Tax Management International Forum: Financing Cross-Border Acquisitions Through Related-Party Debt

By Peter Glicklich and Heath Martin[*]

I. LIMITATIONS ON DEDUCTIBILITY OF INTEREST AND OTHER FINANCING EXPENSES INCURRED BY U.S. ACQUISITION VEHICLE WITH RESPECT TO SHAREHOLDER LOANS FROM FOREIGN COUNTRY INVESTOR AND FUNDS BORROWED FROM THIRD-PARTY BANKS

The principal tax benefit of using debt to finance a U.S. acquisition vehicle (U.S. Acq) is that U.S. Acq enjoys a U.S. federal income tax deduction for the interest payments on that debt, regardless of whether the lenders are shareholders of U.S. Acq or unrelated third-party banks. The interest expense deductions, however, may be limited under several provisions of the Internal Revenue Code of 1986, as amended (the "Code"), or applicable case law.

On December 22, 2017, the Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, commonly known as the "2017 tax act" or "the Act" (Pub. L. No. 115-97), became law. The 2017 tax act includes several provisions that make it more difficult for taxpayers to deduct interest expense in comparison to prior law. The Act's increased limitations on the availability of interest expense deductions is expected to have dramatic implications for mergers and acquisitions in the United States.

This paper describes some of the most significant considerations that could apply to debt used to finance U.S. Acq's acquisition of U.S. Target, and discusses some of the 2017 tax act's effects on acquisition financing.

A. Consolidation

An initial consideration relevant to the acquisition structure is whether U.S. Acq and U.S. Target should file consolidated returns for U.S. federal income tax purposes or whether the two corporations should remain separate for such purposes.

When one corporation holds at least 80% of the stock of another corporation, measured both by vote and by value, those two corporations can elect to file U.S. federal income tax returns on a "consolidated" basis. If such an election is made, the two corporations effectively take tax items into account on a combined basis on a single tax return, as opposed to including the items separately on two different tax returns.

The principal advantage of this method of tax reporting with respect to interest expense deductions is that, if U.S. Acq and U.S. Target file a consolidated return, the two corporations are treated as a single taxpayer, which means that the income of U.S. Target can be offset by any interest expense deductions resulting from the shareholder or third-party debt used to capitalize U.S. Acq.

Other federal income tax advantages of consolidated returns include the elimination of tax on distributions from U.S. Target to U.S. Acq and the ability of U.S. Acq to increase its basis in its stock of U.S. Target to reflect U.S. Target's profits.

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The disadvantages of consolidated returns include the cost of complying with the complex regulatory regime that governs consolidated reporting and the disallowance of losses on subsidiary stock that is disposed of or that becomes worthless.

Combined reporting for U.S. state and local tax purposes can have similar benefits to consolidated re-

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porting in the federal tax context. Some states, however, do not permit combined or unitary reporting. If U.S. Target and U.S. Acq are subject to tax in states that do not permit combined reporting, the only way to allow U.S. Acq's interest expense deductions to offset income of U.S. Target may be for U.S. Target and U.S. Acq to merge.

The rest of this paper assumes that U.S. Acq and U.S. Target do not file consolidated federal income tax returns after the acquisition.

B. Section 163(j)

Historically, the most significant limitation on the deductibility of interest for a corporate borrower such as U.S. Acq has been the "earnings stripping" provision in §163(j) of the Code. Before the 2017 tax act became law, §163(j) disallowed deductions for related-party interest expenses up to 50% of the corporation's adjusted taxable income, provided the corporation's debt-to-equity ratio exceeded 1.5 to 1. The old version of §163(j) was intended to limit the amount of a corporation's earnings and profits that could be paid out of a thinly capitalized corporation without being subject to U.S. tax.

The 2017 tax act enacted a new, stronger version of §163(j). Unlike the old §163(j), the new §163(j) applies to all types of taxpayers, not just corporations, regardless of the taxpayer's debt-to-equity ratio and regardless of whether the lender is related to the borrower, as long as the borrower's gross receipts for the year are at least $25 million, to be adjusted for inflation. The underlying purpose of §163(j) is no longer just to prevent earnings stripping arrangements. Instead, the new §163(j) provides a general limit on the amount of any interest deduction.

The percentage limitation of the new §163(j) has been tightened to 30%, down from 50%. Under the new provision, the corporation's total deductions for business interest expense for the year are generally limited to 30% of adjusted taxable income. Investment interest expense is not limited under new §163(j).

For purposes of new §163(j), adjusted taxable income is defined as taxable income computed without regard to non-trade or business expense, business income or expense, net operating losses and qualified business income.[1] In addition, depreciation and amortization are added back to adjusted taxable income for taxable years beginning before January 1, 2022. As a result, adjusted taxable income approximates EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) until 2022, and EBIT thereafter.

The new §163(j) is a limitation on interest expense allocable to a trade or business. For this purpose, a trade or business does not include the performance of services as an employee or certain energy-related businesses, such as an electricity-generating business. Also, certain real estate and farming businesses are not treated as a trade or business for purposes of new §163(j) if they make an election to that effect.

If interest expense deductions are disallowed under the new §163(j), they carry forward indefinitely. Unlike under the old §163(j), however, unused limitation does not carry forward, so if a taxpayer does not use the maximum limitation available in a particular year the excess capacity is lost.

Since the new §163(j) applies to pass-through entities as well as corporations, the drafters included complex rules describing how the limitation is passed through to partners.[2] The limitation is determined at the entity level, and then allocated to the partners. If the entity's business expense exceeds its §163(j) limitation for the year, the excess is passed through to the partner and becomes a carryforward, although the partner can only use the carryforward with respect to the entity that produced it. If the entity's business expense is less than its §163(j) limitation for the year, the partner receives an allocation of "excess taxable income," which allows the partner to utilize business interest expense deductions from other sources.

Tax practitioners have only just begun to understand the new version of §163(j) and many questions remain. For example, it is unclear what will happen to old §163(j) carryforwards and guidance is needed to coordinate new §163(j) with other limitations on deductions, such as the at-risk limitation of §465, the passive activity rules of §469, and certain other provisions of the 2017 tax act — although the Act does provide that interest disallowed under new §163(j) is treated as paid to unrelated parties first, which should maximize the amount of interest subject to disallowance under the new base-erosion and anti-abuse tax (BEAT). It is also unclear how the new rules will apply to consolidated groups (although the regulations under the old §163(j) provided special rules for consolidated returns). The new §163(j), however, clearly reduces the tax benefit of interest expenses more dramatically than old §163(j) and for a broader range of taxpayers.

[1] Qualified business income is business income of individuals and pass-through entities eligible to be offset by a 20% deduction under §199A, another new provision enacted by the 2017 tax act.

All section references are to the Code or the Treasury regulations thereunder, unless otherwise specified.

[2] For purposes of this discussion of §163(j), the term "partners" is used to refer to partners, members of limited liability companies and shareholders of S corporations.

ISSN 0090-4600

C. Additional Limitations on Deductibility of Interest Under Tax Reform

In addition to new §163(j), the 2017 tax act includes other provisions that limit the deductibility of interest payments that are made to a foreign person related to the payor.

1. The BEAT

The BEAT, enacted in new §59A, requires a corporation to pay a minimum tax on its income as computed without regard to the tax benefit of "base erosion payments." Since interest paid to a related party is a base erosion payment, the effect of the BEAT can be to limit the benefit of deductions for interest payments made to a foreign related person.

In order to be subject to the BEAT, a corporation's average annual gross receipts for the previous three years must be at least $500 million and the ratio of the corporation's "base erosion payments" to its total deductions for the taxable year (the "base erosion percentage") must be at least 3%.[3] The BEAT does not apply to RICs, REITs, or S corporations.

A base erosion payment is a payment to a foreign related party, if the payment is deductible or is used to acquire depreciable or amortizable property.[4] Base erosion payments do not include payments for services that are generally eligible for the "services cost method" under §482 or certain payments with respect to derivatives that are marked to market. In addition, costs of goods sold (COGS) are not base erosion payments, which gives taxpayers an incentive to recharacterize, as COGS, payments that would otherwise be treated as base erosion payments.

Once the BEAT is determined to apply, the amount of the BEAT is the excess of 10%[5] of the corporation's "modified taxable income" over its federal income tax liability computed without regard to the BEAT, but reduced by certain tax credits. Modified taxable income for this purpose is the corporation's taxable income with the base erosion payments added back. In addition, the base erosion percentage of the corporation's net operating losses (NOLs) must also be added back.

If a corporation uses base erosion payments to reduce its overall tax liability, then the BEAT ensures that the corporation pays a minimum tax of 10% on its income computed without regard to its base erosion payments. Accordingly, income used to pay interest to a related foreign party will be subject to tax of at least 10% if the payor corporation is subject to the BEAT.

2. Anti-Hybrid Rules

The 2017 tax act seeks to discourage the use of "hybrid transactions" by denying deductions for related-party interest and royalties that are paid in connection with such transactions under new §267A. For this purpose, hybrid transactions are transactions that involve hybrid entities or payments that are deductible (or otherwise not included in income) by both the payor and the recipient. Section 267A does not apply to Subpart F income.

Both the BEAT and §267A reduce the tax benefit of interest payments with respect to internal cross-border financing. Neither of these provisions, however, should affect borrowing from third-party banks.

D. Respecting Debt Characterization

A corporation can also lose its deduction for interest if the underlying debt instrument is recharacterized as equity. The U.S. federal tax law has traditionally applied a multifactor judicial test to determine whether an instrument is debt or equity for income tax purposes.

This multifactor test looks to all relevant facts and circumstances to determine whether a given instrument is debt or equity. Since one of these factors is whether the lender is related to the borrower, the fact that an instrument is between a corporation and its shareholder makes that instrument more likely to be characterized as equity, in comparison with a similar instrument between a corporation and an unrelated third party. The debt-equity analysis depends on many factors, however, and a loan from an unrelated person that otherwise displays characteristics of equity can be recharacterized as equity for U.S. federal income tax purposes. Therefore, this consideration is likely to be more relevant to a shareholder loan than a third-party loan, although not necessarily so.

The test for whether a particular instrument is debt or equity is complex and looks to more than 20 factors articulated by the courts. These factors include the following:

- Whether the instrument provides an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future;
- Whether the instrument provides for a fixed rate of interest and schedule of interest payments;
- Whether the instrument provides the holders with the right to enforce payment of principal and interest;

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[3] For banks and registered securities dealers, this threshold is reduced to 2%.

[4] Certain other payments relating to reinsurance or made to a "surrogate foreign corporation" are also considered a base erosion payment when made to a related foreign person.

[5] For taxable years beginning in 2018, this percentage is reduced to 5%.

ISSN 0090-4600

- Whether the rights of holders are subordinate to the rights of the issuer's general creditors;
- Whether the instrument provides holders with the right to participate in the management of the issuer or results in an increase in voting rights;
- Whether the lender has a reasonable expectation of repayment;
- Whether there is an identity of interest between the holders of the instrument and the stockholders of the issuer;
- The label assigned to the instrument by the parties, as debt or equity, respectively;
- Whether the instrument is intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency and financial accounting purposes;
- Whether the holders participate in the issuer's earnings or growth;
- Whether interest or principal is only payable to the extent of the issuer's net income; and
- Whether the issuer would be able to obtain funds from an unrelated party dealing with the issuer at arm's length on the same terms as the terms of the instrument in question.

While some of the debt-equity factors are clearly more important than others, none of the factors is dispositive in itself. Accordingly, in cases where a particular instrument manifests characteristics of both debt and equity, it can be difficult to determine the correct classification with a high degree of certainty.

Unlike §163(j) and the other limitations on interest expense deductions described above, which are mechanical in nature, the treatment of U.S. Acq's debt under the multifactor judicial test is subjective. The terms of any third-party bank debt of U.S. Acq are likely to be respected as debt, since it is unlikely that any third-party banks would lend to U.S. Acq on anything other than arm's-length terms. If U.S. Acq's lender is a foreign country investor (FCo), however, U.S. Acq should be careful to structure the debt as similarly to third-party debt as possible in order to minimize the risk of equity recharacterization.

Although the courts are the principal source of the law governing debt-equity determinations, the U.S. Congress and the IRS have repeatedly proposed rules that would codify all or a portion of the debt-equity analysis. One recent and especially controversial attempt by the IRS to use its regulatory power to recharacterize instruments as equity is the package of regulations under §385 that the IRS finalized in October 2016.

The §385 regulations create two main regimes: the first sets out detailed documentation requirements that must be complied with in order for an instrument to be treated as debt; and the second recharacterizes certain instruments as equity based on the purpose for which they were issued. The §385 regulations generally apply when a borrower and a lender are both corporate members of an "expanded group," which generally consists of the members of a group of corporations whose common parent owns directly or indirectly at least 80% of the vote or value of the members' stock. The §385 regulations currently do not apply with respect to debt issued by foreign persons.

Under the documentation rules, certain issuers must prepare and maintain detailed documentation of intercompany debt, or else the debt will be treated as equity for U.S. federal tax purposes. These rules only apply if a member of the relevant expanded group is a publicly traded company, the assets of the expanded group exceed $100 million, or the revenue of the expanded group exceeds $50 million. Under these rules, the documentation must establish that the instrument in question is treated as debt for federal tax purposes. Specifically, the documentation must establish that:

- The issuer has entered into an unconditional obligation to pay a sum certain;
- The holder has the right to enforce the obligation; and
- The issuer's financial position supports a reasonable expectation that the issuer intends to, and would be able to, meet its obligations.

If a particular item of indebtedness fails to meet the documentation requirements, the instrument is automatically treated as equity for all U.S. federal tax purposes.

Under the second set of rules provided in the §385 regulations, debt issued by a domestic corporation to another member of its expanded group is recharacterized as equity if the debt is issued in connection with: (1) a distribution to shareholders; (2) an exchange for stock of an affiliate; or (3) certain exchanges for property in an asset reorganization (these three groups of transactions are referred to in this article as "Specified Transactions"). Under a provision known as the "funding rule," debt issued by a corporation can also be recharacterized as equity if the debt is issued with a principal purpose of funding a Specified Transaction.

The §385 regulations also include a "*per se* rule" under which certain debt issuances are presumptively treated as subject to the funding rule. Under the *per se* rule, any issuance of debt during the 72-month pe-

ISSN 0090-4600

riod beginning 36 months before, and ending 36 months after, the date of a Specified Transaction is treated as having been issued with a principal purpose of funding the Specified Transaction.

The current status of the §385 regulations is unclear. On April 21, 2017, President Trump issued Executive Order No. 13789, in which the Secretary of the Treasury was ordered to review all tax regulations issued on or after January 1, 2016, to determine whether any of such regulations imposed undue burdens on taxpayers. On July 7, 2017, the IRS issued Notice 2017-38, which identified the §385 regulations as one of eight sets of regulations that potentially respond to Executive Order No. 13789. The IRS has stated that it intends to modify the documentation requirements of the §385 regulations, but that the debt-equity recharacterization rules should go into effect as planned.

Once the §385 regulations become effective, U.S. Acq will have to exercise care to avoid being captured by the *per se* rule or other debt recharacterization rules. In the case of a garden-variety acquisition financing, however, the §385 rules are unlikely to apply. Also, although it is not yet known how the IRS will modify the documentation rules of §385, it is unlikely that those rules will apply to U.S. Acq unless FCo or its affiliates are publicly traded or very large.

E. Rate of Interest

Under the transfer pricing provisions of §482, the IRS has broad authority to reallocate income and expenses among related domestic and foreign corporations so that their tax returns more clearly reflect their income. This consideration, by definition, would only apply to related borrowers and lenders, so if U.S. Acq is financed by third-party banks it should be safe from challenge under the transfer pricing rules.

Reg. §1.482-2(a) authorizes the IRS to reallocate income in cases where the rate of interest on inter-company loans or advances is not equal to an arm's-length rate of interest. The §482 regulations generally provide that determining an arm's-length rate of interest requires a consideration of "all relevant factors," including "the principal amount and duration of the loan, the security involved, the credit standing of the borrower, and the interest rate prevailing at the situs of the lender for comparable loans between unrelated parties."[6] Generally, taxpayers show that the terms of a transaction are arm's-length for purposes of §482 by complying with extensive documentation requirements.

The transfer pricing regulations provide a safe harbor pursuant to which an interest rate is presumed to be arm's-length if it is between 100% and 130% of the applicable federal rate in effect as of the date on which the loan is made.[7] This safe harbor does not apply to lenders in the business of making loans or loans expressed in a currency other than the U.S. dollar.

Under these rules, U.S. Acq could avoid a challenge to its interest rate under §482 if the rate is between 100% and 130% of the applicable federal rate. Alternatively, U.S. Acq could use a higher or lower rate, although then U.S. Acq would need to be able to show that the chosen rate does in fact reflect an arm's-length rate, probably through extensive contemporaneous documentation.

If the IRS determines that the interest rate is not arm's-length, however, it can make a reallocation between the borrower and the lender. For instance, if the rate of interest on U.S. Acq's debt to FCo exceeds a market rate, then a portion of the interest payment could be recharacterized as a dividend.

F. Timing of Interest Payments

Regulations under §267(a)(3) provide that interest and certain other obligations owed to a related foreign person must be accounted for under the cash method. In the case of interest payments on a shareholder loan, this rule would limit interest deductions to amounts actually paid (as opposed to merely being accrued).

Accordingly, in the case of a shareholder loan from FCo, U.S. Acq would only be entitled to an interest expense deduction with respect to payments of interest actually made in cash. Interest that is merely accrued for the account of FCo would not be deductible. Interest accrued for foreign banks, however, could be deducted, because the banks are not related to U.S. Acq within the meaning of §267.

G. Debt-Financed Portfolio Stock

Generally, when a corporation receives a dividend from another corporation, the recipient corporation is entitled to a dividend-received deduction for all or a portion of the amount of the dividend. The amount of the deduction ranges from 70% to 100% of the amount of the dividend, depending on how much of the subsidiary's stock is owned by the recipient corporation.

Under §246A, the dividend-received deduction is reduced proportionately if the stock of the corporate subsidiary was acquired with borrowed funds. (Such stock is known as "debt financed portfolio stock.") Accordingly, U.S. Acq could lose all or a portion of

[6] Reg. §1.482-2(a)(2)(i).

[7] For purposes of illustration, the mid-term applicable federal rate, compounded annually, in effect for March 2018 is 2.57%.

ISSN 0090-4600

its dividend-received deduction with respect to distributions from U.S. Target if U.S. Acq is financed by FCo or a third-party bank.

It should be noted that §246A is not a concern for corporations that join in the filing of consolidated tax returns for federal income tax purposes.

II. ADDITIONAL LIMITATIONS IMPOSED ON THE DEDUCTIBILITY OF INTEREST EXPENSES INCURRED IN CONNECTION WITH A MERGER

As noted above, under U.S. federal income tax law, interest deductions related to U.S. Acq's financing can be used to offset the income of U.S. Target by electing to file a consolidated return. It is not necessary to engage in a merger of the two entities under state corporate law to achieve this objective.

Nevertheless, if a target company is merged into an acquisition corporation after an acquisition, the IRS generally gives the acquisition and the merger separate significance.[8] Under this rule, a merger of U.S. Target into U.S. Acq after the acquisition would be treated as a tax-free liquidation under §332, assuming that U.S. Acq acquired at least 80% of U.S. Target's stock, measured by vote and by value.

Accordingly, for federal income tax purposes, a merger would produce the same economic result as electing to file federal income tax on a combined return. If the state tax law relevant to the corporations does not permit combined tax reporting, merging U.S. Target and U.S. Acq after the transaction could enable the parties effectively to combine their tax returns for state and local tax purposes.

III. POTENTIAL OF ANY SUCH ADDITIONAL LIMITATIONS RELATING TO A MERGER TO COMPROMISE THE VIABILITY OF THE TRANSACTION AND AVAILABILITY OF ALTERNATIVE STRUCTURES OR FINANCING ARRANGEMENTS THAT WOULD MITIGATE OR ELIMINATE IMPACT OF LIMITATIONS

There are no additional limitations applicable to the interest expense deductions of the merged company in comparison with the separate corporations.

[8] Rev. Rul. 90-95, 1990-2 C.B. 67.

IV. RESTRICTIONS ON DEDUCTIBILITY OF INTEREST BASED ON BEPS ACTION 4 AND/OR THE EU ANTI-TAX AVOIDANCE DIRECTIVE

Action 4 of the OECD's base erosion and profit-shifting (BEPS) initiative addresses tax reduction strategies relating to the use of corporate interest deductions. For example, Action 4 is primarily concerned with transactions used by multinational groups of corporations that locate interest expense deductions in high-tax jurisdictions, create interest expense deductions in excess of actual interest expenses, and use debt financing to fund the generation of tax-exempt income. The approaches advocated by the OECD generally include limiting an entity's interest deductions to a fixed percentage of the entity's income or the income of the entire group. The European Union's Anti-Tax Avoidance Directive (ATAD) proposes broadly similar measures, such as a limitation of an entity's deductions for net borrowing costs to 30% of the entity's EBITDA.

The United States is not expected to adopt any of the action items that make up the OECD's BEPS initiative. The above-described 2017 tax act provisions — such as the new §163(j), the BEAT, and the anti-hybrid provision — however, are motivated by concerns similar to the concerns behind BEPS Action 4 and ATAD. The 30% limitation of new §163(j) is especially similar to measures proposed in BEPS Action 4 and ATAD.

The draft tax reform bills that preceded the Act included other provisions that were similar to recommendations in BEPS Action 4 and ATAD, but that did not make it into the final version of the legislation.

For instance, §4302 of the version of the bill originally passed by the House of Representatives on November 16, 2017, would have limited the interest deductions of a domestic corporation that is a member of an "international financial reporting group." Like the limitation under the EU ATAD, this limitation was based on the group's EBITDA.

Similarly, §14221 of the version of the bill passed by the Senate on December 2, 2017, would have disallowed a portion of the interest deduction of a domestic corporation that is a member of a multinational group in an amount that was generally intended to make the domestic interest deduction consistent with the debt-equity ratio of the entire multinational group.

Although the United States has been vocal in its opposition to BEPS and similar anti-tax-avoidance measures, provisions that are motivated by BEPS-like concerns and that implement strategies similar to the provisions advocated by the OECD and the broader international tax community seem to appear repeatedly in draft legislation proposed by U.S. lawmakers.

ISSN 0090-4600

With the enactment of the 2017 tax act, some of those provisions are now law in the United States. This may be because there are few alternatives to BEPS-like measures that are available to protect the U.S.'s tax base.

If interest expense deductions are an important aspect of FCo's and U.S. Acq's tax planning around the acquisition of U.S. Target, then provisions such as these should be carefully considered by FCo and U.S. Acq. In the past, the U.S. federal tax provisions governing interest expense deductions have been generally taxpayer-favorable. With the enactment of the Act, however, the balance seems to have shifted in favor of the government. It remains to be seen just how drastically provisions such as the new §163(j) will discourage foreign lenders like FCo from financing acquisitions in the United States with debt instead of equity.

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