of the Proposed Regulations. In particular, they impose documentation requirements that must be met as a prerequisite for related-party debt to be respected as debt for U.S. federal income tax purposes (the Documentation Rules). In addition, they automatically recharacterize certain related-party debt instruments as equity if issued or used to fund certain types of transactions, such as distributions or acquisitions of the stock of affiliates (the Recharacterization Rules). In this regard, the Final Regulations remain a dramatic deviation from decades of debt/equity law because they classify debt instruments not based on the attributes of the particular instrument, but rather on the identities of the issuer and holders and the circumstances of their issuance.

The Final Regulations, however, provide significant relief that will greatly limit the number of debt instruments subject to the rules. In particular, the Final Regulations generally apply only to debt instruments issued by domestic corporations to related parties. In addition, the Final Regulations exempt debt issued by S corporations and groups parented by widely owned real estate investment trusts (REITs) and regulated investment companies (RICs). The Final Regulations also introduce several new exceptions to their application that are intended to exempt many ordinary course business transactions between related parties, as well as certain cash management and treasury functions that many multinational groups utilize. These changes are likely to alleviate many of the substantial concerns that U.S. parented multinational groups, U.S. financial institutions and the U.S. real estate industry had with the Proposed Regulations. The much narrower scope of the Final Regulations is also more consistent with the stated goal of the IRS and Treasury of targeting earnings stripping transactions by so-called "inverted" U.S. companies. Nevertheless, all non-U.S. parented multinational groups that finance their U.S. operations with intercompany debt, and not just companies that were parties to an inversion transaction, are affected by the Final Regulations.

The Final Regulations and their preamble are more than 500 pages long, reflecting that Treasury and the IRS received substantial comments from the business and tax community on the Proposed Regulations. The flow chart accompanying this memorandum summarizes the application of the Final Regulations to assist companies in navigating the Final Regulations and determining whether their intercompany debt arrangements are subject to them.

Some Practical Implications of the Final Regulations

Impact on U.S. Parented Multinational Groups

The Final Regulations generally apply only to debt issued by domestic corporations to related persons who are not members of the same consolidated group, as well as debt issued by certain partnerships and disregarded entities that have domestic corporations as owners. As a result of this change, much of the intercompany debt issued between members of a U.S. parented multinational group (such as debt issued by non-U.S.

[1] Unless otherwise indicated, all "Section" references herein are to the Internal Revenue Code of 1986, as amended (the Code) or to the Treasury regulations (Regulations or Regs. §) promulgated thereunder.

subsidiaries and debt issued between domestic subsidiaries) will be unaffected by the Final Regulations.

Nevertheless, the Final Regulations may still apply to intercompany debt issued within a U.S. parented group in certain circumstances, such as debt issued between U.S. subsidiaries that are affiliated but not members of the same consolidated group and loans made by non-U.S. subsidiaries to U.S. subsidiaries. U.S. parented multinational groups should take inventory of their intercompany debt arrangements to determine which, if any, might be affected by the Final Regulations. Furthermore, it should be noted that the preamble to the Final Regulations (the Preamble) specifically states that the IRS and Treasury have "reserved" on whether the regulations should ultimately be expanded to apply to intercompany debt issued by non-U.S. companies.[2]

Impact on Non-U.S. Multinational Groups

In contrast to U.S. parented groups, the Final Regulations will have significant impact on non-U.S. parented multinational groups that finance their U.S. operations through intercompany debt. According to the Preamble, the Final Regulations are intended to recharacterize debt instruments that "do not finance new investment in the operations of the borrower," such as distributions of notes by U.S. subsidiaries or notes issued in order to purchase the stock of affiliates. In the view of the IRS and Treasury, these types of transactions do not increase the amount of assets on the borrower's balance sheet (*i.e.*, do not represent a true economic investment in the United States) and are purely tax-motivated. Although the stated intention of the Final Regulations was to target earnings stripping transactions engaged in by inverted U.S. companies, the rules apply to all non-U.S. parented groups, regardless of whether the group engaged in an inversion transaction.

In light of this, non-U.S. parented multinational groups that wish to finance their U.S. operations with intercompany debt should strongly consider making loans to their U.S. subsidiaries to fund their U.S. group's working capital needs, to replace existing third party debt of U.S. subsidiaries or to fund new U.S. business acquisitions from unrelated parties. These types of debt investments in the United States should generally not be subject to automatic recharacterization as equity under the Final Regulations, although they may be subject to the "Funding Rule" described below.

[2] At a Practising Law Institute corporate tax conference in New York on October 19, 2016 (within one week of the release of the Final Regulations), Treasury senior counsel Kevin Nichols stated "I want to emphasize that this is a reservation and not an exemption in the final rules." Alison Bennett, *Foreign Issuer Exemption Not Set in Stone: Treasury*, Daily Tax Rep. (BNA), Oct. 19, 2016 at G-6.

Impact on Cash Pooling and Treasury Operations

The Final Regulations clarify that the Documentation Rules apply not only to an instrument issued in the legal form of debt but also to intercompany receivables and payables documented as debt in a ledger, trade payable, accounting system, journal entry or similar arrangement that is not generally evidenced by a separate legal agreement, including cash pooling arrangements and revolving credit arrangements. Under the Proposed Regulations it was not entirely clear whether companies would be required to produce a new loan document for each accounting or journal entry, or how frequently they would be required to perform a credit analysis for purposes of supporting an entity's ability to repay an debt instrument issued pursuant to one of these types of arrangements. The Final Regulations, however, confirm that groups can use "master" or "umbrella" agreements to satisfy the documentation requirements with respect to such arrangements. They also permit the group to perform a credit analysis annually with respect to debt instruments issued under such arrangements, unless a "material event " occurs, which will trigger a new analysis at the time the material event occurs.

In addition, in order to facilitate non-tax motivated cash management techniques, the Treasury provided an exception to the Recharacterization Rules for "qualified short-term debt instruments, which generally include (i) ordinary course loans issued as consideration for the acquisition of property other than money in the ordinary course of the issuer's trade or business, (ii) an interest free loan issued without original issue discount, (iii) a demand deposit received by a "qualified cash pool header" pursuant to a cash management arrangement, and (iv) an instrument that satisfies one of two cash pooling relief tests: (x) the "specified current assets test" or (y) the "270-day test." The specified current assets test generally permits companies to borrow up to the amount of their current assets, other than cash and cash equivalents. The 270-day test generally applies to an instrument that has a term of no longer than 270 days, the issuer of which is a net borrower from the lender for no more than 270 days during the issuer's tax year, and the issuer of which is a net borrower under all debt instruments that would otherwise satisfy the 270-day test for not more than 270 days during the tax year.

While the intent of this exception is to prevent the treatment of short-term debt instruments issued in the ordinary course of a group's business as stock and streamline the documentation process, the rules are complex and may be difficult to administer. Companies concerned about the complexity and burden of complying with the Final Regulations should consider separating the cash pooling and treasury operations of their U.S. subsidiaries from their non-U.S. subsidiaries in order to avoid the application of the Final Regulations to these arrangements.

Impact on Investment Fund "Blocker" Debt

Under many fund structures, U.S. corporate "blocker" entities are commonly used to own certain investments in the United States. Such blockers are often widely held by non-U.S. and tax-exempt investors and are not owned, directly or indirectly, by a related corporate entity holding at least 80 percent of the vote or value, which is the requisite ownership threshold among related parties for the regulations to apply. In apparent recognition of this, the preamble to the Proposed Regulations requested comments regarding whether the Final Regulations, when issued, should be expanded to specifically apply to debt issued by U.S. corporate "blocker" entities. While the Final Regulations do not contain a rule specifically addressing these structures, the Preamble notes that the IRS and Treasury are continuing to study these structures and whether they should be addressed by the Section 385 regulations in the future. In many instances, blockers are owned by a non-U.S. corporate parent, and funding them will require being mindful of the Recharacterization Rules described below.

Impact on Real Estate Investment Trusts

In a helpful change from the Proposed Regulations, the Final Regulations generally exempt REITs and their subsidiaries from the new rules, except where more than 80 percent of the vote or value of the REIT is owned by a corporate entity. Thus, for example, the rules generally do not apply to (i) loans by a public REIT to its taxable REIT subsidiaries (TRSs); (ii) loans by a private REIT that does not have an 80 percent corporate shareholder—such as most REITs owned by private equity funds—to its TRSs; or (iii) loans by either of the aforementioned REITs to their "mini-REIT" subsidiaries, or by such mini-REITs to their own TRSs. The rules would, however, apply to a loan by a non-U.S. or domestic corporation to a subsidiary REIT that is 80 percent owned by that corporation. The rules would similarly apply to a loan by such a subsidiary REIT to its own TRS, although it is unclear why, as a matter of policy, TRS debt in that case should be treated differently than TRS debt in all other cases. Thus, while most REITs can continue to engage in intercompany lending transactions without regard to the new rules, the rules remain relevant to a small subset of REITs that have large corporate owners.

Delayed Effective Date for the Documentation Rules

Under the Proposed Regulations the Documentation Rules applied to debt instruments issued on or after the date the Proposed Regulations became final and required that each threshold requirement be satisfied and fully documented within a relatively short period of time (30 or 120 days) after issuance of the instrument or the instrument would be treated as equity. The Final Regulations extend the effective date and provide that the Documentation Rules apply only to debt instruments issued on or after January 1, 2018. Moreover, the Final Regulations replace the 30/120-day timely documentation requirement with a requirement that the required documentation and financial analysis be prepared by the time the issuer is required to file its U.S. federal income tax return (taking into account all applicable extensions).

Given the extension to the effective date of the Documentation Rules, companies would be well advised to examine their balance sheets and structure chart to identify all relevant intercompany debt and create an internal process for ensuring that the documentation requirements are satisfied. Moreover, in the Preamble, the IRS and Treasury stated that they believe that the Documentation Rules reflect "the best documentation practices under case law." Accordingly, even though the Final Regulations have substantially delayed the effective date of the Documentation Rules, it may be prudent to begin complying with the Documentation Rules even before they become effective.

Importance of Closely Monitoring Earnings and Profits and Capital Contributions

The Final Regulations generally retain the Recharacterization Rules contained in the Proposed Regulations, with some expanded and added exceptions intended to narrow the scope of the rules to more specifically target transactions with earning stripping potential. Similar to the Proposed Regulations, the final Recharacterization Rules contain two main provisions: The "General Rule" and the "Funding Rule." The Recharacterization Rules are effective retroactively to April 4, 2016, which was the date the Proposed Regulations were issued.

Under the General Rule, a debt instrument issued by a U.S. issuer that is not exempt from the Final Regulations (a Covered Member) will be recharacterized as equity if the instrument is issued (i) in a distribution to another member of the group, (ii) in an acquisition of stock of another member of the group or (iii) in an acquisition of property in an asset reorganization, so long as the debt instrument is received pursuant to the reorganization by a member of the group.

Under the Funding Rule, a debt instrument issued by a Covered Member to another member of the group is recharacterized as equity to the extent that it is treated as funding a prohibited distribution or acquisition. The Final Regulations generally retain the controversial six-year per se rule that treats a debt instrument as funding any distribution or acquisition that occurs within the period that begins 36 months before the issuance of a debt instrument and that ends 36 months after the issuance of that debt instrument.

The Final Regulations contain two notable exceptions to the Recharacterization Rules. First, a debt instrument is exempted to the extent of the earnings and profits (E&P) accumulated by the issuing company in tax years ended on or after April 5, 2016, and derived while the entity was a member of the same group. The exception establishes an "expanded group earnings account." A distribution or an acquisition that would otherwise be subject to the Recharacterization Rule is excluded to the extent of the balance in the expanded group earnings account. The expanded group earnings account is an attribute of the group, not the issuing corporation, and does not carry over if the issuing corporation joins another group. Second, a new exception permits taxpayers to net certain capital contributions made to the issuing company within the 36-month period prior to the distribution or acquisition against the amount of the distribution or contribution, with the effect that only the net amount of the distribution or acquisition counted towards application of the Recharacterization Rules.

In light of these exceptions, corporate groups will want to carefully monitor and document the E&P of their members that are subject to the Final Regulations on a go-forward basis. In addition, it would be prudent to obtain contemporaneous valuations of in-kind capital contributions made to subsidiaries. However, certain industries, such as infrastructure and real estate, may generate negative E&P for a number of years and, therefore, these exceptions may not be helpful.

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Please see the following pages for "The Skadden Guide to the Final and Temporary Section 385 Regulations."

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The Skadden Guide to the Final and Temporary Section 385 Regulations

As of October 13, 2016

I. Issuers Subject to the Final Regulations[1]

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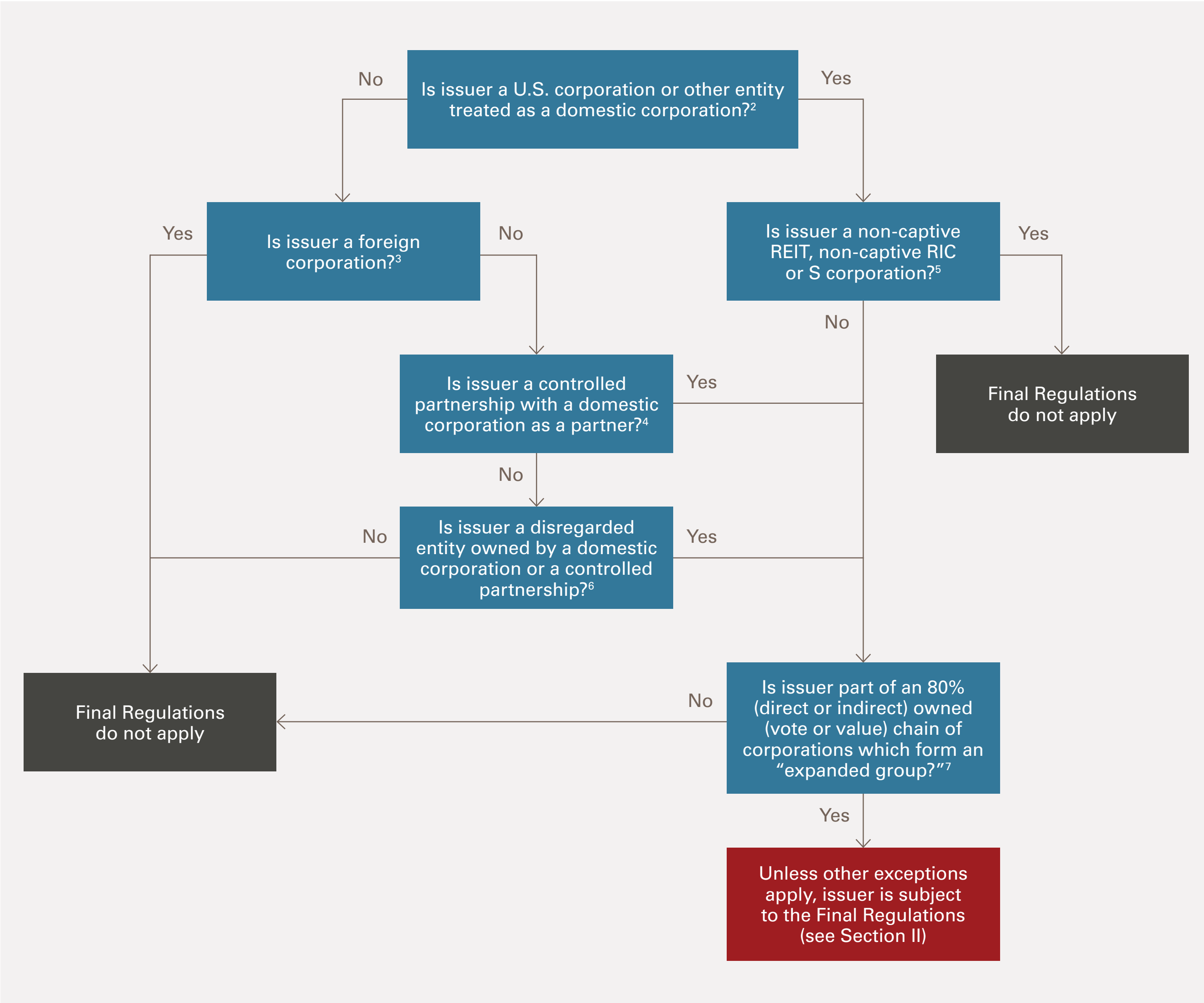

[1] These regulations were issued on October 13, 2016, and supplant proposed regulations issued on April 4, 2016. This flowchart is only intended to provide an overview of the Final Regulations and does not address all taxpayers and all situations. Please consult with your Skadden tax advisor for a more detailed discussion of these provisions.
[2] Treas. Reg. § 1.385-1(c)(2)(i).
[3] Treas. Reg. § 1.385-1(c)(2)(ii) (reserved).
[4] Treas. Reg. § 1.385-1(c)(1). A controlled partnership means a partnership where at least 80 percent of the interest in the partnership capital or profits is owned, directly or indirectly, by members of the expanded group. See note 7 for the definition of expanded group. Debt issued by a controlled partnership is generally treated as issued by its partners. Treas. Reg. § 1.385-3T(f)(3)(i).
[5] Treas. Reg. § 1.385-1(c)(4).
[6] Treas. Reg. § 1.385-1(c)(3).
[7] Generally, for these purposes, an expanded group is one or more chains of corporations connected through stock ownership where the common parent or other members of the expanded group own, directly or indirectly, 80% or more of the vote or value in the other corporations. Treas. Reg. § 1.385-1(c)(4). For these purposes, a U.S. consolidated group of corporations is generally treated as one corporation.

II. Debt Subject to the Final Regulations

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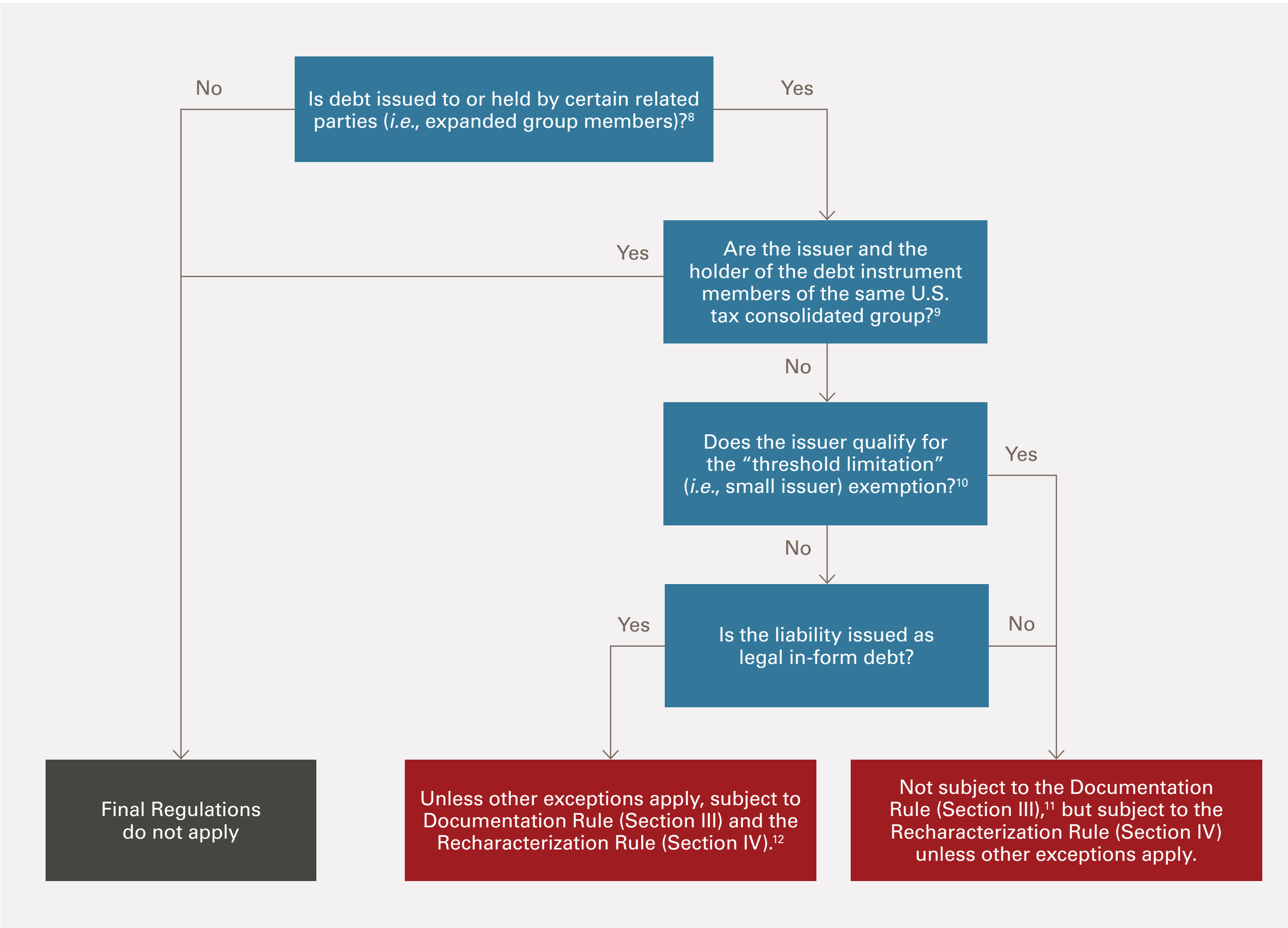

[8] For these purposes and subject to common law principles, certain third party debt guaranteed by a related party is not treated as related-party debt.
[9] Members of the same consolidated group are generally treated as one corporation. Treas. Reg. § 1.385-4T(b).
[10] Treas. Reg. § 1.385-2(a)(3)(ii).
[11] Anti-abuse rules may apply. Treas. Reg. § 1.385-2(a)(4).
[12] This generally includes loans from CFCs to related U.S. corporations.

III. Overview of the Documentation Rule[13]

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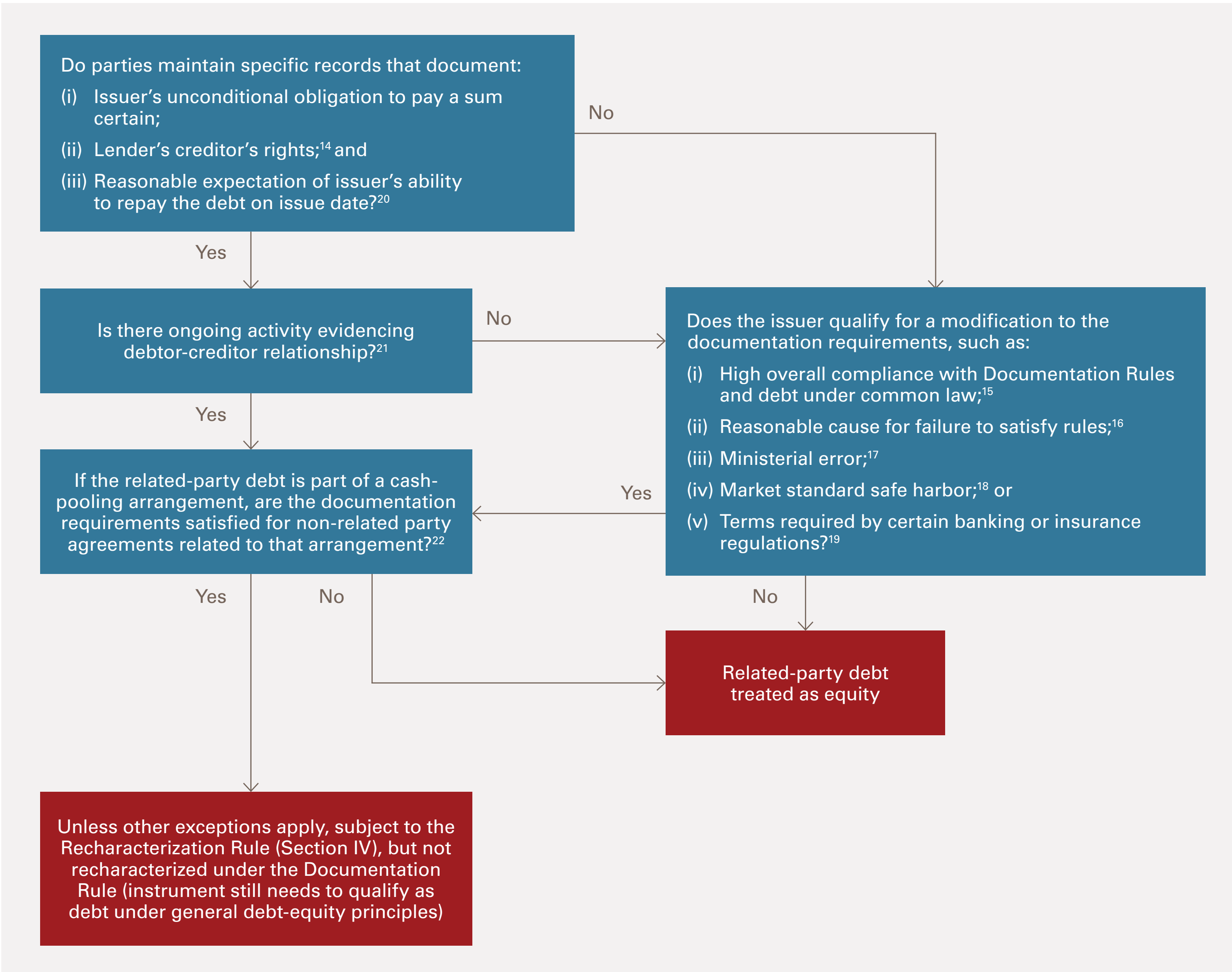

[13] Effective for debt instruments issued after January 1, 2018. Documentation must be completed by due date of issuer's tax return for the year of issuance (including extensions).
[14] Treas. Reg. § 1.385-2(c)(2)(i) and (ii).
[15] Treas. Reg. § 1.385-2(b)(2)(i) (with certain exceptions).
[16] Treas. Reg. § 1.385-2(b)(2)(ii).
[17] Treas. Reg. § 1.385-2(b)(2)(iii).
[18] Treas. Reg. § 1.385-2(c)(1)(ii).
[19] Treas. Reg. § 1.385-2(c)(1)(iii).
[20] Treas. Reg. § 1.385-2(c)(2)(iii).
[21] Treas. Reg. § 1.385-2(c)(2)(iv).
[22] Treas. Reg. § 1.385-2(c)(3)(i)(B). Based on the Preamble to the regulations, this provision also applies to notional cash pool arrangements.

IV. Application of the Recharacterization Rule[23]

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The Recharacterization Rule, which includes the General Rule and the Funding Rule, recharacterizes as stock certain debt instruments issued to expanded group members in certain prohibited transactions, such as a distribution (the General Rule), or, if not issued in such a transaction, that are otherwise issued close in time with or with a principal purpose of funding such prohibited transactions (the Funding Rule).

Does the issuer qualify for an exception to the Recharacterization Rule?

- Exception for certain regulated financial companies[24]
- Exception for certain U.S. life insurance companies[25]

Yes

No

Does the debt instrument qualify for a general exception to the Recharacterization Rule?

- Exception for debt instruments issued before April 5, 2016[26]
- Exception for certain debt issued by dealers in securities[27]
- Exception for certain statutory or regulatory debt instruments[28]

Yes

No

Does the debt instrument qualify as a "short-term" debt instrument?[29]

- Exception for short-term funding arrangement which satisfies either
  - A specified current asset test for ordinary course of business transactions;[30] or
  - A 270-day test for certain debt instruments with a term of 270 days or less (during the taxable year of the issuer).[31]
- Exception for ordinary course loans expected to be repaid within 120 days[32]
- Exception for certain interest-free loans[33]

Yes

Recharacterization Rule does not apply

No

(*Continued on next page*)

[23] Under Treasury Regulation section 1.385-3, if the General Rule or the Funding Rule applies, certain related-party debt may be treated as equity at the time of issuance or in a subsequent taxable year.

[24] Treas. Reg. § 1.385-3(g)(3)(iv). This exception includes certain banks and broker dealers. However, the Funding Rule does apply to certain non-bank subsidiaries of financial holding companies, certain merchant bank and related companies and certain grandfathered financial holding companies.

[25] Treas. Reg. § 1.385-3(g)(3)(v). However, this exception does not apply to, for example, U.S. holding companies of property and casualty insurance companies.

[26] Treas. Reg. § 1.385-3(g)(3)(i).

[27] Treas. Reg. § 1.385-5(g)(3)(ii).

[28] Treas. Reg. § 1.385-3(g)(3)(iii).These debt instruments include certain production payments, REMIC regular interests and certain leases treated as loans.

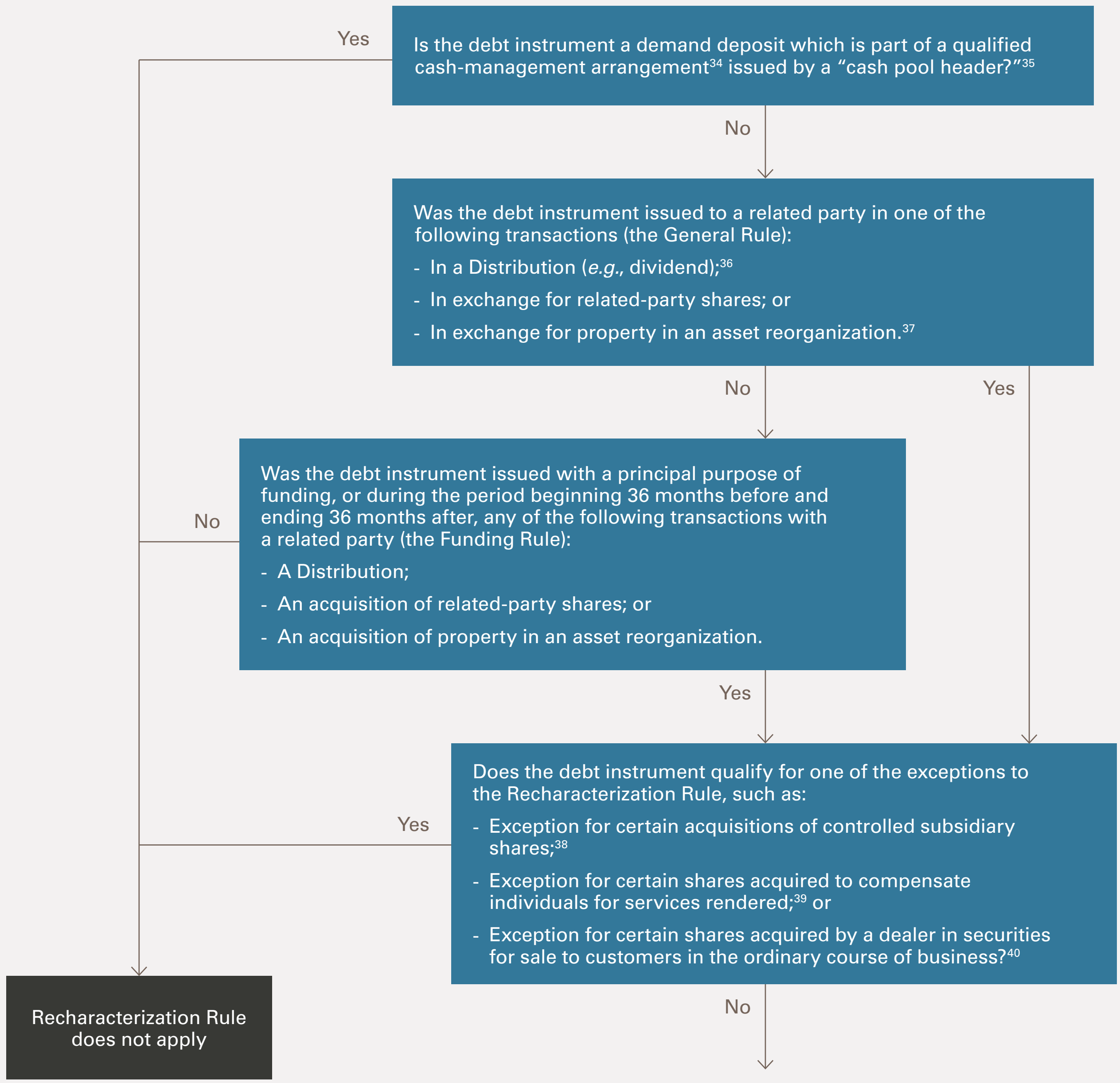
[29] Treas. Reg. § 1.385-3T(b)(3)(viii).

[30] Treas. Reg. § 1.385-3T(b)(3)(viii)(A)(1).

[31] Treas. Reg. § 1.385-3T(b)(3)(viii)(A)(2).

[32] Treas. Reg. § 1.385-3T(b)(3)(viii)(B).

[33] Treas. Reg. § 1.385-3T(b)(3)(viii)(C).



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[34] Treas. Reg. § 1.385-3T(b)(3)(viii)(D). For these purposes, a "cash-management arrangement" means an arrangement the principal purpose of which is the borrowing and lending of excess cash between related parties (including foreign exchange management and investing excess cash with an unrelated person). Treas. Reg. § 1.385-3T(b)(3)(viii)(D)(3).

[35] A "cash pool header" is a group member, controlled partnership or QBU whose principal purpose is managing a "cash-management arrangement" for related parties. Treas. Reg. § 1.385-3T(b)(3)(viii)(D)(2).

[36] Distributions received in complete liquidation, certain stock reorganizations and section 355 transactions are exempt as are distributions to persons that are not members of the expanded group. Treas. Reg. § 1.385-3(g)(10). However, payments on debt instruments, including refinancing, that have not been converted to equity solely as a result of the transition rules are considered distributions under Treasury Regulation section 1.385-3(b)(3). Treas. Reg. § 1.385-3(j)(2)(iii).

[37] Treas. Reg. § 1.385-3(a)(2).

[38] Treas. Reg. § 1.385-3(c)(2)(i).

[39] Treas. Reg. § 1.385-3(c)(2)(ii).

[40] Treas. Reg. § 1.385-3(c)(2)(iv).

IV. Application of the Recharacterization Rule

Continued

[41] Treas. Reg. § 1.385-3(c)(2)(ii).
[42] Treas. Reg. § 1.385-3(c)(2)(i).
[43] Treas. Reg. § 1.385-3(c)(4).