

Client Alert

October 21, 2016

IRS Issues Final Debt-Equity Regulations

On October 13th, the Internal Revenue Service (“IRS”) followed through on its promise to issue final regulations and temporary regulations under Section¹ 385 (the “Final Regulations” and “Temporary Regulations,” respectively) a little over six months after they were proposed. The Final Regulations generally follow the same structure as the regulations proposed by the IRS on April 4, 2016 (the “Proposed Regulations”), but contain significant exceptions that would exempt many types of instruments, some domestic issuers, and all foreign issuers from their application.

The Proposed Regulations have been the subject of significant controversy and provoked an outcry from practitioners, congressional hearings, and over 29,600 comments. Many commenters warned that, if finalized in a similar form, the Proposed Regulations would severely impair normal business conduct.

The Final Regulations are generally effective for taxable years ending on or after January 19, 2017 (the “Effective Date”), although the Documentation Requirements discussed below only apply to related group debt issued on or after January 1, 2018.

SCOPE

The Proposed Regulations generally addressed instruments (Expanded Group Instruments or “EGIs”) labeled as indebtedness between members of the same “Expanded Group,” defined as a chain of corporations (including foreign corporations and tax-exempt entities) with a common parent connected by ownership of 80% of the vote or value of each member (rather than the vote *and* value of each member as in Section 1504(a)). Indirect ownership of corporations was also taken into account by attributing ownership through related entities. Therefore, under the Proposed Regulations, an Expanded Group included not only domestic corporations but also foreign corporations and special status entities such as S corporations, regulated investment companies (RICs), real estate investment trusts (REITs), tax-exempt corporations, life insurance companies and financial entities. In response to comments that the Proposed Regulations were overly broad, the IRS and Treasury Department limited the application of the Final and Temporary Regulations as compared to the Proposed Regulations in several respects.

Most significantly, the application of the Final and Temporary Regulations is generally limited to indebtedness issued by domestic corporations. The Treasury Department and the IRS have reserved on the application to EGIs and debt instruments issued by foreign corporations (including controlled foreign corporations) pending further study. Significantly, this means that purely foreign-to-foreign transactions where both the borrower and the lender are foreign corporations are generally excluded from the application of the Final and Temporary Regulations. The Treasury Department and the IRS achieve this result by adopting a new term of

¹ All references are to the Internal Revenue Code of 1986, as amended.

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“Covered Member” defined as a member of an Expanded Group that is a domestic corporation. The Final Regulations generally do not apply to entities that are not Covered Members.

In addition, the Treasury Department and the IRS significantly limited the definition of Expanded Group for the Final and Temporary Regulations for certain entities with special tax status. In response to comments to the Proposed Regulations, non-controlled RICs, non-controlled REITs, and S corporations are generally excluded from the application of the Final Regulations. The Treasury Department and the IRS thus agreed with the comparison of S corporations, RICs, and REITs to non-controlled partnerships, which are generally excluded from the definition of an Expanded Group. The Treasury Department and the IRS recognized the similar flow-through characteristics of S corporations, RICs, and REITs as non-controlled partnerships and similarly excluded such entities from the definition of an Expanded Group.

While there is no blanket exception from the application of the Final and Temporary Regulations for insurance companies and financial institutions, the requirements are relaxed for certain specified financial entities, financial groups, and insurance companies that are subject to a specified degree of regulatory oversight regarding their capital structure. There is no special exemption for tax-exempt entities.

The remainder of this alert addresses the requirements for those entities that are within the scope of these regulations.

PARTIAL DEBT/EQUITY TREATMENT

The Proposed Regulations authorized the IRS to recharacterize a single instrument as equity in part and indebtedness in part, if warranted by the facts and circumstances. This rule has been removed from the Final Regulations, although the Treasury Department and the IRS are continuing to study the issue.

Although no general power to bifurcate an instrument exists, it is possible that an instrument may be bifurcated under the Automatic Equity Rules discussed below. For example, if the member of an Expanded Group borrows \$100 from another member of the Expanded Group to fund a \$50 distribution, under the Automatic Equity Rules half of the \$100 issuance would be treated as stock. “Principal” payments on the instruments may be designated by the issuer as being with respect to the recharacterized portion or the portion that remains treated as indebtedness. “Interest” payments are treated as paid on pro rata with respect to each portion.

DOCUMENTATION REQUIREMENTS

The Proposed Regulations had established new documentation requirements that must be met to keep the IRS from automatically recharacterizing an instrument as equity. While the Final Regulations retain the basic premise of recharacterization for EGIs that fail to meet the documentations requirements, they provide significant modifications, exceptions, and clarifications to the documentation requirements.

Scope of Documentation Requirements

The Final Regulations narrow the scope of the documentation requirements by excluding certain EGIs. By virtue of their broader exclusion from the Final Regulations, EGIs issued by a foreign issuer, an S corporation, and generally interests issued by non-controlled REITs and non-controlled RICs are excluded from the documentation

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requirements. Instruments issued by controlled partnerships are also generally excluded from the documentation requirements, although they are still subject to an anti-abuse rule. Obligations between members of a consolidated group are also excluded, as the consolidated return regulations already provide a comprehensive regime governing substantially all obligations between members. In addition, the Treasury Department and the IRS recognized that certain regulated entities may be required in some cases to issue an instrument that would be debt under federal tax principles but for certain terms or conditions imposed by a regulator. Therefore, the Final Regulations clarify that EGIs issued by certain regulated financial and insurance companies that are required by regulators to include particular terms or conditions in the relevant instrument are treated as meeting the documentation requirements.

The Final Regulations retain the threshold limitation contained in the Proposed Regulations. As a result, the documentation requirements only apply if a member of the relevant Expanded Group is publicly traded, or if on the date the instrument first becomes an EGI, the group's total assets or total annual revenues exceed \$100 million or \$50 million, respectively.

Rebuttable Presumption for Highly Compliant Taxpayers

As in the Proposed Regulations, the Final Regulations establish the documentation requirements only as a minimum standard that must be met in order for an EGI to be treated as debt based on an application of the federal tax principles developed under applicable case law. Thus, only if the documentation requirements are satisfied would the determination of whether an EGI is properly treated as indebtedness for federal tax purposes be made under general federal tax principles.

Under the Proposed Regulations, failure to prepare and maintain the required documentation resulted in automatic equity characterization of the EGI, subject to a reasonable cause exception. As a welcome relaxation of this per se treatment, the Final Regulations provide a rebuttable presumption for highly compliant taxpayers. For members of an Expanded Group that is "highly compliant" with the documentation rules, an undocumented EGI (i.e., an EGI that fails to meet the documentation requirements) is not automatically treated as stock but is presumed, subject to rebuttal, to be stock for federal tax purposes. A taxpayer can overcome this presumption by clearly establishing that there are sufficient common law factors to treat the EGI as indebtedness. To demonstrate a high degree of compliance, the Expanded Group must meet one of the following tests during the calendar year in which an EGI fails the documentation requirements: (1) the quarterly average of the aggregate adjusted issue price of all undocumented EGIs is less than 10% of the quarterly average of the aggregate adjusted issue price of all outstanding EGIs; (2) no undocumented EGI has an issue price in excess of \$100 million, and the quarterly average of the total number of undocumented EGIs is less than 5% of the quarterly average of the total number of all outstanding EGIs; or (3) no undocumented EGI has an issue price in excess of \$25 million, and the quarterly average of the total number of undocumented EGIs is less than 10% of the quarterly average of the total number of all outstanding EGIs.

The Final Regulations retain the reasonable cause exception to the documentation requirements and add relief for ministerial or non-material failures or errors that are discovered and corrected prior to the IRS's discovery of such failure or error.

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Documentation and Information to Be Prepared and Maintained

The Final Regulations retain the four categories of documentation and information to be prepared and maintained for each EGI that were introduced in the Proposed Regulations, with some exceptions and clarifications. Each of the four requirements described below is meant to reflect an essential characteristic of indebtedness for federal tax purposes.

1. Unconditional Obligation to Pay a Sum Certain

Written documentation must establish that the issuer has entered into an unconditional and legally binding obligation to pay a fixed or determinable sum certain on demand or at one or more fixed dates. The Final Regulations add a market standard safe harbor for this factor; that is, documentation of a kind customarily used in comparable third-party transactions (e.g., trade payables with third parties) may be used to satisfy this requirement.

2. Creditor's Rights to Enforce Terms

The documents must establish that the holder has the legal rights of a creditor to enforce the terms of the EGI. At a minimum, the rights of a creditor must include a superior right to shareholders to share in the assets of the issuer in the case of dissolution. In recognition of the fact that creditor's rights are often established by law and not necessarily included in the loan documentations, the Final Regulations provide that creditor's rights may be provided under local law, as long as the legal agreement contains a reference to the provisions of local law providing such rights. The Final Regulations also adopt the market standard safe harbor for this requirement.

3. Reasonable Expectation of Repayment

The documents must evidence a reasonable expectation that, as of the date of issuance of the EGI, the issuer could in fact repay the amount of the proposed loan. The documentation might include cash flow projections, financial statements, business forecasts, asset appraisals, determination of debt-to-equity, and other relevant financial ratios of the issuer. A number of clarifications are made in the Final Regulations relating to this documentation requirement. If an EGI is nonrecourse, the documentation to support such indebtedness must include the value of property available to support repayment of the nonrecourse EGI. Additionally, the Final Regulations clarify that documentation may include cash flow projections and similar economic analyses prepared by either the members of the Expanded Group of the issuer or third parties. The Final Regulations also add that the documentation may assume that the principal amount of an EGI may be satisfied with the proceeds of another borrowing by the issuer, provided that such assumption is reasonable. A new rule regarding multiple EGIs issued by the same issuer is adopted in the Final Regulations. Under the new rule, a single annual credit analysis may be prepared with respect to multiple EGIs issued by the same issuer, up to an overall amount of indebtedness set forth in the annual credit analysis, provided that any such EGIs are issued on any day within the 12-month period beginning on the date on which the analysis in the annual credit analysis is based.

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4. *Genuine Debtor-Creditor Relationship*

The documents must evidence an ongoing debtor-creditor relationship, which can come in two forms. First, in the case of an issuer that complied with the terms of the EGI, documentation must include evidence of any payments on which the taxpayer relies to establish debt treatment under general federal tax principles. In the alternative, if the issuer did not comply with the terms of the EGI (by not making required payments or otherwise suffering an event of default under the EGI), to show a genuine debtor-creditor relationship there must be documentation showing the holder's reasonable exercise of the diligence and judgment of a creditor. Recognizing the practice of many lenders that choose not to enforce creditor's rights for sound business reasons, the Final Regulations provide that, if a holder does not enforce its creditor's rights, there must be documentation that supports the holder's decision to refrain from pursuing any enforcement actions as being consistent with the reasonable exercise of the diligence and judgment of a creditor.

Revolving Credit Agreements, Cash Pooling and Similar Arrangements

With respect to revolving credit agreements, cash pooling arrangements and similar arrangements under a master agreement, the Proposed Regulations had provided that the documentation requirements apply to the master agreement as a whole (rather than for each individual transaction). The Final Regulations continue with this approach with the following clarification: with respect to EGIs governed by a master agreement, a single credit analysis may be prepared and used on an annual basis up to an overall amount of indebtedness set forth in the annual credit analysis, and the first such annual credit analysis must be performed upon the execution of the master agreement.

Obligations of Disregarded Entities

The Final Regulations provide that, if an EGI issued by a disregarded entity that is owned by a regarded member of an Expanded Group is treated as stock as a result of failing the documentation requirements, the stock is treated as having been issued by the regarded owner of the disregarded entity. Thus, the regarded owner of the disregarded entity will be treated as the holder of the EGI issued by the disregarded entity, and the actual holder will be treated as the holder of the stock deemed issued by the regarded owner. This new rule is a departure from the Proposed Regulations, which would have caused the disregarded entity to become a partnership for tax purposes.

Timely Preparation Requirement

The Proposed Regulations generally required that the documentation be prepared no later than 30 calendar days after the date of a relevant event, which was generally the date the EGI was issued or the date the issuer became an Expanded Group member; in the case of documentation of the debtor-creditor relationship (the fourth requirement above), the Proposed Regulations allowed documentation to be prepared up to 120 calendar days after a payment or relevant event occurred. In response to comments, the Final Regulations replace these 30- and 120-day timely preparation requirements with a requirement that documentation and financial analysis be prepared by the time that the issuer's federal income tax return is filed (taking into account all applicable extensions).

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Delayed Implementation

The Final Regulations delay the implementation of the documentation requirements such that the requirements apply only to EGIs issued on or after January 1, 2018. The effect of this change in combination with the new timely preparation requirement described above is that taxpayers will have until the filing date of their taxable year that includes January 1, 2018 to complete the documentation requirements.

AUTOMATIC EQUITY TREATMENT

Similar to the Proposed Regulations, the Final Regulations provide that debt instruments issued in certain situations, described below, are automatically treated as equity (the “Automatic Equity Rules”). The IRS views these transactions as having limited non-tax effect because the debt issuance does not result in the transfer of capital or assets in a significant way.

In order to be within the scope of the automatic equity rules, a debt instrument must be a “covered debt instrument.” A covered debt instrument is generally any debt instrument that is issued after April 4, 2016 (the date that the Proposed Regulations were released), except for:

- debt instruments issued to or held by a dealer in securities who accounts for the debt as inventory and does not transfer the debt instrument to a non-dealer member of the group;
- certain debt instruments that are given special statutory treatment, such as REMIC regular interests, or stripped bonds or coupons under Section 1286; and
- debt instruments that are issued by a “regulated financial company” (e.g., a bank or bank holding company) or a “regulated insurance company” (generally, a domestic insurance company taxed under Subchapter L of the Code).

Similar to the Proposed Regulations, controlled partnerships are generally treated as aggregates of their members, i.e., each member is treated as owning its proportionate share of the partnership’s assets and is treated as issuing its share of the partnership’s debt. A partner’s share of partnership property is determined by the amount of cash the partner would receive upon a hypothetical liquidation of the partnership. Debt instruments issued by controlled partnerships are treated as issued by each partner in proportion to their reasonably anticipated distributive share of interest expense over a reasonable period, taking into account all relevant facts and circumstances. If a debt instrument issued by a controlled partnership would be recharacterized under the Automatic Equity Rules, the holder is treated as exchanging the debt instrument with the partners in exchange for partnership equity.

Furthermore, members of a consolidated group are treated as one corporation for purposes of the Automatic Equity Rules. As a result, acquisitions and distributions where all parties are members of the same consolidated group are disregarded for these purposes.

Lastly, the Final Regulations contain an anti-abuse rule whereby, if a group member enters into a transaction with a principal purpose of avoiding the Automatic Equity Rules, an interest (including an interest that is not debt) issued or held by the member may be treated as stock, depending on the relevant facts and circumstances.

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1. *Debt Instrument Issued in a Distribution*

A covered debt instrument is automatically treated as equity if it is issued to a member of the issuer's Expanded Group in a distribution. A distribution is defined as any distribution made by a corporation with respect to its stock.

2. *Debt instrument Issued in Exchange for Affiliate Stock*

A covered debt instrument is automatically treated as equity if it is issued by a corporation to a member of the corporation's Expanded Group in exchange for Expanded Group stock. The IRS views such a transaction as similar to the issuance of a debt instrument in a distribution.

3. *Debt Instrument Issued Pursuant to an Internal Reorganization*

The Final Regulations also automatically treat as equity a covered debt instrument issued in exchange for property in an asset reorganization, but only to the extent the covered debt instrument is received by the target's shareholder in exchange for its target stock.

4. *Funding Rule*

A covered debt instrument is automatically treated as equity if it is treated as funding a distribution or acquisition described in (1) through (3) above (the "Funding Rule").² A debt instrument is irrebuttably presumed to fund a distribution or acquisition if it is issued within 36 months of the transaction. In addition to this per se rule, a debt instrument is treated as funding a distribution or acquisition if, based on all the facts and circumstances, it is issued with the principal purpose of funding a distribution or acquisition. Distributions and acquisitions occurring prior to April 5, 2016, are not taken into account.

The Funding Rule does not apply to "qualified short-term debt instruments," which are defined in the Temporary Regulations to include:

- short-term funding arrangements where either (1) the total short-term debt of the issuer does not exceed the amount of assets that are expected to be realized in cash or sold during the subsequent 90-day period (or, if longer, the issuer's normal operating cycle), or (2) the debt instrument has a term of 270 days or less, and the issuer is generally a net borrower with respect to the lender for less than 270 days in a taxable year (or 270 consecutive dates);
- ordinary course loans reasonably expected to be repaid within 120 days;
- interest-free loans with no imputed interest, original interest discount, or interest imposed under Section 482; and
- demand deposits received by a qualified cash pool header (generally an entity or business unit whose principal purpose is the management of cash for participating members) under a cash-management arrangement.

² The member that makes the distribution or acquisition is referred to as the "funded member" and generally includes any predecessor or successor entity, with some exceptions.

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5. Automatic Equity Treatment Exceptions

In addition to excluding debt instruments that are not covered debt instruments, the Final Regulations include several exceptions to the automatic equity rules.

First, similar to the Proposed Regulations, the aggregate amount of distributions and acquisitions is reduced to the extent of current year earnings and profits and (new to the Final Regulations) earnings and profits accumulated by corporations since joining the Expanded Group, as long as those earnings and profits were earned in taxable years ending on or after April 5, 2016.

Second, an acquisition of Expanded Group stock does not include an acquisition of newly issued or existing stock from an Expanded Group member if the acquirer controls the seller (measured by direct or indirect ownership of more than 50% of the vote and value) and there is no plan as of the acquisition to relinquish control. A plan is rebuttably presumed to exist if the acquirer relinquishes control of the seller within 36 months of the acquisition. This represents an expansion of the exception that existed in the Proposed Regulations, which only permitted acquisitions of newly acquired stock from a controlled subsidiary. Furthermore, under the Proposed Regulations, this exception only existed for purposes of the Funding Rule – under the Final Regulations the exception applies for all purposes of the Automatic Equity Rules.

Third, the Final Regulations provide that the first \$50 million (in aggregate adjusted issue price) of covered debt instruments held by the group are exempt from the Automatic Equity Rules. This is an expansion of the threshold exception in the Proposed Regulations, which excepted groups that had covered debt instruments with a less than \$50 million aggregated adjusted issue price. The purpose of this expansion was to avoid the “cliff effect” that would occur if a group has, for example, \$51 million of covered debt instruments outstanding. Under the Proposed Regulations, the entire \$51 million of covered debt instruments were subject to recharacterization, whereas under the Final Regulations, only \$1 million of covered debt instruments are potentially subject to recharacterization.

Lastly, the Final Regulations contain exceptions for qualified capital contributions, compensatory stock acquisitions, distributions or acquisitions deemed to occur under Section 482, distributions under Section 355 or in complete liquidation under Section 336 or 337, and stock acquisitions by dealer members.

6. Effective Date and Transition Rule

The Automatic Equity Rules are generally effective for taxable years ending on or after January 19, 2017, although debt instruments issued before April 5, 2016 are grandfathered. A debt instrument that would be treated as stock by reason of the application of the Final and Temporary Regulations is not treated as stock until January 19, 2017, and then only to the extent that the debt instrument is held by a member of the issuer’s Expanded Group immediately after January 19, 2017.

In order to combat transactions that take place after the Regulations are published but prior to the effective date, a transition funding rule provides that any payment with respect to a debt instrument that would be treated as stock, but for the delayed Effective Date, is treated as a distribution for purposes of the funding rule. This transition rule is intended to prevent issuers from using the delayed Effective Date to issue substantial

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related-party debt that does not finance new investment after having received notice of the Final and Temporary Regulations.

LOOKING FORWARD

The Final and Temporary Regulations scaled back the scope and the application of the Proposed Regulations. As compared to the Proposed Regulations, many more taxpayers are now exempt from the application of some or all of the Final and Temporary Regulations. The following chart provides a quick summary:

Entity	Documentation Requirements	General Automatic Equity Rule	Funding Rule
Foreign Issuers (including Subsidiaries of U.S. Multinationals, U.S. Branches of Foreign Issuers and CFCs)	Exempt	Exempt	Exempt
Between Members of a U.S. Consolidated Group	Exempt	Exempt	Exempt
Brother-Sister Groups Owned by a Non-Corporate Owner (e.g. partnership)	Exempt	Exempt	Exempt
Certain Regulated Financial & Insurance Companies	Not Exempt ³	Exempt	Exempt
S Corporations	Exempt	Exempt	Exempt
Non-Controlled RICs	Exempt	Exempt	Exempt
Non-Controlled REITs	Exempt	Exempt	Exempt

However, some of the exemptions above may be short-lived. As discussed above, the Treasury Department and the IRS have reserved on several areas pending further studies including the following:

- the application of the Final Regulations to EGIs and debt instruments issued by foreign corporations (including U.S. branches of foreign issuers and CFCs);

³ As discussed above, while there is no blanket exemption from the documentation requirements, EGIs issued by certain regulated financial and insurance companies that are required by regulators to include particular terms or conditions in the relevant instrument are treated as meeting the documentation requirements.

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- Expanded Group treatment of brother-sister groups with common non-corporate owners;
- the application to debt not in debt form; and
- the application of the no affirmative use rule.

We will continue to monitor these developments.

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