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Is it Debt or is it Not? Proposed Treasury Regulations Would Significantly Change Debt vs. Equity Analysis

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Earlier in April, the IRS and Treasury Department proposed new Treasury regulations (the "**Proposed Regulations**") under Section 385 of the Internal Revenue Code. The Proposed Regulations would significantly modify the tax analysis concerning the treatment of certain related-party instruments as debt vs. equity for U.S. federal income tax purposes. If finalized in their current form, the Proposed Regulations would represent a dramatic change from long-standing case law and administrative practice in this area.

Although the Proposed Regulations were issued as part of a larger package of temporary and proposed Treasury regulations targeting corporate inversions and earnings-stripping transactions, the Proposed Regulations would have a much broader reach and could impact a wide range of cross-border and domestic activities, including M&A transactions, common strategies employed by private equity funds and their portfolio companies, internal corporate restructurings, and routine financing transactions by multinationals.

Furthermore, if finalized in their current form, certain rules included in the Proposed Regulations would apply to debt instruments issued (or deemed issued) on or after April 4, 2016. Therefore, taxpayers must carefully consider the new rules and their potential implications in connection with their group's structure and currently contemplated and pending transactions.

Prerequisite Procedural Requirements for Related-Party Instruments to Be Treated As Debt

The Proposed Regulations establish new, heightened procedural requirements that must be met as a prerequisite for treating certain related-party instruments as debt. The new rules require contemporaneous preparation of documentation (generally, within 30 days) evidencing (i) an unconditional obligation to pay a sum certain, (ii) creditor-type rights to enforce the terms of the debt, and (iii) a reasonable expectation of repayment (which may be based on cash flow projections or other financial data). In addition, the Proposed Regulations require that a genuine debtor-creditor relationship be evidenced after the instrument is issued, including timely payment of principal and interest and reasonable exercise of creditor's right in case of a default.

Thus, the Proposed Regulations require not only certain procedural and administrative due diligence

and documentation at the outset, but also continuous diligence and record-keeping throughout the term of the applicable instrument. Even if these requirements are met, the instrument will not necessarily be respected as debt for U.S. federal income tax purposes. These requirements are a minimum threshold, and the instrument will still need to "pass muster" under the other debt vs. equity rules set forth in the Proposed Regulations. On the other hand, if these requirements are not satisfied, the instrument will be treated as stock for U.S. federal income tax purposes, regardless of its other terms.

These procedural requirements apply to any related-party debt instruments issued within "large taxpayer groups," generally meaning groups in which the stock of any member of the group is publicly traded, or groups that report any portion of their financial results on financial statements reflecting (1) total assets exceeding $100 million, or (2) annual total revenue exceeding $50 million.

Certain Related-Party Debt Instruments Treated As Equity

In contrast to long-standing case law and tax practice based thereon, subject to certain exceptions, the Proposed Regulations generally treat as stock debt instruments issued in connection with certain related-party transactions, regardless of the terms of the instrument in question (and thus without regard to whether or not the instrument would be respected as debt had it not been issued between related parties). Such related-party transactions include (i) a distribution of a debt instrument by a subsidiary to its parent, (ii) an issuance of a debt instrument in exchange for stock of another member of the group, and (iii) an issuance of a debt instrument as consideration pursuant to a certain type of internal group reorganization.

In addition, pursuant to a "funding rule," the Proposed Regulations treat as stock debt instruments that are issued with a principal purpose of funding a distribution or an acquisition in the circumstances described above. While the "principal purpose" determination is based on all the applicable facts and circumstances, the Proposed Regulations establish a non-rebuttable presumption that the proscribed principal purpose exist if any of the abovementioned related-party transactions occurs within 36 months prior to, or following, the issuance of the debt instrument.

Importantly, the Proposed Regulations provide that these rules would apply to debt instruments issued (or deemed issued) on or after April 4, 2016 (with only a short 90-day transition period following the adoption of final regulations).

Bifurcated Debt / Equity Treatment

In yet another departure from existing law (under which instruments are generally treated as entirely debt or entirely equity), the Proposed Regulations authorize the IRS (but not taxpayers) to bifurcate the treatment of a related-party instrument in a corporation as part debt and part stock for U.S. federal income tax purposes, based on the "substance" of the instrument.

The bifurcated treatment could apply to related-party debt instruments issued between group members that meet a 50%-relatedness threshold (including groups with a partnership or other non-corporate parent).

This new rule, which deviates from the "all or nothing" approach under current law, could also impact tax audit practice and settlement discussions.

What's Next?

While the Proposed Regulations are expected to attract extensive comments, including challenge from those who question the authority of Treasury and the IRS to promulgate such broad-sweeping rules in a dramatic deviation from existing law, the IRS and Treasury have indicated their intention to "move swiftly" to finalize the rules.

The Proposed Regulations generally would apply only after regulations are issued in final form (however, the provisions governing debt instruments issued between related parties in connection with the transactions described above would apply to debt instruments issued (or deemed issued) on or after April 4, 2016).

If finalized in their current form, the Proposed Regulations could treat as equity, for U.S. federal income tax purposes, instruments that would be treated as debt under current law, merely because they are issued among related parties. Therefore, taxpayers should carefully review the Proposed Regulations, study the potential impact of the new rules on their existing structure and contemplated or pending transactions, and consider whether any preparatory action should be taken at this time.

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