

IRS PROPOSED REGULATIONS ON DEBT/EQUITY

Canadian Tax Highlights
May 2016

Portions of this article were originally published in Canadian Tax Highlights, Volume 24, Number 5, May 2016. Reprinted with permission.

On April 4, 2016, the US Treasury issued proposed regulations that seem to have had the desired and dramatic chilling effect on corporate inversions (particularly, the proposed inversion of Pfizer). In fact, the day after the proposals were issued, Pfizer announced that it will not acquire Allergan and invert to Ireland, which will potentially cost Pfizer US\$400 million in break-up fees. Importantly, the scope of the proposals clearly covers much more than inversion transactions and their effect on all related party financings is of particular concern to multinational groups, which often seek to reduce US tax by heavily leveraging a group's US affiliate. Taxpayers should consult their advisors to determine whether their related party debt arrangements are affected.

An inversion is a transaction by which a US parent company is replaced by a non-US parent company (e.g., Pfizer would have become an Irish-parented company). Inversions are typically undertaken to reduce the overall US tax of the corporate group, which presents considerable benefits given that the US has the highest corporate tax rate in the world at 35 percent. The reduction of the overall US tax is accomplished through financing arrangements using intercompany indebtedness. Current limitations under US tax law specifically designed to address interest stripping for multinationals have not been sufficiently effective to reduce the lure of inversions. As noted, however, in addition to the strategies used in the inversion context, the proposals also target related-party debt-financing techniques in general for both multinational and domestic groups (except for US consolidated groups).

The proposals were issued under Internal Revenue Code section 385, which addresses whether a corporate interest is stock or indebtedness. The statute lists five factors to consider, but the characterization of debt or equity in corporate capitalizations has historically been determined primarily by case law, partly because Treasury did not issue meaningful regulations under section 385 even though it is explicitly authorized to do so under the statute. The proposals, however, depart from the judicial approach, which generally looked at a broad range of factors (in addition to those included in the statute). The proposals instead target specific transactions and provide that a debt instrument issued as part of these transactions will per se be treated as stock, subject to limited exceptions.

Attorneys

Carol Fitzsimmons

Practices & Industries

Canada-U.S. Cross-Border

Europe-U.S. Cross-Border

International Tax

Securities Regulation & Corporate
Compliance

IRS PROPOSED REGULATIONS ON DEBT/EQUITY

In particular, Treasury determined that an advance should be classified as equity if issued as part of three broad transaction types, regardless of the parties' characterization (the "Per Se Stock Rules"): (1) a distribution of a debt instrument by a corporation to related shareholders; (2) the issuance of a debt instrument by a corporation in exchange for an affiliate's stock; and (3) the issuance of debt pursuant to an internal asset reorganization. In addition, the Per Se Stock Rules also apply to debt issued during a six-year period surrounding the specified transaction that have a principal purpose of funding the specified transaction. To illustrate the application of the Per Se Stock Rules, the proposed regulations provide numerous examples. Importantly, the Per Se Stock Rules do not apply to the following (1) amounts distributed or used in acquisitions that do not exceed current year earnings and profits of the distributing company; (2) funded stock acquisitions of another affiliate if, for the 36 months after the acquisition, the corporation holds, directly or indirectly, more than 50 percent of the total combined votes and value of the other affiliate; and (3) a debt instrument if the aggregate adjusted issue price of all debt instruments held by the group, and otherwise recharacterized under these rules, does not exceed US\$50 million.

The Per Se Stock Rules that cause purported debt instruments to be recharacterized as equity apply to debt instruments issued after April 3, 2016 which continue to be held by a group member 90 days after the regulations are finalized. Although existing arrangements may thus be grandfathered, modifying an existing debt arrangement after the effective date may trigger the proposals' application. Furthermore, an advance under a revolving line of credit or a cash pooling arrangement established before the cut-off is subject to the proposals.

Additionally, the proposed regulations also impose documentation requirements that are necessary (but not dispositive) to treat an advance as debt. These requirements, however, only apply to certain large taxpayers: a publicly traded corporate group with assets exceeding US\$100 million or annual total group revenue exceeding US\$50 million. The proposals require the following: a contemporaneous written legally binding obligation to repay the advanced funds, creditor rights set out in the debt instrument and consistent with arms-length standards, a reasonable expectation of the funds repayment (cash flow projections or other relevant financial data are analyzed), and the debt's post-issuance treatment by the parties in a manner consistent with arms-length debtor-creditor arrangements. This last requirement may be the most challenging of all: for example, written documentation that requires the annual payment of interest is not sufficient if interest is not paid by the borrower and the related creditor does not enforce that obligation in a manner that is consistent with how it would enforce such rights with a third-party borrower. These documentation requirements are not effective until after the proposals are finalized, but Treasury has indicated that it will endeavor to finalize them as quickly as possible after a public hearing is held this summer.

Lastly, the proposals authorize the IRS to bifurcate debt instruments into part debt and part equity if the circumstances warrant. This is a fundamental departure from settled practice, under which a debt instrument would be treated as debt or equity in its entirety. This proposal increases the risk that a debt instrument will be recharacterized as equity. For example, where the US tax authority concludes that there is only a reasonable expectancy to be repaid on a portion of the indebtedness (which historically was only one factor in the analysis), it now has the authority to bifurcate the instrument into part debt and part equity.

Interestingly, Treasury specifically says that the proposals only apply to debt instruments denominated as such by the lender and borrower. Thus, arrangements such as REPOs and other hybrid instruments, which the taxpayer treats as debt for tax purposes but not necessarily for commercial law purposes, are not subject to the new rules.