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Anti-inversion regulations may impact common business transactions

TAXING MATTERS
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The IRS has gone to war against inversions—transactions in which a U.S.-based multinational moves its tax residence abroad to reduce U.S. taxes.

The IRS's latest salvo in that war, regulations defining the meaning of debt and equity for tax purposes, may have a broad impact on businesses of all sizes.

There are two basic ways to fund a business. First, you can purchase equity in the business, in exchange for which you typically receive a share of the business's profit. Second, you can loan money to the business in exchange for a defined return—typically paid in priority to the stockholders—without a share of the upside.

For tax purposes, the distinction between these two approaches is critical, because interest payments can be deducted, whereas dividends paid to stockholders cannot be. Companies have a significant incentive to argue that a payment is interest, in order to obtain a deduction.

Determining whether an obligation is debt or equity can be very challenging because there are many complicated types of financial instruments that are difficult to classify. Common factors that are considered are whether there is a maturity date, whether the holder has the right to enforce payment, the level of priority of the instrument, and how much debt the company has issued in light of its equity capitalization. Because of the wide variety of financial instruments that exist beyond simple interest-bearing debt and common stock, determining the correct characterization of a given corporate obligation can be very difficult.

In 1969, Congress added a section to the Internal Revenue Code that authorized the IRS to draft regulations defining the distinction between debt and equity. It took until 1980 to do so, and the regulations that were issued were quickly withdrawn.

It was only this past spring, as part of its efforts to combat inversions, that the IRS finally again exercised its regulatory authority and issued proposed regulations to define debt and equity.

The IRS stated that in doing so, its purpose was to address a tactic known as earnings stripping, commonly utilized by multinational corporations, including after an inversion, to move profits overseas.

In this technique, the subsidiary in the United States pays interest to its new foreign parent or to a foreign affiliate in a low-tax jurisdiction. This interest creates a deduction in the United States, which is a high-tax jurisdiction, and income for the parent or affiliate in a low-tax jurisdiction. The total tax burden of the group is reduced. The U.S. Treasury loses out, as the tax burden is shifted from the United States to abroad, a phenomenon known as base erosion.

The proposed regulations seek to combat earnings stripping through three major changes:

First, they specifically target lending transactions often undertaken in connection with inversions to increase related party debt and provide that they will not be respected. The purported debt will be treated as equity and the interest deduction disallowed.

The overall idea of these rules is to curb transactions that increase related party debt if it doesn't finance new investment in the United States. For example, they provide that if a subsidiary issues a note to its foreign parent as a dividend distribution, the note will typically be treated as equity. This treatment would apply even if the debt would have been respected as such under general common law principles.

The regulations include extraordinarily complicated rules that define the special types of debt obligations that are automatically treated as equity. While they are focused on transactions in connection with inversions, they can implicate other planning as well.

Next, the regulations require large companies to follow certain protocols and maintain certain documentation in connection with related party loans. For example, companies are required to conduct due diligence into the creditworthiness of the borrower at the time of the transaction and document information about the amount borrowed and repayment terms. If the rules are not followed, the obligation is deemed to be debt. Significantly, these rules apply to domestic transactions in addition to foreign transactions.

Finally, the regulations allow the IRS on audit to divide a debt instrument into part stock and part debt. In the past, an all or nothing rule has applied in which an instrument is characterized as either debt or equity. Under the proposed rules, the IRS has the authority, on audit, to bifurcate an instrument if it wishes. There are many unanswered questions about this authority and how it would be exercised. However, it is clear that this is a significant change that will impact the risk profile of common related party instruments.

The new regulations have far-reaching implications. Two days after the regulations and related anti-inversion guidance were issued, Allergen and Pfizer called off their planned $160 billion inversion, the largest in U.S. history.

The IRS announced plans to finalize the regulations quickly, but they have been subject to extensive criticism from Congress and the legal and accounting communities. For example, commentators have raised concerns about the impact of the regulations on common cash management functions of large multinationals, and on state taxes. The process appears to have slowed down. Earlier this month, Treasury indicated that it is listening to the comments and committing to addressing the unworkable portions of the regulations. However, portions of the regulations are already applicable by their terms.

The impact of the regulations on common domestic business arrangements will depend on their final contours. Assuming that the draft regulations are finalized in their current form, they will have a significant impact on businesses both large and small. Companies should review their existing and planned related party financings to ensure compliance with the new rules.

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