Proposed Treasury Regulations May Recharacterize Taxable REIT Subsidiary Debt

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This article discusses new regulations proposed by the Internal Revenue Service and Treasury Department that, if finalized, would transform the determination of whether related-party debt obligations are treated as debt or equity for federal income tax purposes.

The Internal Revenue Service ("IRS") and Treasury Department proposed new Treasury regulations (the "Proposed Regulations") that, if finalized, would transform the determination of whether related-party debt obligations are treated as debt or equity for federal income tax purposes. The Proposed Regulations are part of the administration's attempts to frustrate corporate inversion transactions, but their reach is much broader than intercompany indebtedness between domestic and foreign affiliates. The Proposed Regulations would apply to all U.S. corporations (and certain controlled partnerships) regardless of whether such corporations have a foreign parent or subsidiary in their ownership structure and to all related-party debt obligations, in some cases with an ownership threshold as low as 50%. The Proposed Regulations, however, do not apply to debt obligations between members of a consolidated tax group.

The Proposed Regulations apply to loans made by a real estate investment trust ("REIT") to one of its taxable REIT subsidiaries ("TRSs") and to other debt obligations issued by a TRS to its parent REIT. If a TRS debt obligation were recharacterized as equity by the Proposed Regulations, the associated reduction in TRS interest expense would cause a corresponding increase in TRS taxable income. In addition, if the TRS debt obligation is secured by real estate and therefore would be a qualifying REIT asset if it were respected as debt, recharacterization as equity would cause the obligation to no longer be considered a qualifying REIT asset and the income derived by the REIT from the obligation to no longer be qualifying income for purposes of the 75% gross income test applicable to REITs. (Income amounts received from the recharacterized debt obligation would still be qualifying income for purposes of the 95 percent gross income test.)

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The Proposed Regulations contain three main tools to limit so-called "earnings stripping": (1) allowing bifurcation of a single related-party instrument between debt and equity; (2) requiring certain documentation of related-party debt instruments before an instrument can be respected as debt; and (3) providing for per se recharacterization of related-party debt instruments in certain circumstances.

First, the Proposed Regulations would allow the IRS to treat an instrument between members of a "modified expanded group" (very generally, a 50 percent commonly owned group of corporations and/or partnerships) as in part debt and in part equity. This reverses current precedent, which treats an instrument as solely debt or solely equity. Second, the Proposed Regulations would require certain documentation to be produced and maintained for virtually all instruments issued between members of an "expanded group" (generally, an 80% commonly owned group of corporations and/or partnerships with a corporate parent, but not including consolidated groups). Third, the Proposed Regulations would treat certain instruments issued between members of an expanded group as stock regardless of the typical debt/equity characteristics of the instrument and regardless of whether the issuer maintains the documentation referred to in the prior sentence.

The bifurcation authority and the documentation requirements would apply prospectively only to instruments issued after the date the Proposed Regulations are finalized. The third provision, however, would be effective for debt instruments issued on or after April 4, 2016. Because of the potential retroactive effective date, taxpayers should begin taking into account at least that portion of the Proposed Regulations in structuring related-party debt obligations.

Bifurcation

Under the Proposed Regulations, the IRS would have the authority to split a single debt instrument issued between members of an expanded group into a debt portion and an equity portion. For example, if an instrument had a principal balance of $5 million but the IRS's analysis determines that the issuer cannot reasonably be expected to repay more than $3 million of the principal, the interest may be treated as part debt ($3 million) and part stock ($2 million). It is not clear what metrics the IRS will use in determining whether there is a reasonable expectation of repayment. There also is uncertainty as to what situations other than lack of reasonable expectation of repayment could result in bifurcation.

Documentation Requirements

Under the Proposed Regulations, certain documentation must be created and maintained for a related party debt instrument to be respected as debt. If the documentation is not created or is not provided to the IRS upon request, the instrument will be treated as stock, regardless of whether it would be treated as debt under general federal tax principles. If the documentation is created and maintained, the instrument would be evaluated under general federal tax principles, including the bifurcation authority described above. For a related-party debt instrument to be eligible for consideration as debt, the issuer must contemporaneously document in writing the following items related to the instrument:

- An unconditional obligation to pay a sum certain;

- Creditor's rights of the holder (a creditor must be senior to shareholders in the case of dissolution; a creditor typically has the right to declare an event of default and trigger acceleration of the instrument);

- A reasonable expectation that the issuer intended to, and would be able to, pay the instrument (such information may include cash flow projections, financial statements, business forecasts, asset appraisals, debt-to-equity and other financial ratios, etc.; reports or analyses that are protected or privileged are not taken into account if the protection or privilege is asserted); and

- Actions supporting a debtor-creditor relationship (e.g., timely payment and reasonable exercise of the diligence and judgment of a creditor in the event of a default).

These requirements apply to corporations that are publicly traded or exceed certain size thresholds and likely will require related parties to be more formal in documenting intercompany debt than has been common practice in the past.

Per Se Recharacterization

Perhaps the most draconian of the new provisions, and the only one that would have retroactive effect, is the per se equity treatment for debt instruments issued between members of an expanded group if the instrument is issued:

- In a distribution;

- In exchange for stock of an expanded group member (other than certain exempted exchanges); or

- In exchange for property in an asset reorganization to the extent that a member of the expanded group immediately before the reorganization receives the instrument.

Distributions and acquisitions for these purposes are reduced by the amount of the member's current year earnings and profits.

Debt instruments issued to members of the expanded group with a principal purpose of funding a distribution or acquisition in connection with the transactions listed above also are treated as equity. Instruments are treated as issued with such a principal purpose if they are issued during the period beginning 36 months before the date of the distribution or acquisition and ending 36 months after the date of the distribution or acquisition. Thus, for example, under the Proposed Regulations, a loan from a REIT to a TRS in its expanded group would be recharacterized as equity if it was issued within three years before or after the TRS declares a dividend to the REIT that exceeds the TRS's current year earnings and profits in the year of the dividend.

These regulations are proposed and not certain to become final in their current form or at all. Because the per se recharacterization would apply to instruments issued on or after April 4, 2016, however, taxpayers should be aware of the potential impacts of the Proposed Regulations.