IRS Hot Topics

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IRS Increases Scrutiny of Inter-Company Debt Arrangements

In the current economic environment, companies often finance the operational and capital expenditures of their foreign affiliates through intercompany loans. Debt restructuring can enable companies to better manage cash flow, restore liquidity, and achieve other benefits. The current economic turmoil has caused many multi-national entities to revisit their financing strategies. The IRS has always been concerned with issues of thin capitalization, debt versus equity characterization, and interest deductibility. Therefore, it is not surprising, that the Service considers intercompany movement of funds to be a potentially high-risk transaction.

IRS enforcement efforts regarding intercompany debt have evolved over time. In the past, many examiners generally confirmed that the debt was timely repaid and that the interest rate was negotiated at arm's-length. Specialists were not routinely engaged to perform this basic review. Review of debt versus equity issues was generally limited to the domestic or international examiner assigned to the case. Then, in recent years, the IRS focused on Hybrid Transactions, designating these as a Tier 1 issue and requiring the involvement of technical advisor.

Now we are seeing increased IRS examination activity related to Intercompany Debt arrangements and transactions. This focus is consistent with a series of changes that the IRS has initiated over the last two years to establish a more robust international tax and transfer pricing practice.

As part of this increased examination focus, the IRS has enlisted specialists to support the revenue agents in the field examining issues such as debt versus equity. These specialists, who previously worked behind the scenes, now serve a critical role for the audit team. In some instances, the Service

has even enlisted outside banking experts to help the audit team further develop the complex issues surrounding intercompany debt. Furthermore, we have observed the increased participation of Chief Counsel attorneys very early in the examination process.

The IRS utilizes factors established in relevant case law in order to test the validity of an intercompany debt arrangement. These factors include, but are not limited to, whether: (i) an arm's length rate of interest was charged and interest payments were made; (ii) the debt is evinced by written documents such as notes; (iii) the debt has a fixed maturity date and scheduled payments; (iv) there is an expectation that the debt will be repaid with free working capital; (v) security is given for the advances; (vi) the borrower is adequately capitalized; and (vii) the borrower is able to obtain adequate outside financing from third party sources.

While no one particular factor or set of factors is controlling, the case law has established that the objective facts of a taxpayer's situation must indicate the intention to create an unconditional obligation to repay the advances. Although the courts consider both the form and the economic substance of the advance, the economic substance is more important. The more a related party financing arrangement resembles a loan that an external lender would make to the borrower, the more likely the advance will be considered debt.

A new debt to equity IDR is being issued by the IRS

The IRS is now analyzing intercompany debt by comparing these transactions to third party financing arrangements, and this approach is encapsulated in the standard "Debt vs. Equity" IDR that the IRS has developed. This 13-part IDR (with one part containing 16 sub-sections) requires a massive amount of information, including financial data for years outside of the exam. For example, certain taxpayers have received IDRs requiring 10 to 15 years of past financial data, or cash flows in future years for 5 to 10 years past the year under examination. Specifically, the IDR requires taxpayers to provide the following information:

- Any and all tax opinions relevant to the treatment of related foreign party financing arrangements. Furthermore, the Service will request a copy of the engagement letter with the opining firm, and any supporting documentation/information provided with respect to the opinion. This includes opinions provided by both law firms and accounting firms;

- Any letters or reports received by the taxpayer regarding the taxpayer's ability to support the related foreign party loan(s) at issue;
- All correspondence received from Standard & Poor's during the years under examination or the years subsequent thereto;
- An explanation of the purpose for which the taxpayer used the related party loans;
- A copy of any and all solicitations which the taxpayer received from third party financial institutions during the years under examination to provide loans, debt financing, etc.;
- Copies of financial statements and other documentation provided to any third party lenders for the purpose of determining the terms and amount of any third party loans or other financing;
- Details of changes in the taxpayer's capital structure over the preceding five years;
- Internal documentation (e.g., memoranda, presentations, meeting minutes, etc.), of both the taxpayer and the foreign related lenders, which consider the tax aspects of the loans at issue;
- Copies of multi-year financial projections which are prepared for the taxpayer as part of a regular financial planning effort, including: (i) the legal entities included in each financial projection; (ii) the scheduled repayment of each inter-affiliate or third party debt liability, as shown in the statement of cash flows from investing activities; and (iii) multi-year financial projections, to the extent these have been prepared, for individual divisions or subsidiaries of the US taxpayer;
- All wire confirmations for principal and interest payments, as well as loan proceeds made during the years under examination;
- Copies of projections and budgets relative to the third party debt, including information requested by the foreign affiliated lenders in conjunction with securing the same; and
- A list of the individuals and departments involved in any and all loan analyses and the decision making process.

In addition to issuing the onerous Debt vs. Equity IDR, the agent is also required to involve IRS Chief Counsel attorneys and other designated specialists (i.e., lead economists and financial specialists) in developing the issues relevant to a taxpayer's intercompany debt. These specialists, in conjunction with the exam team, will perform an extensive, in-depth investigation to determine if inter-company loans are in fact being treated

as third party loans. This may require taxpayer participation in both in-person and telephone interviews.

Summary

Examinations of related party debt arrangements have dramatically expanded to become a much more burdensome process, involving detailed factual development by the IRS. Throughout the course of the audit, valuable taxpayer resources will be consumed by extensive taxpayer interviews and by responding to expansive IRS requests for information. In light of these new developments, taxpayers who may be impacted should begin preparing now. Developing a sound strategy for managing the review of an intercompany debt arrangement can help limit the amount of time and resources consumed by the examination. The purpose of a compliance review is to replicate as closely as possible the audit process generally followed by the IRS to determine the overall scope of the examination.

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