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IRS Limits "Earnings Stripping" by Multinational Corporate Groups

On October 13, 2016, the Treasury and the IRS issued regulations that make it harder for a non-US parent company with US subsidiaries to use intercompany debt to strip taxable earnings out of those subsidiaries.

Background

The new rules are the final version of a significantly broader proposal that Treasury and the IRS made in April 2016. That proposal would have applied in a range of cases where a US company (or even a non-US company that had a US branch or that was affiliated with a US company) issued debt to a related lender. The proposed rules would have denied a tax deduction for interest expense on such debt, and would have unfavorably altered the US tax treatment of the debt in other ways as well.

The April proposal was meant to hit inversions, and other tax planning perceived as abusive, but was widely viewed as overreaching. Companies across a range of industries and members of Congress of both parties complained that the proposed rules would have imposed harmful tax consequences for taxpayers in cases not involving any type of aggressive tax planning, and would have created big administrative burdens for taxpayers. Treasury indicated it received almost 30,000 written comments.

The final rules have a narrower focus. They will apply largely - though not exclusively - to corporate groups with a non-US parent and US subsidiaries. The rules will limit such a group's ability to use intercompany loans to the US subsidiaries, as a means of stripping taxable earnings out of the US into lower-tax jurisdictions. The new rules will need to be taken into account when structuring most future acquisitions of US businesses by non-US buyers.

(Relatively) Targeted Regulations

Apply to Borrowing by US Companies from Related Parties

The regulations apply to debt between related parties, defined generally as corporations related through a chain of 80% ownership, either by vote or value. However, a number of types of companies are carved out in whole or in part from the new regulations, in contrast to the April proposed rules. In practice, the rules apply mainly to related-party borrowings by a US company that is subject to the regular US corporate income tax regime. REITs, S corporations and RICs are generally excluded. Relief also is provided for many regulated financial services companies as well as for many US insurance companies.

Debt Recast as Equity, where the Rules Apply

A company subject to the rules will generally be required to treat debt borrowed from a related company as equity, with the result that interest payments on the debt will not be tax-deductible, if the debt is issued in certain types of transactions. In general, such related-party debt will be recharacterized as equity if the debt is issued within 36 months before, or after, the borrower: (1) pays a dividend to a member of the borrower's corporate group; (2) acquires shares of any member of the borrower's corporate group; or (3) acquires assets of a member of the group in a tax-free reorganization.

In addition, a company that is subject to the rules also generally must treat debt as equity for US tax purposes if: (a) the debt is issued as a dividend to a shareholder that is a member of the borrower's corporate group; (b) the debt is issued as consideration to buy any shares of a member of the group; or (c) the debt is issued as consideration to acquire assets of another group member in a tax-free reorganization.

However, several exceptions have been provided, including:

- The rules now exempt the first $50 million of intragroup debt that otherwise would be recharacterized as equity.
- Under the rule described above that recharacterizes debt as equity if it is issued within 36 months before, or after, particular types of intercompany transactions, the amount of debt recharacterized is reduced by the amount of equity capital that has been contributed to the borrower by members of its corporate group within the same time period (together with earnings and profits of the borrower that are accumulated in taxable years ending after April 4, 2016 in which the borrower was a group member). For example, if a non-US parent lends $100 of cash to a US subsidiary, and the non-US parent simultaneously contributes $50 of cash to the US subsidiary in exchange for an issuance of US subsidiary shares, then the loan generally will be caught by the new rules only if, and to the extent, the US subsidiary pays more than $50 of dividends during the next 36 months (or engages in more than $50 of the other types of specified transactions within those 36 months).

These rules will go into effect beginning in mid-January 2017. Once the rules go into effect, they will apply to all intercompany debt that has been issued after April 4, 2016, unless such debt has been repaid before mid-January 2017.

Documentation Requirements

The final regulations generally require a corporate group to prepare a written agreement that memorializes each intercompany loan, as well as written materials showing there is a reasonable expectation the debt will be repaid in full. These documents generally must be prepared by the time the US tax return is due for the year in which the debt is issued. In addition, each intercompany loan also needs to be repaid in accordance with its terms, or (to the extent reasonable) actions need to be taken by the lender to enforce its rights in the event of nonpayment of the loan. If these rules are not followed for an intercompany loan, then the loan generally will be recharacterized as equity, resulting in a denial of deductions for interest expense, except in the case of occasional inadvertent noncompliance by a generally compliant corporate group.

These documentation requirements will generally apply to intercompany debt issued on or after January 1, 2018.

What Now?

- These rules are here to stay, at least for the medium term. The new administration will need to consider whether to amend or repeal the regulations, but either process is unlikely to progress quickly.
- Non-US buyers looking to acquire a US target company will need to carefully consider these rules when they structure acquisition financing and debt pushdown and model the US target's effective tax rate. A group with a non-US parent that restructures its US subsidiaries, including in the context of a workout of third party debt, also will need to consider the rules.
- Despite the provision of relief, the new rules do apply piecemeal to certain debt of REITs, RICs, banks and insurance companies. These companies will need to review whether any of their transactions will be subject to the new rules.

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