Death of Earnings Stripping? Proposed Regs Target Related-Party Debt

Donald P. Board • Wood LLP

As tax stories go, the Treasury’s April 4 release of temporary regulations to strengthen the anti-inversion rules of Code Sec. 7874 made quite a splash. The financial press quickly began to speculate whether these powerful new regulations would torpedo the pending Pfizer-Allergan inversion. Less than 48 hours later, Pfizer announced that it was calling off the $160 billion deal, which would have created the world’s largest pharmaceutical firm.

The same day that the Treasury issued the inversion rules, it released 136 pages of proposed regulations under Code Sec. 385, ostensibly to revamp the tax treatment of related-party corporate indebtedness. The proposed regulations have received considerably less press coverage than the inversion rules. But they could be even more significant in the long run, assuming they are finalized in anything like their current form.

At least that is what the Treasury hopes. As one official told practitioners, the proposed regulations are intended to be “disruptive.” The cozy practice to be disrupted is earnings stripping.

According to its critics, earnings stripping erodes the U.S. domestic tax base and is a major driver of tax-motivated foreign acquisitions of U.S. corporations. That includes inversions, the target of the other Treasury missive. Inversions are simply foreign acquisitions in which the shareholders—and managers—of the U.S. target corporation emerge with control of the nominal foreign acquirer.

Overview

The proposed regulations target purported indebtedness between corporations that are members of a large “expanded group.” “Large” in this case means that the expanded group has either total assets exceeding $100 million, total annual revenue exceeding $50 million or at least one publicly traded member.

Under Proposed Reg. §1.385-1(b)(3), an expanded group is a very relaxed version of an affiliated group as defined in Code Sec. 1504(a). An expanded group consists of a parent corporation and all corporations (including foreign corporations, S corporations,
tax-exempts and REITs) in which the parent directly or indirectly owns an 80-percent interest. An 80-percent interest means an 80-percent interest by vote or value, rather than Code Sec. 1504(a)(2)(A)’s more familiar 80 percent by vote and value.

An expanded group can include the members of a U.S. consolidated group. But the consolidated companies are treated as a single corporation under Proposed Reg. §1.385-1(e). As a result, the proposed regulations do not apply to indebtedness between members of consolidated group.

Indebtedness between a member of a consolidated group and a nonmember, on the other hand, is subject to the proposed regulations if the two corporations are members of the same expanded group.

The proposed regulations establish three new sets of rules dealing with purported intra-group indebtedness. Proposed Reg. §1.385-2 imposes new documentation requirements to help the IRS determine whether the parties truly intended to create a debtor-creditor relationship and conducted themselves accordingly while the purported debt was outstanding.

If the specified documentation is not prepared and maintained for IRS review, the purported debt is automatically treated as stock.

Proposed Reg. §1.385-3 attacks earnings stripping following inversions and other foreign acquisitions of U.S. corporations. The key to earnings stripping is the rapid substitution of debt owed to the new foreign parent (or its affiliates) for the U.S. corporation’s existing equity.

The proposed regulations attack this substitution with new rules that are supposed to make it much harder, if not impossible, for a U.S. member of an expanded group to become indebted to a foreign member without receiving any new capital in exchange. The classic example is a U.S. corporation that distributes its own note to its foreign parent as a dividend. The features of the note may qualify it as indebtedness under traditional criteria, but the proposed regulations treat it as equity, because the U.S. corporation did not get anything in return.

Finally, under Proposed Reg. §1.385-1(d), the IRS is permitted (but not required) to treat a purported debt instrument as partly debt and partly equity, if that treatment is appropriate under the circumstances. This rule extends to purported indebtedness between members of a “modified expanded group”—i.e., an expanded group determined using a 50-percent vote-or-value test.

### Scrutinizing Related-Party Debt

The preamble to the proposed regulations starts with the principle that purported indebtedness between related persons should be respected for tax purposes “only if there is intent to create a true debtor-creditor relationship that results in bona fide indebtedness.” That might seem easy. Normally, a lender’s economic self-interest ensures that the terms of a purported loan will be rigorous enough to warrant treating it as indebtedness for tax purposes.

At the same, the lender’s self-interest will encourage serious investigation of the borrower’s creditworthiness and diligent efforts to document the transaction so that the lender can enforce its rights in the event of default.
But when lender and borrower are related parties, relying on the lender’s self-interest becomes problematic at best. As both the IRS and courts have recognized, transactions purporting to create indebtedness between related parties warrant close scrutiny.

Unfortunately, related parties have limited incentives to create the kind of factual record that will facilitate IRS review of their purported debtor-creditor relationship. This is an old problem, but the Treasury reports that it has gotten significantly worse in recent decades. According to the preamble, the size, activities and financial complexity of corporations and their group structures “have grown exponentially,” and the “scope and complexity of intragroup transactions have grown commensurately.”

This makes it difficult for the IRS to identify documents that are relevant to debt characterization. It can be particularly hard to get information to determine whether the purported lender made the loan with a reasonable expectation of repayment. The Treasury says that taxpayers responding to IRS requests for information may inadvertently omit necessary documents, particularly when books and records are located in multiple foreign jurisdictions.

Alternatively, the preamble reports, taxpayers may respond by providing “vast amounts of irrelevant documents and material, such that forensic accounting expertise is required to isolate and evaluate relevant information.” Needless to say, this does not facilitate the IRS examination process.

**Demanding Documentation**

Proposed Reg. §1.385-2 tries to bridge the information gap by requiring the group to prepare and maintain specific kinds of documentation regarding a purported intra-group indebtedness. If the group fails to do so, the purported debt instrument is automatically treated as equity. If the expanded group complies, the purported indebtedness will still be reviewed under the usual multi-factor debt-equity tests.

The documentation rules are demanding, but they do not apply to a group unless: (a) it has a member whose stock is publicly traded; (b) the group’s total assets exceed $100 million; or (c) the group’s total annual revenue exceeds $50 million. While $50 million is not what it used to be, it is still enough to ensure that most mom-and-pop corporate groups will not have to worry about additional loan documentation.

Most of the required documentation sounds like common sense. The group must maintain complete copies of all documents “evidencing the material rights and obligations of the issuer and the holder” relating to the purported indebtedness, including guarantees and subordination agreements.

The documentation must establish that the issuer has an unconditional obligation to pay a sum certain on demand or at one or more fixed dates, and that the holder has the rights of a creditor to enforce the obligation. A promissory note with an acceleration clause should do the trick.

**Reasonable Expectations, Reasonable Diligence**

But the proposed regulations are not limited to formalities. Under Proposed Reg. §1.385-2(b)(2)(iii), the group must document that the issuer’s financial position “supported a reasonable expectation that the issuer intended to, and would be able to, meet its obligations pursuant to the terms of the applicable instrument.” This reasonable expectation of repayment must take into account all relevant circumstances.

These include, sensibly enough, all other obligations of the issuer as of the date of issuance of the applicable instrument or reasonably anticipated to be incurred thereafter. The proposed regulations note that the documentation may include cash flow projections, financial statements, business forecasts, asset appraisals, determination of debt-to-equity and other relevant financial ratios of the issuer in relation to industry averages and other information regarding the sources of funds that will enable the related-party issuer to meet its obligations. The purported loan, in other words, should rest on something resembling normal credit analysis.

Of course, an unrelated lender does more than sign a loan agreement and hand over a check. As long as the loan is outstanding, an unrelated lender will monitor the borrower and will take action to protect its interests if things get bumpy. Related parties may not.

The proposed regulations therefore require the group to prepare documentation concerning
the ongoing debtor-creditor relationship. This includes keeping records documenting all payments with respect to the purported indebtedness. If the event of a default, there should be documentation evidencing the purported lender’s “reasonable exercise of the diligence and judgment of a creditor.”

Under Proposed Reg. §1.385-2(b)(2)(iv)(B), such documentation may include:

- evidence of the holder’s efforts to assert its rights under the terms of the [purported debt instrument], including the parties’ efforts to renegotiate the [purported debt] or to mitigate the breach …, or any change in material terms and conditions …, such as maturity date, interest rate, or obligation to pay interest or principal, and any documentation detailing the holder’s decision to refrain from pursuing any actions to enforce payment.

The proposed regulations, in other words, require documentation that the parties acted consistently with a true debtor-creditor relationship, despite being members of the same expanded group.

The required documentation must be roughly contemporaneous with the relevant event. As regards payments and defaults described in Proposed Reg. §1.385-2(b)(2)(iv), that means within 120 days. Documentation regarding the terms of the indebtedness and the lender’s credit analysis must be prepared within 30 days after issuance of the purported debt instrument.

Earnings Stripping 101
Proposed Reg. §1.385-3 addresses earnings stripping in both domestic and cross-border contexts. As a practical matter, however, the focus is on earnings stripping following foreign acquisitions of U.S. corporations, including inversions. So, it is convenient to discuss the proposed rules in those terms.

By itself, a foreign corporation’s acquisition of a U.S. corporation does nothing to reduce U.S. tax due on the income of its new subsidiary. But if the U.S. subsidiary becomes obligated to make large interest payments to its new foreign parent, the resulting interest deductions can reduce or even eliminate the subsidiary’s taxable income in the United States.

Under Code Sec. 881(a)(1), interest payments flowing up to the foreign parent are subject to a 30-percent withholding tax. In theory, this ensures that the U.S. subsidiary’s earnings will be subject to at least one layer of U.S. tax. In practice, however, tax treaties usually permit a foreign parent corporation to receive the interest subject to little or no U.S. withholding tax. That leaves it up to the foreign parent’s home country to tax the interest payments. That will be fine with the foreign parent. After all, the corporate tax rate in the parent’s home country will almost always be less than the 35-percent U.S. rate.

In fact, these days, the parent’s home country will probably have disclaimed its jurisdiction to tax income earned abroad. Under one of these “territorial” systems, the tax rate on the interest paid to the foreign parent could be zero. That is hard to beat.

Faced with this opportunity for tax arbitrage, the foreign parent may have a strong incentive to load up its subsidiary with debt to generate U.S. interest deductions. In the ideal case, these deductions will zero out the subsidiary’s U.S. taxable income. The subsidiary’s earnings will have been stripped out of the U.S. corporate tax base and simply applied to the foreign parent’s bottom line.

Steering Clear of Productive Investment
How does the foreign parent load up its new U.S. subsidiary with indebtedness? The obvious answer is loans. If the parent lends $100 million to the subsidiary at seven-percent interest, the subsidiary can deduct $7 million a year in interest expense.

Code Sec. 163(j) limits the interest deduction in some high-leverage situations. But in practice, Code Sec. 163(j) often leaves plenty of room for earnings stripping. Still, there is a problem.

What does the U.S. subsidiary do with the $100 million? If the subsidiary uses the loan proceeds for productive investment (e.g., to build a factory), it will (all things being equal) find itself earning additional taxable income on its $100 million investment.

That is good news from a business perspective. But it does not advance the earnings-stripping agenda. The $7 million in interest deductions will shelter much or perhaps all of the U.S. subsidiary’s earnings on its $100 million investment.
But those earnings represent *additional* income to the U.S. subsidiary. At best, only a portion of the $7 million in deductions will be left over to shelter the subsidiary’s *existing* income. So, the foreign parent’s $100 million loan will have done little, or maybe nothing, to reduce the net amount of subsidiary earnings subject to U.S. corporate tax.

If the foreign parent is going to strip out the U.S. subsidiary’s existing earnings, it cannot make a loan that the borrower will use for productive investment. This leaves the foreign parent with two alternatives. The first is to create a $100 million indebtedness without making a $100 million loan.

After all, if there are no loan proceeds, there is no danger that the U.S. subsidiary will use them to earn additional taxable income. The second is to make the loan, but to arrange for the U.S. subsidiary to use the $100 million for *nonproductive* purposes. Paying dividends and repurchasing shares are two obvious candidates.

**Loans Without Proceeds: Debt Distributions**

The basic technology of earnings stripping dates back at least to the 1930s. In 1934, Congress temporarily abolished consolidated returns. Profits earned by a subsidiary could no longer be sheltered by losses at the parent level.

One such profitable subsidiary was the Kraft Foods Company. National Dairy Products Corporation had purchased Kraft in 1930 using borrowed money. Because of the interest on the acquisition indebtedness, National Dairy operated at a loss.

That created a tax shield that had sheltered a significant portion of Kraft’s profits reported on National Dairy’s consolidated return. The abolition of consolidated returns ended this convenient arrangement. But Kraft had a plan. Despite that the fact that it had only $72 million in assets, the company declared a $30 million dividend.

This dividend was paid to National Dairy in the form of Kraft debentures, paying interest at six percent. The $30 million principal was not due until 1948. In the meantime, the debt generated $1.8 million per year in interest deductions, thus reducing Kraft’s taxable income.

The IRS challenged Kraft’s interest deductions on several grounds. Chief among them was the fact that Kraft’s purported $30 million indebtedness to National Dairy had not provided Kraft with a cent of new capital. Kraft’s $30 million obligation had been created by fiat.

The Tax Court, sitting *en banc*, agreed with the IRS and disallowed the interest deductions [*Kraft Foods Co., 21 TC 513, Dec. 20,121 (1954)*]. The Second Circuit, however, reversed the Tax Court and upheld the deductions [*CA-2, 56-1 USTC ¶9428, 232 F2d 118 (1956)*]. Chief Judge Clark dissented, warning that allowing related corporations to manufacture interest deductions in this way would “open a Pandora’s box in the future.” The “pure gold of tax avoidance,” he predicted, “will stimulate imitators.”

A mere 60 years later, the Treasury is invoking its authority under Code Sec. 385 to “overrule” *Kraft Foods*. Under Section 1.385-3(b)(2)(i) of the proposed regulations, a debt instrument is *automatically* treated as stock if it is issued to another group member in a distribution. Under the proposed rule, related corporations can no longer manufacture interest deductions out of thin air.

**Loans to Purchase Affiliate Stock**

Debt distributions may be off the table, but how about issuing debt to an affiliated corporation in exchange for *assets*? From an earnings-stripping perspective, everything depends on the kind of assets purchased.

Suppose a U.S. subsidiary issues its $100 million note to purchase a factory from its foreign parent or another foreign affiliate. That accomplishes no more than simply lending the subsidiary $100 million to build a factory. Under either scenario, every dollar of profit generated by the factory will use up a dollar of the interest deductions generated by the $100 million indebtedness.

Now, suppose instead that the U.S. subsidiary issues its $100 million note to purchase stock of the foreign affiliate. It could be from a stockholder or from the affiliate itself. In principle, there is nothing to prevent the stock from generating piles of current dividend income for the U.S. subsidiary.

That would be just as counter-productive, from an earnings-stripping perspective, as having the subsidiary borrow to buy or build a factory. In reality, however, the U.S. subsidiary
and the foreign affiliate are members of the same expanded group. The foreign parent will control the timing and amount of any dividends paid to the U.S. subsidiary.

If the goal is to create interest expense without generating taxable income, the foreign parent can simply cut the flow of dividends from the foreign affiliate to the U.S. subsidiary. The foreign affiliate can continue to operate as profitably as it did before. It simply retains its earnings.

If the foreign parent wants cash for itself or other group members, it can borrow from the foreign affiliate. Shutting off dividends to the U.S. subsidiary reduces its U.S. earnings at no cost to the expanded group. This special dynamic explains the proposed regulations’ focus on related-party stock acquisitions.

Under Proposed Reg. §1.385-3(b)(2)(ii), debt issued to acquire a fellow member’s stock is automatically re-characterized as equity. The preamble to the proposed regulations offers a related rationale for this rule. The Treasury emphasizes the fact that stock sales between related corporations often serve as a substitute for dividends. After all, that is why Congress enacted Code Sec. 304. As the Treasury sees it, a rule covering related-party stock is necessary to prevent would-be earnings strippers from simply replacing debt distributions with debt issued to finance related-party stock acquisitions, which are dividends de facto.

Debt Issued in Internal Asset Reorganizations

Proposed Reg. §1.385-3(b)(2)(iii) treats a debt instrument as stock to the extent that it is issued by a corporation to a member of the corporation’s expanded group in exchange for property in certain asset reorganizations involving members of the group. The rule applies to the extent that, pursuant to a plan of reorganization under Code Sec. 368(a)(1)(A), (C), (D), (F) or (G), a shareholder that is a member of the issuer’s group receives a debt instrument with respect to its stock in the transferor corporation.

This can take the form of a distribution of the debt instrument to shareholders of the distributing corporation in a divisive reorganization, or a redemption of the shareholder’s stock in the transferor corporation in an acquisitive asset reorganization. The point in both cases is that debt is being substituted for stock in transactions that have only limited nontax significance.

“Principal Purpose” Debt Instruments

The ingenuity of corporate tax planners being what it is, the Treasury has tried to address a range of transactions that indirectly achieve results similar to those that are prohibited under Proposed Reg. §1.385-3(b)(2) (the “general rule”). Under Proposed Reg. §1.385-3(b)(3)(ii) (the “funding rule”), a debt instrument will be treated as stock if it is issued by one group member (the “funded member”) to another member in exchange for property with a principal purpose of: (a) funding a distribution of property to a member of the group; (b) acquiring stock of a member of the group; or (c) acquiring property of a member of the group in an asset reorganization.

A debt instrument can provide funding for one of these purposes even if it is issued after the distribution or acquisition [Proposed Reg. §1.385-3(b)(3)(iv)(A)]. The funding rule operates primarily to backstop the general rule. The general rule applies directly if one group member issues a debt instrument to purchase stock of another.

But suppose that the group member issues a debt instrument to group member A in exchange for a cash loan and then uses the proceeds to purchase stock of group member B. Proposed Reg. §1.385-3(b)(3)(ii)(B) treats the debt instrument issued to group member A as equity if the funded member borrowed the money with a principal purpose of purchasing stock of group member B.

The Per Se Rule

A rule that depends on determining whether a particular result was “a principal purpose” of a transaction invites factual controversy. Section 1.385-3(b)(3)(iv)(B)(1) of the proposed regulations tries to avoid this by adopting a “per se rule.” If a debt instrument is issued within 36 months before or after a distribution or stock acquisition, it is conclusively presumed that the debt instrument has a principal purpose of funding the distribution or acquisition.

If a debt instrument is issued outside the 72-month window, its principal purpose
is determined based on all the facts and circumstances. The *per se* rule will certainly make life easier for the IRS. Taxpayers, on the other hand, may be in for some surprises.

Proposed Reg. §1.385-3(b)(3)(iv)(B)(2) carves out an exception for debt instruments issued in the ordinary course of business to purchase property or services from fellow group members in noncapital transactions. But if a U.S. subsidiary borrows from a related corporation on some other basis, the loan will be treated as equity if the U.S. subsidiary makes (or has made) a distribution to its foreign parent within 36 months of the loan. It is irrelevant whether there was an intentional connection between the loan and the distribution.

**Anti-Abuse Rule**

These days, no regulation is complete without an anti-abuse rule. Under Proposed Reg. §1.385-3(b)(4), a debt instrument is treated as stock if it “is issued with a principal purpose of avoiding the application of” the rules about distributions and acquisitions in Proposed Reg. §1.385-3. This sounds pretty broad, but the examples in Proposed Reg. §1.385-3(b)(4) indicate that the Treasury is aiming at what it has called “structured transactions involving unrelated persons.”

Suppose that a U.S. corporation borrows $75 million from an unrelated U.S. person. Six months later, a foreign corporation acquires the U.S. corporation. Two months after that, the new foreign parent purchases the outstanding debt instrument from the original lender.

Finally, this is followed, a year later, by the U.S. corporation paying a $75 million dividend to its new foreign parent. Will the “funding rule” of Proposed Reg. §1.385-3(b)(3)(ii)(A) treat the subsidiary’s $75 million indebtedness as stock in the hands of the foreign parent? It might appear, under the *per se* rule, that the $75 million loan funded the $75 million dividend, because the loan and the distribution were separated by less than 36 months.

Technically, however, the funding rule requires the original debt to be issued to a member of the U.S. corporation’s expanded group. In the example, the U.S. corporation borrowed from an unrelated third party. So the situation falls outside the letter of Proposed Reg. §1.385-3(b)(3)(ii)(A).

The anti-abuse rule demands that we take a second look. Suppose that the U.S. subsidiary borrowed the $75 million after it had entered negotiations to be acquired by future foreign parent. The preamble says this indicates that the debt instrument was issued with a principal purpose of avoiding the funding rule.

That triggers the anti-abuse rule. The $75 million debt instrument acquired by the foreign parent will then be treated as stock. This is so despite the fact that it was originally issued to an unrelated third party.

**Tax Treatment of Deemed Exchange**

If a debt instrument is re-characterized as equity under the proposed regulations, the holder is deemed to have exchanged the debt instrument for stock of the obligor. Proposed Reg. §1.385-1(c) treats the holder as having realized an amount equal to its adjusted basis in the indebtedness as of the date of the deemed exchange.

The holder therefore realizes no taxable gain and acquires a basis in its new stock equal to its former basis in the debt instrument. The issuer is treated as having retired the relevant portion of the debt instrument for an amount equal to its adjusted issue price as of the date of the deemed exchange.

**Effective Dates**

The Treasury has indicated that it hopes to finalize the proposed regulations soon, perhaps as early as Labor Day. Generally speaking, Proposed Reg. §§1.385-1 and -2, which impose the documentation requirements and provide for part-debt-part-equity treatment of purported debt instruments, will apply to instruments issued on or after the date the regulations are finalized. Section 1.385-3 of the proposed regulations, which applies to debt distributions and acquisitions of related-party stock, will apply to instruments issued on or after April 4, 2016.

It would be a mistake for any issuer to assume that debt instruments issued before the official effective dates are “grandfathered in.” Under the *Cottage Savings* regulations [see Reg. §1.1001-3], a significant modification of a debt instrument is treated as an exchange of the original instrument for a new debt instrument. So, debentures issued in 2013 but modified in 2018 will be considered issued in 2018 and will be subject to the new rules.
A special transition rule applies to debt instruments issued on or after April 4, but before the date when the proposed regulations are finalized. Under the general rule, an interim-period instrument can be treated as stock under the rules governing debt distributions and related-party stock acquisitions. Proposed Reg. §1.385-3(h)(3), however, provides a 90-day grace period following finalization.

During that time, the parties can take steps to eliminate or dispose of the problematic instrument. If they do not do so, the debt instrument will be treated as exchanged for stock at the end of the 90-day period. So much for grace.

**Will It Actually Happen?**

The Treasury wants to finalize the proposed regulations as soon as possible, but it is facing stiff opposition.

Over 200 comments have been submitted, the majority of them hostile to the Treasury’s proposal. Business groups, big-city law firms and international accounting firms warn that the proposed regulations will disrupt non-abusive financing practices. They also object that the new rules tying debt status to the injection of new capital are a major departure from existing practice. Many comments claim that the Treasury has exceeded its authority under Code Sec. 385.

In Congress, both Democratic and Republican tax-writers have expressed concern about the proposed regulations.

So far, however, the Treasury is sticking to its regulatory guns. While it remains unclear whether the new rules will be finalized in their present form, the fact that critics have emerged from both sides of the aisle suggests that the Treasury just might be doing something right.