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IS IT DEBT OR EQUITY? U.S. TREASURY ISSUES FINAL 385 REGULATIONS

HIGHLIGHTS FOR NON-U.S. TAXPAYERS

On October 13, 2016, the U.S. Treasury Department ("**Treasury**") and the Internal Revenue Service ("**IRS**") published highly anticipated final rules setting forth circumstances in which certain intercompany debt would be reclassified as equity (the "**Final Rules**"). Following the earlier publication on April 4, 2016 of exceedingly broad and controversial proposed regulations ("**Proposed Rules**") which generated an overwhelming reaction by the tax bar and taxpayers, the Final Rules cover a narrower scope of transactions, though not without significant impact for those within its reach. At its core, the Final Rules lay out specific circumstances under which purported debt can or will be recharacterized as equity. While there are significant exclusions available, foreign taxpayers with U.S. activities will need to understand the scope and mechanics of the rules because, absent the clear application of an exemption, their typical cross-border tax transactions may be impacted. As an additional complication, the imminent ascendancy come January 20, 2017 of a Republican administration in the United States undoubtedly will shift priorities and introduce changes to the U.S. federal income tax ("**USFIT**") regime, including potentially rolling back the Final Rules. Consequently, taxpayers should closely monitor developments over the course of the coming year.

WHAT DO THE FINAL RULES DO?

The Final Rules target transactions occurring between related parties which can abuse debt characterization to obtain tax advantages like interest deductions and profit shifting. The Final Rules manifest in two primary rules - the "**Documentation Rule**" and the "**Recharacterization Rule**."

Important exemptions apply under the Final Rules, limiting the universe of taxpayers affected. In particular, issuers of debt that are foreign corporations, partnerships, or S corporations are exempt from the Final Rules. Additional exemptions include non-controlled (less than 80% by vote or value) real estate investment trusts and regulated investment companies. The Final Rules also are limited in that they apply only to instruments issued between members of an Expanded Group ("**EG**"). An EG is defined to include companies with 80% vote or value affiliations.

Although the exemption for foreign corporations certainly is welcome news to multinational groups based in France and elsewhere, and includes debt issued by US branches of foreign issuers, any US corporate affiliate borrowers within a multinational EG are still within scope of the Final Rules.

A. The Documentation Rule

In addition to the exemptions applicable generally to the Final Rules, the Documentation Rule is further limited in its scope as it will only apply to members of an EG if (i) the stock of any member of the EG is publicly traded, or (ii) the EG has more than $100M of total assets or more than $50M of annual total revenue reflected on financial statements. The U.S. Treasury has indicated that less than 1500 corporate groups should be impacted by the new rule. Moreover, there is some time given to such corporate groups to prepare since the Documentation Rule will not apply to instruments issued prior to January 1, 2018.

Under the Documentation Rule[1], an intercompany debt or receivable issued by a domestic corporation (or its disregarded entity) to a member of its EG will be respected as debt for USFIT purposes only if certain documentation requirements are satisfied. Specifically, the instrument must be documented to (i) evidence an unconditional binding obligation to repay; (ii) establish standard creditors' rights to enforce the debt; (iii) establish issuer's financial position supporting a reasonable expectation of repayment; and (iv) reflect actions that show a genuine creditor-debtor relationship (*e.g.*, documenting that payments are being made, or provisions being followed in the event of nonpayment).

Failure to satisfy the required documentation does not result in automatic recharacterization but instead will create a rebuttable presumption of equity treatment provided the EG generally was "highly compliant" during the taxable year (meaning the value of undocumented instruments is not considered excessive within parameters set out in the Documentation Rule). Consequently, the Documentation Rule functions as a gateway for compliance and, absent significant failure, non-compliance with respect to a particular instrument does not result in automatic recharacterization; the taxpayer can provide evidence proving its case. However, the four factors to be documented are given great weight in the overall debt/equity assessment, and the taxpayer would need to clearly establish that notwithstanding the lack of concurrent documentation, those factors exist.

If the rebuttable presumption holds, or there is significant failure to comply, the equity generally will be deemed issued in satisfaction of the debt at the adjusted issue price of the debt (to avoid creating an OID (original issue discount) problem). Consequently, there should not be cancellation of debt income although there could be foreign currency gain or loss.

As a practical matter, taxpayers will have until the due date for filing their tax return (including extension) to prepare the necessary documentation in any year. The documentation will need to be retained for all tax years that the instrument is outstanding, through the statute of limitations expiry for such years.

B. The Recharacterization Rule

The Recharacterization Rule effectively applies to certain transactions between members of an EG ("**Specified Transactions**"). The Recharacterization Rule recharacterizes as equity certain debt between EG members defined as "**Covered Debt**" when issued (i) in connection with these Specified Transactions (under a sub-rule known as the "**Distributions Rule**") or (ii) to indirectly fund Specified Transactions under another sub-rule known as the "**Funding Rule**."

Covered Debt is narrower in scope than the debt instruments subject to the Documentation Rule. In addition to the general exemptions applicable under the Final Rules, Covered Debt also does not include qualified short term funding debt (including certain cash pooling arrangements) and debt issued by certain regulated finance and insurance companies.

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[1] Notably, debt between members of the same U.S. consolidated group (as defined for USFIT purposes) is excused from the Documentation Rule as are REMIC interests and any other interests treated as debt under other USFIT provisions.

In addition, the Recharacterization Rule does not apply to the first $50 million of issued debt, and excludes distributions of the issuer's current and accumulated E&P generated since April 4, 2016 forward.

Notably, the Recharacterization Rule applies retroactively to Covered Debt issued after April 4, 2016 (the date the Proposed Regulations were issued).

- **The Distributions Rule**

The Distributions Rule mandates equity recharacterization of Covered Debt issued in connection with Specified Transactions defined to include:

(i) a distribution (i.e., such as a dividend) to EG member shareholders;

(ii) an exchange for stock of an EG member; or

(iii) a payment for assets acquired in a reorganization of assets within the EG.

Important exclusions from Specified Transactions include debt issued in connection with the acquisition of subsidiary stock, compensatory stock options, qualified contributions, and for collateral adjustments required under transfer pricing regulations. Finally, deemed acquisitions of EG stock resulting from the Funding Rule (discussed below) are excluded from the scope of Specified Transactions.

The driver to the Distributions Rule is preventing companies from issuing debt solely to fund intercompany transactions within the EG. In the context of Specified Transactions, the debt funding generally is not meant to finance new investment in the operations of the issuer but is arguably used as a device to create tax benefits like interest deductions or shifting profits.

- **The Funding Rule**

The Funding Rule similarly recharacterizes as equity Covered Debt if the debt is issued too closely in time to a Specified Transaction. This rule is meant to prevent any possibility of an end run of the Distributions Rule by indirectly funding the Specified Transaction with debt issued sometime before or after the Specified Transaction. The time period is set to 72 months computed as of the date the Specified Transaction occurs, looking back 36 months and forward 36 months. Consequently, any Covered Debt issued within that time frame is deemed to have been issued with a principal purpose of funding the Specified Transaction. Taxpayers will need to be mindful of their overall tax planning, looking forward and back before issuing debt between EG members. Notably, most tax practitioners find this time frame overly expansive and predict it will be difficult to for companies to manage.

C. USFIT Consequences to Consider in Case of Recharacterization

Once a debt instrument is recharacterized as equity, payments on that instrument will be treated as distributions on stock, *i.e.,* dividends, and will no longer be deductible interest payments for USFIT purposes. Generally, the prior characterization as interest would have permitted a reduction or elimination of US withholding tax under an applicable US tax treaty. Subsequent to a recharacterization, any reduction or elimination of applicable USFIT withholding tax would need to be tested under the relevant dividend article of the treaty and not under the interest provision.

In many cases, including the U.S. tax treaty with France, dividends are likely to be subject to a USFIT withholding tax whereas interest payments may have been exempt. Even where no treaty applied, the full 30% dividend withholding tax may apply going forward in place of the portfolio interest exemption, a domestic USFIT rule which may have been available to exempt interest payments from withholding. In short, an unexpected recharacterization can result in serious tax costs that must be considered.

D. A Few Basic Examples of the Final Rules Applied

Example 1: A French company issues debt (*i.e.*, a note) to its U.S. affiliate. The Final Rules will not apply because the issuer of the debt is foreign.

Example 2: A U.S. wholly owned subsidiary of a French operating company issues a $40M debt to its French parent. Assume this is the only outstanding intercompany debt. The Recharacterization Rule should not apply even if there is a connected Specified Transaction because the debt is below the $50M threshold.

Example 3: A U.S. wholly owned subsidiary of a French operating company issues a $60M debt to its parent in exchange for stock in an affiliate of their EG. Assume this is the only outstanding intercompany debt. The U.S. subsidiary has $5M of current E&P, and $15M accumulated E&P (since April 4, 2016). The Recharacterization Rule should not apply because after reduction of the issued debt ($60M) by total E&P ($20M), the net debt resulting of $40M is below the $50M threshold.

Example 4: A U.S. wholly owned subsidiary of a French operating company issues a $100M debt in exchange for assets of another EG member. Its current and accumulated E&P totals $30M resulting in net debt of $70M. The Recharacterization Rule applies to $20M of the debt, with the first $50M being excluded. The debt being issued in exchange for assets of another EG member is a Specified Transaction.

Example 5: In January of year 1, a U.S. wholly owned subsidiary of a French operating company issues a $100M debt. Two years later, the same U.S. subsidiary makes a dividend distribution to its French parent. The Recharacterization Rule applies because the debt is issued within the covered period (of 36 months) prior to a Specified Transaction, *i.e.*, the distribution. Assuming no reduction by E&P, the first $50M of the debt will be excluded and the remaining $50M will be recharacterized as equity. ■

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