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This thought leadership paper dwells on proposed earnings stripping regulations introduced by IRS under section 385 of the Internal Revenue Code

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On April 4, 2016, the internal revenue service ("IRS") and the treasury department issued temporary and proposed regulations formalizing rules contained in Notices 2014-52 and 2015-79, limiting corporate tax inversions, as well as adding new rules addressing inversions and earnings stripping transactions. This newsletter focuses on earnings stripping regulations which came in proposed form (REG-108060-15) referred to as the "Proposed 385 Regulations". Proposed Regulations if finalized as proposed, contains changes which would have far-reaching consequences for corporations that issue debt instruments to related corporations and partnerships.

Section 385, statute and legislative history

Section 385(a), as originally enacted as part of the Tax Reform Act of 1969 (Pub. L. No. 91-172, 83 Stat. 487), authorizes the Secretary to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is treated as stock or indebtedness for purposes of the Code. Regulations were issued in 1980 but withdrawn by Treasury and the IRS in 1982. As a result, the determination as to whether an instrument issued by a corporation constitutes debt or equity has largely been left to the courts. There have been a few court cases on this matter (prominent being Fin Hay Realty Co v/s United States and Estate of Mixon v/s United States) which laid down criteria (anywhere between 12 to 16) to be considered while classifying between debt and equity.

Proposed 385 regulations

The proposed 385 regulations can be broadly divided into (A) classification rules; and (B) documentation rules.

(A) Classification rules

Part debt and part stock

The Treasury and the IRS have determined that in certain circumstances an instrument issued between related parties may be treated as part debt and part equity, rather than imposing an "all-or-nothing" approach. This is one of the most significant aspects of the proposed regulations.

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The Congress had amended section 385(a) in 1989 to authorize the issuance of regulations permitting an interest in a corporation to be treated as in part indebtedness and in part stock. In terms of the legislative history to the 1989 amendment - "there has been a tendency by the courts to characterize an instrument entirely as debt or entirely as equity." No regulations had been previously promulgated under the amendment and this tendency by the courts has continued to the present day. Consequently, the Commissioner is generally required to treat an interest in a corporation as either 'wholly indebtedness' or 'wholly equity'. This all-or-nothing approach is particularly problematic in cases where the facts and circumstances surrounding a purported debt instrument provide only slightly more support for characterization of the entire interest as indebtedness than for equity characterization - a situation that is increasingly common in the related-party context.

In the proposed regulations, Section 1.385-1 would authorize the Commissioner to treat a related-party interest in a corporation as indebtedness in part and as stock in part, consistent with its substance. For example, under Prop. Reg. Section 1.385-1, if it is determined that the issuer of a related-party interest that is denominated as a US$5 million debt instrument cannot reasonably be expected to repay more than US$3 million of the principal amount as of the issuance of the interest, the Commissioner may bifurcate the interest into a US$3 million debt instrument and a US$2 million stock instrument. In such a case, the type of stock (e.g., common or preferred) that the instrument would be treated as for federal tax purposes is determined on the basis of the terms of the instrument (for example, voting and conversion rights and rights relating to dividends, redemption, liquidation, and other distributions).

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The term 'with the substance' is important given that the proposed regulations would not affect the authority of the Commissioner to disregard a purported debt instrument as indebtedness or stock, to treat a purported debt instrument as indebtedness or equity of another entity, or otherwise to treat a purported debt instrument in accordance with its substance. [Plantation Patterns v. Commissioner].

Auto-recast transactions - debt treated as equity

The Treasury Department and the IRS have identified following types of transactions between affiliates that raise significant policy concerns. Accordingly, the proposed regulations treat related-party debt instruments issued in any of these transactions as stock, subject to certain exceptions.

(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 (including "hook stock" issued by their related corporate shareholders, e.g., Section 304 sale); and

(3) Certain issuances of debt instruments as consideration in an exchange pursuant to an internal asset reorganization.

(4) A related-party debt instrument is issued in a separate transaction to fund –

(a) A distribution of cash or other property to a related corporate shareholder;

(b) An acquisition of affiliate stock from an affiliate; or

(c) Certain acquisitions of property from an affiliate pursuant to an internal asset reorganization.

For point (4), the determination as to whether a debt instrument is issued with a principal purpose of funding a distribution or an acquisition is based on all the facts and circumstances. However, Prop. Reg. Section 1.385-3 would establish a non-rebuttable presumption that an expanded group debt instrument is issued with such a principal purpose if it is issued by the funded member during the period beginning 36 months before the funded member makes a distribution or acquisition and ending 36 months after the distribution or acquisition.

The Classification Rule is 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 filed on or after April 4, 2016. Under a grandfathering rule, if the application of the Classification Rule would result in a debt instrument being treated as stock, the stock treatment will be effective beginning on the day that is 90 days after the proposed regulations become final.

The recast transactions set forth in Proposed Regulations cast a wide net that will likely have a substantial impact on certain internal restructuring transactions, reorganizations and inter-company lending transactions aimed at moving money around a group or distributing the money to shareholders. Both U.S. and foreign multinational groups need to prudently structure the future transactions to avoid tax exposure arising on account of these proposed regulations, if turned final.

(B) Documentation rules

The proposed regulations introduce documentation requirements that are intended to impose discipline on related-party lending transactions by requiring timely documentation and financial analysis similar to the documentation and analysis that is created when debt is issued to third parties. The proposed rules require documentation of the following:

(i) A binding obligation to repay the funds advanced.

(ii) Creditor's rights to enforce the terms of the debt. The examples of such rights are right to trigger a default, right to accelerate payments and right that a creditor/holder must have, which is a superior right to shareholders to share in the assets of the issuer in the event that the issuer is dissolved or liquidated.

(iii) A reasonable expectation that the funds advanced can be repaid. The proposed regulations give examples of such documentation, including cash flow projections, financial statements, business forecasts, asset appraisals, determination of debt-to-equity and other relevant financial ratios of the issuer *(compared to industry averages).*

(iv) After the instrument is issued, actions evidencing an ongoing genuine debtor-creditor relationship.

Proposed earnings stripping regulations by IRS Under Section 385

Taxpayers subject to the documentation rules must prepare documentation for items (i)-(iii) above within 30 days of the initial issuance date or date the instrument becomes an expanded group instrument (EGI) and prepare documentation for item (iv) no later than 120 days after the date of payment or event of default. Documentation must be maintained for all years the obligation is outstanding and until the statute of limitations expires for the tax return year in which the instrument is relevant.

A related-party debt instrument is not subject to documentation rules unless:

(i) The stock of any member of the expanded group is publicly traded;

(ii) All or any portion of the expanded group's financial results are reported on financial statements with total assets exceeding US$100 million; or

(iii) All or any portion of the expanded group's financial results are reported on financial statements that reflect annual total revenue that exceeds US$50 million.

(iv) It has been proposed that the documentation rule will apply with respect to any applicable instrument issued (or deemed issued) on or after the date that the Section 385 Regulations are finalized.

Certain taxpayers such as non-public companies or small public and private companies falling below specified thresholds will not be affected by these documentation rules. For those taxpayers that are affected, the documentation rules above may pose burden on internal finance, treasury and tax teams, if such or similar documentation is not being currently maintained.

These new rules represent the "minimum standard" for the initial analysis the IRS will conduct to determine if a debt instrument should be respected as debt. If the requirements are not satisfied, the IRS will recast the debt as equity, but even if the requirements are satisfied, the IRS may still recast the debt as equity if the substance of the transaction is different from the form. Thus both 'form' and 'substance' of transaction are vital to support a case for valid debt.

To conclude, the proposed regulations under Section 385 are extremely complicated, impose burdensome documentation requirements on many taxpayers and, if inter-company debt related transactions are not carefully structured, will lead to significant tax exposures for the taxpayers

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