

AN ALERT FROM THE BDO INTERNATIONAL TAX PRACTICE

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SUBJECT

INTERNAL REVENUE SERVICE AND TREASURY RELEASE PROPOSED REGULATIONS ADDRESSING DEBT/EQUITY CLASSIFICATIONS FOR US TAX PURPOSES

AFFECTING

This affects certain taxpayers issuing related party debt instruments.

DETAILS

Background

On April 4, 2016, the United States Department of the Treasury (“Treasury”) and the Internal Revenue Service (“Service”) published proposed regulations under Internal Revenue Code (“Code”) Section 385 addressing the characterization of certain related party debt instruments as debt or equity for United States tax purposes.

The proposed regulations under IRC Section 385 would authorize the Service to treat certain related-party interests in a corporation as indebtedness in part and stock in part for federal tax purposes, and establish threshold documentation requirements that must be satisfied in order for certain related-party interests in a corporation to be treated as indebtedness for federal tax purposes. Additionally, the proposed regulations would treat certain related-party interests as stock that otherwise would be treated as indebtedness for federal tax purposes. Each of these areas is discussed below.

Code Section 385 was originally enacted to allow for the characterization of an interest in a corporation as either stock or indebtedness for United States tax purposes. The code section provides for a number of factors to be considered in making this determination. Furthermore, the list of factors to be considered has also been expanded upon and developed in subsequent years through case

CONTACT:

ROBERT PEDERSEN, Partner and
International Tax Practice Leader
(212) 885-8398 / rpedersen@bdo.com

JOE CALIANNO, Partner and International
Technical Tax Practice Leader
National Tax Office
(202) 904-2402 / jcalianno@bdo.com

SCOTT HENDON, Partner
(214) 665-0750 / shendon@bdo.com

MONIKA LOVING, Partner
(404) 979-7188 / mloving@bdo.com

CHIP MORGAN, Partner
(310) 557-7517 / cmorgan@bdo.com

BRAD RODE, Partner
(312) 233-1869 / brode@bdo.com

WILLIAM F. ROTH III, Partner,
National Tax Office
(616) 776-3761 / wfroth@bdo.com

JERRY SEADE, Principal
(713) 986-3108 / jseade@bdo.com

law. In general, no one factor was dispositive of debt or equity treatment and the determination was heavily based on the facts and circumstances in each particular case.

Treasury notes in the preamble to the proposed regulations that the historical factors used in this analysis have been applied somewhat inconsistently and can arrive at results in the related party context that may be contrary to policy or the intent of the statute.

Taxpayers Affected

In discussing the purpose of the proposed regulations, Treasury references excessive indebtedness in the cross-border context between related parties and how this can be used to significantly reduce a company's tax liability. They also note, however, that these regulations may apply to purely domestic situations (U.S. to U.S.) as well. However, they generally exclude related party indebtedness between members of the same U.S. consolidated group.

The scope of the proposed regulations generally is limited to purported indebtedness between members of an expanded group. The proposed regulations define the term expanded group by reference to the term affiliated group in Code Section 1504(a). However, the proposed regulations broaden the definition in several ways. Unlike an affiliated group, an expanded group includes foreign and tax-exempt corporations, as well as corporations held indirectly, for example, through partnerships. Further, in determining relatedness, the proposed regulations adopt the attribution rules of Code Section 304(c)(3). The proposed regulations also modify the definition of affiliated group to treat a corporation as a member of an expanded group if 80 percent of the vote or value is owned by expanded group members (instead of 80 percent of the vote and value, as generally required under Code Section 1504(a)). However, certain rules or thresholds are contained in the proposed regulations that would modify when the rules would or would not apply. For instance, there is a rule limiting the application of Proposed Regulations Section 1.385-2 to certain large taxpayers and a rule in Proposed Regulations Section 1.385-3 providing a \$50 million threshold exception.

The Proposed Regulations

The proposed regulations address three primary areas relating to debt/equity classification. They are:

1. Allowing the Service to recharacterize an instrument as part debt and part equity;
2. Requiring contemporaneous documentation to support debt classification of related party indebtedness; and
3. Providing specific rules to characterize debt instruments as stock with respect to certain distributions, reorganization transactions and certain other types of transactions.

Allowing the Service to recharacterize an instrument as partly debt and partly equity

Proposed Regulations Section 1.385-1 provides the Service authority to recharacterize a related party debt instrument as debt in part and equity in part. This is a departure from the historical application of the rules, which generally seemed to require an instrument be treated wholly as debt or wholly as equity (the 'all-or-nothing' rule). Treasury sees the 'all-or-nothing' approach as reaching consequences that may not reflect the economic substance of the transaction. Therefore, in the proposed regulations Treasury has provided the ability for the Service to characterize an instrument partially as debt or partially as equity, depending on the facts and circumstances of the case. The proposed regulations authorize the treatment of an interest as indebtedness in part and stock in part in the case of instruments issued in the form of debt between parties that are related, but at a lesser degree of relatedness than that required to include them in an expanded group. Under the proposed regulations, treatment as indebtedness in part and stock in part can apply to purported indebtedness between members of modified expanded groups (which are defined in the same manner as expanded groups, but adopting a 50 percent ownership test and including certain partnerships and other persons). The preamble provides an example for illustration of this rule by way of a five million dollar debt instrument of which the issuer can only reasonably be expected to repay three million dollars, and the instrument could be recharacterized as three million dollars of indebtedness and two million dollars of equity.

Requiring contemporaneous documentation to support debt classification of related party indebtedness

Proposed Regulations Section 1.385-2 contains a new requirement for contemporaneous documentation for certain related party indebtedness in order to allow for the indebtedness to be respected as debt for United States tax purposes. The rules provide that if a taxpayer does not prepare and maintain the documentation such that they can provide it to the Service upon request, the related party indebtedness will be treated as stock or equity.

The documentation requirement focuses on taxpayer substantiation of four key elements of the instrument:

1. Binding Obligation to Repay;
2. Creditor's Rights to Enforce Terms;
3. Reasonable Expectation of Repayment; and
4. Genuine Debtor-Creditor Relationship.

The preamble and the regulations provide some examples of the types of documentation that could be used to support these four elements.

As noted above, the preamble and regulations state that in the absence of this documentation treatment as indebtedness will not be allowed. The preamble also states that satisfaction of these four factors by way of the contemporaneous documentation does not conclusively establish the instrument as indebtedness, but rather simply allows for the possibility of indebtedness treatment pending further analysis by the Service based on the facts and circumstances under existing federal tax principles and case law.

Treasury has provided a few limitations and exceptions to the applicability of the above documentation requirements. The documentation requirement is intended to apply to taxpayers that are 'highly related' (i.e., 80 percent relatedness by ownership) and also only to 'large taxpayer groups'. Therefore, an instrument is not subject to the documentation requirements unless one of the following conditions is met:

- ▶ The stock of any member of the expanded group is publicly traded;
- ▶ All or any of the portion of the expanded group's financial results are reported on financial statements with total assets exceeding US\$100 million; or
- ▶ The expanded group's financial results are reported on financial statements that reflect annual total revenue that exceeds US\$50 million.

Providing specific rules to characterize debt instruments as stock in certain distributions or reorganization transactions

Proposed Regulations Section 1.385-3 is intended to address specific factual situations identified by Treasury as creating policy concerns. Treasury identified three primary types of transactions of concern addressed in Proposed Regulation Section 1.385-3:

1. Distributions of debt instruments by corporations to their related corporate shareholders;
2. Issuances of debt instruments by corporations in exchange for stock of an affiliate; and
3. Certain issuances of debt instruments as consideration in an exchange pursuant to internal asset reorganization.

Treasury also noted that similar concerns arise when a debt instrument is issued in order to fund future payments or transfers of cash.

The preamble to the proposed regulations suggests that of primary concern to Treasury is the issuance of debt instruments in situations where no cash or capital has been transferred as part of the transaction. They discuss several cases in which instruments were treated as indebtedness that Treasury now feels creates policy concerns, and are situations now in which the instruments issued should be treated as stock.

The potential characterization of indebtedness as stock under Proposed Regulations Section 1.385-3 is accomplished through three different rules: a general rule, a funding rule and an anti-abuse rule.

The general rule provides that a debt instrument can be treated as stock to the extent it is issued by a corporation to a member of the corporation's expanded group (1) in a distribution; (2) in exchange for expanded group stock (subject to a limited exception); or (3) in exchange for property in certain asset reorganizations.

The funding rule is targeted at debt instruments issued with a principal purpose of funding a transaction described in the general rule. The funding rule contains a non-rebuttable presumption of a principal purpose within a 72-month period surrounding the distribution or acquisition. This would apply if the instrument is issued by a member during the period beginning 36 months before the distribution or acquisition and ending 36 months after the distribution or acquisition. There is an exception in the proposed regulations to the non-rebuttable presumption rule for certain ordinary course debt instruments (as defined in the proposed regulations).

The anti-abuse rule is targeted towards specific situations that Treasury believes are abusive or may avoid the application of these rules, and the regulations contain several examples outlining these situations.

There are a few exceptions that may apply. For instance, Proposed Regulations Section 1.385-3(c)(1) includes an exception pursuant to which distributions and acquisitions described in Proposed Regulations Section 1.385-3(b)(2) (the general rule) or Proposed Regulations Section 1.385-3(b)(3)(ii) (the funding rule) that do not exceed current year earnings and profits (as described in Code Section 316(a)(2)) of the distributing or acquiring corporation are not treated as distributions or acquisitions for purposes of the general rule or the funding rule. For this purpose, distributions and acquisitions are attributed to current year earnings and profits in the order in which they occur. Additionally, there is a threshold exception to the general rule and the funding rule if all of the expanded group debt instruments that could be treated as stock do not exceed US\$50 million. This is merely a threshold and not an exemption, so once group indebtedness exceeds US\$50 million then all of the indebtedness potentially subject to recharacterization will be subject to these rules. Additionally, there is an exception contained in the proposed regulations for certain funded acquisitions of subsidiary stock by issuance.

Potential Consequences of Recharacterization of Debt as Stock/Equity

In general, if debt is recharacterized as stock or equity, then interest deductions on the indebtedness could be disallowed and any payments could be treated as dividend distributions.

Applicability Dates

The provisions of Proposed Regulations Section 1.385-2 are proposed to be generally effective when the regulations are published as final regulations. Proposed Regulations Section 1.385-2 would apply to any applicable instrument issued on or after that date, as well as to any applicable instrument treated as issued as a result of an entity classification election under Treasury Regulations Section 301.7701-3 made on or after the date the regulations are issued as final regulations.

Proposed Regulations Sections 1.385-3 and 1.385-4 (dealing with the treatment of consolidated groups) generally are proposed to apply to any debt instrument issued on or after April 4, 2016 and to any debt instrument issued before April 4, 2016 as a result of an entity classification election made under Treasury Regulations Section 301.7701-3 that is filed on or after April 4, 2016. However, when certain rules of the proposed regulations (proposed regulations 1.385-3(b) and 1.385-3(d)(1)(i) through (d)(1)(iv) or 1.385-4) would otherwise treat a debt instrument as stock prior to the date of publication of final regulations, the debt instrument is treated as indebtedness until the date that is 90 days after the date of publication of final regulations. To the extent that the debt instrument in the prior sentence is held by a member of the issuer's expanded group on the date that is 90 days after the date of publication of final regulations, the debt instrument is deemed to be exchanged for stock on the date that is 90 days after the date of publication of final regulations.

HOW BDO CAN HELP

BDO can help our clients to understand the application and implications of these new proposed regulations to their company. With the increase in scrutiny over cross-border financing of operations, especially in light of the proposed base erosion and profit shifting recommendations, cross border transactions have become increasingly complex. These new proposed regulations add an additional layer of complexity and compliance to this area. BDO can help our clients to understand what their obligations under these new proposed regulations will be and to comply with such obligations. There will be increased need to document related party financing transactions in light of these new rules, and it is important for companies to understand what they need to do to be in compliance.

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