

On September 21, 2018, in connection with President Donald Trump's Executive Order 13789 instructing the Secretary of the Treasury to review significant tax regulations and take action to alleviate the burdens of regulations that impose undue financial burden or add undue complexity, the Treasury Department (Treasury) and the Internal Revenue Service (IRS) proposed to remove regulations that would have required taxpayers to maintain documentation to support intercompany debt (the "Proposal"). The regulations, which were issued in 2016 and were due to become effective in 2019, established minimum documentation requirements that had to be satisfied in order for debt between certain related parties to be treated as debt for federal income tax purposes.

**Future Regulations.** In the Proposal, Treasury and the IRS stated that they will continue to study the issues related to these documentation regulations and may propose in the future a modified version of them. Such future regulations would be substantially simplified and streamlined to reduce the burden on U.S. corporations and yet would still require sufficient documentation and other information for tax administration purposes. Any such regulations would be proposed with a prospective effective date to allow sufficient lead-time for taxpayers to design and implement systems to comply with those regulations. While the Proposal is only in proposed regulations form and not yet finalized, it states that taxpayers may rely on the Proposal until it is formally adopted.

**Debt vs. Equity for Federal Income Tax Purposes.** As a practical matter, even though these documentation regulations never came into effect, the general rules distinguishing debt from equity for federal income tax purposes developed by the IRS and the courts continue to apply. It is therefore recommended that taxpayers continue to maintain sufficient support for the treatment of their intercompany debt as debt for federal income tax purposes.

Whether a purported debt instrument is respected as debt for federal income tax purposes is determined based on all the facts and circumstances and on the substance, rather than the form, of the relationship between the parties. The difference between a stockholder and a creditor is generally that a creditor expects to receive a return on its investment without regard to the performance of the debtor's business. The courts have therefore held that the most important factor in characterizing an instrument as debt is an unconditional right to a return of principal on demand or at a reasonable pre-determined maturity date.

Other factors that courts and the IRS have considered in making this determination include:

- (i) the ability and intention of the debtor to repay and service the debt;
- (ii) whether the issuer of the debt has sufficient equity capital for its line of business or is thinly capitalized without an adequate equity cushion that would reduce the risk of payment default (whether a debtor is thinly capitalizes depends on the industry, in the financial sector, for example, high debt-to-equity ratios are more common);
- (iii) whether holders of the instrument possess the right to enforce the payment of principal and interest;
- (iv) whether the rights of the holders of the instrument are subordinate to the rights of general creditors;

- (v) whether the instrument gives the holder the right to participate in the management of the issuer;
- (vi) whether there is identity between the holders of the instrument and stockholders of the issuer;
- (vii) the label placed on the instruments by the parties; and
- (viii) whether the instrument is intended to be treated as debt or equity for nontax purposes.

No particular factor is conclusive in making this determination, and the weight given to any factor depends upon all the facts and circumstances.

**No Change to Debt Recharacterization Regulations.** The proposed regulations do not affect Treasury Regulations § 1.385-3, which treat as equity certain debt that is distributed by a corporation to a controlling shareholder or issued in other related-party transactions with similar economic results. These rules therefore continue to be in effect.