

Memorandum

IRS Issues Regulations Addressing Related-Party Debt

October 17, 2016

Introduction

On October 13, 2016, the Internal Revenue Service (the “IRS”) and Treasury Department issued final and temporary regulations under Section 385 of the Internal Revenue Code addressing the federal income tax treatment of debt between certain related parties. Although significantly reduced in scope from the proposed version of those rules (issued in April 2016), the new regulations could meaningfully limit the ability of U.S. entities to engage in earnings stripping through the issuance of debt to their non-U.S. affiliates and otherwise alter the federal income tax treatment of transactions (including those without a tax avoidance motive). In addition, the documentation requirements in the regulations may represent a substantial compliance burden for corporate groups. The regulations generally (i) treat debt between members of an “expanded group” (as defined below) as equity for U.S. tax purposes if the debt is issued in connection with certain specified transactions and (ii) impose threshold documentation requirements with respect to debt between members of an expanded group that must be satisfied for the debt to be respected for federal income tax purposes. The regulations generally implement the basic framework adopted in the proposed regulations, but eliminate a rule authorizing the IRS to treat debt between certain related parties as equity in part and debt in part and also adopt a number of significant exceptions to equity recharacterization (including an exemption for debt issued by a non-U.S. borrower and an offset for capital contributions).

Background

The IRS has long been concerned about what it sees as the over-leveraging of U.S. entities in the cross-border context and about “inversion” transactions where a non-U.S. parent company acquires a U.S. company. The April 2016 proposed rules, however, were criticized for being too broad and interfering with common commercial arrangements. In particular, the proposed rules were not limited to inverted corporate groups and applied even to debt between U.S. entities and to debt issued by a non-U.S. borrower. The issuance of debt may reduce the overall tax burden of a corporate group, in particular through earnings

stripping where the issuer is a U.S. borrower and the holder of the debt is a non-U.S. parent company (or its non-U.S. subsidiary) located in a low-tax jurisdiction. Subject to certain limitations, interest payments on intercompany debt may give rise to tax deductions that provide a U.S. tax benefit to the borrower without a corresponding U.S. or foreign tax cost to the lender. Dividend or other payments with respect to an equity instrument, however, do not result in a tax deduction for a U.S. borrower. Moreover, while interest payments on debt of a U.S. borrower are frequently exempt from U.S. withholding tax under income tax treaty provisions, dividend payments by U.S. issuers to non-U.S. recipients are often subject to some level of withholding tax.

Per Se Treatment of Debt Instruments Issued in Certain Transactions as Equity

General Rules. The regulations generally provide that a debt instrument (regardless of its terms) between members of an “expanded group” (generally, a group of corporations with a corporate parent that are 80%-owned by the corporate parent or other group members by either vote or value) will be treated as equity to the extent the debt instrument (an “expanded group instrument” or “EGI”) is issued:

- in a distribution by an issuer with respect to its stock (i.e., a dividend of notes),
- in exchange for stock of an affiliate or
- in exchange for property in certain tax-free reorganizations (the “distribution rule”).

In addition, equity recharacterization will apply to an EGI if a principal purpose of the issuance of the EGI is to fund any of the three transactions listed above (the “funding rule”). The Treasury Department has stated these rules are intended to cover situations where the issuer does not use proceeds from the debt issuance to fund an investment in its business.

The regulations establish a non-rebuttable presumption (subject to limited exceptions) that an EGI is deemed issued with a principal purpose of funding a distribution or acquisition if the EGI is issued during the 72-month period beginning 36 months before and ending 36 months after such distribution or acquisition.

Exceptions to Distribution Rule and Funding Rule. The regulations generally implement the framework of the proposed regulations with respect to the distribution rule and the funding rule, but provide for a number of taxpayer friendly exceptions, including those described below:

- **Regulated Financial Institutions.** Instruments issued by certain regulated financial companies and regulated insurance companies that are subject to specific regulatory capital or leverage requirements are exempt from the distribution rule and funding rule.

- **Cash Management Arrangements.** The funding rule does not apply to certain short-term debt instruments. The preamble to the regulations indicates the IRS expects this exclusion will generally prevent certain short-term debt instruments issued in the ordinary course of an expanded group's business, including in connection with cash management arrangements, from being recharacterized as equity.
- **Exception for Earning and Profits.** The distribution rule and the funding rule do not apply to distributions or acquisitions to the extent of the earnings and profits (as determined under federal income tax principles) of an issuer accumulated during its membership in an expanded group in taxable years ending after April 4, 2016.
- **Offset for Capital Contributions.** For purposes of the distribution rule and the funding rule, distributions and acquisitions are generally reduced by capital contributions in exchange for equity of an issuer made during the 72-month period beginning 36 months before and ending 36 months after such distribution or acquisition.
- **Equity Used for Compensation.** Acquisitions of stock of an expanded group member used as compensation for employees, directors or independent contractors are exempt from the distribution rule and funding rule.
- **\$50 Million Exclusion.** The distribution rule and funding rule do not apply to up to \$50 million of EGIs of the issuer's expanded group that would otherwise be subject to recharacterization. If the \$50 million threshold is exceeded, only the excess amount is subject to recharacterization.
- **Non-U.S. Borrowers and U.S. Consolidated Group Debt.** As discussed further below, the regulations do not apply to debt issued by non-U.S. corporations or to debt between members of a U.S. consolidated group.

Even if an exception to the distribution rule or the funding rule applies, an EGI may be recharacterized as equity under the other rule (if an exception does not apply) or the documentation rule described below.

Documentation Requirements

The regulations impose documentation requirements with respect to an EGI that generally must be completed no later than the time for filing the issuer's federal income tax return for the taxable year of the issue date (including extensions). Specifically, the regulations require the issuer to maintain (i) written documentation of a legally binding obligation to pay a sum certain on demand or at one or more fixed dates, (ii) documentation that establishes that the creditor has rights to enforce the obligation, (iii) documentation supporting reasonable expectation of repayment at time of issuance (e.g., cash flow projections, financial statements, business forecasts, asset appraisals, debt-equity and other ratios), including from the proceeds of another borrowing if such expectation is reasonable and (iv) documentation of payments of interest and principal (including wire transfer records or bank statements) and enforcement of remedies on non-payment.

Certain EGIs, including EGIs issued under cash management arrangements, are subject to special documentation rules. Satisfaction of the documentation requirements is a precondition to making a determination of the federal income tax treatment of the EGI under general tax principles. A failure to satisfy the documentation requirements will generally result in an EGI being treated as equity, although an expanded group that demonstrates a high degree of compliance with the documentation rule may rebut this presumption by clearly establishing that there are sufficient common law factors present to treat the EGI as debt.

Special Considerations

Non-U.S. Borrowers. The regulations do not apply to indebtedness issued by non-U.S. corporations, an exception that represents a significant departure from the proposed regulations (which applied even to foreign-to-foreign transactions). The IRS and the Treasury Department, however, continue to study how EGIs issued by non-U.S. borrowers should be treated for federal income tax purposes.

U.S. Consolidated Groups. Because many of the IRS's concerns regarding related-party debt are not present in the case of debt between members of a consolidated group of U.S. corporations, the regulations do not apply to debt between members of a U.S. consolidated group.

Brother-Sister Groups. In addition, the regulations generally do not apply to brother-sister corporations that are owned by a non-corporate owner (such as an entity treated as a partnership for federal income tax purposes).

Investment Funds. The regulations do not adopt special rules for debt instruments used in private equity or other investment fund structures (including indebtedness issued by certain "blocker" corporations), although the IRS and the Treasury Department continue to study these structures.

S Corporations, RICs and REITs. The regulations provide that S corporations are excluded from being expanded group members, and RICs and REITs are generally excluded from being expanded group members unless the RIC or REIT is controlled by members of the expanded group. As a result, debt instruments between a REIT and its taxable REIT subsidiary would generally not be subject to the regulations.

Elimination of Bifurcation Rule

The regulations eliminated rules in the proposed regulations that would have allowed the IRS to treat debt between members of a "modified expanded group" (generally, an expanded group applying a 50% ownership test instead of an 80% test) as equity in part and debt in part if facts and circumstances suggested that the EGI should be treated as two separate instruments under general federal income tax principles.

Effective Dates

Although the distribution rule and the funding rule generally apply to debt instruments issued on or after April 4, 2016 (including debt instruments deemed issued as a result of a modification), any recharacterization under those rules would not become effective earlier than January 19, 2017, and the regulations generally apply only to taxable years ending on or after January 19, 2017. The documentation rule applies to debt instruments issued (or deemed issued) on or after January 1, 2018.

Conclusion

The regulations are a welcome scale back of the breadth of the April 2016 proposed rules, although the rules could still have a significant impact on arrangements and transactions in the future.

We will continue to monitor developments in this area, which remains subject to continued study by the IRS and Treasury Department.

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