IRS Rules Could Treat Related Party Debt as Stock

Article By:

Raj Tanden

Multinational groups can strip U.S. earnings away from U.S. taxation by having a domestic corporation issue debt and pay earnings out to foreign affiliates as deductible interest. This strategy could be used after an “inversion,” where a foreign corporation replaces a domestic corporation as the ultimate parent of the group. In the U.S. government’s most recent effort to combat inversions, the Treasury Department issued not only temporary regulations that target inversions specifically, but also proposed regulations that address the tax treatment of related party debt generally, regardless of whether any party is foreign. The latter proposed regulations were issued as *REG-108060-15, Treatment of Certain Interests in Corporations as Stock or Indebtedness; Proposed Rule* (Apr. 4, 2016).

The related party debt regulations would complicate financial planning and increase tax compliance burdens for groups with corporate members. While much of the required documentation would be advisable in some cases anyway, the regulations would require extensive documentation for all related party debt, and also require tracking many other new parameters, such as:

- The existence and membership of corporate groups subject to the rules
- Dates and amounts of debt issuances, dividends, and stock transactions
- The purpose of a debt issuance
- Earning and profits allocations
- Allocations of loans to transactions
- Total amount of related party loans and their treatments

Moreover, once finalized, the regulations would deny the tax benefits of debt treatment to related party loans ***issued after April 4, 2016***, in certain equity displacement transactions, making them important now.

Overview of Proposed Regulations

The proposed regulations set forth rules for two newly-defined groups of persons. First, debt between members of an "expanded group" (EG) will be treated as stock if (i) specified documentation is not created, maintained, and provided to the IRS on request; or (ii) it is issued in certain transactions that effectively displace equity of an EG member. Second, debt between members of a broader "modified expanded group" (MEG) may be treated as part debt/part stock if that is the proper tax treatment.

Expanded Groups

In general, an EG is defined as an affiliated group within the meaning of section 1504 of the Internal Revenue Code, basically a parent corporation and its 80 percent-owned direct and indirect subsidiaries, but with certain modifications. The exclusions under section 1504(b) do not apply, making any entity classified as a corporation for U.S. federal income tax purposes eligible for inclusion in an EG, including tax-exempt organizations, life insurance companies, foreign corporations, RICs (mutual funds), REITs, and S corporations, along with regular C corporations. In addition, however, an affiliated group that files consolidated returns is treated as a single corporation, which itself is not an EG, so intercompany debt between consolidated group members is not subject to the new rules.

In view of this EG definition, the EG debt rules would apply to loans within multinational and wholly domestic EGs (but not within a U.S. consolidated group). While the rules apply mainly to loans between entities classified as corporations for U.S. federal income tax purposes, partnerships and other non-corporate persons can be covered as well in certain circumstances.

Documentation Requirements

The proposed regulations would impose certain documentation requirements for formal debt instruments between members of an EG (denoted as "expanded group instruments" or EGIs). To exempt smaller groups from the documentation requirements, they apply only if any member of the EG has (i) publicly traded stock; or (ii) total assets exceeding $100 million or total annual revenue exceeding $50 million, as shown on certain specified "applicable financial statements."

While the rules are complicated, they basically require specific items of documentation indicative of a *bona fide* debtor-creditor relationship. Subject to a reasonable cause exception, failure to comply with the documentation requirements generally results in the debt being treated as stock. The rules would generally apply to debt instruments issued after the regulation is finalized.

Equity Displacement Debt

Subject to a few exceptions, the proposed regulations would recast all EGIs issued in displacement of EG member equity as stock for tax purposes. This *per se* approach would depart dramatically from the traditional determination of debt status based on the strength of the repayment obligation. Such equity displacement debt would be treated as stock *even if it is 100 percent investment grade debt, the payment and other terms of which will absolutely be honored.*

Essentially, Treasury is proposing to disallow debt treatment unless it reflects the creditor's lending of new capital to the borrower. Treasury indicated that merely converting equity into debt does not have enough economic substance or non-tax business purpose to warrant the tax benefits of debt treatment. We believe that there also may be a notion that, in the multinational context, the benefits of debt treatment should only be extended for investment of new capital into the United States. In so changing the meaning of indebtedness, one could perhaps question whether Treasury has exceeded its broad authority in this area.

Under the proposed regulation, an EGI would be treated for tax purposes as stock if it is issued in various specified transactions that displace equity of the issuer or another EG member, such as (i) an EGI issued as a dividend in kind or in exchange for other EG member stock, or (ii) an EGI issued for cash which is deemed to be used to pay a dividend or acquire other EG member stock (as when the debt is issued within 36 months of the dividend or acquisition).

There are two general exceptions to stock treatment. One, EGIs issued in or assigned to distributions or acquisitions considered made out of current earnings and profits would not be subject to stock treatment. Two, under a $50 million threshold, stock treatment would not be imposed unless and until there is more than $50 million in EGIs that would otherwise be treated as stock. If that threshold is exceeded, then stock treatment applies to all such EGIs from the first dollar, even existing EGIs.

Stock treatment under this equity displacement rule would already apply to EGIs issued on or after April 4, 2016. However, since the regulation is not yet final and in effect, such stock treatment would not be imposed until 90 days after the regulation is finalized, through deemed conversion to stock at that time. Thus, groups need to be cognizant that transactions undertaken even today could be affected by the new rules. For example, suppose a $100 million, 10-year EGI were issued today as a dividend (not out of current earnings and profits), and the regulations were finalized on May 31, 2018. Interest on it would be deductible through August 29, 2018, after which the interest would become non-deductible dividends, and payment at maturity would be treated as a stock redemption (likely dividend-equivalent).

Part Debt/Part Stock Treatment

The proposed regulations would also provide that the IRS “may” treat debt instruments between members of a MEG as part debt/part stock, if that is the proper treatment for U.S. federal income tax purposes. A MEG is basically the same as an EG, except using a lower 50 percent ownership threshold for subsidiary membership (instead of 80 percent required for EG membership), and including all “persons” that own at least 50 percent of a MEG member’s stock. Since persons include individuals, partnerships, and other noncorporations, it appears that this part debt/part stock treatment could apply to debt issued by a corporation to an individual or partnership owning 50 percent or more of its stock.

This provision reflects Treasury’s dissatisfaction with the courts’ usual all-or-nothing approach, under which instruments have been treated as entirely debt even though they may have significant equity characteristics. Another example given is a $5 million debt instrument, of which only $3 million is sufficiently certain of repayment to qualify as debt.

However, the proposed regulation does not actually state any standards for when a debt instrument should be treated as part debt/part stock, but merely references other law supporting bifurcation. Thus, it seems more a direction or reminder to apply such law than to create new bifurcation rules or standards.

This provision of the proposed regulations would only apply to debt instruments issued after it is finalized.

Miscellaneous Rules

The foregoing provides an overview of the proposed regulations. They contain special rules for partnerships and consolidated groups as well, and anti-abuse rules that can extend their reach.

Aside from obvious transactions involving issuances of new debt within an EG, taxpayers will need to be mindful of other transactions which can invoke the rules, such as a change in status (a company joining or leaving an EG or consolidated group), or modifying the terms of an instrument so as to cause a deemed exchange.

To minimize whipsaw scenarios where a corporation treats its debt instrument as debt while a holder, to the holder's tax advantage, treats it as stock, section 385(c) generally requires a holder of a corporate debt instrument to follow its initial characterization by the issuer. However, section 385(c) allows the holder to adopt a different characterization if the holder discloses the inconsistency on the holder's tax return. The proposed regulations would deny EGI holders this disclosed-inconsistency exception, under the rationale that related parties are under common ownership or control and so should not be allowed to take inconsistent positions. Thus, issuers and holders of EGIs will be required to treat EGIs consistently.

The proposed regulations are basically a one-way street in authorizing the IRS to treat EGIs as stock. Taxpayers cannot use the rules affirmatively to their advantage to treat debt as stock.

Further Developments

Treasury must submit the proposed regulations to a comment and hearing process before they are finalized, and they could be modified or not even finalized. Taxpayers may wish to provide comments to Treasury on issues they see with the regulations. If finalized, their validity could be challenged. At a minimum, taxpayers should keep informed of developments in this area.

National Law Review, Volume VI, Number 120