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# IRS Proposes Broad Limit on Intercompany Debt

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The Internal Revenue Service has proposed new regulations that would generally treat intercompany indebtedness in corporate groups with 80% common ownership as equity for U.S. tax purposes. The new restrictions are proposed to be effective for any indebtedness issued on or after April 4, 2016, with limited exceptions; however, equity treatment would not be required for such debt before final regulations are issued. It is likely that the regulations will be finalized this year or not at all. Although intended primarily to reduce earnings-stripping opportunities in the cross-border context, including by inverted companies, the rules would apply much more broadly.

The proposed regulations seek to overturn the long-standing rule enunciated by the Second Circuit Court of Appeals in *Kraft v. Commissioner*[1] that permits a corporation to make a distribution in the form of its own promissory notes to create an indebtedness to its sole shareholder. The proposed regulations would generally treat such indebtedness as stock of the issuer. Debt issued in consideration for stock of an affiliate or in exchange for assets in connection with an asset reorganization would also be recharacterized as stock.

In addition, a true borrowing of funds may also be subject to equity recharacterization if the borrowing is, or considered to be, for a principal purpose of funding a distribution or acquisition of stock of an affiliate by the borrower. The regulations also include a broad anti-abuse rule and provide a non-rebuttable presumption that borrowings within three years before or three years after a distribution or acquisition was made with a bad principal purpose. This rule is so broad that it will likely prove unworkable in its current proposed form.

The proposed regulations contain some narrow exceptions for loans between members of a consolidated group, loans falling below an aggregate $50-million threshold and loans used to fund subsidiary capital contributions.

The proposed regulations also include new due diligence and documentation requirements for related party loans in large corporate groups with an applicable financial statement. The rules would disallow interest deductions and treat any loan made to an affiliated borrower as equity if the parties fail to contemporaneously document the existence of the debt, the lender's legal right to enforce the debt, the issuer's ability to repay the debt and the holder's reasonable exercise of diligence to collect on the debt.

The proposed regulations would expressly authorize the IRS to bifurcate a single loan to treat a portion of a related party loan as equity. This would potentially make it easier for the IRS to disallow interest deductions if a borrower were thinly capitalized, but not to a degree that would support recharacterizing the whole debt as equity. For this purpose, related party loans would include those between 50% commonly controlled corporate groups.

The proposed rules could adversely affect common "tower financing" structures used to fund U.S. operations of Canadian multinationals and would greatly increase the prevalence of hybrid instruments (treated as debt for foreign tax purposes but as equity for U.S. tax purposes). This in turn may cause conflicts with anti-hybrid rules that apply in other jurisdictions or that may be enacted in the future in the United States or other jurisdictions in accordance with the BEPS Action Plan Item 2, which targets such hybrids. Perhaps anticipating the opportunities in this regard created by the new recharacterization rules, the regulations provide that recharacterization of debt as equity under the regulations will not occur if the taxpayer entered into the transaction with a principal purpose of obtaining a U.S. tax benefit from recharacterization. However, this limitation might prove to be impossible to apply in practice, given the broad scope of the proposed rules.

[1] 232 F.2d 118 (1956).

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