

New tax rules treat related party debt as stock and impose strict documentation rules

On April 4, the IRS and Treasury issued proposed regulations under section 385 of the Internal Revenue Code that treat related party debt as stock. These regulations are a major game changer. They overturn decades of case law and tax practice and deny interest deductions on financial instruments which would otherwise clearly qualify as debt for tax purposes. It is important to emphasize that although these proposed regulations were issued at the same time that regulations were issued relating to inversion transactions, these rules apply whether or not an inversion transaction has occurred.

The new rules apply to related party debt instruments issued after April 4, 2016 effective 90 days after the regulations are finalized. In other words, if a debt instrument impacted by the new rules was issued on April 15, 2016 and the regulations were finalized on September 15, 2016, the instrument would be deemed to convert from debt to stock on December 14, 2016. Affected instruments issued after the effective date of the final regulations generally would be treated as stock from the date of issuance.

The new rules also impose strict contemporaneous documentation requirements for related party debt and provide that, on audit, the IRS may treat a debt instrument as part debt and part equity.

Related party debt instruments treated as stock

The proposed regulations provide a “General Rule” that treats as stock (i) notes distributed to a related party, (ii) notes issued to acquire stock of a related party and (iii) notes distributed to a related entity as boot in an asset acquisition. Thus, for example, if a U.S. subsidiary pays a dividend in the form of a note to its foreign parent corporation, the note will be treated as stock and the U.S. subsidiary will not be entitled to deduct any interest payments it makes on the note even though the note is “straight” debt and satisfies all of the other requirements for being treated as debt for tax purposes. One exception to the General Rule provides that it does not apply if the aggregate issue price of all related party instruments that would be treated as stock under the rule does not exceed \$50 million. [1]

The proposed regulations further provide a “Funding Rule” designed to assure that a taxpayer cannot achieve in two steps what it is prohibited from achieving in one step. For example, the Funding Rule covers the situation in which the U.S. subsidiary borrows cash from a related party and then pays a dividend to its foreign parent corporation. More specifically, the Funding Rule generally characterizes a related party loan as stock if that loan is used to fund (i) the distribution of a dividend, (ii) the acquisition of stock in a related entity or (iii) the distribution of boot in asset reorganization. For this purpose, a related party loan made during the 72 month period beginning 36 months before any of these events and ending 36 months after any of these events is generally presumed to be within the scope of the Funding Rule and treated as stock. The determination of whether the Funding Rule applies outside of the 72-month period is a facts and circumstances determination.

For purposes of the regulations, a related party is defined as a member of the “expanded group.” An expanded group is an affiliated group under Section 1504(a) of the Code expanded to include (i) foreign and tax-exempt corporations, (ii) corporations held through partnerships and (iii) corporations connected by ownership of 80% vote or value, rather 80% than vote and value. Consolidated groups are treated as one corporation for the purposes of the proposed regulations. Thus, the General Rule and the Funding Rule do not apply to instruments issued by one consolidated group member to another consolidated group member. Special rules apply when an instrument ceases or becomes a consolidated group debt instrument. In this regard, it is important to keep in mind that the proposed regulations apply not only to cross-border loans but also to domestic loans between related parties that are not members of the same consolidated group.

As previously noted, the General and Funding Rules apply to related party debt instruments issued after April 4, 2016, [2] effective 90 days after the regulations are finalized.

Contemporaneous documentation requirements for related party debt of “large” taxpayer groups

The proposed regulations establish contemporaneous documentation requirements which apply if (i) the stock of one or more members of the taxpayer group is publicly traded, (ii) the group has more than \$100 million of assets, or (iii) the group has more than \$50 million of annual total revenues. If any of those tests are met, the taxpayer must contemporaneously prepare and maintain, for the period that the debt is outstanding and until the period limitations expires for any year for which the treatment of the instrument is relevant, written documentation establishing:

- an unconditional and legally binding obligation to pay a sum certain on demand or at one or more fixed dates;
- that the holder of the instrument has the rights of a creditor to enforce the obligation;
- through, for example, cash flow projections, financial statements, business forecasts, asset appraisals and other information regarding sources of funds, that, as of the date of issuance, the issuer had the ability to repay the debt; and
- that interest and principal payments were made in accordance with the terms of the instrument or, if they were not, describing the holder’s reasonable exercise of its creditor rights.

If these documentations requirements are not satisfied, the indebtedness will be treated as stock, unless the taxpayer shows that its failure to satisfy the documentation requirements was due to reasonable cause. If the requirements are satisfied, the determination of whether the indebtedness constitutes debt or stock is made under federal tax principles developed under applicable case law, as modified by the regulations. The documentations requirements are generally applicable to instruments issued on or after the effective date of the final regulations.

Part debt and part stock

Courts have long treated an instrument on an all or nothing basis – it is either debt or stock but not both. Section 385(a) authorizes the Treasury to issue regulations which treat an instrument as part stock and part debt. The proposed regulations provide that, on audit, the IRS (but not the taxpayer) may determine that a related party debt instrument should be treated as part debt and part equity. For this purpose, the definition of related party is expanded by replacing the 80% or more ownership or vote test with a 50% or more ownership or vote test. Unfortunately, the standards for the IRS making such a determination are not clearly defined and it should be expected that this provision will be a source of controversy. The provision generally applies to any instrument issued after the date that the regulations are finalized.

Final comments

The new rules overturn decades of well-accepted tax practice. Not surprisingly, the notice proposing the regulations is quite long (135 pages) and the regulations are quite complex. This note merely summarizes the highlights of the new rules

Finally, there is the question of whether the proposed regulations are valid in so far as they treat as stock certain related party indebtedness that would otherwise qualify as debt. Section 385(a) authorizes Treasury to issue regulations that determine whether an interest in a corporation is to be treated as stock or indebtedness. Section 385(b) lists factors that courts consider in determining whether an instrument should be treated as stock or indebtedness and provides that “[t]he regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a particular situation whether a debtor-creditor relationship or a corporation-shareholder relationship exists.” Rather than enumerating the factors to be considered, the proposed regulations simply provide that, without regard to of any of these factors, if a related party debt instrument is issued under certain enumerated circumstances it will be treated as stock even though the same exact instrument would be respected as debt if it was issued to a third party or to a related party under other circumstances.

[1]/ Other exceptions to the General Rule include situations in which (i) the aggregate amount of any distributions and acquisitions does not exceed the current year earnings and profits or (iii) a corporation transfers property to a subsidiary in exchange for a note and for 36 months after the transfer continues to own, directly or indirectly, 50% or more of the vote and value of the subsidiary.

[2]/ The regulations may also apply to related party debt instruments issued on or before April 4, 2016 which are substantially modified within the meaning of Treas. Reg. section 1.1001-3 after that date.



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