

November 15, 2016

New Related-Party Debt Rules Target Earnings Stripping

I. Overview.

On October 13, 2016, the Treasury Department and Internal Revenue Service released Final and Temporary regulations under section 385 (the “Regulations”) that broadly impact the tax treatment of certain related-party debt issued by U.S. corporate borrowers. When applicable, the Regulations reclassify a related-party debt instrument as equity for tax purposes, including if the U.S. borrower fails to properly document the loan or substantiate its ability to make timely interest and principal payments.

The Regulations curb a range of transactions that use related-party debt to reduce a U.S. corporation’s future taxable income. Although the Treasury Department had announced plans to prevent “earnings stripping” by “inverted” companies, these Regulations generally apply to borrowings of a U.S. corporate subsidiary from its non-U.S. corporate parent (or affiliate) regardless of whether the anti-inversion rules apply. The Regulations also apply to a limited range of U.S. company borrowings from related U.S. companies (including related tax-exempts) where similar earnings stripping concerns arise.

The Regulations retain the general operative framework of the proposed regulations, but contain numerous modifications and exceptions that narrow their scope. Notably, the Regulations exclude debt issued (i) by a foreign corporation, (ii) by a corporate “blocker” to a non-corporate entity, and (iii) do not generally apply to brother-sister corporations that are not controlled by a common corporate parent (such as a partnership that owns two chains of corporations). As a result, the Regulations should not directly apply to most private investment funds, though non-U.S. portfolio companies that on-lend to U.S. subsidiaries can be impacted.

The rules only apply to debt issued after April 4, 2016, but under the transition rules debt issued after April 4 generally cannot be reclassified as equity until January 19, 2017. The documentation rules apply to affected related-party debt issued beginning January 1, 2018.

II. Executive Summary.

- The Regulations target “earnings stripping” by reclassifying certain related-party debt as equity to eliminate U.S. tax deductions on interest payments and to impose dividend withholding.
- The Regulations target debt issued by a *domestic* corporation to a closely related corporation, such as a foreign corporate parent, but do not apply to loans among members of a U.S. consolidated group.
- Many related-party loans are excluded from the rules:
 - Loans issued before April 4, 2016 (or issued after but repaid before January 19, 2017).
 - Loans that otherwise would be covered if below a \$50 million threshold (calculated on a group-wide basis).
 - Short-term ordinary course related-party loans that do not raise earnings-stripping concerns.

- Loans from individuals and partnerships, including most private investment partnerships, provided the partnership is not controlled or substantially owned by a common corporate parent.
- The Regulations apply to transactions in which a U.S. corporation's capital structure is reshuffled so that net equity is reduced and replaced, in whole or in part, with a related-party debt issuance. For example, the rule can reclassify:
 - A note issued by a U.S. corporation to its foreign corporate parent in a transaction treated as a distribution.
 - Related-party debt issued by a U.S. corporation to acquire foreign parent stock or in connection with certain related-party asset reorganizations.
- Because the basic rules can be avoided by separating steps (e.g., actually loaning cash and later distributing it, in lieu of simply distributing a note), broad rules track the net equity of the borrower resulting from loans, contributions, distributions, and specified stock and asset acquisitions.
 - In this regard, distributions (or specified stock or assets acquisitions) that occur within the 36-month period preceding the debt issuance and the 36-month period following it can cause all or a portions of a debt issuance to be reclassified.
 - The reclassification rules apply even if the issuance, on the one hand, and distribution or acquisition on the other are unrelated transactions with independent business purposes.
 - As a result, actual or expected borrowers, including with respect to borrowings to acquire active operation assets, will need to refrain from making distributions (and certain related-party acquisitions) and carefully monitor those transactions.
- Beginning in 2018, certain issuers of related-party debt, including all publicly listed U.S. corporations, must adhere to significant documentation rules.
 - Even if an instrument otherwise would be regarded unequivocally as debt for tax purposes, *debt will be automatically reclassified as equity* if the issuer fails to satisfy documentation requirements before its U.S. federal income tax filings are due.
 - Affected related-party debt issuances must be documented in writing and include certain fundamental debt terms (e.g., full creditor rights, fixed maturity, etc.).
 - The rules require a borrower to demonstrate its ability to make timely payments of interest and principal, with internal projections and third-party analysis.
 - For substantial related-party borrowings, most well-advised taxpayers in practice have taken steps consistent with the new requirements, but the rules will apply to smaller and more routine debt issuances.
 - The Treasury intends to further study whether rules should permit a purported debt instrument to be bifurcated into part equity and part debt where the issuer lacks the ability to borrow the full principal amount (as provided in the proposed regulations).
- The Regulations are exceedingly complex, contain many material exceptions and can apply in a broad range of cases (not described above).

- Even taxpayers that don't plan to issue related-party debt, but who wish to maintain flexibility to do so in the future, should seek guidance soon, as actions today can impact future planning, even where related-party debt issuances are not tax-motivated.

III. Scope of Regulations.

The Regulations affect certain debt instruments that allow a U.S. corporation tax deductible interest expense on interest paid to a highly related corporation not subject to U.S. income tax.

- Domestic Corporate Borrowers. The Regulations generally apply to debt issued by a *domestic* corporation.
- Related-Party Debt. The debt must be held by a highly related member of an "Expanded Group" (described below). The regulations do not apply to third-party debt issuances.
- Expanded Group Requirement. An Expanded Group will in all cases have a common corporate parent and generally includes one or more chains of corporations (foreign or domestic) connected to each other through ownership (including indirectly through partnerships) of at least 80 percent of the total voting power or total value of stock.
 - An Expanded Group includes a broader set of corporations than would be included in a corporation's U.S. consolidated group. The primary aim is to restrict a non-U.S. corporate parent (or related foreign affiliate, often in a low-tax jurisdiction) from recapitalizing its U.S. subsidiary without added investment in operations.
 - Significantly, an Expanded Group's common parent must be a corporation, which may be foreign or domestic, and can be tax-exempt. "Brother-sister" corporations owned by a common, non-corporate parent (e.g., a partnership) will not be members of the same Expanded Group.
 - If 80 percent of a partnership's capital or profits are ultimately owned by members of an Expanded Group, debt *issued* by the partnership can be treated as proportionately issued by a U.S. corporate partner.

The Regulations exclude a wide range of related-party debt issuances:

- Debt issued by a U.S. corporation to another member of the same U.S. consolidated group.
- Debt issued by a foreign corporation. The Treasury, however, is continuing to study this exception.
- Debt issued by or owed to most private investment partnerships.
- Debt issued by or owed to an S-Corporation.
- Debt issued by or owed to a RIC or REIT, unless the RIC or REIT is controlled by a corporation that is not a RIC or REIT.
- Debt issued by regulated insurance companies and certain financial companies.
- Debt issued prior to April 4, 2016 (or issued after but repaid before January 19, 2017).

Many short-term debt arrangements can qualify for one of several technical exceptions to the general equity reclassification rules, but remain subject to special documentation rules. These exceptions include:

- Short-term funding arrangements. Debt with an interest rate that does not exceed an arm's length rate and either meets:
 - Specified current assets test. In general, a debt instrument satisfies this test only to the extent that the amount owed by the issuer under all related-party short-term debt instruments does not exceed its "short-term financing needs" (very generally, non-cash current assets such as inventory and receivables that remain outstanding no longer than the issuer's normal operating cycle as defined by GAAP or, if longer, 90 days).
 - 270-day test. In general, this test is met if the term of the debt is 270 days or less and, with respect to all such 270-day instruments, the issuer is a net borrower for no more than 270 days during its taxable year, with respect to the instrument's lender and all related-party lenders, respectively.
- Ordinary course short-term lending. Debt used to acquire property other than money in the ordinary course of the issuer's trade or business, provided that the debt is reasonably expected to be repaid within 120 days of issuance.
- Interest-free loans. Debt without stated or imputed interest.
- Short-term cash management arrangements. In general, a demand deposit payable by an Expanded Group member, the issuer, pursuant to an Expanded Group cash-management arrangement, which arrangements include foreign exchange management, clearing payments, settling intercompany accounts, and borrowing excess funds from Expanded Group members and lending such funds to other Expanded Group members.

IV. Operative Debt Reclassification Rules.

The Regulations address related-party debt issuances that both facilitate "earnings stripping" and arguably have limited non-tax significance. Specifically, the Regulations target situations where a U.S. corporation's net equity is reduced or replaced through a related-party debt issuance. Treasury's concern is that the corporate owners have merely reshuffled the capital of the U.S. as compared to situations where leverage is increased to expand operations. Two operative rules, the "general rule" and the "funding rule," specify the situations when related-party debt is reclassified as equity.

These rules can reclassify debt based on a single factor: whether the issuance of the note decreases the net equity capital of the issuer (including in a six-year period surrounding the debt issuance). In this regard, the rules upset well-settled common law that has weighed a broad set of factors and scrutinized whether the parties' actions reflect an intention to create a debtor-creditor relationship. The rules (including the documentation rules described in Part V, below) create an additional hurdle to debt classification, but a related-party debt issuance still must satisfy the traditional common law standards to be respected.

The General Rule.

The "general rule" reclassifies a covered debt instrument when it is used in any of three "earnings stripping" techniques that leverage a U.S. corporate borrower without financing new group investment.

- In the first technique, a U.S. corporation issues a debt instrument and distributes it to its controlling shareholder (i.e., a cashless loan).
 - The policy concern is that future interest expense deductions will erode the U.S. corporate tax base where the non-tax consequences of the transaction are relatively insignificant.

- Specifically, while the borrower's net equity is reduced because it receives no value in exchange for the note, the related group's aggregate capital investment in its U.S. subsidiaries remains intact, and the holder retains (directly or by attribution) ownership and control of the issuer.

The other two techniques may not, as a financial accounting matter, reduce the borrower's net equity but are economically similar to cashless loans.

- In the second technique, a U.S. corporation issues a debt instrument for related group corporation stock in a taxable exchange.
 - The core argument is that holding a minority interest in a *highly related* affiliate (in contrast with a minority stake in an otherwise unrelated company) only has limited non-tax significance and, therefore, the borrower's net equity should be treated as having been reduced as a practical matter.
 - As with a note distribution, related-party debt has increased and interest payments thereon will erode the U.S. corporate tax base. The related group's aggregate capital investment in the U.S. group is intact and the holder retains (directly or by attribution) ownership and control of the issuer.
- In the third technique, a U.S. corporation issues a note in connection with the acquisition of property in certain related-party asset reorganizations. For example, a U.S. corporation can acquire all of the assets of a brother-sister corporation (each owned directly by a foreign parent) in exchange for a note issued by the acquiring U.S. company. Pursuant to the plan of reorganization, the U.S. corporation selling its assets would then liquidate, distributing the newly issued debt it received to the foreign parent.
 - Because this technique merely shifts assets between controlled subsidiaries, and debt of the corporation acquiring the assets is distributed to the common parent, the aggregate net equity of the subsidiaries is reduced.
 - Again, the common shareholder's aggregate capital investment in its U.S. subsidiaries remains intact, and the holder retains (directly or by attribution) control of the issuer, which has succeeded to the assets and liabilities of the former U.S. affiliate. Future interest deductions on the note will erode the U.S. corporate tax base.

The Funding Rule.

The "funding rule" recognizes that related parties may engage synthetically in the general rule "earnings stripping" techniques by separating the "funding" of the U.S. borrower through debt and the distribution of cash (or other property) or the acquisition of related-party stock. Specifically, the funding rule reclassifies related-party debt that is issued with a principal purpose of funding one of the transactions described in the general rule. A "per se" rule treats any debt issued by a U.S. corporation to a group lender as funding a specified distribution or acquisition that occurs within 36 months before or after the related-party debt is issued.

Exceptions to the General and Funding Rules.

The Regulations include three sets of exceptions to the general rule and funding rule.

- Controlled-subsidiary exclusion. The rules do not apply to a U.S. borrower's acquisition of related-party stock from a lender that is a controlled subsidiary of the U.S. borrower.

- The controlled subsidiary's investments will not reduce the U.S. borrower's net equity and, because the controlled subsidiary is likely a U.S. corporation, future interest deductions (after offset by interest payments) will not erode the U.S. corporate tax base.
- Accumulated earnings and profits reduction. The extent to which related-party debt is treated as funding general and funding rule transactions, and thus is reclassified as equity, is reduced to the extent that it could have been funded by the U.S. borrower's accumulated earnings and profits.
 - These reductions permit a U.S. corporation to make ordinary course distributions of its business earnings without risking reclassification of related-party debt as equity.
- Small issuances exclusion. The rules apply only to the extent that the aggregate issue price of covered debt instruments that would be reclassified (but for this exception) and are held by members of the U.S. borrower's expanded group, exceeds \$50 million.
 - This excludes from the rules relatively small issuances of related-party debt.

Key Observations.

While opportunities for increasing debt within the U.S. group beyond annual E&P have been limited, some planning opportunities remain.

- Acquisitions of a U.S. corporation by a foreign parent (whether pre-existing or newly formed). A foreign corporation acquiring U.S. target stock or assets (to be held in a U.S. corporation) for cash (including cash borrowed by the foreign acquirer) should consider funding a U.S. acquisition vehicle to fund the acquisition. In this regard, funds loaned to a U.S. corporation to acquire U.S. assets or operating companies should not result in equity reclassification under the general rule. It is important, however, to ensure that the funding rule does not reclassify the loan either as a result of distributions or acquisitions in the 36-month period preceding or following the intercompany loan.
 - The regulations eliminate a common strategy used by foreign acquirers used to increase to inject related-party debt in connection with a taxable acquisition of a U.S. target. Specifically, a newly formed U.S. acquisition vehicle would acquire shares of its U.S. parent in exchange for debt of the U.S. acquisition vehicle that ultimately would be serviced by the U.S. target. A similar technique was used to acquire parent shares delivered in a tax-free reorganization, although in that situations withholding tax could arise with respect to the related-party debt issuance.
- Debt "push-down." Strategic and private equity buyers of non-U.S. parented targets will often push down a portion of debt borrowed to acquire foreign parent shares to U.S. operating subsidiaries through a distribution of debt issued by the U.S. operating subsidiary to its non-U.S. parent. Intercompany loans may be used in this manner to repatriate funds from the U.S. to both secure and pay down acquisition financing, as well as to tax-efficiently allocate interest expense deductions. Because the general and funding rules can prevent traditional strategies for inserting related-party debt within a U.S. corporate group, acquirers will need to consider alternative strategies. For example, it may be possible for the non-U.S. parent to on-loan externally borrowed funds to the U.S. group to repay existing indebtedness. Alternatively, the U.S. group could separately borrow and distribute the proceeds to its foreign parent, which can use the funds to repay short-term acquisition financing. The withholding tax consequences and income tax consequences to the foreign parent would need to be evaluated.
- Dividend recapitalizations. Private equity funds often use third-party borrowing to finance shareholder distributions. For non-U.S. parented groups, the inability to borrow at the parent level and push down a

portion of the debt in the U.S. will encourage U.S. operating subsidiaries to borrow from third-party lenders directly to finance distributions by the parent. In this regard, a third-party borrowing by a U.S. subsidiary to fund a dividend to its non-U.S. parent does not involve a related-party borrowing. Nonetheless, the U.S. subsidiary will need to be mindful of the impact of the distribution on any related-party borrowings that were made in the prior 36-month period (but not before April 4, 2016) or anticipated in the subsequent 36 months, (say, for example, with an anticipated U.S. add-on).

- **Refinancing.** A pure refinancing of a related-party debt instrument will not run afoul of the general rule as it would not be treated as a distribution. However, because the refinancing would be treated as a new funding, taxpayers will need to be mindful of prior or anticipated distributions or related-party stock acquisitions occurring in the 36-month period (but not before April 4, 2016) or the subsequent 36-month period. Modification of the duration of the term of the debt instrument that is not significant (and therefore would cause a deemed reissuance under section 1001) can permit flexibility for planning during a particular period of time.
- **Joint Ventures.** In a typical 50/50 corporate joint venture between unrelated corporations, the joint venture vehicle, whether organized as a partnership or as a corporation, may borrow from a corporate owner or affiliate thereof. Because the joint venture entity will not have an 80 percent owner by vote or value, the related-party rules will not apply.

V. Documentation.

The Regulations impose new mandatory documentation requirements on certain expanded group related-party borrowings. When applicable, a borrower must (i) enter into a written loan agreement that records certain compulsory debt terms, (ii) substantiate the borrower's expected ability to pay interest and re-pay principal, and (iii) maintain records demonstrating compliance with the terms of the loan. Failure to comply will result in automatic reclassification of the debt instrument as equity for all U.S. federal income tax purposes.

Effective date. The documentation rules apply to related-party debt instruments issued (or deemed issued under the section 1001 regulations) on or after January 1, 2018.

Interim approach. Well-advised taxpayers on significant inter-company borrowings have typically taken steps that are generally consistent with the new documentation rules. Because the taxpayer bears the burden of demonstrating that a debt instrument should be so classified, prudent taxpayers borrowing prior to January 1, 2018 should meet the documentation requirements for non-ordinary course borrowings.

Scope of the Documentation and Substantiation Rules.

- **Applicable to publicly traded or large issuers.** An issuer will be obligated to comply with the documentation rules if (1) the stock of any member of the expanded group is publicly traded; (2) all or any portion of the expanded group's financial results are reported on financial statements with total assets exceeding \$100 million; or (3) the expanded group's financial results are reported on financial statements that reflect annual total revenue that exceeds \$50 million.
- **Exception for debt issued within a U.S. consolidated groups.** Debt issued by one U.S. consolidated group member to another member is exempt from the documentation rules.
- **Revolvers and other master arrangements.** Revolvers and other multiple draw facilities must comply with special documentation rules and complete regular credit assessments (annually, or upon a material change in a borrower's ability to repay). Individual draws under compliant arrangements will not require separate documentation.

- Special rules for regulated financial companies. Regulated financial companies and insurance companies are eligible for certain exceptions to comply with non-tax regulatory requirements.

Substantiating the Factors.

In general, the documentation maintained for every related-party debt instrument must substantiate the presence of (1) the issuer's binding obligation to pay a sum certain; (2) the holder's rights to enforce payment; (3) a reasonable expectation of repayment; and (4) a course of conduct that is generally consistent with a debtor-creditor relationship. These four factors are necessary but not sufficient to classify an instrument as debt. Related-party debt instruments must still satisfy the other provisions of the Regulations and applicable common-law standards.

- Binding obligation to pay a sum certain. The debt instrument must substantiate that the issuer has an unconditional and legally binding obligation to pay a fixed or reasonably determinable sum certain on demand or at one or more fixed dates.
 - Contingent payments are permitted, though the IRS refrained from addressing contingencies that may result in the repayment of less than an instrument's issue price.
- Rights to enforce payment. The debt instrument must provide the holder with full creditors' rights, including the right to demand and accelerate payments of principal and interest after a default and the right to sue to enforce payment.
 - Issuers of related-party subordinated debt must be certain that the senior related-party debt has been properly documented. In this regard, if senior related-party debt is reclassified under the documentation rules, the junior lender's rights would be junior to the rights of shareholders to receive assets in the case of dissolution and, therefore, would be reclassified as equity.
- Reasonable expectation of repayment. The issuer must substantiate that, as of the date of the issuance or deemed issuance (under section 1001), all relevant circumstances relating to the issuer supported a reasonable expectation that the issuer both intended and would be able to comply with the terms of the agreement.
 - Significantly, the Regulations allow the taxpayer to assume that it will repay principal at maturity through a refinancing, but only if the assumption is reasonable.
 - If the lender relies on a third-party report or analysis, the documentation must include the report or analysis, and privilege cannot be asserted in a controversy.
 - In some situations, a single credit analysis may be sufficient documentation in connection with multiple instruments issued by the same issuer.
 - As noted below, in the case of debt issued by a related party, the taxpayer must again substantiate the reasonable expectation of repayment on a deemed reissuance of debt after a significant modification, which generally overrides the rules under Treasury Regulations section 1.1001-3(f)(7) that often prevents debt from being reclassified as equity following a deemed modification, even if the borrower is not expected to fully repay or make timely interest payments on the debt.
- Course of conduct. The course of conduct between the parties must evidence a debtor-creditor relationship between the parties, including, for example, by documenting payments of interest and principal.

- A related lender is not required in all cases to prove that it has enforced its rights, but is required to document an explanation for any inaction and evidence of the lender's reasonable exercise of the diligence and judgment of a creditor.

Required timing for documentation. The Regulations provide that the required documentation must be in place by the time that the issuer's federal income tax return is filed (taking into account all applicable extensions).

Relief for a failure to appropriately document. The Regulations do include some limited relief for failures to comply with the documentation requirements, but foot-faults can result in reclassification of debt as equity.

- Substantial compliance. To the extent an issuer can demonstrate a very high degree of compliance with the documentation rules throughout the issuer's and holder's group with respect to all related-party debt, the issuer has the opportunity to demonstrate the instrument is appropriately classified as debt under general tax principles.
 - In order to avail itself of this exception, an issuer will need a nearly pristine compliance record with respect to either a very large number of prior related-party debt issuances or issuances with an aggregate principal amount that is very large as compared to the undocumented borrowing.
- Ministerial or non-material failure or errors. If a taxpayer discovers and corrects a ministerial or non-material documentation failure or error before discovery by the IRS, the failure or error is disregarded.
- Reasonable cause exception. Where there is reasonable cause, a failure will be disregarded. Demonstrating reasonable cause is a high bar, such as if the failure arose from events beyond the control of the taxpayer's group.

Modifications of debt instruments. In general, after a modification of a debt instrument that results in a deemed exchange, the taxpayer must perform a new credit analysis to establish a reasonable expectation of repayment, but the taxpayer is not required to re-document an unconditional obligation to pay a sum certain or the creditor's rights unless the modification is affected through a written amendment.