Client Alert: Proposed Regulations Would Treat Certain Related-Party Debt Instruments Issued on or After April 4, 2016 as Stock for Federal Tax Purposes

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The IRS recently issued proposed regulations that, if finalized, would treat debt instruments between related persons as stock under certain circumstances. Although these regulations were largely motivated by concern over earnings stripping between related US and foreign corporations, the scope of the regulations goes beyond such cross-border transactions. The proposed regulations do not, however, apply to debt instruments between corporations that are in a group filing a federal consolidated return. As currently drafted, once finalized, certain aspects of the regulations would apply retroactively to instruments issued on or after April 4, 2016. It is therefore important for taxpayers to assess the potential applicability of these proposed regulations to new related-party debt instruments.

Recharacterization of Debt Instruments as Stock

The proposed regulations would require certain debt instruments between members of a group of corporations under common control (generally requiring common ownership of 80% of the vote or value of such corporations, applying attribution rules) to be treated as stock. Foreign corporations, tax-exempt corporations and S corporations may be included in such a group, and the regulations also would affect certain debt instruments issued or held by partnerships that are controlled by members of the group. A debt instrument generally would be treated as stock if it is issued in a distribution or, under certain circumstances, in exchange for stock or property. In addition, a debt instrument generally would be treated as stock if it is issued for cash, with a principal purpose of using that cash to fund such a distribution or exchange. (The regulations would create a non-rebuttable presumption of such a principal purpose if a debt instrument is issued within 36 months of such a distribution or exchange by the issuer.)

Documentation Requirements

The proposed regulations include extensive documentation requirements for debt instruments between certain related parties. If these documentation requirements are not satisfied, the debt instrument would be treated as stock regardless of whether it would be treated as debt under general federal tax principles. These documentation requirements would apply to routine financial transactions such as cash pooling arrangements. Under the proposed regulations, these documentation requirements would not be effective until the regulations are finalized.

Bifurcation of Instruments into both Debt and Stock

Finally, in a departure from existing case law, the regulations would allow the IRS to treat certain related-party instruments as part debt and part stock, based upon general federal tax principles. Because courts historically have followed an all-or-nothing approach to treat an instrument in a corporation as entirely debt or entirely stock, the principles that the IRS might apply in exercising this new authority are particularly uncertain.