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Proposed Section 385 Tax Regulations May Dramatically Impact Portfolio Debt Planning

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On April 4, 2016, the IRS and Treasury issued proposed regulations under Section 385 (the "Proposed Regulations").[1] The Proposed Regulations, which were thought to have been a response to post-inversion earnings stripping transactions, have been heavily criticized as being overbroad and potentially impacting many ordinary business transactions, both in the domestic and international settings.

Under the Proposed Regulations, the IRS would have the ability to:

1. Recharacterize certain related-party debt instruments as equity for federal tax purposes;
2. Treat certain related-party debt instruments as part equity and part debt for federal tax purposes;
3. Automatically treat certain related-party debt instruments as equity if extensive documentation requirements are not contemporaneously satisfied (although a taxpayer is prohibited from affirmatively using this rule to their advantage).

Perhaps the most controversial aspect of the Proposed Regulations is the “funding rule.” Under this provision, the IRS would have the ability to recharacterize a related party debt instrument as equity if a distribution is made by the borrower to a related party (including the lender) within a six-year window. As discussed below, this provision may have a dramatic impact on many inbound financing structures that utilize the portfolio debt exception, which allows for U.S.-source interest payments made to foreign persons to be exempt from U.S. withholding tax.

Section 385 Regulations, in General Section 385(a) was enacted in 1969. It authorizes the Treasury to issue regulations that may be necessary or appropriate determining whether an interest in a corporation is stock or debt. This provision further authorized Treasury and the IRS to establish factors to indicate “for a particular factual situation whether a debtor-creditor relationship exists or a corporate-shareholder relationship exists.” Until the Proposed Regulations, no regulations had ever been issued under Section 385.

As noted above, the Proposed Regulations give the IRS the ability to treat certain related-party debt instruments, in whole or in part, as stock rather than debt for U.S. federal income tax purposes. The Proposed Regulations generally apply only to debt instruments between members of an “expanded group.” For this purpose, the term “expanded group” is defined by reference to the term affiliated group of corporations in Section 1504(a), with three modifications. First, an expanded group includes foreign and tax-exempt corporations, as well as corporations held through controlled partnerships. Second, the attribution rules of Section 304(c)(3) would apply for purposes of determining relatedness. Third, the Proposed Regulations would treat a corporation as a member of an expanded group if 80 percent of the vote or value (not vote and value) is owned by expanded group members.[2] Therefore, under this definition, any two corporations (domestic or foreign) would be treated as part of an expanded group as long as one corporation owns (directly or indirectly) 80 percent or more of the vote or value in the second corporation.

Targeted Transactions

The preamble identifies three specific transactions that raise significant policy concerns that Treasury and IRS believed should be addressed under the Proposed Regulations:

1. Distributions of debt instruments by corporations to their related corporate shareholders;

2. Issuances of debt instruments by corporations in exchange for stock of an affiliate (e.g., “hook” stock); and

3. Certain debt instruments issued as consideration pursuant to an internal asset reorganization.

According to the preamble, these types of transactions involve circumstances in which equity is replaced with debt with no significant non-tax effect, and therefore can create opportunities for abuse. To address these types of concerns, Prop. Reg. Section 1.385-3 contains a general rule that would treat related-party debt instruments issued in any of the foregoing transactions as stock, subject to certain exceptions.

Funding Rule and Principal Purpose Debt Instruments

The preamble notes that the same policy concerns raised by the transactions described above may also arise when a corporation issues a debt instrument to a related party with a principal purpose of funding certain related-party transactions. Accordingly, Proposed Regulation Section 1.385-3 includes a “funding rule” which treats certain debt instruments as stock if such debt is issued to a related corporation with a principal purpose of, among other items, funding a distribution of cash or property to a related corporate shareholder (the “Funding Rule”). The Proposed Regulations initially indicate that whether a debt instrument is issued with such a principal purpose generally depends on all the facts and circumstances. Surprisingly, however, the same regulation then establishes an irrebuttable presumption that requires equity treatment any time an expanded group debt instrument is issued within 36 months before or after the distribution. (emphasis added). In such cases, a principal purpose is automatically deemed to exist and it is impossible for the taxpayer to challenge this treatment.[3]

There is no exception in the regulations for a distribution made by the borrower (i.e., the “funded member”) to the lender. In fact, the preamble makes it clear that the Funding Rule is intended to include distributions made by the borrower to the lender.[4]

Impact on Common Portfolio Debt Structures

The Funding Rule has an extremely broad potential application, to many seemingly innocuous, or at least common, inbound financing structures. As noted above, the Funding Rule does not contain an exception for a distribution made by the borrower to the lender. As a result, many routine lending transactions could be recast as equity (and consequently payments thereon, which were otherwise free of U.S. tax, would be subject to U.S. withholding tax at a 30 percent or lower treaty rate) if even a single dollar of dividends is distributed to the lender within the six year period set forth under the regulations.

For example, assume foreign investors from a non-treaty country wish to invest an aggregate of $100 million in a U.S. real estate fund. The investors therefore set up a foreign feeder corporation in, e.g., the Cayman Islands, and capitalize this company with $100 million. This Cayman company (“Cayco”) in turn forms a U.S. blocker corporation (“U.S. Blocker”). U.S. Blocker has two classes of stock: (i) voting stock with little economic rights, and (ii) non-voting stock with substantially all of the economic rights. Cayco receives 95 percent of the nonvoting shares of U.S. Blocker (and 95 percent of the value of U.S. Blocker), but none of the voting shares.[5] The remaining 5 percent of the shares by value, along with all of the voting shares of U.S. Blocker, are owned by a U.S. LLC (taxed as a partnership), which serves as the GP to the U.S. real estate investment fund.

Cayco then leverages its investment in U.S. Blocker, by using 40 percent of its cash (i.e., $40 million) to capitalize the U.S. Blocker with equity, and then lending the remaining 60 percent, or $60 million, to U.S. Blocker in exchange for a promissory note bearing fixed interest at market rates. This debt-to-equity ratio is designed to comply with the Section 163(j) "thin capitalization" standards, which require a debt-to-equity ratio of no more than 1.5-to-1. Since Cayco owns no voting shares in U.S. Blocker, interest payments on the debt should, assuming other requirements are satisfied, qualify as exempt "portfolio interest" under Section 881(c). Such interest payments made by U.S. Blocker also should be deductible for U.S. federal income tax purposes, thereby reducing the effective U.S. tax rate paid by U.S. Blocker on its income. This is one of the most common inbound structures used by foreign persons to invest in the United States. Assume that in year two, the fund sells some assets at a large gain, and income is allocated and cash is distributed to the U.S. Blocker by the fund. U.S. Blocker in turn pays interest in each year on the intended portfolio debt and deducts those payments for U.S. tax purposes. No U.S. withholding tax is made, in reliance on the portfolio interest exemption. In year three, U.S. Blocker also distributes a small amount of excess cash to its owners, Cayco and the GP/LLC, as a dividend.[6]

Under the Funding Rule, the IRS has the ability to recharacterize the entire $60 million portfolio debt as stock in year three because a distribution (the small dividend) was made by the funded member (i.e., U.S. Blocker) in such year to a member of the funded member's expanded group, i.e., Cayco. The consequence of this recharacterization would be that all otherwise exempt "interest" payments on the debt would instead be treated as non-deductible dividends subject to a 30 percent U.S. withholding tax starting in year three. Even if the distribution occurs outside the mandatory six-year window described above, the IRS still could assert that, based on the facts and circumstances, the debt should be recharacterized as equity. This recharacterization could occur even if the only such "distribution" is a liquidating distribution, as is common in these types of structures.[7]

It is hard to imagine that this was the intended result in defining the scope of these regulations. These regulations were thought to be principally a reaction to abusive post-inversion earnings stripping transactions. While the impact of the Proposed Regulations clearly is not limited to these types of transactions, it appears that even the most commonly used inbound structures may be significantly affected by these new rules. Although the Proposed Regulations will not be effective until 90 days after they are finalized, they will (if finalized in their current form) apply to related party debt instruments issued on or after April 4, 2016. For this reason, existing inbound structures should be carefully examined to determine if restructuring is needed.

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[1] See Prop. Treas. Reg. Sections 1.385-1 through 1.385-4. All references to Section refer to Sections of the

Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder.

[2] Prop. Treas. Reg. Section 1.385-1(b)(3).

[3] It is important to note that the Proposed Regulations contain a “threshold exception,” under which a debt instrument will not be recharacterized as equity unless, immediately after the debt in question is issued, aggregate debt within the expanded group exceeds $50 million. Prop. Treas. Reg. Section 1.385-3(c)(2). Note that separate thresholds exist for purposes of the documentation requirements set out in Section 1.385-2 of the Proposed Regulations. Prop. Treas. Reg. Section 1.385-2(a)(2)(i).

[4] There is a current year earnings and profits limitation under Proposed Regulations 1.385-3, which limits the aggregate amount of any distributions that are subject to these rules to the issuer’s current earnings and profits. Prop. Treas. Reg. Section 1.385-3(c)(1).

[5] This split between voting and economic rights is intended to allow the debt to qualify as “portfolio debt” for purposes of Section 881(c).

[6] Assume that U.S. Blocker has no current year earnings and profits in year three.

[7] Moreover, under the anti-abuse rule set forth in the Proposed Regulations, even if Cayco in this case was a partnership for U.S. tax purposes, the IRS still has the ability to recharacterize the debt as equity. This is because the anti-abuse rule specifically indicates that a debt instrument issued to an entity that is not taxed as a corporation can also result in the debt being recast as equity (even though generally only corporations may be part of an expanded group). Prop. Treas. Reg. Section 1.385-3(b)(4). Finally, it is possible (although certainly not clear) that under the above facts, if the only distribution made by U.S. Blocker is made to the LLC (i.e, the GP) taxed as a partnership, the IRS still could recharacterize the debt as equity under the anti-abuse rule because the LLC owns 100 percent of the voting stock of U.S. Blocker, such that it would be an expanded group member if it were a corporation.