Proposed Treasury Regulations Relating To Intercompany Indebtedness

On April 4, 2016, the United States Treasury Department issued proposed regulations relating to the tax treatment of intercompany debt. Although the proposed regulations were motivated in large part by concerns regarding "earnings stripping" techniques used to reduce U.S. tax liability following inversion transactions, their application is not limited to inverted companies. If and when finalized, the proposed regulations will affect many U.S. and foreign-based multinational groups. The rules, which are extremely complex, would recharacterize certain intercompany indebtedness as equity, based upon the purpose for which the debt is issued, without regard to traditional factors such as debt-to-equity ratios that have been applied under case law in distinguishing between indebtedness and equity. Such recharacterization would result in, among other consequences, the inability of the debtor to claim interest deductions, as well as adverse withholding tax consequences for foreign holders of debt if payments are treated as dividends rather than interest or principal. The proposed regulations would also require taxpayers to maintain substantial documentation supporting the treatment of intercompany debt as indebtedness for tax purposes. In addition, the Internal Revenue Service (the "IRS") would have the authority to bifurcate certain intercompany indebtedness and treat it as part debt, part equity. Because portions of the proposed regulations, if finalized in their current form, would apply to intercompany debt issued on or after April 4, 2016, it is important to take them into account now for planning purposes.

Highlights of the Proposed Regulations

Treatment of Certain Intercompany Debt as Equity

The proposed regulations would recharacterize certain debt between members of an "Expanded Group" as equity for tax purposes. An Expanded Group generally includes corporations affiliated by 80% or more (by vote or value) ownership, as well as partnerships that are 80% or more owned by corporate group members. The rules do not apply, however, if the total intercompany debt in the Expanded Group that would otherwise be recharacterized as equity under the proposed regulations does not exceed $50 million, nor do they apply to loans within a group of U.S. corporations that file consolidated federal income tax returns.

Assuming that the $50 million threshold is exceeded, and subject to an exception for distributions and acquisitions up to the amount of the issuing member's current year earnings and profits and certain other limited exceptions, an intercompany debt instrument issued by an Expanded Group member to another member is recharacterized as equity if the debt instrument is issued:

- in a distribution;
- in exchange for stock of an Expanded Group member; or
- in exchange for assets of another corporation in a reorganization in which the debt instrument is distributed by the asset transferor to an Expanded Group member.

The proposed regulations also include a "funding rule." Under the funding rule, subject to certain exceptions, if one Expanded Group member (the "funded member") issues debt to another member (the "funding member") in exchange for cash or other property, the debt is recharacterized as equity if the debt is issued with a "principal purpose" of funding:

- a distribution of cash or other property by the funded member to another member of the Expanded Group (which could be the funding member or another member);
- an acquisition by the funded member of stock of an Expanded Group Member; or
- an acquisition by the funded member of assets in a reorganization in which cash or other non-stock property is distributed by the asset transferor to an Expanded Group member.

The "principal purpose" language in the proposed regulations understates their extremely broad scope. The proposed regulations include a non-rebuttable presumption that debt is issued with a principal purpose of funding one of the three described transactions if the transaction occurs within a 72-month window period that begins 36 months prior to the date of the loan and ends 36 months after such date, subject to an exception for debt instruments arising in the ordinary course of the issuer's trade or business in connection with the purchase of goods or receipt of services that give rise to a current deduction or an amount currently includible in cost of goods sold or inventory. For example, if a foreign parent lends cash to its U.S. subsidiary and the U.S. subsidiary uses the cash to make an acquisition from an unrelated party or to build a factory, the funding rule will not apply absent some other transaction. If, however, the U.S. subsidiary makes a distribution to the foreign parent 35 months after the date of the loan, it appears that the funding rule will apply to recharacterize the loan as equity effective as of the distribution date to the extent that the amount of the distribution exceeds the subsidiary's current year earnings and profits, regardless of whether there was any plan or intention to make a distribution at the time of the loan. The 72-month window does not provide a safe harbor. In the case of a distribution or acquisition occurring outside the 72-month window, the principal purpose test is applied based upon all the facts and circumstances.

The provisions of the proposed regulations regarding recharacterization of certain intercompany debt as equity include numerous additional detailed rules, including rules relating to partnerships and successor entities and anti-avoidance rules, as well as rules applying where one party to a debt instrument joins or leaves an Expanded Group.

Documentation Requirements

The proposed regulations also require extensive contemporaneous documentation of indebtedness between members of an Expanded Group if:

- stock of any member of the Expanded Group is traded on (or subject to the rules of) an established financial market;
- total assets shown on any "applicable financial statement" exceed $100 million; or
- total annual revenue shown on any applicable financial statement exceeds $50 million.

An "applicable financial statement" includes any financial statement that includes one or more Expanded Group members and is either (i) a financial statement required to be filed with the Securities and Exchange Commission, (ii) a certified audited financial statement that is used for credit purposes, reporting to shareholders or partners, or any other substantial non-tax purpose, or (iii) a financial statement required to be provided to any federal, state, or foreign government or agency.

The purpose of the documentation requirements is to enhance the ability of the IRS to apply traditional debt-equity analysis to intercompany indebtedness. These requirements do not change existing substantive law, but failure to comply with the documentation requirement would result in recharacterization of the intercompany debt as equity.

The proposed regulations require the parties to an intercompany debt to prepare written documentation within 30 days after issuance of the debt establishing the following:

- the unconditional, legally binding obligation to repay a sum certain on demand or on one or more fixed dates;
- the holder's rights as a creditor to enforce the debt, such as the right to call an event of default or acceleration of the debt in the event of non-payment of interest or principal when due and the right to sue the debtor to enforce payment; and
- the reasonable expectation of repayment of the debt, which may be established by cash flow projections, financial statements, appraisals, or other information regarding the financial condition of the debtor.

In addition, the following written documentation must be prepared on an ongoing basis during the life of the loan:

- within 120 days of the due date of any payment of interest or principal, written evidence of payment, such as copies of bank statements, cancelled checks, or wire transfers; and

- within 120 days after any default or event giving rise to a right to accelerate repayment, written evidence of the holder's reasonable exercise of the diligence and judgment of a creditor.

The proposed regulations include special rules applicable to documentation of cash pooling arrangements and revolving credit facilities.

Bifurcation of Instruments

The proposed regulations would permit the IRS to recharacterize, based upon a facts and circumstances analysis, a purported debt instrument between members of a Modified Expanded Group by treating the instrument partially as debt and partially as equity. The Modified Expanded Group definition is the same as that for an Expanded Group, except that a 50% ownership threshold is substituted for the 80% threshold. Although the scope of the bifurcation rule is not entirely clear, the proposed regulations indicate that the rules could apply where the IRS determines that there is a reasonable expectation that a portion, but not the entirety of, a purported indebtedness will be repaid.

Effective Dates

The documentation and bifurcation rules would only apply to debt issued after finalization of the regulations. The rules recharacterizing certain debt as equity, however, would apply beginning 90 days after finalization of the regulations to any debt issued on or after April 4, 2016, although distributions and acquisitions prior to April 4, 2016 would not be taken into account in applying the funding rule. For purposes of the effective date rules, if pre-existing debt is refinanced or significantly modified on or after the effective date, the debt will be treated as new debt issued on the date of refinancing or modification.

What to Do

The government has asked for comments on the proposed regulations, and it is impossible at this time to predict with any accuracy when the regulations will be finalized and what changes will be made. However, the applicability of portions of the proposed regulations to debt issuances and certain transactions occurring on or after April 4, 2016 suggests that taxpayers should carefully and promptly review their intercompany arrangements in order to ascertain the likely impact of the new rules on their particular situations.

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