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New "Inversion" Proposed Regulations Inspired By The Pfizer/Allergan Deal May Impact Corporate Tax Planning Strategies

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The Treasury Department has recently promulgated proposed regulations dealing with so-called inversion transactions. Inversion transactions are ones in which a U.S. corporation changes its domicile to a nation with a more preferable tax system while maintaining its material U.S. operations in order to minimize its U.S. tax obligations. While inversion transactions may yield large tax savings for corporations, the Treasury Department views such transactions with disfavor, as they shrink the U.S. corporate income tax base.

Commentators have suggested that the Treasury Department's Proposed Regulations were aimed at Pfizer, Inc.'s and Allergan PLC's proposed merger. Were it to have been consummated, the Pfizer/Allergen merger would have been the largest "tax" inversion ever attempted. After the proposed merger, the new parent corporation would have had a tax domicile in Ireland, a jurisdiction known for its low corporate income tax rates. However, in light of the Proposed Regulations, Pfizer and Allergen abandoned the transaction. While the Proposed Regulations are intended to combat inversion transactions like the Pfizer/Allergen merger, the related party debt rules within the Proposed Regulations may have a significant impact on corporate tax planning outside of the context of inversion transactions.

Related Party Debt Rules Under the Proposed Regulations

One tax advantage of an inversion is that the U.S. subsidiary of an inverted corporation may issue debt to its inverted parent corporation (Cross-Border Debt), and as the U.S. subsidiary pays interest on the Cross-Border Debt, it receives tax deductions which further reduce its U.S. taxable income. Earlier this month, the Treasury Department released proposed regulations (Proposed Regulations) aimed at curbing inversion transactions, which included provisions that give the IRS discretion to recharacterize debt between certain related corporations as equity for federal income tax purposes.

Generally, the Proposed Regulations (i) automatically recharacterize certain related party debt instruments as equity interests (i.e. stock), (ii) authorize the IRS to bifurcate related party debt instruments into part debt-part equity, and (iii) establish specific documentation requirements for the related party debt of certain publicly traded companies and large non-publicly traded companies. Importantly, these rules apply not only to cross-border related party debt, but also to purely domestic related party debt, unless the related parties are part of the same consolidated group for federal income tax purposes. For purposes of the Proposed Regulations, parties are considered to be related if they are part of the same "Expanded Group" of companies, connected through at least 80% ownership by a common partner corporation.

1. Automatic Recharacterization.

The Proposed Regulations provide for automatic recharacterization of related party debt as equity in three situations. These situations include: (i) distributions of debt by a corporation to its corporate shareholders who are part of the corporation's Expanded Group, including as part of a stock redemption; (ii) issuance of debt by a corporation in exchange for the stock of another member of its Expanded Group; and (iii) the issuance of

debt by a corporation as consideration in pursuance of certain "tax-free" asset reorganizations within the corporation's Expanded Group.

2. Bifurcation of Debt Instrument.

The Proposed Regulations allow the IRS to recharacterize a related party debt instrument within a Modified Expanded Group as part equity and part debt if it is necessary in order to reflect the underlying economic reality of the transactions between the parties. This approach is a departure from current practice in which an instrument must be characterized entirely as either debt or equity. A Modified Expanded Group includes companies connected through at least 50% ownership by a common parent.

3. Documentation Requirements.

The Proposed Regulations require compliance with extensive documentation requirements in order for a related party instrument to be treated as debt if (i) any member of the Expanded Group is publicly traded, (ii) the Expanded Group has total assets exceeding $100 million, or (iii) the Expanded Group has annual total revenues exceeding $50 million. If the documentation requirement applies to an instrument, documentation must be prepared that:

evidences a binding and unconditional obligation to repay a sum certain;

establishes the creditor's rights to enforce the terms of the instrument;

evidences a reasonable expectation of repayment;

evidences that a true debtor-creditor relationship exists between the parties to the instrument.

If a corporation subject to the documentation requirements fails to comply with them, the instrument will be characterized as equity, thereby eliminating any interest deduction to the debtor corporation.

Conclusion

In light of the Proposed Regulations, corporations who make use of cross-border related party debt or related party debt between corporations which are not part of a consolidated group for federal income tax purposes must carefully consider how these rules would impact their operations should the Proposed Regulations become final. In addition to limiting inversion transactions, the Proposed Regulations may limit the usefulness of many common corporate planning techniques which utilize related party debt.