Duff & Phelps

Treasury Proposes New Rules on Intercompany Debt

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On April 4, 2016, the US Department of Treasury (Treasury) issued temporary regulations intended to stifle corporate inversions, whereby US multinationals move their tax residency offshore by combining with a foreign company. Subsequent to such inversions, companies often engage in so-called "earnings stripping" transactions, in which intercompany debt is used to create deductible interest in the US that is paid to the new foreign parent or another related entity in a lower tax jurisdiction. To limit the latter practice, Treasury issued separate, proposed regulations that address the use and characterization of intercompany debt. If finalized, these rules could have one of the most profound impacts in recent US tax rule-making.

Overview of Proposed Regulations on Intercompany Debt

This Duff & Phelps update focuses on the proposed rules related to intercompany debt. If finalized, these proposed regulations would significantly impact the treatment of intercompany debt through three key mechanisms:

Precluding Certain Intercompany Transactions from Qualifying as Debt

The proposed regulations list three transactions that, subject to certain exceptions, would automatically be precluded from qualifying as debt for federal tax purposes:

1. Distributions of debt by corporations to their related corporate shareholders
2. Issuances of debt in exchange for stock of an affiliate (including "hook stock" transactions)
3. Issuances of debt as part of an internal asset reorganization.

Additional limitations are included to preclude the use of multi-step transactions intended to circumvent the proposed regulations "while achieving economically similar outcomes."

Allowing for Partial Characterization

The proposed regulations permit the IRS to treat intercompany debt transactions in part as debt and in part as stock, consistent with the economic substance of the instrument. This intends to address problems that arise in an intercompany context from the historical "all-or-nothing approach" by courts to characterize an instrument entirely as debt or entirely as equity. The proposed regulations do not specify a principled approach to determine when such partial treatment would occur, nor do they elaborate on mechanisms to quantify amounts that would be treated as debt versus equity. Much uncertainty remains as to how IRS agents would interpret and apply these provisions.

Requiring Contemporaneous Documentation

The proposed regulations require taxpayers to document the terms of their intercompany debt in a way that is consistent with the rigorous documentation and financial analysis observed in third-party debt transactions. Specifically, documentation should include the following items:

- The issuer's legally binding obligation to pay
- The creditors' rights to enforce the obligation
- A reasonable expectation of repayment at the time the interest is created (which may include cash flow projections, financial statements, business forecasts, asset appraisals, determination of appropriate debt-to-equity levels and analysis of other relevant financial ratios of the issuer)
- An ongoing relationship during the life of the interest consistent with the arm's length relationships between unrelated debtors and creditors, either documenting 1) the covered payments, if the issuer complied with the terms of the transaction, or 2) the creditor's efforts to enforce and/or renegotiate the terms of the instrument, if the issuer did not comply

Additional documentation guidelines are included for cash pools and revolving credit facilities.

Documentation is generally expected to be completed within 30 days of the debt issuance. Documentation surrounding the debtor-creditor relationship is subject to a 120-day timeline starting from payment due dates, or other relevant events such as dates of default or acceleration. Furthermore, taxpayers are expected to establish that a valid debtor-creditor relationship is being maintained throughout the duration of the issuance.

Most importantly, documentation is "necessary, but not sufficient," for a purported indebtedness to ultimately be characterized as debt by the IRS under the new proposed regulations.

Large multinationals are not the only companies that should take notice of the proposed regulations, as they require compliance by companies that meet any of the following tests: 1) the stock of any member of the expanded group is publicly traded; or 2) all or any portion of the expanded group's financial results are reported on financial statements with total assets exceeding $100 million, or total revenue exceeding $50 million.

Background and Application

The proposed regulations are issued under IRC section 385, a code section authorizing the IRS to establish specific rules for determining whether an interest is treated as stock or debt for federal tax purposes. The determination of debt versus equity classification for federal tax purposes is an issue that has vexed taxpayers and regulators alike for years. Section 385, originally enacted in 1969 and further amended in 1989, as well as in 1992, currently has no regulations outlined thereunder. In absence of concrete regulations, the characterization of an advance as debt or equity for federal tax purposes has generally evolved and been determined based on case law where courts apply varying (and inconsistent) sets of factors, "subjecting substantially similar fact patterns to differing analyses."

The preamble to the newly proposed rules under section 385 makes clear that the new proposed regulations are not intended to "alter the general case law view" of the importance of certain essential characteristics of indebtedness, but instead seek to provide concrete guidance for intercompany debt versus equity determinations and require more documentation and diligence than what is required under current law.

The proposed regulations are far-reaching and are generally expected to affect corporations that issue debt to related corporations or partnerships.

The IRS has provided a 90 day timeline for comments on the proposed regulations which are due July 7, 2016. Please contact a Duff & Phelps transfer pricing professional for more information surrounding these proposed regulations.