

Client Alert

June 2016

Proposed Section 385 Treasury Regulations May Significantly Impact the Tax Treatment of Related-Party Debt and Equity

On April 4, 2016, the Treasury Department and the Internal Revenue Service (“IRS”) issued proposed Treasury regulations under Section 385 of the Internal Revenue Code (the “Proposed Regulations”) that would impose new rules for characterizing related-party obligations as debt or equity for federal income tax purposes. If finalized as proposed, the Proposed Regulations would drastically change current rules and well-established case law dealing with the treatment of related-party securities as either debt or equity. Certain of the proposed rules apply to related-party debt issued on or after April 4, 2016, so taxpayers need to consider the potential impact of the Proposed Regulations in structuring current transactions involving the issuance of related-party debt.

In general, the Proposed Regulations increase the risk that debt instruments between related parties will be recharacterized, in whole or in part, as equity investments resulting in decreased interest deductions. The increased recharacterization risk results from the following components of the Proposed Regulations:

“Expanded Group”

Related parties subject to the Proposed Regulations include not just members of an “affiliated group” that are eligible to file consolidated federal income tax returns, but also any members of an “expanded group.” The term “expanded group” includes corporations normally excluded from an affiliated group (e.g., foreign corporations, tax-exempt corporations, S corporations) and indirectly owned corporations (e.g., corporations owned indirectly through partnerships). Instead of the “80% vote *and* value” ownership requirement for “affiliated groups,” an expanded group uses a broader “vote *or* value” test and in many instances drops the ownership threshold to 50 percent (50%). The Proposed Regulations also use the broader attribution rules of Section 304(c)(3) of the Internal Revenue Code. This expansive definition of the relevant group of corporations will permit the Proposed Regulations to reach related party debt instruments in a wide variety of international and domestic settings well beyond transactions between members of traditional affiliated groups.

The Proposed Regulations apply to instruments issued by a member of an expanded group to another member of the same expanded group (“EGIs”) and cover the following four main areas: (i) the bifurcation rule (permitting the IRS to characterize a related-party debt instrument as part debt and part equity); (ii) documentation rules; (iii) per se equity/funding rules; and (iv) consolidated group rules.

Bifurcation

The Proposed Regulations significantly depart from current law in permitting the IRS to treat an EGI as part debt and part stock for federal income tax purposes consistent with its substance. The IRS would have this bifurcation authority with respect to an EGI of a “modified expanded group” (very generally, an expanded group using the 50 percent ownership test and including certain partnerships and other persons). An IRS determination of whether an EGI should be treated as debt or equity or a combination of both is based on a review of the applicable facts and circumstances, including the ability of the debtor corporation to repay the stated amount of the EGI. Unfortunately, the Proposed Regulations do not

provide clear guidance as to how the IRS will determine whether there is a reasonable expectation of repayment and what other facts or circumstances are important in determining when an EGI should be treated as part debt and part equity.

Documentation Requirements

The Proposed Regulations require that certain documentation must be prepared and maintained to support the taxpayer's characterization of an EGI as debt. These preparation and maintenance requirements are intended to apply only to large corporate taxpayer groups. Accordingly, a debt instrument is subject to these documentation requirements only if the stock of one or more members of the expanded group is publicly traded or if at least a portion of a member of the expanded group's financial results are reported on financial statements with total assets exceeding \$100 million or annual total revenue exceeding \$50 million on the date an applicable instrument becomes an EGI. Failure to provide the documentation to the IRS upon request could result in the EGI's being treated as stock, regardless of whether it would otherwise be treated as debt under general federal tax principles.

Per Se Recharacterization as Stock/Funding Rules

The Proposed Regulations recharacterize a nominal debt instrument as per se equity for all federal income tax purposes to the extent it is issued between members of an expanded group if the instrument is issued:

- In a distribution;
- In exchange for stock of an expanded group member (other than certain exempted exchanges);
or
- In exchange for property in an asset reorganization but only to the extent that, pursuant to the plan of reorganization, a shareholder that is a member of the issuer's expanded group immediately before the reorganization receives the instrument.

In addition, a debt instrument also will be treated as stock to the extent it is issued by a corporation for the principal purpose of funding a distribution described above.

Consolidated Group Exception

The Proposed Regulations do not apply to debt instruments between members of a consolidated group filing a United States federal income tax return. The rules also would not apply to debt owed to outside banks or even member guarantees of that debt. However, general tax principles continue to apply to these debt instruments. In addition, a debt instrument issued by one member of the consolidated group to a member of its expanded group that is not a member of its consolidated group may be recharacterized under the funding rule as funding a distribution or acquisition by another member of that consolidated group, even though that other consolidated group member was not the issuer and was not funded directly.

Broad Anti-abuse Rule

The Proposed Regulations contain an open-ended anti-abuse rule that would apply if a debt instrument is issued with a principal purpose of avoiding the application of the characterization rules or the consolidated group rules described above. The anti-abuse rule can be used to characterize notional principal contracts and other instruments as stock if they are issued in lieu of a debt instrument with the intent of avoiding the application of the characterization rules or the consolidated group rules.

Action Plan

The IRS and Treasury have indicated that they intend to “move swiftly” to finalize the Proposed Regulations. Furthermore, while some provisions will apply only after the Proposed Regulations have been issued in final form, some provisions will have retroactive effect. Given the broad scope of the Proposed Regulations, corporations are well advised to take steps now to prepare for their potential finalization and implementation, including the following:

- Make sure your tax, accounting and treasury personnel are aware of the Proposed Regulations and prepare a process for vetting potential issues.
- Identify current related-party debt instruments covered by the Proposed Regulations and determine whether the instruments will be grandfathered or benefit from one of the exceptions to the proposed rules.
- Modify current due diligence procedures to include the proposed rules.
- Determine whether the documentation requirements will apply to you. If so, develop procedures to provide reasonable documentation to support the character of related-party debt instruments, including reasonable payment expectations. Procedures should be put in place to timely provide required documentation since most documentation must be prepared within 30 calendar days of the later of the date the debt instrument becomes subject to the rules or the date that an expanded group member becomes an issuer of a debt instrument subject to the rules.

If you would like more information about the Proposed Regulations and their potential impact on transactions involving the issuance of related-party debt, please contact one of the attorneys listed below.

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