CLEARY GOTTLIEB

ALERT MEMORANDUM

April 11, 2016 clearygottlieb.com

Not Just Inversions: Proposed Changes in the Tax Treatment of Related-Party Debt Will Affect M&A Transactions, Restructurings and Financings

I. OVERVIEW

Recently released proposed regulations that would classify certain intragroup loans as equity for U.S. tax purposes could have very significant consequences for M&A transactions, private equity ("PE") investments and restructurings.[1] If adopted in their present form, the proposed regulations would eliminate strategies that have been widely used in cross-border transactions. However, the proposal could also have unpredictable consequences for the day-to-day funding practices of both U.S. and foreign-owned multinational groups. Moreover, the proposal would impose burdensome documentation and substantiation requirements on intragroup loans as a necessary condition to having the loans respected as debt for tax purposes (regardless of whether as a legal and economic matter the loans are debt).

The proposed regulations are part of Treasury's and the IRS's efforts to combat inversion transactions,[2] but they have a broader anti-"earnings stripping" objective and effect. Hopefully, after receiving comments, the drafters will moderate features of the proposed regulations that are unworkable, cause unintended consequences or adversely affect conventional, non-tax motivated funding practices of multinational groups. However, because some of the rules are proposed *to apply to instruments issued on or after April 4, 2016*, taxpayers will need to take them into account starting now.

The proposed regulations would treat many intragroup loans as equity for U.S. federal income tax purposes. The consequences of such treatment could include:

1 The proposed regulations were released on April 4, and were published in the Federal Register of April 8. The proposed regulations were issued under the authority of section 385, which was enacted in 1969 and grants the Treasury Department and the Internal Revenue Service (the "IRS") broad authority to promulgate regulations to determine whether an interest in a corporation is stock or indebtedness for tax purposes. Treasury and the IRS last attempted to prescribe regulations under section 385 more than 30 years ago. No such regulations have ever entered into force.

2 Indeed, the Treasury Department and the IRS concurrently issued temporary regulations under the inversion rules, which are not discussed here.

1. The loss of interest deductions, and the imposition of U.S. withholding tax on payments (including payments of principal) by a U.S. borrower to a related foreign lender.

2. The taxation of payments (including principal payments) received by a U.S. lender from a related foreign borrower as foreign source dividend payments.

3. The possible loss of foreign tax deductions for interest under BEPS anti-hybrid rules.[3]

4. The possible loss of foreign tax credits, and other undesirable consequences, in respect of payments of interest and principal by an issuer that is a foreign subsidiary of a U.S. company.

5. Collateral consequences from a change in debt/equity characterization when an affiliate acquires or disposes of debt issued in the capital markets.

The proposal would not apply to third-party borrowings, even if guaranteed by an affiliate (although a foreign affiliate guarantee may implicate the section 163(j) earnings stripping rule and possibly have other effects).

***The proposed regulations have four important components*:**

The **"<u>Basic Rule</u>"** would treat an intragroup loan as equity if the borrower doesn't receive cash proceeds from the lender. Examples of arrangements that would be recharacterized as equity under the Basic Rule include:

- A pushdown of debt from parent to subsidiary for no consideration – *e.g.*, through a distribution of debt by the subsidiary. This is a common technique in M&A transactions (including inversion transactions).
- The sale of stock of one affiliate to another for debt, or the issuance of debt in an intragroup asset reorganization. These are common techniques in intragroup restructurings, which may follow (or precede) an M&A transaction or be carried out for independent business or regulatory reasons.

[3] The OECD's BEPS (base erosion and profit shifting) guidance regarding hybrid instruments requires the tax jurisdiction of the issuer of an instrument that would otherwise give rise to deductible payments to deny the deduction in cases where the holder (or, in certain circumstances, the ultimate owner) does not recognize a corresponding income inclusion.

The **"<u>Funding Rule</u>"** – which serves as a backstop to prevent circumvention of the Basic Rule – would provide that a related-party loan will be treated as equity to the extent the borrower has made a distribution[4] (or purchased stock of a group member[5] or acquired assets in an asset reorganization) during the *36 months preceding the date of the loan*, and will become equity if, when and to the extent the borrower makes a distribution (or purchases stock of a group member or acquires assets in an asset reorganization) during the *36 months following the date of the loan.*[6]

- There is a limited exception to the Funding Rule (and Basic Rule) for distributions made out of the borrower's current year earnings and profits.

- This rule could have much more unpredictable consequences than the Basic Rule because under the Funding Rule the classification of an arrangement as debt or equity can be affected by unrelated events, occurring as much as three years before or three years after the date of the loan. For example:

  - A foreign subsidiary lends money to a foreign sister company. Two years later, when it has no current year earnings, the borrower makes a distribution for wholly unrelated reasons. The intragroup loan was debt for U.S. tax purposes when it was issued. In general, the loan would be treated as equity for U.S. tax purposes after the payment of the distribution, to the extent of the amount of the distribution.

  - A U.S. subsidiary buys shares from its foreign parent company in connection with a share-based employee compensation plan. Two years later, when it has no current year earnings, the subsidiary borrows money from its parent or a foreign sister company. In

---

4 Significantly, a "distribution" that may trigger the Funding Rule is broadly defined, and encompasses virtually any actual or deemed distribution in respect of stock, including cash, property and liquidating distributions, but generally excluding spin-offs that are part of a D reorganization. There is no netting of distributions against contributions.

5 A relatively narrow exception would allow the borrower to acquire stock of an affiliate if it owns more than 50% of the voting power and value of the affiliate for the 36-month period immediately following the issuance of the stock to it. The funding of intragroup joint venture companies that fails to satisfy this exception could trigger the Funding Rule.

6 A debt instrument will not be subject to the Funding Rule if it qualifies for a narrow "ordinary course of business" exception relating to the purchase of inventory or deductible items of property or services.

A distribution, purchase or acquisition before or after the 72-month period would also trigger the rule if it is determined that "a principal purpose" of the debt issuance was funding that distribution, purchase or acquisition.

general, the loan would be treated as equity for U.S. tax purposes, to the extent of the consideration paid for the shares.

The Basic Rule and the Funding Rule may affect any transaction occurring on or after April 4, 2016. Although these rules will not take effect until 90 days after the regulations are adopted in final form, on that day any post-April 3 financing transactions within the scope of the rules will turn into equity for U.S. tax purposes, either in whole or in part.[7] For planning purposes, this means that if debt can be repaid within a 90-day window after the regulations become final, it will not be affected by the proposed regulations.[8]

The **"Documentation Rule"** would impose detailed new requirements that would be required to be satisfied *as a precondition* to classifying a related-party loan as debt.[9] The documentation generally corresponds to what a well-advised group would prepare where there is reason to be concerned about the risk of an IRS challenge to the status of the debt as debt for tax purposes. The proposed regulations would, however, require that this type of documentary support be prepared – generally within 30 days of the loan's issuance or other relevant event – and maintained in connection with *every* related-party loan, no matter how routine, and without regard to the credit quality of the borrower.

The documentation requirements are as follows: On issuance, the terms of the debt must be in written form, with a stated promise to repay principal and creditor remedies, and there must be prepared and maintained documentation showing the issuer's ability to repay the debt. Documentation (such as wire transfer records or bank statements) must also be maintained for each payment of interest and principal. Finally, if there is a default, documentation must be prepared evidencing the holder's reasonable exercise of the diligence and judgment of a creditor.

Failure to comply with the Documentation Rule's requirements (subject to a reasonable cause exception), would result in an automatic recharacterization of the loan as equity. The Documentation Rule (in combination with the Bifurcation Rule described below) would give the IRS a powerful new tool to challenge the treatment of related-party loans. Moreover, while the rule is denominated as a procedural change, it may in practice result in a shift of the substantive line between related-party debt and

7 Pre-April 4 debt may also be affected, for example, if there is a material modification of the debt after that date or if the issuer's entity classification is changed retroactively to before April 4.

8 The Basic Rule and the Funding Rule apply only if the aggregate amount of debt instruments held by members of the group that would be subject to those rules exceeds $50 million.

9 The Documentation Rule will apply only if the issuer or an affiliate is publicly traded or the group meets minimum asset ($100 million) or revenue ($50 million) standards.

equity towards equity. It will remain to be seen how IRS audit agents will in practice use the rule.

While the Documentation Rule is by its terms effective only for debt issued after the regulations are issued in final form, a conservative approach would be to start using these proposed regulations now as guidelines for documentation to be prepared and maintained for all related-party loans. IRS agents may well start asking for this type of documentation prior to finalization of the regulations.

The Basic Rule, Funding Rule and Documentation Rule would generally apply to financing transactions between U.S. and foreign affiliates (including controlled partnerships and disregarded entities) of a U.S. or foreign multinational group, or between foreign affiliates (including controlled partnerships and disregarded entities) of a U.S. group, if the affiliates are 80% commonly controlled by vote *or* value by a corporate parent, taking into account attribution rules (including via options). However, members of a U.S. consolidated tax group would be treated as a single U.S. corporation for purposes of these rules.

Under the last important component of the proposed regulations, the **"Bifurcation Rule,"** the IRS would have the authority to bifurcate a related-party loan and treat part of it as equity if it is reasonable to believe only part of the debt could be repaid. For this purpose, the relationship test is expanded to include a 50% ownership threshold and to include cases where the parent is an individual or a partnership (such as a PE fund). Like the Documentation Rule, the Bifurcation Rule will take effect generally only for debt issued after the regulations are issued in final form.

The proposed regulations would preclude a taxpayer from affirmatively using these rules to their advantage, contain anti-abuse and predecessor-successor rules, and would require the holder to treat a related party debt instrument consistently with the treatment claimed by the issuer.

***Action plan*:**

Taxpayers should:

- Review the terms of any pending and future M&A transaction, and the terms of any associated financing, to determine whether any planned non-cash intragroup funding, such as the distribution of a note, should be replaced with third-party funding, or whether an exit strategy can be put into place for the intragroup funding after the regulations become final;

- Review the terms of any pending and future internal stock sale or asset reorganization to determine whether it involves the creation of a debt instrument or a distribution, and in the latter case, whether the acquirer is likely to borrow from an affiliate during the period from April 4, 2016 through the date that is 36 months after the transfer, and if so whether the transaction can be restructured.

- Keep track of distributions (understood broadly) and loans by intra group borrowers, and be prepared to repay those loans from external borrowings or internally generated (or equity-contributed) cash before the end of the 90-day window.

- Consider putting in place now procedures to prepare and maintain documentation for all related-party loans that would satisfy the Documentation Rule.

II. PRACTICAL IMPLICATIONS OF THE BASIC RULE AND FUNDING RULE

1. *M&A transactions: Foreign acquirer, U.S. target*

- The proposed regulations will not prevent the use of shareholder loans to fund a foreign acquisition of a U.S. target company, so long as the loan is made in cash. Thus, for example, if a foreign Parent forms a U.S. Newco to acquire a U.S. Target, the Parent can lend Newco the money that it uses to acquire Target.

    - Current law debt-equity principles and section 163(j) anti-earnings stripping rules will continue to apply. In addition, once the proposed regulations are finalized, the Documentation Rule will need to be satisfied.

    - The shareholder loan could be recharacterized as equity under the Funding Rule to the extent that Newco makes an actual or deemed distribution within 36 months.

- However, the proposed regulations would prevent Parent from "pushing down" the economic burden of external borrowings by causing Newco to distribute a note (thereby recapitalizing equity into debt), or engaging in other intragroup restructuring techniques in which Parent does not pay cash in exchange for the note.

    - For example, where a foreign Parent incurs debt in connection with the acquisition of a non-U.S. multinational that owns a substantial U.S. Subsidiary and wishes to allocate the debt burden proportionately among the companies that will support the debt, a note issued by the U.S. Subsidiary in a cashless push-down will be treated as stock.

- Consequently, there will be an incentive for foreign multinationals to maximize the initial internal leverage of their U.S. subsidiaries to the extent they can do so consistently with traditional debt-equity principles.

- A foreign multinational may be able to increase the leverage of its U.S. subsidiaries by causing them to borrow from third parties and distribute the proceeds, to the extent that such a third-party borrowing can be effected consistently with the group's business and financial objectives.

2. ***<u>M&A transactions: U.S. acquirer (or PE fund); foreign target</u>***

- Similar to Paragraph 1: up-front debt capitalization with cash is fine, but a debt obligation resulting from a cashless leveraging up of the target or its subsidiaries is treated as equity.

- Most leveraged blocker corporations set up by PE funds would not be affected by the proposed regulations (other than the Bifurcation Rule), because they are not members of an expanded corporate group (although a leveraged blocker corporation set up by, say, an offshore hedge fund taxable as a corporation would need to be mindful of these rules). The preamble to the proposed regulations asks for comments regarding whether the rules should be extended to PE fund leveraged blocker corporations.

3. ***<u>Intragroup restructurings</u>***

- Internal group restructurings, which are commonly undertaken after an acquisition, may involve intragroup sales of stock (*e.g.*, section 304 transactions), or asset reorganizations (*e.g.,* "cash" (or "debt") D reorganizations). Intragroup debt created in connection with such a restructuring may be recharacterized as equity under the Basic Rule or the Funding Rule.

4. ***<u>Conventional intragroup financing practices</u>***

- An intragroup loan generally will be recharacterized as equity to the extent the borrower makes a distribution (broadly defined, see note 4 above) in excess of its earnings in the year of the distribution within the 36 months preceding or following the borrowing.[10]

- This recharacterization applies to distributions by a U.S. subsidiary to its foreign parent where the intragroup borrowing is from a lender that is not a member of the U.S. subsidiary's consolidated tax group.

- It also applies to distributions by a CFC (controlled foreign corporation) that has intragroup borrowings from any affiliate, even if the affiliate is in the same country and files a combined tax return with the CFC borrower.

- The Funding Rule is effective for any distributions made after April 4, 2016 if the loan is outstanding 90 days after the proposed regulations are finalized.

- No exception is provided for ordinary pooling and cash sweep arrangements, revolving credit facilities or other centralized treasury funding functions, although the preamble to the proposed regulations asks for comments on whether special rules are warranted for these cash management arrangements.

- The Funding Rule could apply, for example, to employee stock plans, where a subsidiary purchases parent stock and has intragroup borrowings.

- While the exception for distributions up to the amount of current-year earnings may provide some relief, it is often difficult to project earnings during the year, which will complicate planning to mitigate adverse consequences.

- It is hoped that the Funding Rule will be scaled back and reasonable exceptions provided in the final regulations.

5. *Impact on financial institutions*

- Regulated financial services companies are highly leveraged and rely extensively on intercompany borrowings that can vary significantly from day to day. The Funding and Documentation Rules will have a material adverse impact on these companies unless the final

10 As indicated in note 4 above, very limited exception is provided for debt incurred in the ordinary course of business to fund costs that are capitalized into inventory or deductible expenses for goods or services.

regulations provide appropriate exceptions to take account of their special circumstances.

- U.S. and foreign securities dealers that make a market in their cross-border parent's stock will need to be mindful of the Funding Rule, while those dealers that make a market in their affiliates' debt will need to be mindful of the collateral consequences of recharacterization described in Paragraph 6 below.

- For bank regulatory reasons, bank groups often borrow at the parent level and lend money to their subsidiaries. They may be required for regulatory or business reasons to adjust the amount of debt and equity capital in a subsidiary. Depending on the circumstances, the Basic Rule or the Funding Rule might cause new intragroup debt to be recharacterized as equity. Moreover, economically equivalent transactions may have different consequences.

- The Fed has proposed requirements for "internal TLAC" to be issued by U.S. intermediate holding companies to their foreign bank parents that appear to conflict with the Documentation Requirement. Unless a special rule is provided, this could jeopardize the availability of debt treatment for such instruments.

6. *Potentially serious collateral consequences can arise from recharacterization*

- Recharacterization can occur (i) under the Basic Rule, (ii) as a result of the Funding Rule, (iii) when recharacterized debt is transferred outside the group (through transfers of the debt, or if the borrower or lender ceases to be a member of the group) or (iv) when externally-held debt is acquired by a member of the group and triggers the Funding Rule. The preamble suggests an intention to minimize tax consequences from the recharacterization event, by essentially eliminating gain or loss to the member-holder and cancellation of debt (COD) income or amortizable premium to the issuer. But other potentially serious consequences can arise, which should be taken into account in planning under these rules.

- For example, the recharacterization of a distribution of debt as a stock distribution, or the recharacterization of equity as debt upon a transfer of recharacterized debt outside the group, may give rise to a dividend, in each case in an amount up to the value of the debt (or, in the case of a distribution, may create section 306 stock). If the issuer is a U.S.

corporation, such a dividend can result in withholding tax. If the issuer is a CFC, it can result in Subpart F income,[11] and the movement of tax attributes (such as earnings and profits, previously taxed income and tax pools) from borrower to lender, both upon the recharacterization event and in respect of future "interest" payments on the recharacterized debt.

- The recharacterization of debt as equity under these rules creates hybrid disparities between the U.S. and foreign tax characterizations, which may result in disallowance of interest expense by the foreign jurisdiction of a CFC issuer, under the BEPS anti-hybrid rules. As the preamble recognizes, it may also result in splitting of foreign tax from the related income and thereby require monitoring the timing of foreign tax credits under the splitter rules of section 909.

7. ***Debt issued by partnerships and disregarded entities***

- Additional complexities and collateral consequences may arise where the intra group borrower or lender is a partnership or a disregarded entity.

- Debt issued by controlled partnerships owned by corporate groups generally is subject to the proposed regulations. If the debt is recharacterized as equity, however, it may be treated as equity issued by the partners of the partnership. This treatment is completely inconsistent with the normal partnership tax rules, and gives rise to numerous issues not addressed in the proposed regulations.

- The proposed regulations provide that if related-party debt issued by a disregarded entity is recharacterized as equity, it will be treated as stock issued by the owner of the disregarded entity, and thus should not create collateral consequences that would arise if the entity's status were to change as a result of the recharacterization. On the other hand, related-party debt that is recharacterized under the Documentation Rule or the Bifurcation Rule would be treated as an equity interest in the disregarded entity, thus changing its U.S. tax status to a partnership with potentially broad ancillary consequences.

* * *

[11] In certain cases, an exception may apply, such as under section 954(c)(3) or (6).

If you have any questions, please feel free to contact any of your regular contacts at the firm. You may also contact our U.S. partners and counsel listed under "Tax" located in the "Practices" section of our website at http://www.clearygottlieb.com.

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS
12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW
Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE
Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME
Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN
Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG
Cleary Gottlieb Steen & Hamilton (Hong Kong)
Hysan Place, 37th Floor
500 Hennessy Road, Causeway Bay
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING
Cleary Gottlieb Steen & Hamilton LLP
45th Floor, Fortune Financial Center
5 Dong San Huan Zhong Lu
Chaoyang District
Beijing 100020, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES
CGSH International Legal Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO
Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299

ABU DHABI
Al Sila Tower, 27th Floor
Abu Dhabi Global Market Square
Al Maryah Island, PO Box 29920
Abu Dhabi, United Arab Emirates
T: +971 2 412 1700
F: +971 2 412 1899

SEOUL
Cleary Gottlieb Steen & Hamilton LLP
Foreign Legal Consultant Office
19F, Ferrum Tower
19, Eulji-ro 5-gil, Jung-gu
Seoul 100-210, Korea
T:+82 2 6353 8000
F:+82 2 6353 8099