Simpson Thacher

Memorandum

Internal Revenue Service Issues Proposed Regulations Addressing Related-Party Debt

April 8, 2016

Introduction

On April 4, 2016, the Internal Revenue Service (the "IRS") and Treasury Department issued proposed regulations under Section 385 of the Internal Revenue Code of 1986, as amended, addressing the federal income tax treatment of debt between certain related parties. The proposed regulations, if finalized, would 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 would impose threshold documentation requirements with respect to debt between members of an expanded group that must be satisfied in order for the debt to be respected as debt for federal income tax purposes. In addition, the proposed regulations would allow the IRS to treat debt between members of a "modified expanded group" (as defined below) as equity in part and debt in part if warranted under general U.S. tax principles. Although the rules are motivated in part by the perceived over-leveraging of U.S. entities in the cross-border context and were issued in connection with regulations addressing "inversion" transactions in which a foreign parent company acquires a U.S. group, the rules are not limited to inverted corporate groups and may apply even if the debt is between U.S. entities.

Background

In 2014 and 2015, the IRS issued notices that the IRS expected to issue additional guidance to limit the benefits of certain post-inversion tax avoidance transactions. In particular, the IRS was considering guidance to address strategies that avoid federal income tax on U.S. operations by shifting U.S.-source earnings to lower-tax jurisdictions, including through use of intercompany debt. 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 the borrower. A

U.S. corporate subsidiary of a foreign parent company, therefore, may issue debt to a foreign affiliate in order to reduce the overall tax burden of the group.

Treatment of Debt Instruments as Equity

Debt Instruments Issued in Certain Transactions. The proposed regulations generally provide that debt instruments between members of an "expanded group" (generally, a group of companies with a corporate parent that are 80%-owned by 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"). A statement from the Treasury Department indicates 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 proposed regulations establish a non-rebuttable presumption (subject to a limited exception) 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. A more taxpayer friendly rule, however, provides that distributions and acquisitions that are not in excess of a taxable year's current earnings and profits are generally not taken into account for purposes of the distribution rule or the funding rule. This rule, plus a separate exception for debt instruments that arise in the ordinary course of the issuer's trade or business, are intended to accommodate ordinary course distributions and acquisitions within a corporate group.

Authority for IRS to Bifurcate Instruments. The proposed regulations allow 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 suggest that the EGI should be treated as two separate instruments under general U.S. tax principles.

Documentation Requirements and Other Items

The proposed regulations impose contemporaneous documentation requirements with respect to an EGI. Specifically, the proposed 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) and (iv) documentation of payments of interest and principal (including wire transfer records or bank statements) and enforcement of remedies on non-payment. Satisfaction of the documentation requirements is a precondition to making a determination of the federal tax treatment of the EGI under general tax principles. A failure to satisfy the documentation requirements will result in an EGI being treated as equity.

Since 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 proposed regulations do not apply to debt between members of a U.S. consolidated group.

Effective Date

If finalized, the proposed regulations generally will apply to debt instruments issued on or after the date of publication of final regulations. Debt instruments issued on or after April 4, 2016 and before the date of publication of final regulations, however, may be recharacterized as equity under the distribution rule or the funding rule. Any such recharacterization would become effective ninety days after the date of publication of final regulations.

Conclusion

The proposed regulations could significantly affect the ability of U.S. entities to engage in earnings stripping through the issuance of debt to their foreign affiliates, and could also apply outside of the cross-border context. In addition, the documentation requirements in the proposed regulations may represent a substantial compliance burden for corporate groups.

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

For further information, please contact one of the following members of the Firm's Tax Department.

John C. Hart
+1-212-455-2830
jhart@stblaw.com

Robert E. Holo
+1-212-455-2514
rholo@stblaw.com

Marcy G. Geller
+1-212-455-3543
mgeller@stblaw.com

Nancy L. Mehlman
+1-212-455-2328
nmehlman@stblaw.com

Simpson Thacher Worldwide

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
900 G Street, NW
Washington, D.C. 20001
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3901 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul
25th Floor, West Tower
Mirae Asset Center 1
26 Eulji-ro 5-Gil, Jung-Gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000