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Treasury Issues Inversion Regulations, Proposes Sweeping Changes to Debt/Equity Classification

On April 4, 2016, as the most recent step in its ongoing battle against inversion transactions, the U.S. Department of Treasury issued both new temporary and proposed regulations addressing certain inversion and post-inversion restructuring transactions and debt/equity characterizations. Although the proposed and temporary regulations related to inversions largely adopt the anti-inversion rules set forth in earlier notices,[i] they also contain a brand new per se aggregation rule that reportedly led Pfizer and Allergan to abandon their combination transaction shortly after the Treasury announcement.

While the termination of the Pfizer-Allergan transaction was the most immediately noteworthy result of the Treasury action, there will likely be a much broader and long-lasting impact from a set of proposed regulations under Section 385 of the Internal Revenue Code promulgated at the same time. In inversion guidance issued two years ago, Treasury made clear that it was considering taking action regarding earnings stripping, possibly limited to inversion transactions, but possibly on a broader basis. The proposed regulations issued as part of the April 4 announcement go well beyond limiting post-inversion tax avoidance. If adopted, they will have a significant impact on a variety of common transactions and structures (both international and domestic), whether or not related in any way to an inversion.

Inversion Rule Changes

Background. Section 7874 treats a non-U.S. corporation as a "surrogate foreign corporation" where (i) the non-U.S. corporation acquires substantially all of the assets of a U.S. corporation in a transaction, (ii) at least 60 percent of the stock of the non-U.S. corporation is treated as being held by former shareholders of the U.S. corporation by reason of holding stock in the U.S. corporation and (iii) the expanded affiliated group of the non-U.S. corporation does not have substantial business activities in the country in which the non-U.S. corporation is organized. The status as a "surrogate foreign corporation," both under the original statutory provisions of Section 7874 and through more recent Treasury action,[ii] has limited the ability of corporations so designated to obtain many of the benefits originally sought from inversions such as accessing trapped cash held by controlled foreign subsidiaries of the U.S. party to the inversion. If the former shareholders of the U.S. corporation are treated as owning at least 80 percent of the non-U.S. corporation after the acquisition, the non-U.S. corporation will be treated as a U.S. corporation for U.S. federal income tax purposes.

Implementing Prior Treasury Guidance. Prior Treasury guidance set out certain additional restrictions on inversion transactions, including rules for determining the post-acquisition ownership of the former shareholders of the U.S. corporation that are affected by, among other things, certain pre-combination distributions made by the U.S. corporation and pre-combination acquisitions made by the non-U.S. corporation.[iii] The newly-issued temporary regulations implement these rules, and provide helpful clarity, for example, on the manner in which taxpayers are to take into account non-ordinary course distributions made by a U.S. corporation during the three-year period preceding an acquisition that is potentially subject to the inversion rules. In addition, the regulations explain in greater detail the rules limiting the ability of inverted corporations to enter into post-inversion planning, such as de-controlling a controlled foreign subsidiary.

Three-Year Look-back. The temporary regulations issued on April 4 also broke new ground. The existing regulations provided that if a foreign corporation acquired more than one domestic corporation as a part of a plan, those acquisitions could be aggregated for purposes of applying the 60 percent and 80 percent tests.[iv] The temporary regulations introduce a new rule requiring a three-year look-back, without regard to whether prior acquisitions were part of a plan.[v] All stock issued to former shareholders of acquired U.S. corporations in the past three years is excluded from the denominator of the ownership fraction; that is, it does not count as stock of the foreign corporation for purposes of applying the 60 percent and 80 percent tests. Moreover, the look-back period begins not on the closing date of the acquisition in question, but rather the date on which a binding contract to effect the relevant acquisition became enforceable. Some have argued that such a rule is beyond Treasury's regulatory authority. Unable to mount a preemptive challenge by virtue of the Tax Anti-Injunction Act and certainly unwilling to go forward with the acquisition and face a long contest with an uncertain outcome, the parties to the Pfizer-Allergan merger, like Sir John Falstaff, decided that "the better part of Valour is Discretion," (*Henry IV*, part 1, Act v, sc.4) and terminated the transaction.

Earnings Stripping and Beyond

Since its enactment in 1969, Section 385 has granted the Secretary of the Treasury broad authority to promulgate regulations for the purpose of determining whether an interest in a corporation should be treated as stock or indebtedness for U.S. federal income tax purposes. Section 385 has long been dormant, however. Although the Treasury issued, and subsequently withdrew, a set of proposed regulations in the early 1980's, the determination of whether an interest constituted debt or equity was largely left to the various facts and circumstances tests developed by the courts. Some commentators had suggested that Treasury use the apparently broad grant of regulatory authority under Section 385 as a weapon in the inversion war. Even though inversions may have been the impetus for these rules, the proposals rolled out on April 4 under Section 385 will have consequences well beyond the inversion context.

Section 385 Proposed Regulations

- ***In General.*** The proposed Section 385 regulations (with certain exceptions) recharacterize debt instruments between members of an "expanded group" (as described below) as stock where a corporation that is an expanded group member

  (i) distributes the debt instrument to another expanded group member as a dividend,
  (ii) issues the debt instrument to another expanded group member in exchange for stock of an expanded group member, or
  (iii) issues the debt instrument to an expanded group member in exchange for assets in certain tax-free reorganizations,

As a result interest on the recharacterized instrument is not deductible and may be subject to dividend withholding tax.

- A few basic points about the operation of the rule:

  Expanded Group. The recharacterization rule applies only to debt instruments (so called "expanded group instruments" or "EGI's") between members of an expanded group. This is a group of entities with a corporate common parent having 80 percent direct and indirect ownership. The definitional rules are based on the rules applying to affiliated groups filing consolidated returns, but are expanded to include foreign corporations, partnerships and certain other entities otherwise excluded by the basic affiliated group rules.

  - This rule is intended to capture the techniques that have routinely been used to create intercompany debt in transactions that do not involve actual cash funding.

  - Not surprisingly, companies cannot circumvent the rule through the mere appearance of cash funding. Under an anti-avoidance rule, if intercompany debt is actually funded for a principal purpose of indirectly achieving the creation of intercompany debt that would be recharacterized as stock under the basic rule, it will be so recharacterized. Thus, for example, a loan from parent to subsidiary, followed by a dividend of the cash, will result in characterization of the purported loan as stock.

  - Although the determination as to principal purpose requires a facts and circumstances analysis, there is a per se rule treating any distribution or acquisition occurring within a period beginning 36 months before the issuance of the EGI and ending 36 months after the issuance of the EGI as being issued for a principal purpose of funding a distribution or an acquisition (though the transition rules provide that distributions and acquisitions that occurred before April 4, 2016, are disregarded). Thus, for example, if a corporate parent makes a loan to a subsidiary to fund an acquisition or capital expenditure, the loan will be respected as such, subject to the existing rules regarding related party lending. But if the subsidiary, having generated profits from the investment, distributes a dividend to parent two and a half years later, a portion of the original loan equal to the amount of the distribution will be prospectively recharacterized as equity. Similarly, if the subsidiary paid a dividend two and a half years earlier, all or a portion of the later loan will be treated as equity.

- There is a limited array of exceptions under the rules, and certain debt obligations issued in the ordinary course of an entity's trade or business are intentionally not picked up by the proposed regulations.
- The proposed regulations contain broad predecessor and successor rules for determining which entities' loans may be recharacterized.

Some EGI's Still Debt. As noted, not all intergroup debt is recharacterized under these rules.

- Funded debt and intercompany debt for an acquisition of assets (other than in a tax-free acquisition), and traditional intercompany payables and receivables for goods and services will remain unaffected, subject to the anti-avoidance rule described above.
- The proposed regulations also provide a de minimis exception for EGI's that would otherwise be recharacterized as equity for up to $50 million. This exception is not available for any EGI if the aggregate issue price of all EGI's relying on this exception exceeds $50 million.
- The proposed regulations also provide an exception from recharacterization for such amount of an acquisition or distribution otherwise deemed funded by an EGI that is equal to the current earnings and profits of that EGI's issuer generated in the year the EGI is created.
- The proposed regulations generally do not apply to intercompany debt between members of a consolidated group. They do, however, apply to domestic as well as cross-border intercompany debt: for example, the rules could apply to a REIT's attempted debt recapitalization of a taxable REIT subsidiary, or a surplus note of a

non-consolidated life insurance subsidiary, unless the de minimis exception or e&p exception applies.

- Perhaps most significantly, the proposed rules do not apply to intercompany debt that existed before April 4, 2016. As a result, a foreign multinational will be able to continue treating existing intercompany debt from its U.S. subsidiaries as debt, eligible for deductions and generally not subject to withholding tax in the case of foreign holders resident in most treaty jurisdictions. Future fundings could produce very different results. A heretofore conventional recapitalization of intercompany debt that upsizes the amount based on increased enterprise value of the U.S. subsidiary will likely be treated as equity.

- Finally, although the regulations as proposed appear to be intended to apply only to a group with a corporate parent, the preamble to the proposed regulations seeks comments on the possibility of extending the reach of these rules to leveraged blockers commonly used by private equity fund partnerships for the benefit of their foreign and tax exempt investors.

- ***Documentation***. The proposed regulations require that expanded group members that intend for their EGIs to be treated as debt, and who otherwise meet the general and funding rules established by the regulations, meet certain documentation requirements. If the expanded group members fail to meet these requirements, which apply to members of an expanded group with group assets over $100 million and total annual revenue over $50 million, the EGIs with respect to which the documentation requirements have not been met will automatically be treated as equity. Taxpayers who are not required to satisfy these documentation rules may nevertheless wish to consider building their files to address some of these documentation requirements (e.g., by documenting journal entry intercompany notes), as these may become checklists for future Internal Revenue Service audits.

- ***Debt/Equity Bifurcation***. Additionally, and significantly, the proposed regulations allow the IRS to treat a purported debt instrument between members of a "modified expanded group" as part debt and part equity. A "modified expanded group" is generally defined the same as an "expanded group" but with the relationship threshold reduced to 50 percent.

The proposed regulations are intended to be effective with respect to EGI's issued on or after April 4, 2016, but only with effect from the date that is 90 days after the regulations become final. Treasury has requested comments on the proposal, and given its broad sweep, one can expect a significant amount of commentary—and perhaps controversy as well.

We will continue to follow developments in this area and report as matters progress.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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[i] I.R.S. Notice 2014-52, 2014-42 I.R.B. 712; I.R.S. Notice 2015-79, 2015-49 I.R.B. 775.
[ii] I.R.S. Notice 2014-52, *supra* note 1; I.R.S. Notice 2015-79, *supra* note 1.
[iii] I.R.S. Notice 2014-52, *supra* note 1; I.R.S. Notice 2015-79, *supra* note 1.
[iv] Treas. Reg. § 1.7874-2(e) (2012).
[v] Temp. Treas. Reg. § 1.7874-8T (2016).