Impact of Section 385 Proposed Regulations on Real Estate Investment Structures

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2016-Issue 18 – In prior editions of the Tax Advisor Weekly, we have discussed the proposed regulations under Section 385 issued by the Internal Revenue Service and the Treasury Department that address whether related-party indebtedness is treated as stock or debt for federal income tax purposes (see “Section 385 Proposed Regulations: Treasury’s Attempt to Clamp Down on Earnings Stripping and a Whole Lot More,” April 19, 2016, and “Proposed New Documentation Rules for Related-Party Debt: A Practical Approach,” April 28, 2016). The proposed regulations were issued in part to curb excessive indebtedness in cross-border transactions between related parties; however, they have far broader implications than intercompany indebtedness between domestic and foreign related parties. They also apply to many U.S. corporations, including real estate investment trusts (REITs) and certain controlled partnerships, regardless of whether such corporations are the parent or subsidiary of a foreign affiliate.

In this edition, we analyze the collateral impacts of the proposed regulations, specifically in connection with recast transactions, on several typical real estate investment structures.

Inbound Blocker Investment Structure

We begin our analysis with a U.S. blocker investment structure. In many blocker investment structures, a foreign parent lends money to a controlled or wholly-owned U.S. subsidiary corporation on arm’s-length terms in lieu of obtaining third-party debt. In turn, the U.S. subsidiary corporation acquires an equity interest in U.S. real property using a combination of equity and the related-party debt proceeds. The interest payments made by the U.S. subsidiary corporation to the foreign parent may potentially be deductible by the subsidiary (assuming that the debt is respected as such under IRC Section 385 and historic case law principles), subject to U.S. earnings stripping and/or interest capitalization rules. The interest deductions in question thus have the potential to reduce the net taxable income of the U.S. subsidiary corporation. In some cases, these loans may qualify for the portfolio interest exemption, in which case there is no withholding on the interest payments, or be subject to a reduced withholding rate on the interest payments as a result of the availability of U.S. double tax treaty benefits.

The proposed regulations have the potential to affect the blocker investment structure in several ways. First and foremost, the proposed regulations apply to debt instruments issued to a member of a debtor’s “expanded group.” This term is defined by reference to the definition of an “affiliated group” in Section 1504(a), subject to several modifications. Notably, the proposed regulations expand the definition of “affiliated group” to include foreign corporations and domestic corporations (including REITs). As a result, in the common blocker investment structure context, the foreign parent and the U.S. subsidiary corporation are members of the same expanded group, necessitating compliance with the proposed regulations.

Under these regulations, the IRS has the ability to recast as stock certain debt instruments issued between members of the same expanded group, in this case, the foreign parent and the U.S. subsidiary. Although the initial debt issuance in the typical U.S. blocker investment structure described herein — that is, a transaction in which a foreign parent lends money to a U.S. subsidiary corporation for purposes of acquiring property — does not fall under the purview of the general rule of Prop. Reg. Section 1.385-3, subsequent transactions between the foreign parent and the U.S. subsidiary require more careful analysis.

For example, certain revolver-type loan agreements and return of capital distributions (note that distributions to the extent of earnings and profits are exempt) made after April 4, 2016, may run afoul of the general rule or the even more onerous "funding rule." The funding rule of Prop. Reg. Section 1.385-3 takes the general rule one step further and treats as stock any debt instrument issued by a corporation with the principal purpose of funding any one of the three transactions described in the general rule. The determination as to whether a debt instrument is issued with a principal purpose of funding a distribution or acquisition is generally based on all of the facts and circumstances; however, there is a non-rebuttable presumption that a debt instrument is issued with the principal purpose of funding one or more of the distributions or acquisitions if it is issued during the period beginning 36 months before the distribution or acquisition and ending 36 months after the distribution or acquisition (the "72-month rule"). A typical revolver-type loan allows the borrower to drawdown, repay and redraw loans over a specified period of time. Accordingly, the multiple drawdowns of the revolver line of credit may be construed as separate instruments and run afoul of the recast rules if the drawdowns are made on or after April 4, 2016.

The proposed regulations provide a narrow exception to this presumption, which applies to ordinary course debt instruments. The exception is intended to apply to debt instruments that arise in connection with the purchase of certain types of property (e.g., inventory) or the receipt of services between members of the same expanded group in the ordinary course of the purchaser's or recipient's trade or business, and is not intended to apply to intercompany financing or treasury activities or to capital expenditures.

In light of these rules, common intercompany financing practices, including revolver-type loan agreements and return of capital distributions made by the U.S. subsidiary to the foreign parent, may be recast as exchanges of equity rather than as debt instruments. Depending on the timing of the event that gives rise to a recasting, such instruments may be viewed as equity from their inception. As a result, current and/or future payments related to such instruments may potentially be treated as distributions rather than as interest payments, potentially subject to differing rates of withholding tax under the applicable income tax treaties, potentially eroding the tax benefits of a blocker investment structure.

Controlled Partnership

The term "controlled partnership" means a partnership in which at least 80 percent of the interests in the partnership capital or profits are owned, directly or indirectly, by one or more members of an expanded group. The proposed regulations take an aggregate approach to controlled partnerships to prevent the use of partnerships in avoidance of these rules. For example, when a corporation that is an expanded group member becomes a partner in a partnership that is a controlled partnership with respect to that expanded group, the corporation is treated as acquiring its proportionate share of the partnership's assets. In addition, each expanded group partner in a controlled partnership is treated as issuing its proportionate share of any debt instrument issued by the controlled partnership and acquiring its proportionate share of any expanded group stock acquired by the controlled partnership.

If a debt instrument issued by the partnership is re-characterized, the holder of the re-characterized debt instrument is treated as holding stock in the expanded group partner or partners rather than as holding a partnership interest in the controlled partnership. The proposed regulations provide that the partnership and its partners must make appropriate conforming adjustments to reflect this treatment. Such adjustments must be consistent with the purposes of the proposed regulations and must be made in a manner that avoids the creation of, or increase in, the disparity between the controlled partnership's aggregate basis in its assets and the aggregate bases of the partners' respective interests in the partnership.

The examples provided in Prop. Reg. Section 1.385-3 analyze controlled partnerships where all partners are members of the same expanded group. In the context of a recasting event, such examples provide that the stock issued by the corporate partners in turn results in corresponding deemed capital contributions by the expanded group partners into the partnership. Accordingly, the conforming adjustments (i.e., including the deemed capital contributions to the controlled partnership) appear to be consistent with the purpose of the proposed regulations. However, the examples provided do not address situations where a controlled partnership has one or more partners that are not members of the same expanded group. Therefore, it is unclear how the recasting event would affect the non-expanded group members. In addition, the examples provided only considered a recast of the entire debt instrument as equity. Thus, would the remaining debt instrument that was not recast as equity be allocated to the partner(s) of the non-expanded group or on a pro rata basis to all respective partners of the partnership?

It is not entirely clear how these rules will interact with the code and regulation provisions that already address partnerships. One specific example relates to the classification of debt and the related liability allocations that already exist under the sub-chapter K regulations that address partnership liabilities. Would the re-characterization of a partnership debt instrument as equity cause the expanded group partners to have more or less basis in their partnership interests as compared with the amount they would have had as a result of the debt being allocated under Section 752? A reduction in basis in relation to the elimination of a partnership loan could generate gain to some partners.

Additionally, partnership agreements typically have provisions that discuss the events that could give rise to a reevaluation of partnership property such as certain contribution events (i.e., including debt to equity conversions). Would a re-characterization of partnership debt as equity under these proposed regulations give rise to a reevaluation event?

Furthermore, how can Section 704 principles be adhered to if the tax law creates a fictional recasting event that does not exist from an economic standpoint? Can a taxpayer get comfortable that partnership allocations will have substantial economic effect in this context?

Additional consideration is also needed to determine the effects of the proposed regulations under Section 108 (i.e., indebtedness satisfied by partnership interest) if the debt instrument is originally respected as a true debt and subsequently re-characterized as equity and disguised sale rules under Section 707 (i.e., contributions may be re-characterized as sale or exchange if the contributing partner receives a distribution from the partnership that is, in substance, consideration for the contributed property). It seems that the inclusion of certain partnerships in the definition of an expanded group could create significant unintended consequences that will require detailed guidance.

REITs & Taxable REIT Subsidiaries (TRSs)

As mentioned earlier, the proposed regulations also include REITs in its definition of an “expanded group.” In a typical REIT structure, the parent REIT forms (directly or indirectly) a TRS to conduct non-customary or tenant-specific services to the REIT’s tenants that the parent REIT is otherwise prohibited from furnishing. The parent REIT may make loans (or in some cases, from an operating partnership in an umbrella partnership REIT structure) to the TRS using a debt instrument secured by real property.

The parent REIT must comply with a set of organizational and operational requirements to qualify as a REIT. Among these requirements is the quarterly asset and income test, which includes:

(i) At least 75 percent of the value of the total assets held by a REIT must be represented by real estate assets (including mortgages secured by real property), cash and cash items, and government securities;

(ii) Not more than 25 percent of the value of the REIT’s total assets may be represented by securities;

(iii) Not more than 25 percent of the value of the REIT’s total assets can be made up of TRS securities (20 percent for tax years beginning after December 31, 2017) (“25 percent TRS test”);

(iv) Not more than 5 percent of the value of the REIT’s total assets can be made up of securities of any one issuer;

(v) A REIT cannot own securities representing more than 10 percent of the voting power or value of a single issuer;

(vi) At least 75 percent of gross income must be from rents from real property, mortgage interest (secured by real property) and other specified real estate related income (“75 percent income test”); and

(vii) At least 95 percent of gross income must be from rents from real property, mortgage interest (secured by real property), other specified passive income such as dividends, interest and other portfolio type income (“95 percent income test”).

The debt instrument secured by real property may be a qualifying REIT asset if it is respected as a true debt. As a result, the interest income received by the REIT may also be qualifying income for purposes of the 75 percent and 95 percent income test. However, if the TRS were to make certain types of distributions to the parent REIT (perhaps for purposes of limiting the size of the TRS in order to satisfy the 25 percent TRS test), the debt instrument could be re-characterized as equity if the distribution were to be made within 36 months before or after the loan was made. Accordingly, future payments could potentially be treated as dividends that are not deductible by the TRS or the REIT (i.e., REITs are not entitled to a dividends received deduction), thereby potentially impacting both the REIT and TRS’s taxable income on a going forward basis. Any resulting dividend income to the REIT would also fail to qualify under the 75 percent gross income test, and the related debt instrument would be treated as additional equity investment in the TRS, which does not qualify for the 75 percent asset test and also adversely impacts the 25 percent TRS test.

In summary, the re-characterization of the debt instrument as an equity investment in the TRS could have material adverse consequences to the REIT causing the REIT to potentially fail the 75 percent asset test, the 25 percent TRS test and/or the 75 percent gross income test.

Alvarez & Marsal Taxand Says:
Even though the initial target of the proposed regulations was seemingly cross-border inversion transactions between related parties, these rules have much broader implications. Related-party debt instruments entered into prior to the issuance of the proposed regulations are grandfathered in and thus potentially respected as debt (assuming that the debt is respected as such under IRC Section 385 and historic case law principles). But a refinancing or significant modification of such debt after the effective date could be subject to these rules. Therefore, taxpayers should review their intercompany debt arrangements and analyze the potential implications of these rules.

Emily Edwards contributed to this article.

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Proposed New Documentation Rules for Related-Party Debt: A Practical Approach

As is often the case in practical tax planning, “an ounce of prevention is worth a pound of cure.” On April 4, 2016, the IRS and Treasury issued proposed regulations under the authority of Section 385 of the Internal Revenue Code. Numerous commentators have questioned the IRS and Treasury’s authority to create several of the rules in these regulations. As a result, their validity may or may not be upheld in court, if the regulations are finalized as proposed. Unfortunately, while the possibility of a future court battle between taxpayers and the IRS over these regulations may be of major academic interest, it is of no present or practical help to internal tax departments that are undoubtedly asking the questions, “What do these regulations mean to my company? What should I be doing about them now?”

Section 385 Proposed Regulations: Treasury's Attempt to Clamp Down on

Earnings Stripping and a Whole Lot More

On April 4, 2016, the IRS and Treasury released two sets of proposed and temporary regulations that caused various taxpayers, investment bankers and large sectors of the investment community, particularly in the pharmaceutical and biomed sectors, to sound alarm bells.

A Peek at Their Practice Units Reveals Clues to the IRS Game Plan

The Internal Revenue Service (IRS) has been busy of late producing internal guidance for its examiners (both specialists and non-specialists) for use in auditing foreign and cross-border transactions.

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