DISTRICT OF COLUMBIA BAR

Taxation Section

District of Columbia Bar

Taxation Section[1]

Comments Regarding the Proposed Regulations on Related-Party Debt Instruments

Prop. Treas. Reg. Sections 1.385-1, -2, -3 and -4

[June 30], 2016

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Re: Comments to Proposed Regulations under Section 385 of the Internal Revenue Code

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[1] The views expressed herein represent only those of the Taxation Section of the District of Columbia Bar and not those of the D.C. Bar or its Board of Governors.

The following members of the Tax Section participated in the drafting of this report: Scott M. Levine (primary drafter and Corporate Tax Committee Chair), Layla J. Asali (Section Vice Chair), Devon Bodoh, Didi Borden, Joshua T. Brady, Greg Featherman, Jon G. Finkelstein (Pass-Throughs and Real Estate Vice Chair), Elizabeth Hale, Christopher Hanfling, Britt Haxton, Lena Y. Hines (Financial Products Vice Chair), Robert Honigman, Lee Kelley, Richard G. Larkins (Section Chair), Natan Leyva, Stephen Massed, Brian Peabody, Hubert C. Raglan, Paul M. Schmidt, Steven Schneider, Timothy S. Shuman, Jay M. Singer (Corporate Tax Committee Vice Chair), Wade Sutton and James Wang. Helpful comments were provided by Robert Crnkovich, Jonathan Forrest, John Lehrer and Jeffrey L. Vogel. The assistance of Victoria Diaz, Francesca C. Dickson, Daria A. Kasparek, Trenton Kool, Krista Lindhard, Kevin Sarro, Drew Tidwell and Taylor Vance is gratefully acknowledged. Finally, we would be remiss for not mentioning the critical role that Christopher Hanfling played in the overall drafting of this report.

On June 20, 2016, the Steering Committee of the Taxation Section of the D.C. Bar voted (by a tally of 7-0 with one member absent and another member recusing herself) to adopt this report.

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I. Introduction

This letter (this "Comment Letter") comments on proposed regulations issued under section 385 of the Internal Revenue Code of 1986, as amended (the "Code"),[2] by the Treasury Department ("Treasury") and the Internal Revenue Service (the "IRS" and collectively with Treasury, the "Government") on April 4, 2016 (the "Proposed Regulations").[3] The Proposed Regulations were accompanied by a request for comments by July 7, 2016.

Section 385 generally grants the Government the authority to promulgate regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated as stock or indebtedness. The preamble to the Proposed Regulations (the "Preamble") provides that such regulations are an exercise of such authority under section 385.[4] The Preamble further provides that the Government was motivated to draft the Proposed Regulations in part by the enhanced incentives that current law provides for related parties to engage in transactions that result in excessive indebtedness in the cross-border context.[5] Although we appreciate the Government's interest in addressing these enhanced incentives, we have significant concerns with the Government's authority to issue the Proposed Regulations in final form (such regulations, if issued, the "Final Regulations"). Further, in addition to our authority-related concerns, we have significant policy and technical concerns with the Proposed Regulations.

The Proposed Regulations represent a significant departure from long-standing principles regarding the classification of debt and equity, and if finalized, would result in dramatic consequences—both anticipated and unanticipated—for a wide range of taxpayers. This Comment Letter addresses a number of the potential consequences raised by the Proposed Regulations as well as some of our concerns with the validity and the policy and technical details of the Proposed Regulations.

In light of the significant number of issues discussed below, we urge the Government to reconsider issuing the Final Regulations. If the Proposed Regulations are to be finalized, however, we ask that, due to the complex technical nature of the Proposed Regulations and the significant impact that they would have on the application of, and compliance with, U.S. federal tax laws, such finalization only take place after substantial additional study and revision in light of our and other stakeholders' comments. In particular, we are concerned that even with the modifications we have recommended in this Comment Letter, Prop. Treas. Reg. section 1.385-3 and portions of Prop. Treas. Reg. sections 1.385-1 and -2 do not appropriately advance the Government's stated policy objectives, have numerous technical deficiencies and create burdensome administrative requirements. As a result, we recommend that if issued, the Final Regulations exclude Prop. Treas. Reg. section 1.385-3 and incorporate material changes to Prop. Treas. Reg. sections 1.385-1 and -2.

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[2] All "section" and "I.R.C." references herein are to the Code and all "Treas. Reg. section" and "Treas. Reg. §" references are to the Treasury regulations promulgated thereunder.

[3] REG-108060-15, 81 Fed. Reg. 20912 (April 4, 2016).

[4] Preamble at 20912.

[5] Preamble at 20914.

II. Summary of Recommendations

Below is a summary of the recommendations provided in this Comment Letter.[6]

Authority-Related Recommendations

Recommendation 1: We recommend that Prop. Treas. Reg. section 1.385-3 be withdrawn.

Recommendation 2: In the event that the Government does not withdraw Prop. Treas. Reg. section 1.385-3 in its entirety, we recommend that the No Affirmative Use Rule of Prop. Treas. Reg. section 1.385-3(e) be withdrawn. In the alternative, we recommend that the Government clarify the limits of the No Affirmative Use Rule.

Recommendation 3: We recommend that the Government revise Prop. Treas. Reg. section 1.385-1(d) to incorporate specific enumerated standards for determining when to bifurcate a purported debt instrument and how to determine what portion of such instrument's principal amount should be recharacterized as stock.

Recommendation 4: We recommend that the Government clarify that any determination issued under Prop. Treas. Reg. section 1.385–1(d) may be challenged in court and specify the limits of the courts' discretion.

Recommendation 5: We recommend that the Government clarify that written documentation is a significant, but not dispositive, factor in analyzing purported debt between highly-related parties and that failing to satisfy the Documentation Requirements, alone, does not result in a per se classification of a corporate instrument as stock.

Recommendation 6: We recommend that the Final Regulations be limited to determining whether a debt instrument issued by a corporation is recharacterized as stock and not provide for the recharacterization of a debt instrument issued by a partnership as an equity interest in the issuing partnership.

Recommendation 7: If the Government takes the position that it has the authority to provide for the recharacterization of a debt instrument issued by a partnership as equity in the issuing partnership, it should only apply this rule to recharacterize a debt instrument issued by a partnership to the extent that a corporation that is a member of the partnership's EG is a partner in the issuing partnership.

Recommendation Regarding Limiting Application to Section 163

Recommendation 8: We recommend that application of the recharacterization of a debt instrument as stock under the Proposed Regulations be limited such that any such recharacterizations apply solely for purposes of section 163 or, alternatively, that taxpayers be afforded an election to limit the application in this manner.

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[6] Defintions of the defined terms used in this Section are provided below in the recommendations' respective sections of this Comment Letter.

Recommendations Regarding Prop. Treas. Reg. Section 1.385-1

Recommendation 9: We recommend that for purposes of defining an EG, section 1504(a)(1)(B)(ii) be modified by substituting "directly or indirectly" for "directly."

Recommendation 10: We recommend that the concept of a MEG be removed from the Final Regulations and that the Bifurcation Rule only be applicable to EGs.

Recommendation 11: We recommend that Prop. Treas. Reg. section 1.385-1(b)(5) be modified to clarify that section 7701(a)(1) persons other than corporations and partnerships can be treated as MEG members only to the extent that they hold creditor positions in EG instruments described in Prop. Treas. Reg. section 1.385-1(d)(2).

Recommendation 12: We recommend that section 318(a)(3)(A) attribution apply only from partners that are highly related to their partnerships, such as a partner that owns at least 80 percent of the interests in a partnership.

Recommendation 13: We recommend that the Final Regulations clarify that section 304(c)(3)(B) only applies to modify the ownership requirements in sections 318(a)(2)(C) and (3)(C), and does not extend to other provisions of section 318(a), such as section 318(a)(2)(A). We also recommend that an 80-percent relatedness threshold be introduced for section 318(a)(3)(A) attribution regardless of the application of section 304(c)(3) principles in the partnership attribution context.

Recommendation 14: We recommend that the Final Regulations provide a safe harbor for purposes of determining "proportionately." We believe that an appropriate safe harbor for "value" for these purposes is the liquidation value of a partner's interest.

Recommendation 15: We recommend that the Final Regulations retain the current aggregate treatment of investment partnerships and not test the 80 percent and 50 percent thresholds for EG or MEG status by looking at the investment partnership's percentage ownership in a leveraged corporate blocker.

Recommendation 16: We request clarification that, under Prop. Treas. Reg. section 1.385-1(c), deductions for QSI that accrue while the instrument is indebtedness continue to be available unless otherwise limited by a provision of the Code or Treasury regulations outside of section 385.

Recommendation 17: We request clarification regarding the treatment of foreign exchange gain or loss with respect to accrued but unpaid QSI.

Recommendation 18: We request clarification as to the tax treatment of the deemed stock-for-debt exchange when an instrument treated as stock under the Proposed Regulations is subsequently recharacterized as debt.

Recommendation 19: We recommend that the Bifurcation Rule be limited to cases in which the instrument would be a debt instrument under federal tax principles except that there is doubt about the ability of the issuer to repay the full amount of the principal (i.e., cases in which the

amount of debt is thought to be too large for the issuer to support it with reasonably projected cash flows).

Recommendation 20: We recommend that the Final Regulations clarify that the Bifurcation Rule only operates to recharacterize an instrument that is "in form" debt but in substance treated as stock under historical federal tax principles (e.g., an instrument that is debt in form but has a 100-year maturity date) as in part indebtedness and in part stock.

Recommendation 21: We recommend that in order to apply the Bifurcation Rule, the IRS should be required to show that it was unreasonable for the taxpayer to expect that the principal could be repaid in full.

Recommendation 22: We recommend that Final Regulations adopt a *de minimis* threshold to clarify when the Bifurcation Rule is never applicable.

Recommendation 23: We recommend that the Final Regulations provide a safe harbor such that the Bifurcation Rule will not apply to instruments issued by a corporation with adequate capitalization.

Recommendation 24: We recommend that the Final Regulations clarify that in order for the Bifurcation Rule to apply to an EGI, the instrument must be an EGI at the time that it is issued.

Recommendation 25: We request clarification as to how payments made with respect to a bifurcated instrument should be treated.

Recommendation 26: We recommend that the Government give additional consideration and provide clarifications in the Final Regulations regarding whether an applicable instrument, when treated as stock (or equity) under Prop. Treas. Reg. sections 1.385-1(d)(1) and 1.385-2(a)(1), should be treated as stock in the corporate owner (if any) of the partnership or the DRE, or as equity in the partnership or the DRE.

Recommendation 27: We recommend that the Final Regulations provide that an applicable instrument issued by a QSub or QRS that is treated as stock under the Proposed Regulations is treated as stock in such issuer's regarded S Corporation parent or REIT parent (as appropriate).

Recommendations Regarding Prop. Treas. Reg. Section 1.385-2

Recommendation 28: We recommend that Final Regulations clarify the scope and meaning of an "applicable instrument" and debt "in form" for purposes of Prop. Treas. Reg. section 1.385-2, and that such terms exclude debt instruments that are deemed to exist solely for tax purposes, such as accounts receivable described in Treas. Reg. section 1.367(d)-1T(g)(1) or Rev. Proc. 99-32.

Recommendation 29: We recommend that the Final Regulations clarify that the $100 million threshold is not determined on an aggregate basis if the members are required to report separate financial results under GAAP, IFRS or other applicable accounting standards. A similar clarification should be made with respect to the $50 million revenue threshold.

Recommendation 30: We recommend that the Final Regulations clarify that stock and debt issued by EG Members is excluded from the calculation of total assets for purposes of the $100 million threshold and that the receipt of payments (e.g., interest or dividends) from EG Members is excluded from the calculation of total revenue for purposes of the $50 million revenue threshold.

Recommendation 31: We recommend that the Final Regulations be clarified to provide that if an EGI treated as debt ceases to be an EGI, subsequent holders or persons relying on the characterization of the instrument should be entitled to treat the instrument as stock (or stock in part), if those holders or persons disclose such treatment consistent with section 385(c)(2).

Recommendation 32: We recommend that the Proposed Regulations should clarify that the requirements of Prop. Treas. Reg. section 1.385-2(b)(2)(i) can be satisfied if the members of the EG clearly document the rights of the holder to receive a principal amount, whether fixed or not.

Recommendation 33: We believe the Final Regulations should recognize that rights of enforcement and seniority over equity may be provided under the relevant law governing the instrument and need not be set forth in detail in the instrument itself.

Recommendation 34: The Final Regulations should incorporate the view that a creditor's expectations of reasonableness are subjective and should afford the creditor with reasonable latitude based on its business judgment.

Recommendation 35: The Final Regulations should not require the members of an EG to provide revised documentation of the reasonable expectation to repay when an EGI is subject to a significant modification under Treas. Reg. section 1.1001-3 (as would be the case under Prop. Treas. Reg. section 1.385-2(b)(3)(ii)(B)).

Recommendation 36: The Final Regulations should clarify that it is the existence of bona fide creditor rights and default remedies, rather than whether or not those rights or remedies were actually exercised, that is relevant for purposes of the Documentation Rules.

Recommendation 37: We recommend that the Timeliness Requirements should conform to similar third-party arrangements in that a credit analysis should only be required on a single entity basis upon inception of a loan facility (or an increase in the maximum borrowing amount with respect to a facility or an addition of an entity to, or removal of an entity from, an existing facility subject to a *de minimis* threshold), provided that the facility is of a reasonably limited duration (e.g., five years or less) and provides for a reasonable stated maximum loan amount. This rule may be premised upon the loan facility including typical covenants that would be included in a third-party loan facility. For facilities that do not contain such covenants or do not provide for a reasonably limited duration or maximum borrowing amount, such credit analysis should be undertaken periodically (e.g., in no event more frequently than annually). Furthermore, in order to ease the documentation burden associated with such loans, we would propose that such analysis may be based on applicable financial statements prepared under GAAP, IFRS or statutory accounting to avoid the costs of third-party valuations.

Recommendation 38: We recommend that the relevant date definition be restricted to eliminate instances in which a non-EGI becomes an EGI.

Recommendation 39: In light of the potential adverse consequences of an inadvertent failure to comply with the Documentation Requirements and the general lack of federal tax planning underlying the issuance of consolidated or disregarded debt, we recommend that "relevant dates" with respect to such instruments only include deemed issuances of such instruments of which taxpayers are aware (either through affirmative actions on the taxpayer's part or as a result of notification by the Government). This change could be incorporated into the Final Regulations as a stand-alone "relevant date" rule or, alternatively, as a facet of a revised reasonable cause exception, which we propose below.

Recommendation 40: The reasonable cause exception described in Prop. Treas. Reg. section 1.385-2(c)(1) should be broadened.

Recommendation 41: We recommend that the Final Regulations should amend the mechanics of the deemed exchange that occurs when an EGI that has been recharacterized as stock becomes a non-EGI such that the exchange is deemed to occur "immediately after" the event that causes the instrument to become a non-EGI, in order to avoid the possibility of noneconomic dividend income and issues regarding the allocation of unrecovered basis.

Recommendations Regarding Prop. Treas. Reg. Section 1.385-3

Recommendation 42: We recommend that the second and third prongs of the General Rule be eliminated in the Final Regulations.

Recommendation 43: If the second and third prongs of the General Rule are not eliminated, we request that the Government articulate how transactions described in the second and third prongs of the General Rule have "economic similarities" and "implicate similar policy considerations" from a debt-equity perspective as transactions described in the first prong of the General Rule.

Recommendation 44: We recommend that the General Rule exempt debt instruments issued in exchange for stock of an EG Member and debt instruments issued and distributed in certain asset reorganizations from the application of the General Rule when the distribution or deemed distribution results in sale or exchange treatment.

Recommendation 45: The Final Regulations should exempt debt instruments issued for EG stock used to compensate employees of the issuer of such debt instruments from the application of the General Rule.

Recommendation 46: Funded Stock Acquisitions and Funded Section 356 Exchanges should be eliminated from the Funding Rule in the Final Regulations.

Recommendation 47: Revise the Proposed Regulations to provide a *rebuttable* presumption that a debt instrument is a PPDI.

Recommendation 48: If the Per Se Rule is not eliminated, the Per Se Period should be significantly reduced, perhaps to 24 months instead of the proposed 72-month period.

Recommendation 49: Clarify that the definitions of predecessor and successor are an exhaustive list of potential predecessors and successors. The first instance of the word "includes" in the definition of "predecessor" and "successor" should be changed to "means."

Recommendation 50: A funded member should be treated as having made a Funded Distribution or Acquisition that was in form made by a predecessor or successor only to the extent the funded member is treated as having made such Funded Distribution or Acquisition during the Per Se Period by virtue of a transaction that results in predecessor/successor status occurring within the Per Se Period.

Recommendation 51: The Final Regulations should provide that the Funding Rule can apply only if the corporation making the loan to the funded member, and (i) the corporation to which the funded member makes a Funded Distribution, (ii) the corporation from which the funded member acquires EG stock or assets in a Funded Stock Acquisition or (iii) the corporation that receives "other property" or money in a Funded Section 356 Exchange, are members of the same EG.

Recommendation 52: We recommend that the Government clarify in the Final Regulations that a deemed purchase of EG stock pursuant to Treas. Reg. section 1.1032-3 is not treated as a Funded Distribution or Acquisition.

Recommendation 53: We recommend that the Government change the general timing rule in Prop. Treas. Reg. section 1.385-3(d)(1)(i) such that in no event will debt be recharacterized as stock under the Funding Rule before the date on which a Funded Distribution or Acquisition occurs that triggers application of the Funding Rule.

Recommendation 54: The Government should treat section 332 liquidations only as successor transactions for purposes of the Funding Rule, not as Funded Distributions.

Recommendation 55: The Government should not treat Straight Section 355 Transactions as Funded Distributions.

Recommendation 56: We recommend that, for purposes of the Per Se Rule, neither a deemed exchange of debt for equity (by virtue of a recharacterization of the debt under either Prop. Treas. Reg. section 1.385-2 or Prop. Treas. Reg. section 1.385-3), nor any transfer or redemption of or payment with respect to the deemed equity should give rise to a General Rule transaction or Funded Distribution or Acquisition.

Recommendation 57: We recommend that the Final Regulations include a Net Funding Rule.

Recommendation 58: We recommend the Final Regulations include a Net Contribution Rule.

Recommendation 59: We recommend an exception to the definition of Funded Acquisitions or Distributions when the distribution or deemed distribution results in sale or exchange treatment.

Recommendation 60: We recommend that the Final Regulations explicitly provide that the Funding Rule cannot apply to recharacterize a debt instrument as stock if that debt instrument

would have been recharacterized as stock under the General Rule but for the application of the Current E&P Exception.

Recommendation 61: In an effort to place some limitations on the -3 Anti-Abuse Rule in light of both its overbreadth and the fact that there are already significant backstops to the perceived abuse that the Government wishes to curb, we recommend that the Government significantly narrow the scope of the -3 Anti-Abuse Rule. At a minimum, the Government should clarify that the -3 Anti-Abuse Rule does not apply to indebtedness between an EG Member and an unrelated party where the unrelated party is not acting as a conduit (perhaps applying the principles of the anti-conduit regulations in Treas. Reg. section 1.881-3).

Recommendation 62: We recommend modifying the Current E&P Exception to include both current and accumulated E&P, but only to the extent such accumulated E&P is earned in (i) the member's tax year that includes April 4, 2016 or (ii) all years thereafter.

Recommendation 63: In the event the Government decides not to modify the exception to allow for the carrying forward of Current E&P to subsequent tax years, we recommend that the amount eligible for the Current E&P Exception for a given tax year should be an amount equal to Current E&P of the current year plus the amount of Current E&P in the previous tax year to the extent such previous year's Current E&P was not counted toward the previous year's Current E&P Exception.

Recommendation 64: We recommend providing the taxpayer with an irrevocable election whereby the taxpayer could elect to which distribution(s) the Current E&P Exception applies.

Recommendation 65: Given the lack of tax motivation for and the ordinary course nature of PTI distributions, we recommend an additional exception to Prop. Treas. Reg. sections 1.385-3(b)(2) and (b)(3) be created for all transactions to the extent they are excluded from a U.S. shareholder's income under section 959(a)(1) as distributions of PTI.

Recommendation 66: We recommend that the Final Regulations clarify that a CFC's Current E&P include distributions received during the year that are excluded from the CFC's gross income under section 959(b).

Recommendation 67: The Final Regulations should include additional examples illustrating the operation of the Current E&P Exception in slightly more complicated fact patterns.

Recommendation 68: We recommend that the Current E&P Exception be replaced with an exception that reduces an EG Member's distributions and acquisitions with respect to a given taxable year by an amount equal to such EG Member's Current ATI.

Recommendation 69: As described in Recommendation 12, we recommend that section 318(a)(3)(A) attribution apply only from partners that are highly related to their partnerships, such as a partner that owns at least 80 percent of the interests in a partnership. If, however, Recommendation 12 is not adopted, we strongly recommend at a minimum that section 318(a)(3)(A) attribution apply only from highly-related partners for the purposes of calculating the Threshold Exception.

Recommendation 70: To prevent disproportionately benefitting only certain mid-size companies, we would recommend eliminating the cliff effect from the Threshold Exception. Instead, the exception should exempt from recharacterization the first $50 million of intercompany debt that would otherwise be recharacterized, and only debt in excess of $50 million would be subject to the General Rule and the Funding Rule.

Recommendation 71: If Recommendation 70 is not adopted, we recommend a rule providing that the first $50 million of EG debt is eligible for the Threshold Exception, unless the total amount of EG debt that would be recharacterized is more than $500 million. Under this proposal, once the total amount of EG debt exceeds $500 million, the cliff effect is reintroduced and none of the EG debt is eligible for the Threshold Exception.

Recommendation 72: We recommend clarifying the application of the Ordinary Course Exception through further explanatory text in Prop. Treas. Reg. section 1.385-3(b)(3)(iv)(B)(2) and examples.

Recommendation 73: We recommend that the Ordinary Course Exception apply not only to the Per Se Rule of Prop. Treas. Reg. section 1.385-3(b)(3)(iv)(B)(1), but also to the Facts and Circumstances Test of Prop. Treas. Reg. section 1.385-3(b)(3)(iv)(A).

Recommendation 74: We recommend that the Ordinary Course Exception also apply to Prop. Treas. Reg. section 1.385-2.

Recommendation 75: We recommend excepting a debt instrument between EG Members from the Funding Rule to the extent that such instrument is issued in the ordinary course of a financing business and bears terms substantially similar to those that the issuer uses and accepts in debt issued to third parties.

Recommendation 76: We recommend that the Ordinary Course Exception be expanded to cover not merely debt issued directly in exchange for specified goods and services, but also debt issued to facilitate the payment for such goods and services.

Recommendation 77: The Ordinary Course Exception should not be premised on the receipt of goods or services from another member of the EG. Rather, it should cover any debt instrument issued by one EG Member to another in order to facilitate payment for goods or services from any person (whether or not a member of the EG).

Recommendation 78: We recommend a safe harbor for the Ordinary Course Exception based on an EG Member's current assets, which should serve as a proxy for its short-term working capital needs. Alternatively, a safe harbor could be based upon an EG Member's annual expenses.

Recommendation 79: We recommend that the Subsidiary Stock Exception apply whenever the Transferor owns (applying the principles of section 958(a) without regard to whether an entity is foreign or domestic) more than 50 percent of the vote and value of the Issuer immediately after the transfer without a strict holding period requirement, but instead applying principles under section 351 to determine whether the requisite ownership exists.

Recommendation 80: We recommend that the Subsidiary Stock Issuance Exception be modified so that if the Issuer is not an EG Member as of the Cessation date, the exception does not cease to apply.

Recommendation 81: We recommend that the Subsidiary Stock Issuance Exception be expanded to apply for purposes of Prop. Treas. Reg. section 1.385-3(b)(2)(ii) in addition to Prop. Treas. Reg. section 1.385-3(b)(3)(ii)(B).

Recommendation 82: We recommend an exception from the application of the Proposed Regulations for debt instruments that have no U.S. tax relevance at the time of issuance. However, if a related-party debt instrument is issued in a transaction undertaken with a principal purpose of avoiding the Proposed Regulations by taking advantage of this exception (e.g., when a related-party debt instrument is issued as part of a plan (or series of related transactions) pursuant to which the instrument becomes relevant), then the instrument would be subject to the Proposed Regulations.

Recommendation 83: We recommend an exception to the definition of a Funded Distribution or Acquisition for transactions where the funded member was not relevant at the time of the transaction.

Recommendation 84: We recommend the Final Regulations include a CFC-to-CFC Exception as described herein.

Recommendation 85: The Proposed Regulations should clarify that the deemed stock resulting from the application of Prop. Treas. Reg. section 1.385-3 is not taken into account when determining which entities are members of a corporation's EG.

Recommendation 86: We recommend that if the Threshold Exception amount is not exceeded at the time of an issuance of a debt, that debt should not be subject to recharacterization until the Threshold Amount is exceeded, irrespective of whether the Threshold Exception amount was previously exceeded and resulted in recharacterization of other debt.

Recommendation 87: We recommend that, like the Subsidiary Stock Issuance Exception, the re-testing period described in both Prop. Treas. Reg. sections 1.385-3(d)(1)(iv) and (d)(2) should be limited to 36 months after the debt is issued.

Recommendation 88: The Final Regulations should clarify that if a debt instrument is issued by an EG Partner to such EG Partner's Controlled Partnership, the debt instrument should not be subject to recharacterization under Prop. Treas. Reg. section 1.385-3 to the extent the EG Partner would be treated as both the borrower and the lender under the aggregate treatment of partnerships set forth in Prop. Treas. Reg. section 1.385-3(d)(5).

Recommendation 89: The Final Regulations should clarify that if a debt instrument is issued by a partnership to an EG Partner, the debt instrument should not be subject to recharacterization under Prop. Treas. Reg. section 1.385-3 to the extent that the EG Partner would be treated as both the lender and borrower with respect to the debt instrument under the aggregate treatment of partnerships set forth in Prop. Treas. Reg. section 1.385-3(d)(5).

Recommendation 90: We recommend that the Final Regulations should not apply to preferred equity in a Controlled Partnership.

Recommendation 91: If the Government determines it is necessary to provide for the application of an anti-abuse rule to partnership equity, we recommend the Final Regulations contain examples of situations that are not abusive and those that are.

Recommendation 92: We recommend that the Final Regulations either (i) provide with specificity the manner in which partnership profits are calculated for purposes of Treas. Reg. section 1.385-3(b)(3), or (ii) consider use of partner capital for purposes of that regulation.

Recommendation 93: If the Final Regulations retain the partner's share of partnership profits test for purposes of Prop. Treas. Reg. section 1.385-3(b)(5), we recommend an alternative approach to determining a partner's proportionate share of a partnership's debt instrument that is subject to Funding Rule.

Recommendation 94: In addition to providing methods for determining a partner's proportionate share of a partnership, we recommend that the Final Regulations specify the time for determining an EG Partner's proportionate share of a partnership.

Recommendation 95: We recommend that the Final Regulations clarify that the distribution of a partnership's own note to its partners is not subject to Prop. Treas. Reg. section 1.385-3.

Recommendation 96: We recommend that the Final Regulations clarify that if a debt instrument of a DRE is treated as stock under Prop. Treas. Reg. section 1.385-3, such debt instrument should be treated as stock in the *first* regarded owner, but if the first regarded owner is a partnership, then such debt instrument should be treated as stock in the corporate partners of the partnership under the principles of Prop. Treas. Reg. section 1.385-3(d)(5).

Recommendations Regarding the Treatment of Consolidated Groups

Recommendation 97: We recommend that certain items be clearly included or excluded from "one corporation" treatment and that a principle-based rule be used to address the items not expressly included or excluded.

Recommendation 98: We request that the Final Regulations clarify whether the determination of an issuer's ability to repay an instrument for purposes of the Documentation Requirements and the Bifurcation Rule be based on an analysis of the single corporate issuer or the entire consolidated group of which it is a member.

Recommendation 99: We recommend that the Final Regulations provide for the same treatment of a distribution by a consolidated group member outside the consolidated group of its own note and a distribution by a consolidated group member outside the consolidated group of a note issued by another member of the consolidated group.

Recommendation 100: In order to prevent duplication, and in order to provide administrability to both the IRS and taxpayers, we recommend that a Departing Member take with it *an allocable* portion of the amount of the taint, with such portion being determined based

on the relative fair market value of the Departing Member as compared with the fair market value of the consolidated group from which it departed.

Recommendation 101: We recommend that Prop. Reg. section 1.385-1(e) be clarified to indicate that distributions or acquisitions occurring within a consolidated group are disregarded for purposes of the Proposed Regulations subsequent to the period of consolidation.

Recommendation 102: We recommend that the Final Regulations clarify how to calculate the Current E&P of a consolidated group.

Recommendation 103: The Final Regulations should provide that any debt instrument that is recharacterized as stock under the Final Regulations is not considered stock for purposes of section 1504(a) even if the recharacterized instrument would not otherwise qualify as section 1504(a)(4) stock.

Recommendation 104: We recommend that, for purposes of the ordering rule of Prop. Treas. Reg. section 1.385-3(b)(3)(iv)(B)(3), debt instruments such as that described in Example 64 be regarded as issued immediately after deconsolidation.

Recommendation 105: We recommend the provision of a "subgroup" exception under which Prop. Treas. Reg. section 1.385-4(b)(1)(ii)(B) would not apply where the issuer and holder together depart one consolidated group and together join another consolidated group within the same EG.

Recommendation 106: We recommend the Proposed Regulations be amended to provide that any deemed issuances, satisfactions, or exchanges arising under Treas. Reg. section 1.1502-13(g) and Prop. Treas. Reg. sections 1.385-4(b) or 1.385-4(e)(3) as part of the same transaction or series of transactions be respected as steps that are separate and apart from one another, similar to the rules currently articulated under Treas. Reg. sections 1.1502-13(g)(3)(ii)(B) and 1.1502-13(g)(5)(ii)(B).

Recommendation 107: We recommend that Prop. Treas. Reg. section 1.385-4(d)(3), Example 4 be revised to reflect properly the impact of Treas. Reg. section 1.1502-13(g).

Recommendation 108: We recommend that the Final Regulations expressly indicate which ancillary consequences of the "one corporation" treatment of consolidated groups are intended and the policy rationale for such ancillary consequences.

Recommendation 109: We recommend that the Final Regulations clarify that any applicable instrument issued or held by a Consolidated Group Partnership should be treated as issued or held by one corporation for purposes of Prop. Treas. Reg. sections 1.385-1(d) and 1.385-2.

Recommendation Regarding Cash Pooling

Recommendation 110: We recommend that the Government clarify that the Proposed Regulations do not apply to notional pooling arrangements that are bank loans in form, except in the rare circumstances in which the -3 Anti-Abuse Rule should be applied (e.g., circumstances in

which a taxpayer uses a notional cash pool to effect a third-party loan in form that is an EG debt instrument in substance). Further, the decision to use a notional pooling arrangement rather than a physical pooling arrangement should not trigger the application of the -3 Anti-Abuse Rule.

Recommendations Regarding the Ancillary Issues Related to Recharacterization of Debt Instruments

Recommendation 111: We recommend that related-party debt instruments treated as stock under the Proposed Regulations' not be treated as "stock" for purposes of disqualifying a corporation from one of the Code's alternative corporate tax regimes, including qualifying as an S Corporation or a REIT.

Recommendation 112: We recommend that the Government clarify that if S Corporation-issued debt is recharacterized as stock under the Proposed Regulations, such recharacterization does not apply for purposes of the single class of stock requirement of section 1361(b)(1)(D).

Recommendation 113: We recommend that debt recharacterized as stock under the Proposed Regulations not be taken into account for purposes of determining a foreign corporation's status as a CFC.

Recommendation 114: We recommend that payments with respect to debt instruments that are recharacterized as stock under the Final Regulations not be treated as dividends for purposes of section 902.

Recommendation 115: We recommend that the Final Regulations include an exception to section 909 for debt instruments that are recharacterized thereunder as stock.

Recommendation 116: If the Final Regulations do not contain an exception to section 909 for recharacterized debt instruments, we believe that additional guidance under section 909 is warranted given the predictable increase in U.S. equity hybrid instruments.

Recommendation 117: We recommend that related-party debt instruments recharacterized as stock under the Proposed Regulations not be treated as "stock" for purposes of determining whether (i) a foreign corporation satisfies a test in the LOB article of an in-force income tax treaty, or (ii) a foreign corporation is a Controlled Entity.

Recommendation 118: We recommend that the Final Regulations state that the creditor rights associated with a recharacterized debt instrument are not taken into account for purposes of applying sections 246(c)(4) and 901(k).

Recommendation 119: We recommend that related-party debt instruments treated as stock under the Proposed Regulations not be taken into account for purposes of determining control under section 368(c).

Recommendation 120: We recommend that the Final Regulations include a provision that related-party debt instruments recharacterized as stock thereunder are not subject to further recharacterization under the Fast-Pay Regulations.

Recommendation 121: We recommend that the Final Regulations include a provision that expressly provides that a related-party debt instrument recharacterized thereunder as stock is not a "listed transaction" for purposes of Notice 2009-59 because the recharacterized stock is not the same or substantially similar to a "fast-pay arrangement."

III. Authority-Related Discussion

A. Prop. Treas. Reg. Section 1.385-3[7]

Based on the statutory language and history of section 385, we are concerned that the provisions of Prop. Treas. Reg. section 1.385-3 exceed Treasury's authority. Section 385 was enacted in 1969. At the time, there was in place a substantial body of federal case law addressing the distinction between debt and equity.[8] That case law, developed over several decades, did not consist of bright-line rules. Instead, the judiciary identified factors to be taken into account in determining whether an instrument represented corporate debt or equity. In enacting section 385, Congress granted Treasury the authority to clarify how such factors were to be applied in making the debt-equity determination.[9]

Although Congress gave Treasury significant discretion to promulgate regulations under section 385, that discretion was not unbounded. Section 385(a), as further modified in 1989, authorizes the Secretary of the Treasury "to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness)." Congress provided further instructions as to the nature of the regulations authorized by section 385. Section 385(b) states that:

> The regulations prescribed under this section *shall set forth factors which are to be taken into account* in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. The factors so set forth in the regulations may include among other factors: (1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest, (2) whether there is subordination to or preference over any indebtedness of the corporation, (3) the ratio of debt to equity of the corporation, (4) whether there is

[7] See Section VII for technical comments regarding Prop. Treas. Reg. section 1.385-3.

[8] For a detailed review of this case law, see William T. Plumb, Jr., The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal, 26 Tax L. Rev. 369, 530 (1971).

[9] Recognizing that "[t]he differing circumstances which characterize these situations . . . would make it difficult for the committee to provide comprehensive and specific statutory rules of universal and equal applicability," Congress concluded that it should "specifically authorize the Secretary of the Treasury to prescribe the appropriate rules for distinguishing debt from equity in different situations." S. Rep. No. 91-552, at 138 (1969).

> convertibility into the stock of the corporation, and (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.[10]

In light of Congress's mandate to issue regulations providing factors to be taken into account to determine whether an instrument is to be treated as debt or equity, we question whether Prop. Treas. Reg. section 1.385-3 is within the scope of Treasury's authority to issue regulations pursuant to section 385(a). On its face, section 385 provides Treasury with the authority to craft regulations that provide factors for determining whether an instrument should be treated as debt or equity for tax purposes. It might be appropriate for the factors provided in such regulations to vary based on the relationship of the entities involved. We do not believe, however, that Congress provided Treasury with the authority to write per se rules based solely on the relationship of the parties and the type of transaction that created the debt instrument. It is our view that Congress authorized Treasury to develop a list of factors to be used to determine whether an instrument is, as an economic matter, more appropriately characterized as debt or equity. We do not believe that Congress provided Treasury with a mandate to write rules that eliminate interest deductions and other benefits potentially associated with related-party debt whenever such instruments result in a reduction in federal income tax.

Section 385 was enacted together with section 279 as part of a single statutory package addressing the debt-equity question. Accordingly, Congress's approach to section 279, applicable to corporate acquisition indebtedness, is instructive of Congress's expectations in enacting section 385. Section 279 disallows interest deductions on equity-like corporate acquisition indebtedness, defining corporate acquisition indebtedness subject to the disallowance by reference to certain equity-linked characteristics of the debt instrument, including subordination to other creditors, convertibility into stock, an option to acquire stock, a high debt-to-equity ratio, and interest deductions that are high in comparison to earnings. It is significant that, in section 279, Congress disallowed a deduction only on corporation acquisition indebtedness that presented certain indicia of equity. The Senate report on section 279 explains Congress's rationale that certain debt issued in acquisition transactions have "characteristics" that make the instrument "more nearly like a stockholder's interest than a creditor's interest."[11]

Congress saw section 385 as picking up where section 279 left off, referring to the section 385 regulations as "general debt-equity regulatory guidelines."[12] Congress further stated:

> In view of the uncertainties and difficulties which the distinction between debt and equity has produced in numerous situations other than those involving corporate acquisitions, the committee further believes that it would be desirable to

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[10] (Emphasis added.) The Senate report states with respect to this provision that "[i]t is not intended that only these factors be included in the guidelines or that, with respect to a particular situation, any of these factors must be included in the guidelines, or that any of the factors which are included by statute must necessarily be given any more weight than other factors added by regulations." *Id.*

[11] *Id.* at 137-38.

[12] *Id.* at 138.

> provide rules for distinguishing debt from equity in the variety of contexts in which this problem can arise.[13]

Thus, when Congress provided Treasury authority, via section 385, to determine whether an instrument was debt or equity in circumstances other than corporate acquisition indebtedness, it made clear that it contemplated that Treasury would take into account factors relevant to determining whether an instrument's characteristics pointed to debt or to equity, just as Congress had done in section 279.

Nowhere does Prop. Treas. Reg. section 1.385-3 set forth factors to be considered, weighed, or otherwise taken into account in making a determination between debt and equity. Neither can they be considered general guidelines as to the debt-equity determination. Instead, the proposed regulation overrides the debt treatment of debt instruments between EG Members (defined below) in certain circumstances. To the exclusion of all other factors, Prop. Treas. Reg. section 1.385-3 treats as equity any debt instrument between EG Members that is issued in, or funds, one of the related-party transactions enumerated within that regulatory section. Thus, the proposed regulation does not set forth "factors" as that term has traditionally been used by Congress and the courts; instead, the regulations adopt per se rules that ignore long-established debt-equity characteristics.

Thus, the proposed regulation has not been crafted to fairly determine whether an instrument has characteristics that make it more debt-like or more equity-like on balance. Instead, they have been crafted to achieve a different objective. The Preamble states that the "regulations are motivated in part by the enhanced incentives for related parties to engage in transactions that result in excess indebtedness" in both the cross-border context and between domestic parties.[14] This motivation is inconsistent with Congressional intent in enacting section 385, as evidenced by the legislative history and the statutory language. There is no evidence that Congress contemplated section 385 as a tool for Treasury to restrict the ability of taxpayers to engage in transactions that, in Treasury's view, inappropriately reduce the federal income tax base.

This conclusion is bolstered by the fact that other provisions in the Code address the objectives of Prop. Treas. Reg. section 1.385-3. For instance, section 163(j), enacted in 1989, already addresses the earnings-stripping concerns reflected in this proposed regulation through a detailed statutory scheme. If Treasury were actually empowered under section 385 to promulgate the proposed regulation, it is unclear why Congress would have gone to the trouble to craft such an extensive framework in section 163(j). Likewise, other provisions in the Code already address how to treat many of the transactions described in the proposed regulation,[15] and

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[13] *Id.* at 138-39.

[14] That objective is particularly highlighted through the inclusion of a provision that, notwithstanding the bright-line nature of the rules, prevents a taxpayer from asserting those rules if, with a principal purpose of reducing its (or an EG Member's (defined below)) federal tax liability, such taxpayer entered into a transaction in which such bright-line rules result in the treatment of the instrument as equity. *See* Prop. Treas. Reg. § 1.385-3(e).

[15] *See, e.g.*, I.R.C. §§ 301(c), 304, 332, 337, 351, 354, 368(a)(1)(D).

nothing in section 385 suggests Congress intended to give Treasury the authority to issue categorical rules overriding these legislative choices.[16]

Accordingly, if finalized in their current form, we are concerned that Prop. Treas. Reg. section 1.385-3 does not constitute a valid exercise of Treasury's authority under section 385.[17] First, by not setting forth a series of factors or otherwise providing guidelines on the application of such factors to determine whether an instrument is debt or equity and, instead, creating per se characterization rules for certain related-party instruments, the regulations fail to fit within the parameters set forth by Congress in its section 385 grant of authority.[18]

Second, these per se rules are arguably not a reasonable means of determining whether an instrument is debt or equity. As explained by the Supreme Court in *Chevron*, even when given broad latitude by the statute to fill a gap in the relevant rules, including when there is an express grant of rulemaking authority, the legislative regulation must be a reasonable means of achieving the objectives committed to the agency's care by the statute.[19] Whether a rule set forth in a regulation is reasonable is determined in light of the general purposes of the relevant statute and the policy objectives entrusted to the care of the agency by Congress.[20] We are concerned that

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[16] In light of the broad reach of these regulations and their consequences, in our view it would be more appropriate to enact such consequential rules by the representative process in Congress. Such a sea change in current law should not be brought about by regulatory action, particularly when Congress never contemplated such a result. Instead, the appropriate balancing of the various considerations at play in enacting such an impactful set of rules is best achieved via the law-making process constitutionally entrusted to Congress.

[17] The Supreme Court has addressed the question of the level of deference to be given to regulations putatively issued under a specific broad grant of authority by Congress (i.e., "legislative regulations"). Such legislative regulations are generally upheld unless "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." *Chevron U.S.A. Inc. v. Nat. Res. Def. Council, Inc.*, 467 U.S. 837, 844 (1984).

[18] *Cf. Woodall v. Fed. Bureau of Prisons*, 432 F.3d 235, 249 (3d Cir. 2005) (concluding a regulation was invalid because it applied categorical rules to classes of prisoners, rather than providing for the consideration of "factors" as required by the statute, stating:

> Of course, *Chevron* and its progeny recognize the wide deference granted to agencies such as the [Federal Bureau of Prisons] in administering their governing statutes, and we are well aware of the expertise of the Bureau of Prisons in matters concerning prison administration and inmate placement. However, we are also mindful that the Bureau cannot depart from the clearly expressed intent of Congress, including its desire that several factors, one of which is the recommendation of a sentencing judge, be considered in placement designations. To accept the [Federal Bureau of Prisons'] argument would be to ignore that intent as embodied in the statute's plain language and legislative history.).

[19] *United States v. Shimer*, 367 U.S. 374, 382-383 (1961), quoted in *Chevron* at 845 ("If this choice represents a reasonable accommodation of conflicting policies that were committed to the agency's care by the statute, we should not disturb it unless it appears from the statute or its legislative history that the accommodation is not one that Congress would have sanctioned.").

[20] *Lopez v. Davis*, 531 U.S. 230, 242 (2001) ("[W]here Congress has enacted a law that does not answer the precise question at issue, all we must decide is whether . . . the agency . . . has filled the statutory gap in a way that is reasonable in light of the legislature's revealed design.") (citation and internal quotation marks omitted); *Zheng v. Gonzales*, 422 F.3d 98, 119 (3d Cir. 2005) ("Under the second step of the *Chevron* test, we must determine whether the regulation harmonizes with the plain language of the statute, its origin, and purpose. So long as the regulation bears a fair relationship to the language of the statute, reflects the views of those who sought its enactment, and matches the purpose they articulated, it will merit deference.") (citation and internal quotation marks omitted).

Prop. Treas. Reg. section 1.385-3 is not reasonably aimed at advancing the purposes that motivated Congress to enact section 385 (i.e., providing guidelines to determine whether an instrument is debt or equity in various contexts). Instead the proposed regulation appears to be aimed at advancing a different objective not contemplated by Congress (i.e., curtailing the reduction of the U.S. taxable income base through the use of related-party debt). As such, we are concerned that Prop. Treas. Reg. section 1.385-3 as currently drafted does not reflect a debt-equity determination methodology "that is reasonable in light of the legislature's revealed design" or that "bears a fair relationship to the language of the statute, reflects the views of those who sought its enactment, and matches the purpose they articulated."[21]

Recommendation 1: We recommend that Prop. Treas. Reg. section 1.385-3 be withdrawn.

B. The No Affirmative Use Rule of Prop. Treas. Reg. Section 1.385-3

We are particularly concerned about the validity of the no affirmative use rule contained in Prop. Treas. Reg. section 1.385-3(e) (the "No Affirmative Use Rule"). Although we understand the rationale behind this rule, we are concerned that it is legally deficient in multiple respects.

To start, as with the other rules included in Prop. Treas. Reg. section 1.385-3, the affirmative use rule lacks a statutory basis. As previously explained, section 385 authorizes Treasury only to issue regulations setting forth factors to determine whether an instrument should be treated as debt or stock, not to create per se rules furthering particular policy objectives. The No Affirmative Use Rule, however, is an example of the latter, as it categorically provides that even if the other proposed rules in Prop. Treas. Reg. section 1.385-3 generally would treat the relevant instrument as stock, those bright-line rules will "not apply" where the taxpayer entered into the transaction "with a principal purpose of reducing the federal tax liability of any member of the expanded group."[22] Aside from being unsustainable when considered in isolation, the No Affirmative Use Rule only underscores the fact that the whole package of regulations set forth in Prop. Treas. Reg. section 1.385-3 are designed to further a particular policy goal rather than capture financial concepts of debt and stock.

In addition, the No Affirmative Use Rule provides taxpayers with little guidance as to what would constitute a transaction "with a principal purpose of reducing the federal tax liability of any member of the expanded group." Under one reading, it appears that when combined with the other proposed rules in Prop. Treas. Reg. section 1.385-3, the No Affirmative Use Rule requires the IRS to adopt the characterization of an instrument that is least favorable to the taxpayer. More generally, the rule's sweeping language could in theory encompass a wide variety of transactions, and the Proposed Regulations furnish not a single example of a scenario that would trigger it. It is unclear, for example, whether the use of a debt instrument to secure a deduction for *foreign* tax purposes coupled with the knowledge of the domestic tax consequences of that choice under the Proposed Regulations would implicate this rule. Absent further

[21] *Lopez* at 242; *Zheng* at 119.

[22] Prop. Treas. Reg. § 1.385-3(e).

clarification, this proposed rule could end up the target of challenges under both the Administrative Procedure Act and the Due Process Clause due to its standardless nature.[23]

> Recommendation 2: In the event that the Government does not withdraw Prop. Treas. Reg. section 1.385-3 in its entirety, we recommend that the No Affirmative Use Rule of Prop. Treas. Reg. section 1.385-3(e) be withdrawn. In the alternative, we recommend that the Government clarify the limits of the No Affirmative Use Rule.

C. Prop. Treas. Reg. Section 1.385-1[24]

We also are concerned that Prop. Treas. Reg. section 1.385–1(d), as currently written, suffers from a number of legal deficiencies. To start, we are concerned that Treasury lacks authority under section 385 to issue the regulation as drafted. As previously discussed, section 385(b) authorizes Treasury only to "set forth factors which are to be taken into account" in determining whether a particular instrument should be treated as debt, stock, or a combination of the two. Rather than take this approach, the proposed regulation simply gives the IRS open-ended authority to determine whether an expanded group instrument ("EGI") should be treated as part debt and part stock on a case-by-case basis. The only relevant restriction is that the IRS must make "an analysis . . . of the relevant facts and circumstances . . . under general federal tax principles."[25] Accordingly, this regulation makes no attempt to enumerate factors, but simply grants Treasury nearly unbounded discretion to classify certain instruments as part debt and part stock on an individual basis.

The standardless nature of this regulation also could open the door to a constitutional challenge on vagueness grounds. Due process demands that federal laws—including administrative regulations—that "regulate persons or entities must give fair notice of conduct that is forbidden or required."[26] If a regulation "'fails to provide a person of ordinary intelligence fair notice of what is prohibited, or is so standardless that it authorizes or encourages seriously discriminatory enforcement,'" it cannot stand.[27] This proposed regulation may well be just such a law. It is difficult to see how entities planning to use an EGI could possibly predict in advance whether doing so will increase their tax liability if all this regulation tells them is that the IRS will make "an analysis . . . of the relevant facts and circumstances . . . under general federal tax principles." Nor is it easy to see how the IRS could guarantee that such a standardless test would not risk arbitrary enforcement. Without further elaboration, we are concerned that this provision could be invalidated as impermissibly vague. And even if this regulation survived a constitutional challenge, its indeterminacy might doom it under the

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[23] See Section III.C below.

[24] See Section V for technical comments regarding Prop. Treas. Reg. section 1.385-1.

[25] Prop. Treas. Reg. § 1.385–1(d)(1).

[26] *FCC v. Fox Television Stations, Inc.*, 132 S. Ct. 2307, 2317 (2012).

[27] *Id.*

Administrative Procedure Act, which was enacted precisely "to avoid the inherently arbitrary nature of unpublished ad hoc determinations" by federal agencies.[28]

> Recommendation 3: We recommend that the Government revise Prop. Treas. Reg. section 1.385-1(d) to incorporate specific enumerated standards for determining when to bifurcate a purported debt instrument and how to determine what portion of such instrument's principal amount should be recharacterized as stock. Certain specific recommendations in this regard are described later in this Comment Letter.

In addition, we are worried that Prop. Treas. Reg. section 1.385-1(d) could be construed to give the IRS practically unreviewable discretion in this area. One could read this regulation to mean that once "the Commissioner determines that the EGI should be treated as indebtedness in part and stock in part," that determination will be beyond challenge in any court proceeding.[29] The proposed regulation neither imposes meaningful limits on such determinations, nor does it explain how a taxpayer could even begin to contest their validity. But courts apply "a 'strong presumption' favoring judicial review of administrative action" that is overcome only when "a statute's language or structure demonstrates that Congress wanted an agency to police its own conduct,"[30] and section 385 furnishes no indication that Congress wanted the IRS to regulate itself here. Unlike other provisions of the Code empowering the IRS to exercise unreviewable discretion in making a specific determination,[31] section 385 authorizes Treasury only "to prescribe such regulations" that "set forth factors which are to be taken into account." That is no warrant for issuing case-by-case determinations that no taxpayer will ever be able to contest in court in a meaningful manner.

> Recommendation 4: We recommend that the Government clarify that any determination issued under Prop. Treas. Reg. section 1.385–1(d) may be challenged in court and specify the limits of the courts' discretion.

D. Prop. Treas. Reg. Section 1.385-2[32]

We also are concerned that Treasury lacks the authority to issue the contemporaneous documentation requirements set forth in Prop. Treas. Reg. section 1.385-2 (the "Documentation Requirements"). To be sure, section 385 empowers Treasury to issue regulations that "shall set forth factors," and one "of the factors so set forth in the regulations may include" whether there

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[28] *Morton v. Ruiz*, 415 U.S. 199, 232 (1974); *see also FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 522 (2009) (suggesting that "a standardless regime of unbridled discretion" would violate the Administrative Procedure Act).

[29] Prop. Treas. Reg. § 1.385–1(d)(1). In our view, a reference to "general federal tax principles" is not instructive as we know of no federal income tax guidance (judicial or administrative) that undergoes an analysis of what factors to consider when attempting to bifurcate a traditional debt instrument as part stock and part debt.

[30] *Mach Mining, LLC v. EEOC*, 135 S. Ct. 1645, 1651 (2015) (citation omitted).

[31] *See, e.g.*, I.R.C. § 7805(b)(8) ("The Secretary may prescribe the extent, if any, to which any ruling (including any judicial decision or any administrative determination other than by regulation) relating to the internal revenue laws shall be applied without retroactive effect."); I.R.C. § 7805(e) ("Except to the extent otherwise provided by this title, any election under this title shall be made at such time and in such manner as the Secretary may prescribe.").

[32] See Section VI for technical comments regarding Prop. Treas. Reg. section 1.385-2.

is "written" documentation.[33] But as previously explained, section 385 does not authorize Treasury to issue categorical rules, but instead demands a factor-based approach. This proposed regulation, however, imposes a per se rule that any time the Documentation Requirements are not satisfied, an EGI is automatically "treated for federal tax purposes as stock."[34] But there is no basis in section 385 for treating a particular EGI as stock *solely* because a taxpayer failed to comply with the proposed Documentation Requirements.[35] There is a significant difference between including the existence of written documentation as a factor in a regulation and ordering parties to satisfy a burdensome administrative scheme in order to get an EGI treated as debt.

This legal deficiency is confirmed by the fact that, as the Preamble itself concedes, the proposed Documentation Requirements would exceed what is required under current case law. As the Preamble acknowledges, courts have held that the absence of written documentation does not automatically convert a purported related-party debt instrument into equity. For instance, in *C.M. Gooch Lumber Sales Co. v. Comm'r*,[36] the Tax Court stated in a court-reviewed opinion that "[t]he absence of a written debt instrument, security, or provision for payment of interest is not controlling; formal evidences of indebtedness are at best clues to proof of the ultimate fact."[37] Similarly, in *Byerlite Corp. v. Williams*,[38] the Sixth Circuit stated:

> The fact that advancements to a corporation are made without requiring any evidence of indebtedness or fixing any date for repayment; without requiring the payment of any interest; and with the realization that the tangible assets of the corporation were not such, at any given time during the taxable period, as to repay any part of the loan—was not a controlling consideration requiring a conclusion that the advances were not loans, and that a deduction from ordinary income for a bad debt was not properly allowable, when the advances became uncollectible.[39]

And in *Am. Processing and Sales Co. v. United States*,[40] the Claims Court expanded on *Byerlite*, noting that the absence of written documentation of related-party debt was "unexceptionable," and explaining:

> [T]he open account form of the dealings between plaintiff and [its indirect subsidiary], as contrasted with standard secured interest-bearing notes which many an arms-length lender will exact from an unrelated borrower, is of little

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[33] I.R.C. § 385(b)(1).

[34] Prop. Treas. Reg. § 1.385-2(b)(1).

[35] We acknowledge that the Government has provided a reasonable cause exception to the Documentation Requirements, but that reasonable cause exception does not change the fact that the Prop. Treas. Reg. section 1.385-2 purports to recharacterize debt as stock solely based on the production of written documentation rather than multiple factors.

[36] 49 T.C. 649 (1968).

[37] *Id.* at 656.

[38] 286 F.2d 285 (6th Cir. 1960).

[39] *Id.* at 290–91.

[40] 371 F.2d 842 (Ct. Cl. 1967).

> influence in identifying the transaction irrevocably as a capital contribution rather than a loan. Formal debt paraphernalia of this type in a closeknit family of corporate cousins are not as necessary to insure repayment as may be the case between unrelated entities, nor do they alone dictate a bona fide intention to create a debt without the accompaniment of other factors.[41]

The Claims Court further warned that classifying related-party debt as equity solely based on the absence of documentation would be misguided:

> The logical consequence of the Government's contention would be to impress on [the debtor] an all-capital rather than a mostly debt structure, a more absurd result than reason permits be entertained. Another consequence would be to shrink to almost nothing the circumstances under which companies in the relative positions of the two in question could safely occupy a debtor-creditor relationship without danger of accusation by the taxing authorities that surface indicia of debt are contrived decoys to mask another aim.[42]

In each of those cases, the courts recognized that written documentation of the debtor-creditor relationship was an important factor—as evidenced by their careful consideration of the issue—but was not intended to be a dispositive one. Yet in direct conflict with both this precedent and section 385 itself, the proposed Documentation Requirements improperly elevate the importance of written documentation to a conclusive consideration and create unnecessary traps for taxpayers. We therefore believe the Government should withdraw the Documentation Requirements or, consistent with both the relevant statute and the case law, clarify that written documentation is a significant, but not dispositive, factor in analyzing purported debt between related parties.

> Recommendation 5: We recommend that the Government clarify that written documentation is a significant, but not dispositive, factor in analyzing purported debt between highly-related parties and that failing to satisfy the Documentation Requirements, alone, does not result in a per se classification of a corporate instrument as stock.

E. Classification of Partnership Equity

We are also concerned that the Government does not have the authority to extend the application of section 385 to partnership equity. Section 385(a) states that "[t]he Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether *an interest in a corporation* is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness)."[43] It is not clear that any regulations issued under this authority may apply to partnerships. In fact, the Preamble states as the purpose of the Proposed Regulations that "[t]hese proposed regulations under section 385 address whether an interest in a

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[41] *Id.* at 857.

[42] *Id.* at 856.

[43] Preamble at 20912 (emphasis added).

related *corporation* is treated as *stock* or indebtedness, or as in part stock or in part indebtedness, for purposes of the Code."[44] Further, in the legislative history underlying the enactment of section 385, the Senate report states, "[a]lthough the problem of distinguishing debt from equity is a long-standing one in the tax laws, it has become even more significant in recent years because of the increased level of corporate merger activities and *the increasing use of debt for corporate acquisition purposes*."[45] The Senate report goes on to state:

> In view of the increasing use of debt for corporate acquisition purposes and the fact that the substitution of debt for equity is most easily accomplished in this situation, the committee also agrees with the House that it is appropriate to take action in this bill to provide rules for resolving, *in a limited context,* the ambiguities and uncertainties which have long existed in our tax law in distinguishing between a debt interest and an equity interest in a *corporation*. In view of the uncertainties and difficulties which the distinction between debt and equity has produced in numerous situations other than those involving corporate acquisitions, the committee further believes that it would be desirable to provide rules for distinguishing debt from equity in the variety of contexts in which this problem can arise. The differing circumstances which characterize these situations, however, would make it difficult for the committee to provide comprehensive and specific statutory rules of universal and equal applicability. In view of this, the committee believes it is appropriate to specifically authorize the Secretary of the Treasury to prescribe the appropriate rules for distinguishing debt from equity in these different situations . . . . For the above reasons, the committee has added a provision to the House bill which gives the Secretary of the Treasury or his delegate specific statutory authority to promulgate regulatory guidelines, to the extent necessary or appropriate, for determining whether a *corporate* obligation constitutes stock or indebtedness. The provision specifies that these guidelines are to set forth factors to be taken into account in determining, with respect to a particular factual situation, whether a debtor-creditor relationship exists or whether a *corporation-shareholder* relationship exists.[46]

It is clear that Congress's primary concern in enacting section 385 was leveraged corporate acquisitions; partnerships are not mentioned as a source of concern.

Nonetheless, as currently drafted, the Proposed Regulations provide in both Prop. Treas. Reg. sections 1.385-2(c)(6) and 1.385-3(d)(5) for the recharacterization of certain debt instruments issued by partnerships.[47] Similar to its silence regarding partnerships, the legislative history does not express concern about the use of equity interests as a policy reason underlying the enactment of section 385. Thus, an expansion of the Proposed Regulations to partnership

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[44] Preamble at 20914 (emphasis added).

[45] S. Rep. No. 91-552, at 137 (1969) (emphasis added).

[46] *Id.* at 138 (emphasis added).

[47] As noted below, Prop. Treas. Reg. section 1.385-1(d) authorizing the Commissioner to recharacterize debt in whole or in part is, by its terms, limited to a recharacterization of debt into *stock*.

equity interests would represent a broadening of scope beyond the apparent authority granted by the Code.

> Recommendation 6: We recommend that the Final Regulations be limited to determining whether a debt instrument issued by a corporation is recharacterized as stock and not provide for the recharacterization of a debt instrument issued by a partnership as an equity interest in the issuing partnership.

Moreover, where a partnership that issues a debt instrument is not owned, directly or indirectly, by corporations that are members of its EG (defined below), it appears that there is even less authority for the Government to promulgate regulations providing for debt instruments to be recharacterized as equity in the partnership.

> Recommendation 7: If the Government takes the position that it has the authority to provide for the recharacterization of a debt instrument issued by a partnership as equity in the issuing partnership, it should only apply this rule to recharacterize a debt instrument issued by a partnership to the extent that a corporation that is a member of the partnership's EG is a partner in the issuing partnership.

IV. Limiting Application to Section 163

The Proposed Regulations were issued under section 385, and where applicable, recharacterize debt as equity for all purposes of the Code. Applying section 385 to recharacterize related-party debt as equity for all purposes of the Code results in meaningful complexities, distortions and potentially unintended consequences. The effects are dramatic, and many of them are cataloged in this Comment Letter. However, the full impact of the proposed recharacterization approach is not likely to be known until years after the regulations are finalized. We believe that many of the resulting consequences are unnecessary to achieve the goals of the Proposed Regulations.[48] Rather, the goals could be achieved in a more targeted manner by applying the proposed recharacterization approach solely for purposes of section 163.

Section 385(a) authorizes Treasury "to prescribe such regulations as may be *necessary or appropriate* to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness)."[49] The "necessary or

[48] The Preamble to the Proposed Regulations states, "[w]hile these proposed regulations are motivated in part by the enhanced incentives for related parties to engage in transactions that result in excessive indebtedness in the cross-border context, federal income tax liability can also be reduced or eliminated with excessive indebtedness between domestic related parties." Preamble at 20914. In discussing the purpose of the transactions-based rules, the Preamble states, "[f]or example, inverted groups and other foreign-parented groups use these types of transactions to create interest deductions that reduce U.S. source income without investing any new capital in the U.S. operations. In addition, U.S. parented groups obtain distortive results by, for example, using these types of transactions to create interest deductions that reduce the earnings and profits of controlled foreign corporations (CFCs) . . ." Preamble at 20917. *See also* Notice 2014-52 ("[T]he Treasury Department and the IRS are considering guidance to address strategies that avoid U.S. tax on U.S. operations by shifting or 'stripping' U.S.-source earnings to lower-tax jurisdictions, including through intercompany debt.").

[49] (Emphasis added). The parenthetical language "(or as in part stock and in part indebtedness)" was added to section 385 pursuant to the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239.

appropriate" limitation affords sufficient flexibility to limit the scope of the application of the recharacterization. Moreover, because the statute's grant of authority is generally for purposes of "this title," regulations drafted thereunder arguably could be drafted so as to be applicable to only a subset of the Code (e.g., section 163).

To that end, section 163 allows as a deduction all interest paid or accrued within the taxable year on *indebtedness*. Thus, assuming *arguendo* that the Proposed Regulations are a valid exercise of authority under section 385 to determine whether an interest in a corporation is treated as stock or indebtedness, the implementation of that exercise of authority could be circumscribed to define indebtedness solely "for purposes of section 163." Insofar as section 163 is a subset of the Code, limiting the application of characterization-related regulations promulgated under section 385 to section 163 may be consistent with the necessary or appropriate limitation discussed above. Moreover, limiting the application of the regulations in this manner would significantly improve administrability of the rules, reduce complexities and burdens, and limit unforeseen, unintended consequences. This approach would, for example, provide relief to cash pools, which are discussed later in this Comment Letter. We believe that any concerns over authority possibly could be resolved by providing an election to limit the application of the Proposed Regulations to deductibility under section 163.

To the extent an interest deduction is disallowed, a question arises as to whether it is appropriate for the recipient to be taxable on the receipt of the income. If an instrument were recharacterized as equity for all purposes, in some circumstances a dividends received deduction might be allowed or potentially the payment might carry foreign tax credits.[50] Electivity could be helpful in this regard such that if a taxpayer would be entitled to a dividends received deduction or foreign tax credit, the taxpayer could elect between the application of the Proposed Regulations for all purposes of the Code or solely for purposes of section 163.[51] In either case, we would think the earnings and profits ("E&P") of the payor would be reduced and the E&P of the recipient increased by the payment.

> Recommendation 8: We recommend that application of the recharacterization of a debt instrument as stock under the Proposed Regulations be limited such that any such recharacterizations apply solely for purposes of section 163 or, alternatively, that taxpayers be afforded an election to limit the application in this manner.

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[50] *See* I.R.C. §§ 243, 245, and 902.

[51] There is an interaction with this approach and the general question of whether the recharacterized interest payment is eligible for the dividends received deduction because of the creditor rights and potential application of section 246(c)(4). See discussion at Section X.E below. Similarly, there is an interaction with the potential eligibility for foreign tax credits. See discussion at Section X.C.2(a) below. To the extent an election is allowed, it should be coupled with Recommendation 118, where we recommend that creditor rights associated with the recharacterized instrument should not be taken into account for purposes of applying section 246(c)(4) and Recommendation 114, where we recommend section 902 credits be allowed in a wider range of situations.

V. Comments Regarding Prop. Treas. Reg. Section 1.385-1

A. Overview

Prop. Treas. Reg. section 1.385-1 provides general definitions and operating rules. As described below, this section defines the key terms that set forth the scope of the Proposed Regulations, including the terms "expanded group," "controlled partnership," and "modified expanded group." This section also provides a Bifurcation Rule (defined below) pursuant to which the Commissioner may recharacterize a debt instrument as part-stock and part-indebtedness. Additionally, this section provides rules for the treatment of the deemed exchange of a debt instrument for stock that may occur by operation of the Proposed Regulations, and a rule providing that all members of a consolidated group are treated as one corporation for purposes of the Proposed Regulations.

B. Definition of Expanded Group

1. Summary

Prop. Treas. Reg. section 1.385-1(b)(3) defines the term "expanded group," which is critical in delineating the scope of the Proposed Regulations because only debt instruments between expanded group members ("EG Members") are subject to the rules of Prop. Treas. Reg. sections 1.385-2, -3, and -4.[52] Pursuant to Prop. Treas. Reg. section 1.385-1(b)(3)(i), an expanded group ("EG") is generally defined as an "affiliated group" within the meaning of section 1504(a), but determined: (i) without regard to section 1504(b)(1) through (8); (ii) by permitting direct or "indirect" ownership for the purposes of section 1504(a)(1)(B)(i); and (iii) by using a vote *or* value test instead of vote *and* value under section 1504(a)(2)(A). Prop. Treas. Reg. section 1.385-1(b)(3)(ii) provides that "indirect" stock ownership is determined by applying the rules of section 304(c)(3), which in turn applies section 318(a) with five percent substituted for 50 percent in sections 318(a)(2)(C) and (a)(3)(C).[53]

Under section 1504(a), as modified by Prop. Treas. Reg. section 1.385-1(b)(3), an EG is defined as one or more chains of includible corporations connected through stock ownership with a common parent that is an includible parent, but only if (i) the common parent owns directly or indirectly 80 percent of the vote or value of at least one other includible corporation (the "Section 1504(a)(1)(B)(i) Requirement"), and (ii) 80 percent of the vote or value of each includible corporation other than the common parent is owned directly by one or more of the other includible corporations (the "Section 1504(a)(1)(B)(ii) Requirement"). As modified by Prop. Treas. Reg. section 1.385-1(b)(3)(i)(A), an includible corporation is any corporation (including tax-exempt corporations, foreign corporations, real estate investment trusts ("REITs"), and regulated investment companies ("RICs")) because the limitations of sections 1504(b)(1) through (8) do not apply.

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[52] Prop. Treas. Reg. section 1.385-2(c)(6) further provides that for purposes of Prop. Treas. Reg. section 1.385-2, an EG includes Controlled Partnerships (defined below).

[53] Section 304(c)(3)(B)(i)(II) further provides that where section 318(a)(3)(C) downstream attribution would apply but for the failure to satisfy the five percent threshold, the corporation will still be treated as owning its proportionate share of the stock owned by its less-than-five-percent shareholder.

The Preamble explains that an EG was defined as described above to limit the Proposed Regulations "to transactions between highly-related parties."[54]

2. Lack of "Indirect" Language for Section 1504(a)(1)(B)(ii)

As described above, the definition of an EG permits the common parent to own, directly or indirectly, stock of at least one other includible corporation under a modified version of section 1504(a)(1)(B)(i). This permits the Section 1504(a)(1)(B)(i) Requirement to be satisfied through indirect ownership. Consider the following example:

> Example 1: *Indirect ownership of subsidiaries.* Corporation P owns 79 percent of the stock of corporation S1 (assume an unrelated individual owns the other 21 percent of the S1 stock) and 79 percent of the stock of corporation S2, with S1 owning the remaining 21 percent of the S2 stock. P does not own 80 percent of the S2 stock directly, but when P is attributed 79 percent of S1's 21 percent interest in S2 pursuant to section 318(a)(2)(C), P owns 95.6 percent of S2 indirectly. As a result, P and S2 are members of an EG by reason of indirect ownership.[55]

Unlike the Section 1504(a)(1)(B)(i) Requirement, Prop. Treas. Reg. section 1.385-1(b)(3) does not modify the Section 1504(a)(1)(B)(ii) Requirement so that it can be satisfied through indirect ownership. Therefore, in Example 1 above, if P owns 100 percent of S1, which owns 79 percent of S2 and S3 (assume the other 21 percent of S2 is owned by an individual), and S2 owns the remaining 21 percent of S3, then S3 is not a member of the EG that includes P and S1. Alternatively, if P directly owns 100 percent of each of S1 and S3, then S1 and P comprise one EG while S3 and P comprise another, but S1 and S3 are not members of the same EG. Finally, if individual A directly owns 100 percent of each of S1 and S3, then neither of the entities is in an EG. In any of these structures, intercompany debts between S1 and S3 are not subject to the rules of Prop. Treas. Reg. sections 1.385-2, -3 or -4.

It is not clear if the foregoing results were intended. Although restraint in defining the scope of the EG is laudable, there also appears to be no policy rationale for the distinctions created by failing to allow indirect ownership to satisfy the Section 1504(a)(1)(B)(ii) Requirement. For example, as described above, a corporation wholly owned by an individual would be treated as being in an EG with its wholly-owned subsidiary, but brother-sister corporations wholly owned by the same individual would not be in an EG.

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[54] Preamble at 20919.

[55] Except as otherwise stated, the following facts are assumed (where relevant) for purposes of the examples in this Comment Letter: (i) no two entities are members of the same consolidated group; (ii) each EG has more than $50 million of debt instruments described in Prop. Treas. Reg. section 1.385-3(c)(2) at all times; (iii) no issuer of a debt instrument has Current E&P (defined below); (iv) the Subsidiary Stock Issuance Exception (defined below) does not apply; (v) no notes are eligible for the Ordinary Course Exception (defined below); (vi) each entity has as its taxable year the calendar year; (vii) no domestic corporation is a United States real property holding company within the meaning of section 897(c)(2); (viii) each note is issued with adequate stated interest; and (ix) all steps take place after the date that the Final Regulations are effective.

Recommendation 9: We recommend that for purposes of defining an EG, section 1504(a)(1)(B)(ii) be modified by substituting "directly or indirectly" for "directly."

C. Definition of Modified Expanded Group

1. Summary

Unlike the rules of Prop. Treas. Reg. sections 1.385-2, -3 and -4, the Bifurcation Rule (defined below) applies to debt instruments between members of a "modified expanded group." A modified expanded group ("MEG") is defined in Prop. Treas. Reg. section 1.385-1(b)(5) as an EG, but is determined by substituting 50 percent for 80 percent in section 1504(a)(2). Moreover, if a person (as defined in section 7701(a)) is treated, under the rules of section 318, as owning at least 50 percent of the value of the stock of a MEG member, the person is treated as a member of the MEG.

The Preamble explains that the scope of the MEG is "consistent with other provisions used in subchapter C of the Code to identify a level of control or ownership that can warrant different federal tax consequences than those of less-related parties."[56] In this regard, the Preamble cites control under section 304, attribution under section 318, relatedness under section 267(b), and other provisions of the Code.[57]

2. Comments and Recommendations

(a) Eliminate MEG

The concept of a MEG exists only for purposes of bifurcation under Prop. Treas. Reg. section 1.385-1(d). Every other aspect of the Proposed Regulations applies only to EGs of highly-related corporations. Limiting the Proposed Regulations to EGs is logical and administrable because courts have noted that concerns of whether an instrument should be treated as debt or equity are particularly acute when the debtor and creditor are in a close relationship. With respect to this policy rationale, there is nothing unique about the power to bifurcate a debt instrument that warrants departing from the EG definition for a lower relatedness threshold. Utilizing the lower threshold of the MEG concept only serves to create confusion and a trap for unwary taxpayers who may believe that only members of an EG are subject to any of the rules contained in the Proposed Regulations. Moreover, limiting the Bifurcation Rule (defined below) to the EG would not deny courts the power to bifurcate instruments outside the scope of the Proposed Regulations, as they can already do and have done in appropriate circumstances.[58]

Recommendation 10: We recommend that the concept of a MEG be removed from the Final Regulations and that the Bifurcation Rule only be applicable to EGs.

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[56] Preamble at 20919.

[57] *See id.*

[58] *See, e.g., Farley Realty Corp. v. Comm'r*, 279 F.ed 701 (2d Cir. 1960).

(b) MEG Membership Limitation

Pursuant to Prop. Treas. Reg. section 1.385-1(b)(5), any "person" under section 7701(a)(1) is treated as a MEG member if it owns at least 50 percent of the value of the stock of a MEG member.[59] Section 7701(a)(1) provides that a "person" includes an individual, trust, estate, partnership, association, company or corporation. Under these rules, an individual or entity other than a corporation or partnership can be treated as a member of a MEG. Thus, for example, if individual A wholly owns all of the stock of corporation P, then A and P are members of the same MEG and debts between them can be bifurcated. However, this rule has unintended consequences when multiple persons other than corporations or partnerships are treated as members of the same MEG.

> Example 2: *Debt instruments issued by an individual.* Individuals A and B each own 50 percent of the stock of corporation P; A, B, and P are members of the same MEG. As a result, a debt instrument issued by A to B could be bifurcated under Prop. Treas. Reg. section 1.385-1(d), which would lead to the absurd result of one individual owning stock in another. The same applies to any other entity treated as a "person" under section 7701(a)(1), including a trust or estate.

Although the Government may have no intent to treat an instrument issued by an individual as stock, the literal text of the Proposed Regulations permits just that. The Bifurcation Rule (defined below) also permits bifurcation in potentially less outlandish, but still apparently unintended circumstances—for example, a debt issued by a trust may be bifurcated in part into "stock" in the trust, perhaps meaning a right of ownership akin to that of a grantor or trustee depending on the type of trust at issue. These rules appear unintended because the Proposed Regulations and the Preamble never address the debt-equity treatment of instruments owed by entities other than corporations or partnerships. Moreover, and as discussed above, the text of section 385(a) only authorizes Treasury to prescribe regulations determining whether an interest in a *corporation* is treated as stock or indebtedness. When considered in this context, it appears that the Proposed Regulations treat all section 7701(a)(1) persons as MEG members with the intention of allowing Prop. Treas. Reg. section 1.385-1(d) to apply to debt instruments issued by corporations or Controlled Partnerships (defined below) *to* persons such as individuals, trusts and estates, and not the converse.

> Recommendation 11: We recommend that Prop. Treas. Reg. section 1.385-1(b)(5) be modified to clarify that section 7701(a)(1) persons other than corporations and partnerships can be treated as MEG members only to the extent

[59] Prop. Treas. Reg. section 1.385-1(b)(5) provides that the person must be "treated" as owning at least 50 percent of a MEG member under "the rules of section 318." When read literally, this regulatory text appears to provide that a person can only be treated as a MEG member if it owns 50 percent of the stock of a MEG member *indirectly* under section 318, but not if it owns such stock directly. Thus, for example, an individual directly owning all of the stock of a corporation would not be "treated . . . under the rules of section 318" as owning the stock of the corporation, because it does not own such stock indirectly through attribution and section 318 has no relevance. For the purposes of this Comment Letter, we have assumed that a person other than a corporation or partnership can be treated as a MEG member if it *directly* owns at least 50 percent of the stock of a MEG member, but further clarification of the regulatory text would be welcome in this regard.

that they hold creditor positions in EG instruments described in Prop. Treas. Reg. section 1.385-1(d)(2).

D. Issues Related to Partnerships

1. Downstream Attribution Through Partnerships

Permitting indirect ownership under section 304(c)(3), even if only for the purposes of the Section 1504(a)(1)(B)(i) Requirement, causes the definition of an EG to apply outside of the "highly-related" context through partnership attribution. Under section 318(a)(3)(A), all of the stock owned by a partner is treated as owned by the partnership, which can cause corporations with minimal relatedness to be treated as members of the same EG.

> Example 3: *Downstream attribution through a partnership.* Partnership PRS is one-percent owned by a corporation P1. P1 wholly owns corporation S1, which wholly owns corporation S2. PRS wholly owns corporation P2, which wholly owns corporation S3. Pursuant to section 318(a)(3)(A), PRS is treated as wholly owning S1. In turn, P2 is treated as wholly owning S1 pursuant to section 318(a)(3)(C), thereby satisfying the Section 1504(a)(1)(B)(i) requirement with respect to P2's ownership of S1. S1's ownership of S2 satisfies the Section 1504(a)(1)(B)(ii) Requirement through direct ownership, so the EG is comprised of P2, S1, S2, and S3. Because of section 318(a)(3)(A), S1 and S2 are members of the same EG as P2 even though they are connected to P2 only through P1's one percent ownership of PRS.

The application of section 318(a)(3)(A) in situations such as Example 3 above is contrary to the policy of Prop. Treas. Reg. sections 1.385-2 and -3, which are aimed at highly-related corporations because of particularly acute concerns raised about whether debt instruments between such corporations should be treated as debt or stock for U.S. federal tax purposes. Debt instruments between S2 and S3 or P2 and S2 in the above fact pattern are not between highly-related corporations and should not generate the same level of debt-equity concern as in a highly-related context, but under the Proposed Regulations such instruments are treated in the same way as an instrument between parent and subsidiary. Moreover, and as more fully described elsewhere in this Comment Letter, such an expansive definition of the EG creates practical problems when applying certain aspects of the Proposed Regulations, including in particular the threshold exception of Prop. Treas. Reg. section 1.385-3(c)(2) (the "Threshold Exception").

For the foregoing reasons, we recommend providing a limitation to the application of section 318(a)(3)(A) downward attribution to partnerships for purposes of determining membership in the EG. Such recommendation would apply to the Section 1504(a)(1)(B)(i) Requirement and, if indirect ownership is adopted for the Section 1504(a)(1)(B)(ii) Requirement as discussed above, such recommendation would apply to the Section 1504(a)(1)(B)(ii) Requirement as well. We recognize that simply eliminating section 318(a)(3)(A) from the attribution rules for purposes of Prop. Treas. Reg. section 1.385-1(b)(3) could lead taxpayers to artificially segregate their EGs through the use of blocker partnerships.

Recommendation 12: We recommend that section 318(a)(3)(A) attribution apply only from partners that are highly related to their partnerships, such as a partner that owns at least 80 percent of the interests in a partnership.

2. Clarify Reference to Section 304(c)(3)

The Proposed Regulations provide that indirect ownership of a partnership interest is determined by applying the "principles" of Prop. Treas. Reg. section 1.385-1(b)(3)(ii), which, in turn, applies the indirect stock ownership rules of section 304(c)(3). Section 304(c)(3)(A) states that section 318(a) applies for purposes of determining control. Section 304(c)(3)(B), however, goes on to modify section 318(a). We recommend that the Final Regulations clarify the manner in which the "principles" of the Proposed Regulations are to apply and, in particular, whether section 304(c)(3)(B) applies for purposes of determining indirect ownership of a partnership interest. As described below, we believe section 304(c)(3)(B) should apply to modify the ownership requirements in sections 318(a)(2)(C) and (3)(C), but should not be extended to other sections of 318(a), including in particular section 318(a)(2)(A). However, and as described above, we also recommend that an 80-percent relatedness threshold be introduced for section 318(a)(3)(A) attribution regardless of the application of section 304(c)(3) principles in the partnership context.

Sections 318(a)(2)(C) and (3)(C) contain rules for attributing to and from corporations, both of which require a threshold amount of ownership ("Threshold Amount"). Specifically, section 318(a)(2)(C) provides:

> If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation.

Section 318(a)(3)(C) states:

> If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person.

Section 304(c)(3)(B) modifies the 50 percent rule provided for in sections 318(a)(2)(C) and (3)(C) by substituting "5 percent" for "50 percent." Section 318(a), however, contains rules for attributing to and from partnerships, which contain no threshold ownership requirement. Thus, the better interpretation would be that a five percent threshold would not apply to partnership attribution as a result of the application of section 304(c)(3) principles. We believe the intention of the Government was to apply a five percent rule to sections 318(a)(2)(C) and (3)(C), but not to extend that minimum threshold ownership requirement to attributions to and from partnerships.

Recommendation 13: We recommend that the Final Regulations clarify that section 304(c)(3)(B) only applies to modify the ownership requirements in sections 318(a)(2)(C) and (3)(C), and does not extend to other provisions of section 318(a), such as section 318(a)(2)(A). We also recommend that an 80-percent relatedness

threshold be introduced for section 318(a)(3)(A) attribution regardless of the application of section 304(c)(3) principles in the partnership attribution context.

3. Guidance on Proportionality

We also recommend the Final Regulations provide guidance on how "proportionately" should be determined for purposes of sections 318(a)(2)(A) and (3)(A). As noted above, section 318 attribution in the corporate context is determined based on the "value" of stock owned. In a partnership context, the determination of the "value" of a partner's interest is not always a straightforward analysis. Preferred interests, profits interests, and interests with targeted or special allocations all represent partnership interests for which the "value" may differ from the percentage of the partnership represented by those interests.

> Recommendation 14: We recommend that the Final Regulations provide a safe harbor for purposes of determining "proportionately." We believe that an appropriate safe harbor for "value" for these purposes is the liquidation value of a partner's interest.[60]

4. Investment Partnership Blocker Corporations

The Preamble requests comments on "whether certain indebtedness commonly used by investment partnerships, including indebtedness issued by certain 'blocker' entities, implicate similar policy concerns as those motivating the Proposed Regulations, such that the scope of the Proposed Regulations should be broadened."[61]

Although we acknowledge the conceptual concern, we strongly believe that the Proposed Regulations should not apply to investment fund blocker partnerships.

> Recommendation 15: We recommend that the Final Regulations retain the current aggregate treatment of investment partnerships and not test the 80 percent and 50 percent thresholds for EG or MEG status by looking at the investment partnership's percentage ownership in a leveraged corporate blocker.

The mechanics and scope of the Proposed Regulations generally address perceived abuses in EGs of *highly-related corporations*. In an investment fund structure, to the extent the ultimate investor may be a corporation, such corporation would have a very small ownership percentage in the fund (likely five percent or less). Thus, to include fund blockers within an EG based on the partnership's control alone would mean that a mere five percent or smaller corporate investor would be treated as part of an EG. Moreover, the only mechanical way to expand the Proposed Regulations to reach such a result would be to treat the fund partnership as an "entity" for the limited purpose of finding control, and then an "aggregate" to ultimately get

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[60] The constructive liquidation of a partnership interest is a common way to measure a partner's rights or ownership in a partnership, including the fair market value of a partnership interest issued to a creditor in satisfaction of debt under Treas. Reg. section 1.108-8(b), the amount of the basis adjustment under section 743(b), and the presence of a capital interest under Rev. Proc. 93-27. Treas. Reg. § 1.108-8(b); I.R.C. § 743(b); Rev. Proc. 93-27, 1993-2 C.B. 343.

[61] Preamble at 20929.

to the corporate investor. Such "heads I win, tails you lose" treatment of partnerships solely to bring them into the scope of the Proposed Regulations would both be fundamentally unfair and of questionable authority.

We further believe that there is strong comparable precedent for looking through partnerships in determining whether threshold control exists under the portfolio interest exemption ("PIE").[62] The PIE rules are particularly comparable because they relate to the tax treatment of interest. Specifically the PIE rules limit their favorable treatment of lender interest income to less than 10 percent shareholders. Thus, like the Proposed Regulations, the application of the PIE rules is based on determining a lender's proportionate equity ownership of an issuer. The preamble to the 2006 proposed PIE regulations noted that although there was not statutory guidance on how to test control when the direct lender is a partnership, the Government felt that it was more appropriate in the PIE context to treat partnerships as an aggregate to give proper effect to the exemption and not penalize an investor merely by investing indirectly as opposed to directly.[63] We feel that a similar test of control should be made by looking through partnerships, consistent with the aggregate treatment of partnerships in the Proposed Regulations generally.

Finally, we believe that creating an entity treatment for partnerships would have far-reaching unintended detrimental consequences to an industry that is completely removed from the inversion context that the Proposed Regulations are intended in part to police. To create per se presumptions and recasts in the investment fund context would significantly impede legitimate and sought after foreign investment in real U.S. businesses. Investment funds are third-party economic investment vehicles and not the types of related-party restructurings intended to be targeted by the rules. Further, a fund owes duties to all investors individually and each investor exercises its control rights independently, and thus a fund blocker structure is far removed from an EG and should not be considered to be one.

E. Deemed Exchanges

Prop. Treas. Reg. section 1.385-1(c) addresses the tax consequences of the deemed exchange that occurs when a debt instrument is recharacterized as stock under the Proposed Regulations. The Proposed Regulations appropriately aim to minimize the tax consequences of the deemed exchange to the holder and the issuer. In particular, the holder is treated as having realized an amount equal to its adjusted basis in the debt deemed exchanged, and as having basis in the stock deemed received equal to the holder's adjusted basis in the debt deemed exchanged. The issuer is treated as retiring the debt for an amount equal to its adjusted issue price. The holder and issuer must, however, recognize foreign exchange gain or loss under section 988.[64]

Prop. Treas. Reg. section 1.385-1(c) also provides that neither the holder nor the issuer "accounts for any accrued but unpaid qualified stated interest ("QSI") (if any) as of the deemed

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[62] Treas. Reg. § 1.871-14(g)(3)(i).

[63] REG -118775 -06, 71 Fed. Reg. 34047 (June 13, 2006).

[64] Similar to the discussion above, the Proposed Regulations do not discuss the consequences when partnership debt is recharacterized as partnership equity. Without specific guidance, taxpayers would have to apply the potentially unfavorable rules under Treas. Reg. section 1.108-8.

exchange" or for foreign exchange gain or loss with respect to such accrued but unpaid QSI. It is not clear what is intended by the requirement that the parties not "account for" accrued but unpaid QSI.

> Recommendation 16: We request clarification that, under Prop. Treas. Reg. section 1.385-1(c), deductions for QSI that accrue while the instrument is indebtedness continue to be available unless otherwise limited by a provision of the Code or Treasury regulations outside of section 385.

Assuming that such deductions for accrued but unpaid QSI continue to be available, we understand the effect of the provision to be that payment of such accrued but unpaid QSI would not give rise to additional tax consequences. However, we request clarification with respect to the rule that neither the holder nor the issuer accounts for foreign exchange gain or loss with respect to such accrued but unpaid QSI. If the issuer is permitted a deduction for QSI that has accrued but has not been paid prior to the deemed exchange, and then subsequently makes a payment, it is unclear why foreign exchange gain or loss should not be taken into account at the time of payment.

> Recommendation 17: We request clarification regarding the treatment of foreign exchange gain or loss with respect to accrued but unpaid QSI.

Further, the Proposed Regulations do not provide parallel rules for the deemed exchange that occurs when an interest treated as stock under the Proposed Regulations is subsequently recast as debt (for example, if the holder and issuer cease to be members of the same EG or if the instrument becomes a consolidated group debt instrument subject to Prop. Treas. Reg. section 1.385-4).

Given that the new debt instrument would be deemed issued in exchange for property that is not publicly traded, it would seem appropriate for section 1274 to apply to determine the issue price of such debt. We also request clarification as to the treatment of the deemed exchange as a redemption of the deemed stock subject to section 302. As noted in the technical discussion of Prop Treas. Reg. section 1.385-2, if the deemed exchange is treated as occurring prior to the event that causes the instrument to be treated as debt, the section 302 redemption would often result in a dividend under section 302(d), a result that seems inappropriate.

> Recommendation 18: We request clarification as to the tax treatment of the deemed stock-for-debt exchange when an instrument treated as stock under the Proposed Regulations is subsequently recharacterized as debt.

F. Bifurcation

Under the bifurcation rule (the "Bifurcation Rule") of Prop. Treas. Reg. section 1.385-1(d), the Commissioner may treat an EGI as:

> [I]n part indebtedness and in part stock to the extent that an analysis, as of the issuance of the EGI, of the relevant facts and circumstances concerning the EGI (taking into account any application of Prop. Treas. Reg. section 1.385-2) under

general federal tax principles results in a determination that the EGI is properly treated for federal tax purposes as indebtedness in part and stock in part.[65]

This "Bifurcation Rule" is applicable to an EGI that is an "applicable instrument (as defined in [Prop. Treas. Reg. section] 1.385-2(a)(4)(i)) an issuer of which is one member of a [MEG] and the holder of which is another member of the same [MEG]."[66] An "applicable instrument" means "any interest issued or deemed issued that is in form a debt instrument."[67]

The Proposed Regulations present the Bifurcation Rule as a one-sided enforcement tool that can be applied only by the Commissioner in hindsight. The Preamble states for example that under the Bifurcation Rule, "the Commissioner is not required" to treat an instrument as indebtedness in part and stock in part. In this respect, it appears that the purpose of the Bifurcation Rule is not to set forth an affirmative rule on which taxpayers may rely in determining the substance of an instrument, but rather to provide the IRS with a tool to be used on audit.

Given the nature of the Bifurcation Rule as a one-sided enforcement tool, it has the potential to give rise to unprecedented uncertainty as to the tax treatment of debt instruments. Moreover, given that the Bifurcation Rule applies at the level of the MEG, this uncertainty extends to instruments issued in the context of bona fide joint ventures, including 50/50 joint ventures. Because of the potential for uncertainty inherent in the Bifurcation Rule, it is particularly important that it be drafted and applied in a way that is focused on specific and identifiable policy concerns. The following recommendations would significantly ameliorate such uncertainty.

1. Limit Bifurcation Rule to Disputes over Issuer's Ability to Repay

The policy concern identified in the Preamble as the motivation for the Bifurcation Rule is a concern that the "all-or-nothing" approach to the debt/equity analysis in traditional case law "frequently fails to reflect the economic substance of related-party interests that are in form indebtedness."[68] The Bifurcation Rule departs from this all-or-nothing approach in "the interests of tax administration."[69] Consistent with this focus on the difficulty faced by the IRS in administering the traditional all-or-nothing standard on audit, the Proposed Regulations describe the Bifurcation Rule by reference to a case where only a portion of the principal of an EGI is reasonably expected to be repaid.[70] For example, in a case where the issuer of a $5 million debt instrument cannot be reasonably expected to repay more than $3 million of the principal, the instrument may be treated as a $3 million debt instrument and $2 million stock interest under the Bifurcation Rule. Although traditional case law would suggest that such an instrument should be

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[65] Prop. Treas. Reg. § 1.385-1(d)(1).

[66] Prop. Treas. Reg. § 1.385-1(d)(2).

[67] Prop. Treas. Reg. § 1.385-2(a)(4)(i)(A). See Section VI.A for a discussion of the definition of an "applicable instrument."

[68] Preamble at 20914.

[69] *Id.*

[70] Prop. Treas. Reg. § 1.385(d)(1).

treated as stock in its entirety if it truly can be demonstrated that the issuer can be expected to repay only 60 percent of the principal, it may be that the issuer's ability to repay the debt, or some portion of it, is in dispute. The policy rationale for the Bifurcation Rule is that "the interests of tax administration would be best served" if the IRS could resolve such disputes by treating such an instrument as in part debt and in part equity.

We urge that Final Regulations adopt a workable standard to be considered by the IRS in applying the Bifurcation Rule.

> Recommendation 19: We recommend that the Bifurcation Rule be limited to cases in which the instrument would be a debt instrument under federal tax principles except that there is doubt about the ability of the issuer to repay the full amount of the principal (i.e., cases in which the amount of debt is thought to be too large for the issuer to support it with reasonably projected cash flows).

Furthermore, the assessment of whether there is a reasonable expectation of repayment should be made in accordance with traditional caselaw, consistent with our recommendations to the Documentation Requirements relating to the reasonable expectation of repayment, discussed in Section VI.D.3, below.[71]

Thus the Final Regulations should provide that the Bifurcation Rule will not be applied to treat an instrument as in part debt and in part stock unless there is a certain level of uncertainty as to the issuer's ability to repay the debt based on its terms. Case law addressing the tax treatment of debt instruments with equity-like features should not be wholly abandoned. Under traditional case law, if a debt instrument is accompanied by strong equity-like terms, the debt may be treated as equity for federal tax purposes.[72] In specific contexts, existing law provides for the treatment of specific types of debt instruments as debt notwithstanding the presence of equity-like features such as convertibility, subordination and stapling to equity.[73] Furthermore, existing law applies a rigorous analysis in determining whether and when to integrate two instruments and treat them as a single instrument for U.S. federal tax purposes.[74] We recommend that these principles and authorities should apply in determining when an instrument should be severed into constituent elements, or when two elements should be integrated for U.S. federal tax purposes. If the Bifurcation Rule were applied in a way in which the Commissioner has the discretion on

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[71] Because of the structure of the Proposed Regulations, in general the Bifurcation Rule applies only to debt instruments that meet the Documentation Requirements of Prop. Treas. Reg. section 1.385-2. Accordingly, the IRS will have access to information sufficient to allow it to determine the ability of the borrower to repay the EGI.

[72] *See, e.g., Farley Realty Corp. v. Comm'r*, 279 F.2d 701 (2d Cir. 1960) (debt issued with right to appreciation in issuer's property treated as equity).

[73] *See, e.g.*, I.R.C. § 163(*l*) (generally denying interest deductions with respect to debt instrument in which interest is determined by reference to, or payable in, stock of the issuer; debt instrument is not recharacterized as equity); Rev. Rul. 69-91, 1969-1 C.B. 106 (debentures that were convertible into common stock of the issuer treated as debt, not stock, for purposes of section 368(a)(1)(B)).

[74] *See* Rev. Rul. 2003-97, 2003-2 C.B. 380 (note and purchase contract treated as separate instruments when rights and obligations were separately transferable and there was no economic compulsion to keep the instruments unseparated); AM 2006-001 (Sept. 7, 2006) (note and forward purchase agreement between identical parties were integrated such that they were treated as stock for federal tax purposes although note was treated as debt for foreign tax purposes).

audit (i.e., with hindsight) to sever any "equity-like" feature of a debt instrument in order to treat that feature as "stock" of the issuer, the result would be a significant disruption to well-settled tax law.[75] Without objective standards, furthermore, it is hard to detect any limiting principle to the potential scope of the Bifurcation Rule. To the extent the Government is concerned about the hybrid nature of certain instruments, it may be appropriate to craft rules targeting the presence of equity-like features in debt instruments. As a backward-looking rule that operates only on audit, however, the Bifurcation Rule is an ill-suited mechanism to address concerns about hybridity.

> Recommendation 20: We recommend that the Final Regulations clarify that the Bifurcation Rule only operates to recharacterize an instrument that is "in form" debt but in substance treated as stock under historical federal tax principles (e.g., an instrument that is debt in form but has a 100-year maturity date) as in part indebtedness and in part stock.

2. Clarify Burden of Proof on IRS's Application of Bifurcation Rule

The Final Regulations should clarify the burden of proof on the analysis that the IRS must undertake in order to apply the Bifurcation Rule. The Bifurcation Rule applies if an analysis of the facts and circumstances concerning an instrument under general federal tax principles "results in a determination" by the IRS that the instrument is properly treated as indebtedness in part and stock in part. The accompanying example in the Proposed Regulations applies the Bifurcation Rule in a case where "the Commissioner's analysis supports a reasonable expectation" that only a portion of the principal will be repaid.

> Recommendation 21: We recommend that in order to apply the Bifurcation Rule, the IRS should be required to show that it was unreasonable for the taxpayer to expect that the principal could be repaid in full.

3. *De Minimis* Threshold for Applying Bifurcation Rule

The Final Regulations should provide a *de minimis* threshold for the application of the Bifurcation Rule. For example, the Final Regulations could provide that in order to apply the Bifurcation Rule, the Commissioner must treat at least 20 percent of the EGI as debt. The purpose of a *de minimis* rule would be to limit the Bifurcation Rule (which is itself based on a policy of sound tax administration of debt/equity disputes) to cases in which there is no reasonable expectation that a borrower can pay a material part of the EGI. Establishing a *de minimis* threshold also minimizes the risk that the Bifurcation Rule could be applied in a way that implicates or undermines the IRS's policy against nuisance settlements.[76] Additionally, without a *de minimis* threshold, the administration of the Bifurcation Rule could result in the recharacterization of a very small portion of the debt instrument as equity (e.g., as little as one

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[75] Note that in many cases, severing an equity-like feature of a debt instrument would create a financial instrument other than equity. For example, severing the conversion feature from a convertible debt instrument could produce a debt instrument and a call option. It is not clear whether the Proposed Regulations are intended to or could reach instruments of this type. Limiting the Bifurcation Rule ensures that all EGIs with equity-like features remain subject to well-settled law rather than subject in some cases to a subjective, after-the-fact bifurcation analysis.

[76] *See* I.R.M. 8.6.4.1.3 (policy against nuisance settlements).

percent) that has an outsized effect in terms of ancillary consequences, such as failing to satisfy the control requirement of section 368(c).[77] Adopting a *de minimis* threshold would minimize the ancillary consequences of a debt recharacterization, which is especially important in the case of the Bifurcation Rule because it is a one-sided rule that will be applied only by the IRS in hindsight.

> Recommendation 22: We recommend that Final Regulations adopt a *de minimis* threshold to clarify when the Bifurcation Rule is never applicable.

4. Adopt Exemption from Bifurcation Rule Based on Financial Ratios

In order to provide taxpayers with more certainty as to the potential application of the Bifurcation Rule, we recommend that Final Regulations provide a safe harbor such that the Bifurcation Rule will not apply to instruments issued by a corporation with adequate capitalization. For example, we recommend that the Bifurcation Rule not be applied to a corporate issuer with a specified ratio of debt to EBITDA or if the interest expense of the issuer does not exceed a specified percent of adjusted taxable income within the meaning of section 163(j).[78] Provided the Bifurcation Rule is properly limited to instances where the issuer's ability to repay is in doubt, it is not appropriate to apply the Bifurcation Rule to an issuer with demonstrated adequate capitalization.

> Recommendation 23: We recommend that the Final Regulations provide a safe harbor such that the Bifurcation Rule will not apply to instruments issued by a corporation with adequate capitalization.

5. Clarify Instrument Must be an EGI at Time of Issuance for Bifurcation Rule to Apply

The Bifurcation Rule provides that it applies to an EGI "to the extent that an analysis, *as of the issuance of the EGI*, of the relevant facts and circumstances" results in a determination that the EGI is in part indebtedness and in part stock.[79]

We request clarification that in order for the Bifurcation Rule to apply to an EGI, the instrument must be an EGI at the time that it is issued. Because the analysis of the relevant facts and circumstances is made as of the time of issuance, it is not appropriate to apply the Bifurcation Rule if the holder and issuer were not members of the same MEG at the time of issuance.

> Recommendation 24: We recommend that the Final Regulations clarify that in order for the Bifurcation Rule to apply to an EGI, the instrument must be an EGI at the time that it is issued.

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[77] See Section X below for a discussion of such ancillary consequences.

[78] For example, Treasury's FY 2014 proposal to amend section 163(j) to limit earnings stripping by expatriated entities proposed a limit on interest expense of 25 percent of adjusted taxable income. General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals (April 2013), at 53-54.

[79] Prop. Treas. Reg. § 1.385-1(d)(1) (emphasis added).

6. Clarify Treatment of Bifurcated Debt Instrument Departing MEG

It is unclear whether an instrument's bifurcated status survives the departure of the instrument's holder or issuer from the MEG. As discussed in Section VI.C, we believe that subsequent holders or persons relying on the characterization of the instrument should be entitled to treat the instrument as stock (or stock in part), if those holders or persons disclose such treatment under section 385(c)(2).

7. Clarify Character of Payments on Bifurcated Debt

As currently drafted, the Proposed Regulations provide no guidance as to the treatment of payments made on a debt instrument that is bifurcated by the IRS under the Bifurcation Rule.

The Proposed Regulations provide that the Bifurcation Rule will apply in cases where the substance of the transaction and "general federal tax principles" support treating a debt instrument as stock in part and debt in part. Further, it is consistent with general federal tax principles to treat payments on such an instrument as made first with respect to the debt component of the instrument given that a creditor's interest is senior to that of a stockholder. That said, such an ordering rule could result in a payment of stated interest on a bifurcated instrument being characterized as interest in part and principal repayment in part. Alternatively, payments with respect to a bifurcated instrument could be allocated pro rata between the debt and equity portions of the instrument in proportion to the bifurcation of the instrument between debt and stock. However, if Recommendation 56 is not adopted, then payments made on the equity portion of a bifurcated instrument may result in a recharacterization of the debt portion under the Funding Rule. Finally, stated interest payments made with respect to a bifurcated instrument may be allocated pro rata while payments of principal are allocated to the debt portion first.[80] While the foregoing methodologies each appear to be reasonable; each of these allocation methodologies has advantages and disadvantages.[81]

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[80] We note that ordering rule mechanics may be further complicated when, for example, one related-party debt instrument is subordinated to another related-party debt instrument. Recharacterization of the senior instrument into equity under the Proposed Regulations would result, for federal tax purposes, in the non-recharacterized, subordinated debt instrument being junior to stock of the issuer if the recharacterized instrument is treated as equity for all purposes of the Code. Such a result, in our view, is not appropriate. We believe the Final Regulations should, at a minimum, clarify that the recharacterization of a relatively senior related-party debt instrument as stock under the Final Regulations has no relevance in determining the characterization of other related-party debt instruments that are junior or *pari passu* to the recharacterized instrument.

[81] Given the complexity involved with evaluating these options and the short time frame within which comments were due, we have not been able to reach a consensus as to the appropriate methodology, including whether a different methodology is warranted under Prop. Treas. Reg. section 1.385-3(b) versus Prop. Treas. Reg. section 1.385-1(d). In the latter context, there is a stronger policy argument for allocating payments first to the debt component of an instrument given that an instrument may be bifurcated based on the IRS's determination that an issuer will not reasonably be able to make payments with respect to the equity portion of an instrument. It goes without saying that different methodologies can result in disparate tax results, both in terms of the amounts and timing of dividend and interest income. Furthermore, evaluation of these options is extremely complex in the event that the Government declines to adopt our Recommendation 56, which prevents the cascading recharacterization phenomenon. The Government therefore should carefully evaluate these methodologies before adopting final rules.

Recommendation 25: We request clarification as to how payments made with respect to a bifurcated instrument should be treated.

8. Treatment of Partnerships and Disregarded Entities

We recommend that the Final Regulations clarify the application of Prop. Treas. Reg. sections 1.385-1(d)(1) and 1.385-2(a)(1) (discussed below) to debt instruments issued by a partnership or a disregarded entity ("DRE"). The Bifurcation Rule provides, in part, that the Commissioner may treat a modified expanded group instrument ("MEGI")

> as in part indebtedness and in part *stock* to the extent that an analysis, as of the issuance of the [MEGI], of the relevant facts and circumstances concerning the [MEGI] . . . under general federal tax principles results in a determination that the [MEGI] is properly treated for federal tax purposes as indebtedness in part and *stock* in part.[82]

Prop. Treas. Reg. section 1.385-2(a)(1) provides, in part, that "[i]f the [Documentation Requirements] are not satisfied with respect to an EGI the substance of which is regarded for federal tax purposes, the EGI will be treated as *stock*."[83] In situations where a MEGI issued by a partnership or a DRE should be treated as equity, in part or in whole, under general federal tax principles, it is unclear whether the Government intended to apply Prop. Treas. Reg. sections 1.385-1(d)(1) and 1.385-2(a)(1) to treat such applicable debt as *stock* in the corporate owner (if any) of the partnership or the DRE, or as *equity* in the partnership or the DRE. If a MEGI issued by a DRE is treated as equity in the DRE, it could potentially result in the DRE becoming a partnership, but we acknowledge that such treatment is arguably consistent with the treatment under general federal tax principles.

> Recommendation 26: We recommend that the Government give additional consideration and provide clarifications in the Final Regulations regarding whether an applicable instrument, when treated as stock (or equity) under Prop. Treas. Reg. sections 1.385-1(d)(1) and 1.385-2(a)(1), should be treated as stock in the corporate owner (if any) of the partnership or the DRE, or as equity in the partnership or the DRE.

A corporate entity that satisfies the requirements for treatment as a qualified Subchapter S corporation subsidiary (a "QSub") or qualified REIT subsidiary (a "QRS") is disregarded as an entity separate from its owner. One of the requirements for QSub and QRS treatment is that all of the entity's equity be owned by a Subchapter S corporation (an "S Corporation") or REIT (as appropriate). If a debt instrument of a QSub or QRS that is owned by an EG Member other than its parent corporation is treated as stock in whole or in part under the Proposed Regulations, the QSub or QRS generally would no longer meet the requirement for disregarded entity treatment and thus would be considered a separate corporation for federal income tax purposes. We believe such a result would be inappropriate, particularly given that, unlike the case with a DRE as discussed above, this would introduce a new level of corporate tax.

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[82] Prop. Treas. Reg. § 1.385-1(d) (emphasis added)

[83] (Emphasis added).

Recommendation 27: We recommend that the Final Regulations provide that an applicable instrument issued by a QSub or QRS that is treated as stock under the Proposed Regulations is treated as stock in such issuer's regarded S Corporation parent or REIT parent (as appropriate).

VI. Prop. Treas. Reg. Section 1.385-2

A. Overview

Prop. Treas. Reg. section 1.385-2 provides threshold requirements that must be satisfied regarding the preparation and maintenance of documentation and information with respect to an EGI (i.e., the Documentation Requirements). The Preamble explains that the proposed Documentation Requirements are intended to impose discipline on related parties by requiring timely documentation and financial analysis that is similar to the documentation and analysis created when indebtedness is issued to third parties. The Proposed Regulations provide that satisfying the Documentation Requirements would not establish that an interest is indebtedness. Instead, such satisfaction would serve as a minimum standard. The other requirements of the Proposed Regulations would need to be satisfied independently.

A. In-Form Debt Instruments

The Proposed Regulations define an EGI as an "applicable instrument" the issuer of which is one EG Member and the holder of which is another EG Member.[84] The Proposed Regulations define an applicable instrument as "any interest issued or deemed issued that is in form a debt instrument,"[85] and reserve on the treatment of an interest that is not in form a debt instrument.[86] It is clear that plain vanilla loan documents are debt *in form*, and repo transactions, for example, are not debt *in form* although such transactions are traditionally treated as debt for tax purposes.[87] Final Regulations should provide guidance as to what other debt transactions (e.g., trade payables, open account intercompany debt, journal entries, etc.) would be considered to be debt in form and thus an "applicable instrument" subject to such regulations. Similarly, it is unclear whether the term "applicable instrument" includes debt instruments that are deemed to exist solely for tax purposes, such as accounts receivable described in Treas. Reg. section 1.367(d)-1T(g)(1) and Rev. Proc. 99-32.[88]

Recommendation 28: We recommend that Final Regulations clarify the scope and meaning of an "applicable instrument" and debt "in form" for purposes of Prop. Treas. Reg. section 1.385-2, and that such terms exclude debt instruments that are deemed to exist solely for tax purposes, such as accounts receivable described in Treas. Reg. section 1.367(d)-1T(g)(1) or Rev. Proc. 99-32.

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[84] Prop. Treas. Reg. § 1.385-2(a)(4)(i).

[85] Prop. Treas. Reg. § 1.385-2(a)(4)(i)(A).

[86] Prop. Treas. Reg. § 1.385-2(a)(4)(i)(B).

[87] *See, Union Planters Nat'l Bank v. United States*, 426 F.2d 115 (6th Cir. 1970), *cert denied*, 400 U.S. 827 (1970); Rev. Rul. 74-27, 1974-1 C.B. 24.

[88] 1999-2 C.B. 296.

B. Scope of Application

Prop. Treas. Reg. section 1.385-2(a)(2) provides that an EGI is subject to the Documentation Requirements only if (i) the stock of any member of the EG is traded on (or subject to the rules of) an established financial market within the meaning of Treas. Reg. section 1.1092(d)-1(b)), (ii) on the date that an applicable instrument first becomes an EGI, total EG assets exceed $100 million on any applicable financial statement, or (iii) on the date that an applicable instrument first becomes an EGI, annual total EG revenue exceeds $50 million on any "applicable financial statement."

Prop. Treas. Reg. section 1.385-2(a)(4)(iv) defines an "applicable financial statement" as one of the following types of financial statements: (i) a financial statement required to be filed with the SEC; (ii) a certified audited financial statement certified by an independent certified public accountant used for credit purposes, reporting to shareholders, partners or similar persons, or any other substantial non-tax purpose; or (iii) a financial statement (other than a tax return) required to be provided to a federal, state or foreign government or agency. The Preamble explains that because this list represents a set of financial statements created for non-tax purposes for persons outside the EG, such "financial statements are expected to be sufficiently reliable for this purpose."[89] In addition, to prevent the use of stale financial information, only applicable financial statements prepared within three years of the EGI becoming subject to the Proposed Regulations are relevant for determining whether an EGI is subject to the Documentation Requirements.[90]

The Proposed Regulations should clarify how the $100 million asset threshold is met if the members of the EG prepare and file separate applicable financial statements.

> Example 4: *EG Members that prepare separate applicable financial statements.* An EG consists of Parent and each of its two majority-owned subsidiaries, Sub 1 and Sub 2. None of the stock Parent, Sub 1 or Sub 2 is publicly traded. The members of the EG prepare applicable financial statements on a separate entity basis, each of which reports total assets of $60 million.

It appears in the above example that the EGI is not subject to the Documentation Requirements because none of Parent's, Sub 1's, and Sub 2's applicable financial statements reports total assets of $100 million.

> Recommendation 29: We recommend that the Final Regulations clarify that the $100 million threshold is not determined on an aggregate basis if the members are required to report separate financial results under GAAP, IFRS or other applicable accounting standards. A similar clarification should be made with respect to the $50 million revenue threshold.

Further, the Proposed Regulations are unclear as to the impact that debt instruments and stock of related companies have on this calculation.

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[89] Preamble at 20920.

[90] *Id.*

Example 5: *Debt and equity interests in EG Members.* An EG consists of Parent and each of its two wholly-owned subsidiaries, Sub 1 and Sub 2. Excluding the stock of Sub 1 and Sub 2, Parent has assets worth $30 million. Sub 1 has issued an EGI to Sub 2 of $20 million (the "Sub 1 Note"). Excluding the Sub 1 Note, Sub 1 and Sub 2 each have assets of $30 million. The value of the Sub 1 stock held by Parent is $10 million, and the value of the Sub 2 stock held by Parent is $50 million.

In the above example, the EG collectively only owns assets worth $90 million. In the aggregate, however, the individual members of the EG own gross assets worth $170 million, because the stock of Sub 1 and Sub 2, as well as the Sub 1 Note, are assets held by Parent and Sub 2, respectively. A similar issue arises with respect to the payment of interest or dividends by Sub 1 for purposes of applying the $50 million revenue threshold.

We believe that it is inappropriate to count the value of EG Member stock or indebtedness when applying the $100 million threshold or payments of interest or dividends between EG Members when applying the $50 million revenue threshold because it effectively double counts the assets and income of the EG. This issue has been addressed by the Government in other regulations. For example, Treas. Reg. section 1.7874-7T(f)(2), which also requires a calculation of the total assets held by a group of corporations, explicitly excludes stock and debt issued by group members from the calculation of total assets, which eliminates this double-counting issue.

Recommendation 30: We recommend that the Final Regulations clarify that stock and debt issued by EG Members is excluded from the calculation of total assets for purposes of the $100 million threshold and that the receipt of payments (e.g., interest or dividends) from EG Members is excluded from the calculation of total revenue for purposes of the $50 million revenue threshold.

C. Consistency Rule

Prop. Treas. Reg. section 1.385-2(a)(3) provides that if the issuer of an EGI characterizes that EGI as debt, the issuer, the holder, and any other person relying on the characterization of the EGI as debt for U.S. federal tax purposes is required to treat the EGI as debt for all federal tax purposes. In this way, the Proposed Regulations eliminate the possibility that members of the same EG could take contrary positions as to the treatment of an EGI as debt or stock.

Recommendation 31: We recommend that the Final Regulations be clarified to provide that if an EGI treated as debt ceases to be an EGI, subsequent holders or persons relying on the characterization of the instrument should be entitled to treat the instrument as stock (or stock in part), if those holders or persons disclose such treatment consistent with section 385(c)(2).

We believe the policies underlying the proposed consistency rule are not present when an instrument ceases to be an EGI.

D. Documentation and Other Information Required

1. Unconditional Obligation to Pay a Sum Certain

Prop. Treas. Reg. section 1.385-2(b)(2)(i) provides that, of the Documentation Requirements apply, there must be written documentation prepared establishing that the issuer has entered into an unconditional and legally binding obligation to pay a "sum certain on demand or at one or more fixed dates."

As one often-quoted opinion has stated, "classic debt is an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof."[91] Of course, even the IRS has acknowledged that certain types of instruments other than "classic debt" can qualify as debt for tax purposes, and an instrument does not have to provide for a single, fixed principal amount on a fixed date in order to be treated as debt for tax purposes.[92]

> Recommendation 32: We recommend that the Proposed Regulations should clarify that the requirements of Prop. Treas. Reg. section 1.385-2(b)(2)(i) can be satisfied if the members of the EG clearly document the rights of the holder to receive a principal amount, whether fixed or not.

We believe that such a clarification would preserve the policies of the Documentation Requirements without unduly constraining the types of debt instruments that can be issued among related parties.

2. Creditor's Rights

Where the Documentation Requirements apply, Prop. Treas. Reg. section 1.385-2(b)(2)(ii) provides that there must be written documentation evidencing the establishment of creditor's rights to enforce the obligation under the EGI. For this purpose, typical creditor's rights include (but are not limited to) the right to cause or trigger an event of default or acceleration of the EGI for failure to make timely required payments and the right to sue the

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[91] *Gilbert v. Comm'r*, 248 F.2d 399, 402 (2d Cir. 1957).

[92] *See, e.g.*, Treas. Reg. § 1.1275-4(b)(9)(i)(F), Ex. 2 (instrument that provides fixed interest rate on stated $1,000 issue price but principal amount equal to $1,000 plus or minus $10 times the positive or negative difference between a specified amount and the value of an index on a specified date, subject to a floor of $650, is subject to contingent payment debt regulations, although no inference is intended as to whether instrument is debt); Treas. Reg. § 1.1275-5(a)(2) (variable rate debt instruments include instruments that provide for contingent principal amounts up to 1.5 percent for each full year to maturity of the debt instrument, subject to a maximum of 15 percent of the total noncontingent principal payments); Rev. Rul. 2003-97, 2003-2 C.B. 380 (note that issuer may use to offset holder's forward obligation to purchase issuer stock in the event the note cannot be resold not subject to section 163(l) because it is substantially certain note could be resold); Rev. Rul. 2008-1, 2008-1 C.B. 248 (instrument that is issued and redeemed for U.S. dollars, but that provides an economic return that is determined by reference to the euro and market interest rates in respect of the euro is treated as euro-denominated indebtedness of the issuer); *cf.* Treas. Reg. §§ 1.1361-1(l)(4), (5) (inherently recognizing that debt instruments that do not qualify for the S Corporation single class of stock "straight debt" safe harbor, which requires a written unconditional obligation to pay a sum certain on demand, or on a specified due date, may still be treated as indebtedness for tax purposes).

issuer to enforce payment. The documented creditor's rights must include a superior right to shareholders to share in the assets of the issuer upon a dissolution of the issuer.

The right to enforce payment and seniority over equity claims are two of the traditional factors courts have considered to determine whether an instrument is properly characterized as debt.[93] Such courts have also recognized that documentation among related parties may not be as extensive as that undertaken by unrelated parties and that alone should not defeat debt characterization.

> Recommendation 33: We believe the Final Regulations should recognize that rights of enforcement and seniority over equity may be provided under the relevant law governing the instrument and need not be set forth in detail in the instrument itself.[94]

3. Reasonable Expectation to Repay

Prop. Treas. Reg. section 1.385-2(b)(2)(iii) provides that, when so required by the Documentation Requirements, written documentation must establish that, as of the date of issuance of the applicable instrument and taking into account all relevant circumstances (including all other obligations incurred by the issuer as of the date of issuance of the instrument or reasonably anticipated to be incurred after the date of issuance), the issuer's financial position supports a reasonable expectation that the issuer intended to, and would be able to, meet its obligations pursuant to the terms of the instrument. The Proposed Regulations provide examples of relevant documentation, including cash flow projections, financial statements, business forecasts, asset appraisals, determination of debt-to-equity and other relevant financial ratios of the issuer in relation to industry averages, and other information regarding the sources of funds enabling the issuer to meet its obligations pursuant to the terms of the instrument. If a member of the EG relied on a third-party report or analysis regarding the issuer's ability to fulfill its debt service obligations, the required documentation must include this report or analysis.

The creditor's expectation that it should be repaid is a key factor courts have applied in determining whether an instrument is properly characterized as debt.[95]

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[93] *See, e.g., United States v. S. Georgia Ry.*, 107 F.2d 3, 5 (5th Cir. 1939) ("[M]ost significant, if not the essential feature of a debtor . . . [is the] right to force payment of the sum as a debt in the event of default."); *Sarkes Tar Inc. v. United States*, 240 F. 2d 467, 470-71 (7th Cir. 1957) ("[S]ubordination necessarily destroys one of the essential rights of the creditor, and the willingness to subordinate is indicative of equity investment.").

[94] *See, e.g., Piedmont Minerals Co., Inc. v. United States*, 294 F. Supp. 1040 (Dist N.C. 1969) (noting that advances from stockholders qualified as negotiable instruments under state Uniform Commercial Code); *see also Am. Processing and Sales Co. v. United States*, 371 F.2d 842, 857 (Ct. Cl. 1967) ("Noninterest bearing open accounts resulting from mutual trading are a commercial commonplace, and none can say that an enforceable obligation to repay does not arise fully as much as from a promissory note.").

[95] *See, e.g., Gilbert v. Comm'r*, 248 F. 2d 399, at 406 (2d Cir. 1957) (significant factor includes "whether the funds were advanced with reasonable expectations of repayment regardless of the success of the venture or were placed at the risk of the business").

Recommendation 34: The Final Regulations should incorporate the view that a creditor's expectations of reasonableness are subjective and should afford the creditor with reasonable latitude based on its business judgment.[96]

Ultimately, the Final Regulations should not allow the Government to substitute its view of what constitutes a reasonable expectation of repayment where its view reflects a significant departure from market practice or what is "reasonable" under current law. For example, clarify that an expectation as to the ability to service a debt instrument by refinancing the instrument prior to maturity, should continue to support a reasonable expectation of payment.[97] Courts have recognized that hindsight-driven determinations would be improper.[98] Additionally, Prop. Treas. Reg. section 1.385-2(b)(3)(ii)(B) currently requires the creditor's reasonable expectation of repayment to be redocumented when an EGI undergoes a significant modification under Treas. Reg. section 1.1001-3. This requirement of the Proposed Regulations conflicts with existing law under Treas. Reg. section 1.1001-3(f)(7)(ii), and thus we request clarification of the interaction between these rules. Specifically, Treas. Reg. section 1.1001-3(f)(7)(ii) provides that, except in the case of the substitution of a new obligor or the addition or deletion of a co-obligor, any deterioration of the financial condition of the obligor is not taken into account in determining whether the modified debt instrument is equity. That provision properly recognizes that a significant modification of a debt instrument is generally not a proper time to retest the debt-equity determination. The Final Regulations should not overturn this principle by requiring documentation of the expectation of repayment of an EGI when it is substantially modified.

Recommendation 35: The Final Regulations should not require the members of an EG to provide revised documentation of the reasonable expectation to repay when an EGI is subject to a significant modification under Treas. Reg. section 1.1001-3 (as would be the case under Prop. Treas. Reg. section 1.385-2(b)(3)(ii)(B)).

4. Actions Evidencing Debtor-Creditor Relationship

When the Documentation Requirements apply, Prop. Treas. Reg. section 1.385-2(b)(2)(iv) provides that there must be written documentation evidencing the issuer's payment under the instrument (such as a wire transfer record or bank statement) and, in the event of nonpayment or default under the instrument, evidencing the holder's reasonable exercise of the diligence and judgment of a creditor (including pertaining to the holder's efforts to assert its rights under the terms of the instrument or the holder's decision to refrain from pursuing further enforcement actions).

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[96] *See, e.g.*, *Scotland Mills, Inc.*, TC Memo 1965-48 ("An amount of capital which would be sufficient to launch a company in one industry might be completely inadequate by the standards of another industry.")

[97] *See Green Bay Structural Steel, Inc. v Comm'r*, 53 T.C. 451, 457 (1969) (recognizing that refinancing is an acceptable business practice which is not viewed as contrary to a debtor-creditor relationship if it is reasonable in the context of the particular facts).

[98] *See, e.g.*, *Am. Processing and Sales Co. v. United States*, 371 F.2d 842, 853 (Ct. Cl. 1967) ("courts are loathe to rewrite corporation balance sheets to reflect a Government version of glowing corporate health").

The Final Regulations should clarify that documentation of a creditor's assertion of its rights upon default is only relevant in analyzing whether there was an intention to create a bona fide debt when the instrument was issued. As the Tax Court recognized in *Santa Anita Consolidated, Inc. v. Comm'r*, the determination of whether an instrument issued between related taxpayers was debt or equity is not determined solely based on a later default:

> For the purposes of this determination, we must attempt to place ourselves in the position of petitioner at the time the advances were made. Hindsight is a particularly inappropriate tool in this instance. If the venture had succeeded, and the loans had been paid, we doubt that respondent could succeed with this argument. He can do no better now, for the view must be the same.[99]

> Recommendation 36: The Final Regulations should clarify that it is the existence of bona fide creditor rights and default remedies, rather than whether or not those rights or remedies were actually exercised, that is relevant for purposes of the Documentation Rules.

Courts have recognized that when related taxpayers modify a debt instrument (e.g., by extending maturity or subordinating it to the claims of general creditors), a hindsight-driven determination that the debt instrument should be treated as stock would be improper.[100]

E. Timely Preparation Requirement

One of the factual premises underlying the Documentation Requirements is that such requirements are consistent with the documentation that would be required by a third party with respect to a similar loan.[101] In several regards, however, this premise is not consistent with market practice, particularly with respect to the timely preparation requirement discussed in this subsection.[102] In light of the disconnect between the documentation rule's premise and the available market evidence, we believe that the Proposed Regulations, and the timely preparation requirement in particular, should be revised in the manner described below.

1. Revolvers and Similar Credit Facilities

One example of this disconnect is with respect to loan facilities. For this purpose, we use the term "loan facility" to refer to any loan in which a lender agrees to advance up to a specified

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[99] 50 T.C. 536, 554 (1968).

[100] *See, e.g., Liflans Corp. v. United States*, 390 F.2d 965, 969 (Ct. Cl. 1968) (extensions of maturity upon unforeseen business difficulties "neither erased the debt characteristics of the instrument nor refuted plaintiff's intent to create a valid debt"); *Bullock v. Comm'r*, 26 T.C. 276, 299 (1956) ("[N]o basis for holding that [subordinate debt to general creditors] amounted to a conversion of an admittedly bona fide debt into a capital advance.")

[101] "The [P]roposed [R]egulations are intended to impose discipline on related parties by requiring timely documentation and financial analysis that is similar to the documentation and analysis created when indebtedness is issued to third parties." Preamble at 20916.

[102] We make this statement based on the authors' collective years of experience in assisting our respective clients in making or obtaining loans involving third parties. We have also cited relevant sources with respect to specific documentation practices in the discussion below.

amount at the borrower's request over a specified period. The borrower is not required to borrow the entire principle at closing, but rather can "draw" upon the facility at its option as funds are needed. A paradigmatic example of a loan facility is a revolving credit facility, commonly referred to as a "revolver." The term would also cover many cash pooling, trade payable, and centralized paying agent arrangements.[103]

As currently drafted, the timeliness requirements of Prop. Treas. Reg. section 1.385-2(b)(3) (the "Timeliness Requirements") create "rolling" documentation burdens with respect to loan facilities that are inconsistent with market practice. Specifically, the Timeliness Requirements require a lender to provide documentation regarding the reasonable expectation of repayment *every time* cash is advanced under a loan facility.[104] As noted above, this documentation can be burdensome to compile; it includes asset valuations, cash flow projections, financial ratios and business forecasts, among other items.

This approach is out of step with market practice. The credit analysis for third-party loan facilities is typically undertaken at the inception of the facility, not as credit balances increase.[105] In exchange for a fee, the borrower is effectively granted an option to borrow up to a specified sum during a set period of time.[106] The lender may negotiate to monitor certain financial covenants to protect against the risk of default over the term of the facility, but the lender is not entitled to continuously analyze the borrower's creditworthiness and reprice the debt accordingly.[107] The point of these facilities is most often to provide a borrower with easy access to cash with a "locked in" financing cost for working capital and related purposes. The ability to lock in this source of future funding on an as-needed basis is essential for many borrowers to operate their businesses.

By contrast, the Proposed Regulations would require EG lenders to document a "reasonable expectation of ability to repay" every time a loan (or draw) is made under one of these facilities. By requiring a "rolling" documentation requirement with respect to a borrower's

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[103] See Section IX for a discussion of cash pooling arrangements.

[104] This is the case because each draw under such types of facilities is viewed as a new loan, which appears to be a "relevant date" that requires documentation under Prop. Treas. Reg. section 1.385-2(b)(3)(ii)(B). Although there are special "relevant date" rules for cash pools and revolvers under Prop. Treas. Reg. sections 1.385-2(b)(3)(iii)(A) and (B), it appears that those rules only add additional relevant dates with respect to such loans—namely, the provision adds the date of execution of the facility or any amendment to the facility that increases the maximum principal amount. Stated differently, these additional dates do not appear to be the exclusive relevant dates with respect to loan facilities because the special rule uses the word "includes," indicating that these dates are part of a larger class. Furthermore, the general timing rule with respect to documenting a reasonable expectation of repayment describes several relevant dates and then adds "and any *subsequent* relevant date that occurs under the special rules in [Prop. Treas. Reg. section 1.385-2(b)(3)(iii), the special relevant date rule with respect to loan facilities]" (emphasis added).

[105] *See* Association of Corporate Treasurers, An Introduction to Loan Finance, *available at https://www.treasurers.org/ACTmedia/introtoloanfin.pdf* (last visited May 29, 2016).

[106] *See* Shapiro, Yaghmour and Schneider, "A Tax Field Guide to Debt-Related 'Fee' Income," 143 Tax Notes 1027 (June 2, 2014) (analogizing facility fees and commitment fees to option premiums).

[107] Association of Corporate Treasurers, The ACT Borrower's Guide to LMA Loan Documentation for Investment Grade Borrowers, *available at https://www.treasurers.org/ACTmedia/ACT_guide_LMA_doc.pdf* (last visited May 29, 2016).

ability to repay, the Proposed Regulations would impose a tremendous burden on taxpayers—a burden that is impractical and possibly impossible to satisfy. In theory, given the fluctuations in the daily balances of a typical cash pool, the regulations may be requiring certain EG lenders to update asset valuations, cash flow projections and so forth on a daily basis.

> Recommendation 37: We recommend that the Timeliness Requirements should conform to similar third-party arrangements in that a credit analysis should only be required on a single entity basis upon inception of a loan facility (or an increase in the maximum borrowing amount with respect to a facility or an addition of an entity to, or removal of an entity from, an existing facility subject to a *de minimis* threshold), provided that the facility is of a reasonably limited duration (e.g., five years or less) and provides for a reasonable stated maximum loan amount. This rule may be premised upon the loan facility including typical covenants that would be included in a third-party loan facility. For facilities that do not contain such covenants or do not provide for a reasonably limited duration or maximum borrowing amount, such credit analysis should be undertaken periodically (e.g., in no event more frequently than annually). Furthermore, in order to ease the documentation burden associated with such loans, we would propose that such analysis may be based on applicable financial statements prepared under GAAP, IFRS or statutory accounting to avoid the costs of third-party valuations.

2. Issues Related to Non-EGIs Becoming EGIs

A similar disconnect between market practice and the Documentation Requirements is the fact that such requirements are triggered when a non-EGI becomes an EGI. There are two ways this generally could happen: either (i) the debt is transferred from a non-EG Member to an EG Member or (ii) the creditor becomes a member of the same EG as the debtor. We are unaware of any circumstances in a third-party context in which a transfer of a receivable could trigger additional documentation obligations with respect to a debtor (other than, perhaps, registration obligations). Furthermore, it is rarely the case that a change in the ownership of either the debtor or creditor would trigger such obligations. For example, a change of control provision in a typical high-yield bond indenture does not provide the creditor with the right to solicit additional documentation from the borrower. Rather, the creditor usually is given the right to put the instrument back to the issuer.[108]

In many, if not most, instances, triggering the Documentation Requirements when a non-EGI becomes an EGI will be redundant and inefficient. Non-EGI instruments presumably will be priced and documented in an arm's length manner.[109] To require additional documentation when the instrument becomes an EGI adds nothing to the initial credit analysis performed by an unrelated party.

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[108] *See* William J. Wellan, III, Bond Indentures and Bond Characteristics, *in* Leveraged Financial Markets: A Comprehensive Guide to High-Yield Bonds, Loans and Other Instruments, *available at https://www.cravath.com/files/Uploads/Documents/Publications/3234772_1.PDF* (last visited May 29, 2016).

[109] That is one of the underlying premises of the Proposed Regulations: "[A] lender typically carefully documents a loan to a third-party borrower and decides whether and how much to lend based on that documentation and objective financial criteria." Preamble at 20915.

In our view, the only instances in which the foregoing analysis might not apply is where a third party acts to facilitate a loan that is in substance between EG Members that is a non-EGI in form.[110] The anti-abuse rule in Prop. Treas. Reg. section 1.385-2(e) (the "-2 Anti-Abuse Rule"), however, provides the Government with a powerful tool to combat this sort of abuse. It applies in every case that "an applicable instrument that is not an EGI is issued with a principal purpose of avoiding the purposes of this section." Although the Government might prefer to not have to rely on this rule to police potential abuses, that burden surely pales in comparison to the superfluous documentation burdens imposed in numerous benign instances.

Additionally, the Documentation Requirements do not appear to function appropriately in distressed debt situations. For example, suppose that an EG Member purchases distressed debt of another EG Member in the open market. The EG creditor will often not be able to document a "reasonable ability to repay" in such circumstances, notwithstanding that it is required by Prop. Treas. Reg. sections 1.385-2(b)(iii) and (c)(2).[111] Under such circumstances, all of the distressed debt would appear to be automatically recharacterized as stock under Prop. Treas. Reg. section 1.385-2(a) because (i) the market-determined discounted purchase price indicates that the holder of the instrument does not reasonably expect the issuer to repay all of the principal amount plus accrued but unpaid interest and (ii) the taxpayer is not permitted to treat the portion of the debt as stock and the remainder as debt under Prop. Treas. Reg. section 1.385-1(d). We do not understand the rationale for such disparate treatment between distressed debt held by EG creditors and third-party purchasers of distressed debt, especially when one considers that an EG creditor must still document that it is acting at arm's length with respect to the borrower under Prop. Treas. Reg. section 1.385-2(b)(2)(iv).

> Example 6: *Retesting of debt instrument negotiated at arm's length.* Corp 1 is one of the owners of Corp 2, a corporation that is held by several noncontrolling unrelated corporate shareholders. Corp 1 makes a loan to Corp 2. Given the lack of common control between the debtor and creditor we would anticipate that the loan would be made on an arm's-length basis, which is consistent with our experience. If Corp 1 were to subsequently acquire the remainder of the interests in Corp 2 in an unrelated transaction, it seems superfluous to require an additional layer of documentation requirements with respect to an arm's-length loan.

> Recommendation 38: We recommend that the relevant date definition be restricted to eliminate instances in which a non-EGI becomes an EGI.[112]

3. Issues Related to EGIs Held by Consolidated Group Members and DREs

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[110] *See, e.g.*, Rev. Rul. 87-89, 1987-2 C.B. 195 (treating a bank as a conduit with respect to loans to and from affiliated entities).

[111] In this regard, we note that Prop. Treas. Reg. section 1.385-2(c)(3)(ii) explicitly "turns off" the exception for financially distressed issuers in Treas. Reg. section 1.1001-3(f)(7)(ii)(A). That exception generally provides that a debt instrument that is significantly modified will not be recharacterized as equity due to the financial deterioration of the debt issuer.

[112] See Section V.F.5 above for a similar recommendation that the Bifurcation Rule not apply when a non-EGI becomes an EGI.

Similarly, disregarded debt (or debt that is issued between members of a consolidated group) often has significance for reasons other than U.S. federal income taxes.[113] It goes without saying that, if debt is disregarded for U.S. federal tax purposes, it must have been issued for other reasons. Given the potential for the Proposed Regulations to spring such debt into existence (e.g., through inadvertent deconsolidation or partnership formations), the Documentation Requirements create a trap for the unwary.

The Documentation Requirements generally apply 30 days after the issuance of an EGI, which will often be unpredictable in light of the potential to create deemed stock in an EG Member inadvertently. Without the ability to accurately track and analyze these deemed issuances, taxpayers may often miss the 30-day documentation deadline.[114]

> Recommendation 39: In light of the potential adverse consequences of an inadvertent failure to comply with the Documentation Requirements and the general lack of federal tax planning underlying the issuance of consolidated or disregarded debt, we recommend that "relevant dates" with respect to such instruments only include deemed issuances of such instruments of which taxpayers are aware (either through affirmative actions on the taxpayer's part or as a result of notification by the Government). This change could be incorporated into the Final Regulations as a stand-alone "relevant date" rule or, alternatively, as a facet of a revised reasonable cause exception, which we propose below.

Exempting such "deemed" issuances from the scope of the Documentation Requirements cedes little ground to taxpayers. In such circumstances, the Government will still retain the ability to recharacterize debt under Prop. Treas. Reg. sections 1.385-1(d) or -3(b), and taxpayers may very well prepare additional documentation with respect to such debt for non-tax reasons or in order to defend against recharacterization. Moreover, the -2 Anti-Abuse Rule provides a powerful tool for the Government to protect against abuse in this area.

For a discussion of issues specific to cash pooling arrangements, see Section IX below.

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[113] As a general matter, we would also contest the Preamble's assertion that the distinction between debt and stock in a related-party context is meaningless:

> [A]lthough the holder of a debt instrument has different legal rights than a holder of stock, the distinction between those rights usually has limited significance when the parties are related. Subsidiaries often do not have significant amounts of debt financing from unrelated lenders (other than trade payables) and, to the extent they do, they may minimize any potential impact of related-party debt on unrelated creditors, for example, by subordinating the related-party debt instrument.

Preamble at 20917.

We especially disagree with this assertion in instances in which a member of an EG is highly regulated or in a bankruptcy, insolvency or similar proceeding. *See, e.g.*, Vadim Mahmoudov, Intragroup Wars: Abusive Parents, Rebellious Subsidiaries, 150 Tax Notes 1555 (Mar. 28, 2016) (describing the competing tax and other incentives of parents and subsidiaries in bankruptcy proceedings).

[114] It is unclear whether "inability to comply with regulatory complexity" would qualify for the reasonable cause exception.

F. Operating Rules

We also believe that the operating rules described in Prop. Treas. Reg. section 1.385-2(c) should be modified in several respects.

We believe that the reasonable cause exception described in Prop. Treas. Reg. section 1.385-2(c)(1) should be broadened. As currently drafted, the reasonable cause exception keys off of the principles of Treas. Reg. section 301.6724-1. That provision is vague and, in our experience, may be inconsistently applied by IRS examination agents. Given the likelihood of inadvertent EGI issuances as a result of the Proposed Regulations and the potentially adverse consequences resulting from a failure to properly document an EGI as debt, we believe this exception should be broadened. The Government has recently crafted a similar set of rules in the section 367(a) context for failures to file a gain recognition agreement, which is another area where a failure to file can result in extremely adverse tax consequences. There, a taxpayer is not penalized for failure to file a gain recognition agreement unless such failure was "willful."[115] Given the stakes at issue under Prop. Treas. Reg. section 1.385-2, we believe that a similar standard should be used for purposes of the reasonable cause exception.

> Recommendation 40: The reasonable cause exception described in Prop. Treas. Reg. section 1.385-2(c)(1) should be broadened.

The operating rules provide, under Prop. Treas. Reg. section 1.385-2(c)(2)(ii), that the deemed exchange of EGI stock for debt at the time it becomes a non-EGI occurs "immediately before" the event that causes the instrument to be treated as a non-EGI. Accordingly, a deemed exchange of EGI stock for debt immediately before a transfer of the instrument outside of the EG will often result in noneconomic dividend income under section 302(d).

> Example 7: *Deemed exchange of recharacterized debt instrument.* P owns 100 percent of the common stock of S and an EGI issued by S that has been recharacterized as stock under Prop. Treas. Reg. section 1.385-2. If P transfers that EGI to a third party, it may be recharacterized as debt under general debt-equity principles. This deemed exchange of S "stock" for debt occurs immediately before the transfer of the EGI. Because P will own 100 percent of the equity of S immediately after the transfer, the deemed redemption from the exchange should result in a distribution under section 302(d), notwithstanding that S has not distributed property to P. Moreover, the deemed redemption of S's stock could raise unsettled issues as to where any unrecovered basis in the redeemed EGI should attach.[116]

> Recommendation 41: We recommend that the Final Regulations should amend the mechanics of the deemed exchange that occurs when an EGI that has been

[115] Treas. Reg. § 1.367(a)-8(p).

[116] *See* Treas. Reg. § 1.302-2(c) (which provides that proper adjustments should be made with respect to unrecovered basis). In the simple example posed herein, most taxpayers would take the position that the unrecovered basis should attach to P's common shares in S. However, that question would become substantially more difficult if S were a second-tier subsidiary of P.

recharacterized as stock becomes a non-EGI such that the exchange is deemed to occur "immediately after" the event that causes the instrument to become a non-EGI, in order to avoid the possibility of noneconomic dividend income and issues regarding the allocation of unrecovered basis.

VII. Comments Regarding Prop. Treas. Reg. Section 1.385-3

A. Overview

Subject to limited exceptions, Prop. Treas. Reg. section 1.385-3 automatically treats related-party debt instruments that are issued in one of three enumerated transactions as stock. Although the Preamble indicates that a distribution of a debt instrument is the prototypical transaction targeted by Prop. Treas. Reg. section 1.385-3, the Proposed Regulations apply equally to debt instruments issued in transactions that Treasury believes "implicate[] similar policy considerations."[117] In the Preamble, the Government states that inverted and foreign parented groups would often receive debt instruments in the form of dividends from U.S. subsidiaries, which would then make deductible interest payments and reduce U.S. source income. In addition, the Government noted that U.S.-parented groups could use the distribution of a debt instrument from a first-tier controlled foreign corporation ("CFC") to facilitate the receipt of untaxed foreign earnings without recognizing dividend income.[118] Based on these policy concerns, the General Rule (defined below) recharacterizes such debt instruments as stock.[119]

Prop. Treas. Reg. section 1.385-3 also contains the Funding Rule (defined below) which automatically recharacterizes a debt instrument issued for property, including cash, as stock if the debt instrument was issued to an EG Member with a principal purpose of funding one of three transactions similar to the transactions listed in the General Rule.[120] The Preamble notes that the Funding Rule was deemed necessary to prohibit taxpayers from successfully circumventing the General Rule through multi-step transactions that achieve "economically similar outcomes."[121]

Based on the technical and policy concerns discussed at length below, as well as the validity concerns discussed above, we strongly believe that Prop. Treas. Reg. section 1.385-3 should be withdrawn in its entirety. However, we have provided comments and recommendations regarding Prop. Treas. Reg. section 1.385-3 in the event that the Government decides to include Prop. Treas. Reg. section 1.385-3 in the Final Regulations.

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[117] Preamble at 20917.

[118] *Id.*

[119] Prop. Treas. Reg. § 1.385-3(b)(2)(i).

[120] Prop. Treas. Reg. § 1.385-3(b)(3).

[121] Preamble at 20918.

B. The General Rule

1. Background and Purpose

Under Prop. Treas. Reg. section 1.385-3(b)(2) (the "General Rule") a debt instrument issued to an EG Member is treated as stock for all purposes of the Code if it is issued:

(i) In a distribution,

(ii) In exchange for stock of an EG Member (other than an Exempt Exchange),[122] or

(iii) In exchange for property in an asset reorganization, but only to the extent that, pursuant to the plan of reorganization, a shareholder that is an EG Member receives the debt instrument with respect to its stock in the target corporation (collectively with (i) and (ii), a "Prohibited Distribution or Acquisition").[123]

In the Preamble, the Government states that the distribution of a debt instrument generally lacks meaningful non-tax significance and, if such debt instrument is respected as indebtedness for federal tax purposes, produces inappropriate results.[124] For example, the Preamble discusses the use of debt by (i) foreign-parented groups to create interest expense deductions that reduce U.S. source income, and (ii) U.S.-parented groups to create interest expense deductions that reduce the E&P of CFCs and to facilitate the payment of untaxed earnings without the recognition of dividend income.[125] Based on the examples in the Preamble, it appears that the intended effect of the Proposed Regulations is to deny interest deductions and the tax-free return of principal between related parties in certain situations.

2. General Rule

As discussed above, the Government states three principal reasons for proposing the first prong of the General Rule. First, the Government believes that related-party debt deserves close scrutiny. Second, the Government believes that the creation of debt through the distribution of a note without receiving new capital or other property in exchange for the note generally lacks a non-tax business purpose. Third, the Government believes that the lack of new capital investment when a closely held corporation issues indebtedness to a controlling shareholder but receives no new investment in exchange weighs in favor of stock characterization. In describing the purpose of the second and third prongs of the General Rule, the Government states that it is concerned that such transactions have "economic similarities" to transactions described in the

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[122] An exempt exchange ("Exempt Exchange") means an acquisition of EG stock in which the transferor and transferee of the stock are parties to an asset reorganization, and either (i) section 361(a) or (b) applies to the transferor of the EG stock and the stock is not transferred by issuance, or (ii) section 1032 or Treas. Reg. section 1.1032-2 applies to the transferor of the EG stock and the stock is distributed by the transferee pursuant to the plan of reorganization. Prop. Treas. Reg. § 1.385-3(f)(5).

[123] Prop. Treas. Reg. § 1.385-3(b)(2).

[124] Preamble at 20917.

[125] *Id.*

first prong and that issuances of debt instruments in such transactions implicate "similar policy considerations."[126] However, apart from the fact that transactions described in the first prong of the General Rule and those described in the second and third prongs of the General Rule involve related parties, the Preamble does not clearly explain how the policy implications are similar.

Unlike transactions described in the first prong of the General Rule, many transactions described in the second prong and all transactions described in the third prong occur in the context of group restructurings or tax-free reorganizations. As a result, such transactions must have a non-tax business purpose even in the absence of the Proposed Regulations.[127] Moreover, all such transactions result in the issuer receiving additional capital or property in exchange for its newly-issued debt.[128] In transactions described in the second prong of the General Rule, the corporation that issues new debt always acquires stock of a related party in exchange for its debt. Often, that stock is in turn used to acquire other businesses or compensate employees.[129] In transactions described in the third prong of the General Rule, the corporation that issues new debt acquires assets from a related party as part of an asset reorganization.[130] As described in more detail below, certain key aspects of the Proposed Regulations themselves indicate that the concerns Treasury intends to address under the General Rule are not present in transactions described in the second and third prongs because they result in an introduction of "new capital" into the corporation issuing the debt.[131]

More specifically, the General Rule does not apply to a debt instrument issued to an affiliate in exchange for non-stock property (other than pursuant to an asset reorganization), presumably because the Government believes that an acquisition of non-stock property *does* result in the introduction of "new capital" into the acquiring corporation. On the other hand, the second and third prongs of the General Rule apply to debt instruments issued to an EG Member in exchange for stock. A simple series of examples illustrates the anomalies that result from this distinction.

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[126] *Id.*

[127] *See* Treas. Reg. § 1.368-2(g); *see also Gregory v. Helvering*, 293 U.S. 465 (1935). All transactions described in the third prong of the General Rule are subject to a business purpose requirement because they occur in the context of tax-free reorganizations. Transactions described in the second prong of the General Rule are subject to a business purpose requirement if the stock acquired is used in a tax-free reorganization. Transactions described in the second prong that are not subject to a business purpose requirement generally result in sale or exchange treatment or dividend treatment unless an EG Member is selling its own stock in a transaction to which section 1032 applies.

[128] If such a transaction were not in form to be undertaken as a value-for-value exchange, section 482 would support deeming additional consideration as being received, or another deemed transaction to fill the gap between fair market value and the consideration in form provided. *See, e.g.*, Rev. Rul. 69-630; Rev. Rul. 78-83; Treas. Reg. § 1.368-2(*l*)(2)(i).

[129] See Sections VII.C.3(c) and VII.B.4 for a discussion of certain issues related to the use of EG Member stock to compensate employees.

[130] *See* Treas. Reg. § 1.368-2(*l*); Rev. Rul. 70-240, 1970-1 C.B. 81.

[131] The Funding Rule (defined below), however, does apply to such acquisitions of property. However, the Funding Rule does not result in a recharacterization of the debt as stock unless a "Funded Distribution or Acquisition," (described below) occurs.

Example 8: USP owns all of the stock of CFC1 and CFC2. CFC1 owns all of the equity interests of FCo, a Country X entity that is treated as a DRE for U.S. federal income tax purposes. FCo operates a business in Country X. FCo does not constitute substantially all of the assets of CFC1. CFC2 acquires all of the equity interests in FCo from CFC1 in exchange for a CFC2 note. Because FCo is a DRE, CFC2 is treated as acquiring assets from CFC1 in exchange for the CFC2 note. The General Rule does not apply to recharacterize the CFC2 note. [132]

Example 9: The facts are the same as Example 8, except that FCo is treated as a corporation for U.S. federal income tax purposes. Under these revised facts, because CFC2 is treated as acquiring EG Member stock, the General Rule applies and treats the CFC2 note as stock.

Example 10: The facts are the same as Example 9, except that, immediately after the acquisition by CFC2 of the stock of FCo, FCo elects to be treated as a DRE for U.S. federal income tax purposes. Under these facts, CFC2's acquisition of FCo, followed by the deemed liquidation of FCo, is treated as a reorganization under section 368(a)(1)(D) in which CFC1, the shareholder of FCo, receives the CFC2 note in exchange for its FCo stock.[133] The General Rule applies and treats the CFC2 note as stock.

From a debt-equity perspective, we see no material distinction between the facts of these three examples, and yet the General Rule treats the debt issued in the latter two as stock, purportedly on the basis that such transactions do not result in the introduction of new capital. This distinction simply does not make sense. The fact that a section 304(a)(1) transaction is treated as giving rise to a deemed distribution, similar to a section 301 distribution, does not mean that a section 304(a)(1) transaction is economically equivalent to a section 301 distribution from a debt-equity perspective.

Moreover, the consequences of transactions described in the second and third prongs of the General Rule have been addressed by the longstanding framework enacted by Congress primarily located in subchapter C of the Code. Under this well-settled statutory framework, the corporation receiving the debt may be treated as recognizing gain or loss in a sale or exchange, receiving a dividend, or recognizing no gain or loss whatsoever.[134] The second and third prongs of the General Rule thus appear to be intended to supplant the tax consequences contemplated by these Code provisions—provisions that were drafted specifically contemplating how tax consequences should vary based on the relationship of the parties.[135] There is no indication in

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[132] Except as otherwise stated, it is assumed for purposes of the examples in this Section VII that all notes are debt instruments described in Prop. Treas. Reg. section 1.385-3(f)(3) and therefore have satisfied any requirements under Prop. Treas. Reg. section 1.385-2, if applicable, and are respected as debt instruments in whole under general federal tax principles.

[133] *See* Treas. Reg. § 1.368-2(*l*).

[134] *See* I.R.C. §§ 302, 304, 356, 1032.

[135] I.R.C. § 302(b) (taking into account relatedness in determining whether a taxpayer is afforded section 301 or sale or exchange treatment); I.R.C. § 304 (similar); I.R.C. § 368(a)(1)(D) (requiring 50 percent relatedness for transaction to qualify as a reorganization); *see also* Treas. Reg. § 1.368-2(*l*) (all boot D reorganization regulations);

either the statutory text of these Code sections or their respective legislative histories that Congress intended for the regulatory authority under section 385 to be used to override these other provisions.

In addition, with respect to the second prong of the General Rule, we note that the Preamble states that acquisitions of stock of one affiliate from another "introduce no new operating capital to either affiliate."[136] We respectfully submit that this statement is inaccurate. Corporations frequently acquire stock of affiliates for both operational and capital purposes. Both Congress and the Government have taken numerous actions over time to provide taxpayers with more flexibility to use stock of affiliates for such purposes.[137]

> Recommendation 42: We recommend that the second and third prongs of the General Rule be eliminated in the Final Regulations.
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> Recommendation 43: If the second and third prongs of the General Rule are not eliminated, we request that the Government articulate how transactions described in the second and third prongs of the General Rule have "economic similarities" and "implicate similar policy considerations" from a debt-equity perspective as transactions described in the first prong of the General Rule.

As described above, we believe that Prop. Reg. section 1.385-3 should be withdrawn in its entirety. However, we have provided recommendations to improve Prop. Reg. section 1.385-3 in case the Government retains any portion of this provision in Final Regulations.

3. Treatment of Non-Dividend Equivalent Distributions and Similar Transactions

As currently drafted, the General Rule covers debt instruments issued in exchange for stock of an EG Member and debt instruments distributed pursuant to certain asset reorganizations, without regard to whether the actual or deemed distribution of the debt

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Rev. Rul. 70-240, 1970-1 C.B. 81; Treas. Reg. § 1.1032-3 (addressing use of parent stock by a subsidiary to acquire property or services). The Preamble states that the second prong of the General Rule is based on similar policy concerns as section 304, in which Congress sought to prevent circumvention of section 301 through the sale of stock to a related corporation. Example 3 of Prop. Treas. Reg. section 1.385-3(g)(3) makes it clear that treating a debt instrument issued for stock of an EG Member as stock for federal tax purposes prevents section 304(a)(1) from applying to a cross-chain transfer of stock. If the Proposed Regulations are adopted without change, the issuance of a note to the transferor in a cross-chain transfer of stock would not result in a dividend to the transferor and a carryover basis for the acquiring corporation; the only consequences would seem to be the recognition of gain by the transferor and a stepped-up basis in the transferred stock for the acquiring corporation (if the transaction does not qualify as some form of tax-free exchange, such as a section 351 exchange). These results seem to have been intended even though they are inconsistent with section 304(a).

[136] *See* Preamble at 20917.

[137] Sections 368(a)(2)(D) and 368(a)(2)(E) were enacted in 1968 and 1971, respectively, to enable corporations to engage in tax-free reorganizations using stock of their parents. The Government later promulgated Treas. Reg. section 1.1032-2 to limit circumstances under which corporations engaging in triangular reorganizations recognize gain. T.D. 8648 (Dec. 20, 1995). In 2000, the Government promulgated Treas. Reg. section 1.1032-3 to limit circumstances under which corporations using parent stock to acquire property must recognize gain. T.D. 8883 (May 12, 2000).

instrument is dividend-equivalent. However, the Preamble places special emphasis on the fact that there is no change in ultimate ownership in justifying its expansion of the General Rule to include debt instruments issued in exchange for stock of an EG Member and debt instruments issued and distributed in certain asset reorganizations.

Under section 302, the determination of whether a redemption is dividend-equivalent is generally based on whether the ownership of the redeeming corporation (or the issuing corporation in the case of a section 304 transaction) has sufficiently changed to warrant respecting the redemption as a sale or exchange.[138] For example, in *United States v. Davis*,[139] the Supreme Court held that qualification under section 302(b)(1), which provides sale or exchange treatment for redemptions that are not essentially equivalent to a dividend, depended on whether the redemption resulted "in a meaningful reduction of the shareholder's proportionate interest in the corporation."[140] Similarly, in determining whether the receipt of "other property" has the "effect of the distribution of a dividend" under section 356(a)(2), section 302 is applied by treating the receipt of "other property" as though it was received in redemption of the stock of the acquiring corporation immediately after the transaction.[141]

Because sale or exchange treatment under sections 302 and 356(a) is predicated on a meaningful reduction in the shareholder's proportionate interest in the corporation, it would be more consistent with the stated policy of the General Rule to exempt debt instruments issued in exchange for stock of an EG Member and debt instruments issued and distributed in certain asset reorganizations from the application of the General Rule when the distribution or deemed distribution results in sale or exchange treatment. This exception would include upstream stock sales (as described in Rev. Rul. 74-605),[142] redemptions similar to those in *Zenz v. Quinlivan*,[143] and section 304 transactions similar to those described in *Merrill Lynch & Co., Inc. v. Comm'r*.[144]

> Recommendation 44: We recommend that the General Rule exempt debt instruments issued in exchange for stock of an EG Member and debt instruments issued and distributed in certain asset reorganizations from the application of the General Rule when the distribution or deemed distribution results in sale or exchange treatment.

4. Application of General Rule to Stock Recharges

Another significant area in which the General Rule results in unnecessary complexity with little policy justification is in the area of stock recharges. In a typical stock recharge

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[138] *See* I.R.C. § 302(b).

[139] 397 U.S. 301 (1970), *rev'g* 408 F.2d 1139 (6th Cir. 1969), *reh'g denied*, 397 U.S. 1071 (1970).

[140] *Id.* at 313.

[141] *Comm'r v. Clark*, 489 U.S. 726, 732 (1989), *aff'g* 828 F.2d 221 (4th Cir. 1987).

[142] 1974-2 C.B. 97.

[143] 213 F.2d 914 (6th Cir. 1954), *rev'g* 106 F. Supp. 57 (N.D. Ohio 1952).

[144] 120 T.C. 12 (2003), *aff'd in part and remanded*, 386 F.3d 464 (2d Cir. 2004).

arrangement, employees of any company within a multinational group can become entitled to equity compensation with shares of the parent company. The parent company will typically deliver shares to the relevant employees, and the employer of the employees will pay for the parent's provision of stock by establishing a payable to the parent. Although practices can vary, these payables often carry a short term (e.g., 30-day payment terms). The amount and timing of the equity compensation can vary widely and can change as a multinational group's business changes and employees join and leave the group.

A subsidiary that pays the parent company for the parent company stock using a payable has engaged in an exchange of a debt instrument for EG stock under the General Rule. Thus, the General Rule would characterize these payables as stock for all federal tax purposes.

For many companies, providing equity compensation to employees—whether they be employees of the parent company, a U.S. subsidiary, or a non-U.S. subsidiary—is an important part of the company's culture. Stock recharges in this manner are very common, particularly in certain industries (e.g., high-tech).

Applying the General Rule to this fact pattern would lead to significant adverse consequences, as set forth in more detail throughout this Comment Letter. To highlight a few, while the payables are outstanding, the parent company could be viewed as having a stock investment in each of dozens or hundreds of subsidiaries throughout a multinational group. When the payables are repaid, the General Rule would result in such repayments being treated as redemptions of stock, resulting in deemed distributions to the parent company.

Similar to our discussion of the application of Treas. Reg. section 1.1032-3 set forth below in the context of the Funding Rule (defined below), we see no justification for applying the General Rule in these circumstances. Stock recharges are exceedingly common ordinary course transactions engaged in to compensate employees of subsidiaries of public companies. The subsidiaries are not using stock recharges to reduce their equity value—the concern described by the Government in the Preamble for note distributions—but instead are using recharges to pay for parent company stock in connection with services rendered by employees (services that increase the value of the company).

> Recommendation 45: The Final Regulations should exempt debt instruments issued for EG stock used to compensate employees of the issuer of such debt instruments from the application of the General Rule.

C. Funding Rule

1. Overview of Funding Rule

Under Prop. Treas. Reg. section 1.385-3(b)(3) (the "Funding Rule"), a debt instrument that is treated as a principal purpose debt instrument ("PPDI") is treated as stock for all purposes of the Code. A debt instrument is a PPDI to the extent it is issued by a funded member to a member of the funded member's EG in exchange for property with a principal purpose of funding one of the following transactions:

(i) A distribution of property by the funded member to a member of the funded member's EG, other than a distribution of stock pursuant to an asset reorganization that is permitted to be received without the recognition of gain or loss under section 354(a)(1) or 355(a)(1) (a "Funded Distribution").

(ii) An acquisition of EG stock, other than in an Exempt Exchange, by the funded member from a member of its EG in exchange for property other than EG stock (a "Funded Stock Acquisition").

(iii) An acquisition of property by the funded member in an asset reorganization but only to the extent that, pursuant to the plan of reorganization, a shareholder that is a member of the funded member's EG immediately before the reorganization receives "other property" or money within the meaning of section 356 with respect to its stock in the transferor corporation (a "Funded Section 356 Exchange," and any of a Funded Distribution, a Funded Stock Acquisition, or a Funded Section 356 Exchange, a "Funded Distribution or Acquisition").[145]

In the Preamble, the Government states that the Funding Rule addresses transactions that, when viewed together, present similar policy concerns as the transactions that are subject to the General Rule.

In general, whether a debt instrument is a PPDI is based on "all the facts and circumstances" (the "Facts and Circumstances Test").[146] However, under a "per se rule," the Proposed Regulations will treat a debt instrument as a PPDI if it is issued by the funded member during the period beginning 36 months before the date of the Funded Distribution or Acquisition, and ending 36 months after the date of the Funded Distribution or Acquisition (the "Per Se Period," and such rule, the "Per Se Rule").[147] In effect, the Per Se Rule assumes satisfaction of the Facts and Circumstances Test within the Per Se Period.

For purposes of the Funding Rule, references to the funded member include references to any predecessor or successor of such member.[148] The Proposed Regulations provide that a "predecessor" is "defined to include" the distributor or transferor corporation in a transaction described in section 381(a) in which a member of the EG is the acquiring corporation, and the transferor corporation in a divisive reorganization described in section 368(a)(1)(D) or (G).[149] The term "successor" is "defined to *include*" the acquiring corporation in a transaction described

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[145] Prop. Treas. Reg. § 1.385-3(b)(3)(ii).

[146] Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(A).

[147] Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(B). The Proposed Regulations provide an exception from the Per Se Rule for a debt instrument that arises in the ordinary course of the issuer's trade or business in connection with the purchase of property or the receipt of services to the extent that it reflects an obligation to pay an amount that is currently deductible by the issuer under section 162 or currently included in the issuer's cost of goods sold or inventory, provided that the amount of the obligation outstanding at no time exceeds the amount that would be ordinary and necessary to carry on the trade or business of the issuer if it was unrelated to the lender. This exception is described and discussed in detail in Section VII.F.3 of this Comment Letter.

[148] Prop. Treas. Reg. § 1.385-3(b)(3)(v).

[149] Prop. Treas. Reg. § 1.385-3(f)(9).

in section 381(a) in which a member of the EG is the distributor or transferor corporation, and the acquiring corporation in a divisive reorganization described in section 368(a)(1)(D) or (G).[150]

Based on the Preamble, the Funding Rule appears to serve primarily as a backstop to the General Rule. Specifically, the Preamble states that "without [the Funding Rule], taxpayers that otherwise would have issued a debt instrument in a one-step transaction described in [the General Rule] would be able to use multi-step transactions to avoid the application of these [P]roposed [R]egulations while achieving economically similar outcomes."[151]

Because of this backstopping role of the Funding Rule, we believe that the Funding Rule, if retained in the Final Regulations, should be pared back in a manner equivalent to our suggested revisions to the General Rule in B.2 above. That is, the Funding Rule should be limited to transactions that are the equivalent of a distribution of a note (i.e., the first prong of the General Rule). Both a Funded Stock Acquisition and a Funded Section 356 Exchange, similar to the second and third prongs of the General Rule, respectively, result in the acquiring corporation obtaining stock or assets with value equivalent to the value of the debt issued in exchange therefor. As a result, in our view, these prongs of the Funding Rule are not justified by the Preamble's focus on transactions that do not introduce new capital, and we recommend that such prongs be eliminated.

> Recommendation 46: Funded Stock Acquisitions and Funded Section 356 Exchanges should be eliminated from the Funding Rule in the Final Regulations.

2. Principal Purpose Test

(a) Non-Rebuttable Presumption for Shorter Time Period

As described above, the Proposed Regulations presume that a debt instrument is issued with a principal purpose of funding a Funded Distribution or Acquisition if it is issued by the funded member during the Per Se Period. The taxpayer is not given the opportunity to rebut this presumption with evidence that it did not issue the debt instrument with the prohibited principal purpose. In effect, Prop. Treas. Reg. section 1.385-3(b)(3)(iv)(B) establishes a non-rebuttable presumption that certain EG instruments are PPDIs.

There is nothing novel about the Government using a principal purpose test in the application of an anti-abuse rule. What is new, and we believe unprecedented, is a rule that presumes a bad purpose without providing the taxpayer with the opportunity to prove the absence of a principal purpose of income tax avoidance. In fact, we are not aware of any other rule in the Code that applies based on the presence of "a principal purpose" to effect a particular transaction that contains a 72-month non-rebuttable presumption that the taxpayer acted with a prohibited "principal purpose."[152] To the extent any of the rules provide for a presumption, the

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[150] Prop. Treas. Reg. § 1.385-3(f)(11) (emphasis added).

[151] Preamble at 20918.

[152] The Code and Treasury Regulations contain a number of provisions that are based on a principal purpose rule. *See, e.g.*, Treas. Reg. § 1.367(b)-10(d) (providing that appropriate adjustments shall be made pursuant to Treas. Reg. § 1.367(b)-10 if, in connection with a triangular reorganization, a transaction is engaged in with a view to avoid the purpose of this section); Treas. Reg. § 1.701-2(c) (providing a rule that whether a partnership was "formed or

presumption is described along with an explanation of the taxpayer's ability to demonstrate to the Commissioner that the prohibited facts do not exist (i.e., a rebuttable presumption).[153] In

availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K" is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction); Treas. Reg. § 1.1502-17(c) (providing that if one member (B) directly or indirectly acquires an activity of another member (S), or undertakes S's activity, with the principal purpose to avail the group of an accounting method that would be unavailable (or would be unavailable without the Commissioner's consent) if S and B were treated as divisions of a single corporation, B must use the accounting method for the acquired or undertaken activity or must secure the Commissioner's consent); Treas. Reg. § 1.269-3(a) (providing that the provision applies only if the acquisition of control or property had a "principal purpose of evading or avoiding Federal income tax through a deduction or credit they would not otherwise have been entitled to); Treas. Reg. § 1.382-4(d) (providing the rule that in determining whether an ownership change has occurred, an option satisfies the ownership, control, and income test (and thus is treated as stock) if a "principal purpose of the issuance, transfer, or structuring of the option" is to avoid or ameliorate the impact of an ownership change); Treas. Reg. § 1.882-5(d)(2)(v) (providing the rule that U.S. booked liabilities shall not include a liability if one of the principal purposes for incurring or holding liability is to increase artificially the interest expense on the U.S. booked liabilities of a foreign corporation); Treas. Reg. § 1.956-1T(b)(4)(i)(B), (C) (providing that for purposes of section 956, U.S. property considered indirectly held by a CFC includes property acquired by any other foreign corporation or partnership controlled by the CFC if a principal purpose of creating, organizing, or funding by any means (including through capital contributions or debt) the other foreign corporation or partnership is to avoid application of section 956 with respect to the CFC); Treas. Reg. §§ 1.865-1(c)(6)(iii) and 1.865-2(b)(4)(iii) (providing that the matching rule will only apply if a taxpayer engages in a transaction or series of transactions with a principal purpose of recognizing foreign source income that results in the creation of a corresponding loss); Treas. Reg. § 1.304-4(b)(1) (providing that for purposes of determining the amount constituting a dividend (and source thereof) under section 304(b)(2), a corporation (deemed acquiring corporation) shall be treated as acquiring for property the stock of a corporation (deemed issuing corporation) controlled by the issuing corporation if, in connection with the acquisition for property of stock of the issuing corporation by the acquiring corporation, the issuing corporation acquired stock of the deemed issuing corporation with a principal purpose of avoiding the application of section 304 to the deemed issuing corporation); Treas. Reg. § 1.304-4(b)(2) (providing that for purposes of determining the amount constituting a dividend (and source thereof) under section 304(b)(2), the acquiring corporation shall be treated as acquiring for property the stock of a corporation (deemed issuing corporation) controlled by the issuing corporation if, in connection with the acquisition for property of stock of the issuing corporation by the acquiring corporation, the issuing corporation acquired stock of the deemed issuing corporation with a principal purpose of avoiding the application of section 304 to the deemed issuing corporation); Treas. Reg. § 1.1502-13(h) (providing that if a transaction is engaged in or structured with a principal purpose to avoid the purposes of this section (including, for example, by avoiding treatment as an intercompany transaction), adjustments must be made to carry out the purposes of this section).

[153] *See, e.g.*, section 336(d)(2)(B)(i) (providing a presumption that, except as otherwise provided by regulations, any section 351 transaction or contribution to capital after the date two years before the date the corporation adopts a plan of liquidation has a prohibited purpose; legislative history shows Congress's intent that Treasury will issue regulations providing that the prohibited purpose presumption will apply only if there is no clear and substantial relationship between the contributed property and the conduct of the corporation's current or future business enterprises); section 355(e) (providing a rebuttable presumption that a plan exists if one or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation during the 4-year period beginning on the date which is two years before the date of the distribution, unless it is established that the distribution and the acquisition are not pursuant to a plan or series of related transactions); section 382(l)(1) (providing a rebuttable presumption that any capital contribution made during the two-year period ending on the change date is, except as provided in regulations, treated as part of a plan a principal purpose of which is to avoid or increase any limitation under section 382; Notice 2008-78 provides that whether a contribution is part of a plan is determined based on all facts and circumstances unless the contribution is described in one of four safe harbors); Treas. Reg. § 1.707-3(b) (providing a rebuttable presumption that, where a partner transfers property to a partnership and within a two-year period the partnership transfers money or other consideration to the partner (without regard to the order of the transfers), the transfers are presumed to be a sale of

fact, the *only* principal purpose tests containing in effect a non-rebuttable presumption based on a specified time period of which we are aware stem from the same April 4, 2016 regulatory package that issued the Proposed Regulations at issue here.[154]

The Government justifies the non-rebuttable presumption within the Funding Rule because it believes it "difficult for the IRS to establish the principal purpose of internal transactions."[155] The Preamble goes on to provide that, due to the fungible nature of cash, "[i]n the absence of a per se rule, taxpayers could assert that free cash flow generated from operations funded any distributions or acquisitions," and "it would be difficult for the IRS to establish that any particular debt instrument was incurred with a principal purpose of funding a distribution or acquisition."[156]

Under the theory of the Preamble, any internal transaction where the IRS would have difficulty proving the taxpayer's intent would be subject to a non-rebuttable presumption. This theory would not be unique to the Proposed Regulations. In making this argument, the Government seems to disregard the fact that it does not have the burden to prove the taxpayer's intent when a presumption applies to a rule. Indeed, when a tax avoidance plan is deemed to exist under a "principal purpose test," the Government is not required to prove that such a plan or intent existed. Rather, the burden of proof has shifted to the party most capable of producing the necessary evidence (i.e., the taxpayer) to prove otherwise. For example, two or more CFCs are *presumed* to have been organized to prevent income from being treated as foreign base company income if the corporations are related persons.[157] This presumption may be rebutted by proof to the contrary. In our view, by arguing here that a presumption should be non-rebuttable when the Government cannot refute the taxpayer's rebuttal is, in effect, justifying a need to make an argument that is not the Government's argument to make.

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the property to the partnership unless the facts and circumstances clearly establish that the transfers do not constitute a sale); Treas. Reg. § 1.643(h)-1(a)(2) (providing a rebuttable presumption that a principal purpose of tax avoidance is deemed to exist if property is distributed to the U.S. person related to a grantor of the foreign trust during the period beginning 24 months before and ending 24 months after the intermediary's receipt of property from the foreign trust and the U.S. person is unable to demonstrate that the intermediary acted independently); Treas. Reg. § 1.954-1(b)(4)(i) (providing a rebuttable presumption that two or more CFCs are presumed to have been organized, acquired or maintained to prevent income from being treated as foreign base company income or insurance income under the *de minimis* test if the corporations are related persons, and the corporations are described in Treas. Reg. § 1.954-1(b)(4)(ii)(A), (B), or (C)); Treas. Reg. § 1.679-3(c)(2) (providing a rebuttable presumption that a principal purpose of tax avoidance exists if property is distributed to the U.S. person related to a beneficiary of the foreign trust and the U.S. person is unable to demonstrate that the intermediary acted independently).

[154] *See* Treas. Reg. § 1.7874-10T (providing a per se rule treating certain distributions during the 36-month period ending on the date of a domestic entity acquisition as "non-ordinary course distributions" ("NOCDs") for purposes of applying section 7874); Treas. Reg. § 1.7874-8T (providing, for purposes of section 7874, in effect a non-rebuttable presumption that excludes from the denominator of the ownership fraction stock of the foreign acquiring corporation attributable to a domestic entity acquisition that occurred within the 36-month period ending on the signing date of the relevant domestic entity acquisition); Treas. Reg. § 1.367(a)-3T(c)(3)(iii)(C) (providing a rule similar to the NOCD rule in the context of applying section 367(a) to an outbound transfer of domestic corporation stock).

[155] Preamble at 20923.

[156] *Id.*

[157] Treas. Reg. § 1.954-1(b)(4)(i).

A rebuttable presumption would adequately police whether a debt instrument was issued with a principal purpose of funding a particular distribution or acquisition. Moreover, a rebuttable presumption would accommodate fact patterns where a new debt is demonstrably not used to engage in a Funded Distribution or Acquisition. For example, if a new debt is incurred and repaid during the presumption period but before the Funded Distribution or Acquisition occurs, then the debt simply cannot have been used with a principal purpose of funding the Funded Distribution or Acquisition.[158]

In addition, the Preamble's discussion of cash fungibility simply does not support the establishment of a per se principal purpose rule. The concern expressed in the Preamble is that, because cash is fungible, a taxpayer could potentially rebut a presumption by identifying other sources of cash used for a Funded Distribution or Acquisition. In essence, the Government apparently is concerned with taxpayer tracing of "good" cash or property to a "bad" Funded Distribution or Acquisition while tracing "bad" cash or property (i.e., cash or property acquired through the issuance of intercompany debt) to "good" uses of the cash or property (e.g., using the cash in operations or to acquire assets). However, the Per Se Rule turns this tracing concern completely on its head, as illustrated by the following example.

> Example 11: USP owns CFC1 and CFC2. On January 1, Year 1, CFC1 borrows $100x from CFC2. As of December 31, Year 1, CFC1 has generated $500x of cash flow from operating its business. On December 31, Year 1, CFC1 distributes $100x to USP. Under the Per Se Rule, because the $100x distribution occurs within 36 months of the borrowing from CFC2, the distribution is per se treated as having been funded with the $100x borrowing. However, if cash were fungible, then only a pro rata portion of the December 31 distribution should be viewed as funded with the borrowed cash as opposed to the cash from operations, i.e., one-sixth of the December 31 distribution should be viewed as funded with the $100x borrowed cash.

Finally, to the extent a presumption is retained in the Final Regulations—whether rebuttable or non-rebuttable—the time period of the presumption should be shortened to be more in line with other provisions providing a presumption for a specified time period (generally, a 48-month time period).[159] Compared to such other provisions, the reach of the Proposed Regulations is far greater, affecting many ordinary course transactions and routine intercompany activities that have little to do with tax planning. As a result, we believe that the presumption period for purposes of the Funding Rule arguably should be reduced even more compared to such other provisions—perhaps to a 24-month period.

> Recommendation 47: Revise the Proposed Regulations to provide a *rebuttable* presumption that a debt instrument is a PPDI.

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[158] We note that none of the examples in the Proposed Regulations involve a fact pattern where the intercompany debt is repaid. See Section VII.C.6(b) for a discussion of such fact patterns.

[159] See the authorities cited in footnote 153 above.

Recommendation 48: If the Per Se Rule is not eliminated, the Per Se Period should be significantly reduced, perhaps to 24 months instead of the proposed 72-month period.

3. Application of Funding Rule to EG

Many basic definitional issues relating to the Funding Rule exist, rendering the rule difficult for taxpayers to administer, particularly in light of the Per Se Rule. These definitional issues appear to be ill-supported by the policy rationales articulated in the Preamble. Below we address a few of these complex issues and suggest amendments to the regulations to more appropriately align the operative rules with the apparent policy rationale.

(a) Predecessor/Successor Definition Issues

The Per Se Rule for testing whether a debt instrument is a PPDI poses significant compliance hurdles for large multinational groups even where the identity of the EG and the location of stock and assets within the group remains generally static. More likely, however, group membership is frequently changing for reasons that may have nothing to do with federal income taxes. Because the term "funded member" includes any predecessor and successor of such member, the scope of the terms "predecessor" and "successor" are critically important in these circumstances for determining the application of the Funding Rule.

As noted, the Proposed Regulations purport to "define" the terms "predecessor" and "successor" not by what those terms actually mean, but by what the terms include. Prop. Treas. Reg. section 1.385-3(f)(11)(A) provides that the term successor:

> *[I]ncludes*, with respect to a corporation, the acquiring corporation in a transaction described in section 381(a) in which the corporation is the distributor or transferor corporation. For purposes of the preceding sentence, the acquiring corporation in a reorganization within the meaning of section 368(a)(1)(D) or (G) is treated as an acquiring corporation in a transaction described in section 381(a) without regard to whether the reorganization meets the requirements of sections 354(b)(1)(A) and (B). The term successor does not include, with respect to a distributing corporation, a controlled corporation the stock of which was distributed by the distributing corporation pursuant to section 355(c).[160]

From this definition, only three aspects of the term "successor" are known for certain: (i) a section 381 transaction results in a predecessor/successor relationship, (ii) a divisive reorganization satisfying the requirements of section 368(a)(1)(D) and section 355 (a "D/355 Transaction") causes a distributing corporation and controlled corporation to be predecessor and successor, and (iii) a section 355(c) qualifying distribution (a "Straight Section 355 Transaction") does not cause a distributing corporation and controlled corporation to be predecessor and successor. Because the definition uses the words "includes" instead of "means," it leaves open the possibility that the list of successors is nonexclusive.

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[160] (Emphasis added).

For example, it is unclear whether a transferee in a section 351 transaction is a successor and, if it could be a successor, whether it depends on the transferor transferring all or substantially all of its assets. It could be argued that because the Proposed Regulations include a special successor rule in Prop. Treas. Reg. section 1.385-3(f)(11)(ii) for Funded Stock Acquisitions of subsidiary stock by issuance—in which an issuer of stock is treated as a successor with respect to a transferor of property to the issuer only with respect to a debt instrument issued by the transferor during the Per Se Period—that the general "successor" definition should be interpreted as not including a section 351 transferee. If that is the intention, it should be clarified in the Final Regulations.

Further, it is unclear whether a purchaser of assets could be viewed as a successor and, if it could be a successor, if it depends on whether the purchaser is acquiring all or substantially all of the seller's assets (assuming the seller is not viewed as liquidating for federal income tax purposes).

Finally, in addition to the above-mentioned section 351 and taxable asset purchase scenarios, taxpayers have no guidance as to what other transactions, if any, could give rise to a predecessor/successor relationship.

Providing that the terms predecessor and successor "include[]" certain items without providing a meaning of such terms imposes significant uncertainty with little apparent policy justification. The Proposed Regulations already impose a significant compliance burden on taxpayers. Knowing the identity of a predecessor or successor is a critical component of monitoring compliance with—and the application of—the rules, particularly in light of the Per Se Rule. The results of being a predecessor or successor to a "funded member" can be significant, resulting in recharacterization of purported debt as stock in whole or in part. Without a clear definition of these terms, taxpayers are left to attempt to apply the Funding Rule under multiple scenarios—scenarios where successor status does and does not exist. This level of uncertainty does not appear to advance the policy goals articulated in the Preamble.

Finally, using the word "includes" to define predecessor and successor is inconsistent with the approach taken in a wide array of other areas of the tax law. In numerous instances in the Code and regulations, "successor" is defined by what the term "means" or a similar formulation that provides an exhaustive list of potential successors.[161]

In addition to ambiguity, the definitions of predecessor and successor create the possible extension of the Funding Rule beyond the Per Se Period.

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[161] *See, e.g.*, Prop. Treas. Reg. § 1.172(h)-1(b)(2) (for purposes of the CERT rules, successor defined as transferee or distributee in a section 381(a) transaction); Prop. Treas. Reg. § 1.302-5(b)(4)(i)(B) (for purposes of redemptions under section 302(d), corporation that acquires assets of a redeeming corporation in a section 381(a) transaction); Prop. Treas. Reg. § 1.355-8(c) (for purposes of successors in section 355(e), corporation that receives property in a section 381(a) transaction); Treas. Reg. § 1.856-8(c)(2) (for purposes of restrictions on REIT elections after termination or revocation, entity meeting continuity of interest and continuity of assets requirement); Treas. Reg. § 1.1502-1(f)(4) (for purposes of successors in consolidated return rules, transferee or distributee of assets in a section 381(a) transaction, or if the transferee or distributee's basis in assets is determined by reference to the transferor's basis in assets; Treas. Reg. § 1.1502-28(b)(10) (for purposes of successors in consolidated section 108, section 381(a) successor); Treas. Reg. § 1.1275-6(g) (for purposes of integration of qualifying debt instruments, transferee in a nonrecognition transaction).

Example 12: *Subsequent merger of funded entity.* FP owns all of the stock of FS1, FS2 and USP, and FS1 issues a note to FS2 in exchange for cash in Year 1. In Year 3, USP distributes cash to FP. Ten years later, FS1 merges into USP. Because USP is treated as a successor to FS1, it appears as drafted that USP would be treated as having issued a note in exchange for property in Year 1 and as having made a distribution of property in Year 3, i.e., both legs of a Funding Rule transaction within the Per Se Period. Due to the lack of a clear time limitation on the definition of a predecessor and successor, the FS1 note issued in Year 1 would be treated as PPDI due to a merger in Year 13.

Recommendation 49: Clarify that the definitions of predecessor and successor are an exhaustive list of potential predecessors and successors. The first instance of the word "includes" in the definition of "predecessor" and "successor" should be changed to "means."

Recommendation 50: A funded member should be treated as having made a Funded Distribution or Acquisition that was in form made by a predecessor or successor only to the extent the funded member is treated as having made such Funded Distribution or Acquisition during the Per Se Period by virtue of a transaction that results in predecessor/successor status occurring within the Per Se Period.

(b) Application of Funding Rule when EG Changes

Another critical component to applying the Funding Rule is determining whether each leg of the Funding Rule (i.e., the issuance of debt in exchange for property and the Funded Distribution or Acquisition) has occurred. Each leg applies only if a transaction occurs within the EG.[162] More specifically, debt is considered funded debt only to the extent it is issued "by a corporation (the funded member) to a member of the funded member's [EG] in exchange for property."[163] Distributions or acquisitions can be treated as Funded Distributions or Acquisitions only if (i) there is a distribution of property "by the funded member to a member of the funded member's [EG]";[164] (ii) there is an acquisition of EG stock "by the funded member from a member of the funded member's [EG]";[165] or (iii) there is an acquisition by the funded member in an asset reorganization in which a shareholder that is a "member of the funded member's [EG] immediately before the reorganization"[166] receives boot.

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[162] *See* Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(A) (distribution of property by the funded member to a member of the funded member's EG); Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(B) (acquisition of EG stock by the funded member from a member of the funded member's EG); Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(C) (acquisition of property by the funded member in an asset reorganization where a shareholder that is a member of the funded member's EG receives boot).

[163] Prop. Treas. Reg. § 1.385-3(b)(3)(ii).

[164] Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(A).

[165] Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(B).

[166] Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(C).

Because each of these provisions looks only to whether the transaction occurs within the "funded member's [EG]," the rules appear to apply without regard to whether such EG changes during the relevant periods of time. If this reading is correct, then the Funding Rule can lead to very curious results, as illustrated by the following examples.

> Example 13: *Legs of Funding Rule Transaction involve different groups.* USP1 owns all of the stock of FT. FT is unrelated to USP2, which owns all of the stock of FS. In Year 1, FT makes a distribution of $100x to USP1. In Year 2, USP2 acquires all of the stock of FT in exchange for cash. In Year 3, FS lends $100x to FT.

In Example 13, the Year 1 distribution is a distribution of property by FT to a member of FT's EG. The Year 3 debt issued by FT to FS is issued to a member of FT's EG. Because the Year 1 distribution and the Year 3 borrowing occur within 36 months of each other, the Per Se Rule appears to treat the Year 3 debt as stock under the Funding Rule. This result occurs despite the fact that the distribution is made to a company that is completely unrelated to the company that made the intercompany loan.

In these types of fact patterns, the policy rationales set forth in the Preamble are not advanced by applying the Funding Rule. FS's loan to FT demonstrably did not fund FT's prior distribution to USP1, unless unique facts exist suggesting coordination between the unrelated parties.[167]

If this result is correct, it would impose an extraordinary diligence burden on every company that is acquiring an unrelated target company. A potential acquirer will need to inquire about the target corporation's previous history of incurring intercompany debt or making Funded Distributions or Acquisitions, including undertaking transactions that are not in form distributions or acquisitions but that could be so characterized for U.S. federal income tax purposes (e.g., deemed distributions through non-arm's length transfer pricing). Moreover, because of the cascading impact of recharacterization transactions, and the fact that the Per Se Rule is not a safe harbor, such diligence efforts will potentially need to extend for many years in the past. For example, an intercompany debt issued six years ago (assuming we are far enough from the effective date of the Proposed Regulations) could be treated as stock because of a distribution four years ago; and the deemed exchange of debt-for-stock resulting from such recharacterization could cause another debt issued two years ago to be treated as equity. The potential look-back period is bounded only by the effective date of the regulations. We question whether this diligence burden is justified by the purported policy rationale of the Proposed Regulations where the two legs of the Funding Rule transaction involve unrelated taxpayers.[168]

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[167] *See, e.g., Waterman Steamship v. Comm'r*, 430 F.2d 1185 (5th Cir. 1970).

[168] We note there is some overlap between the discussion here regarding the legs of a Funding Rule transaction occurring within different EGs and our later discussion that Prop. Treas. Reg. section 1.385-3 should be subject to a "relevance" exception and should apply differently to payments with respect to acquisitions of debt instruments recharacterized as stock. However, the points are not coextensive, and the relevance exception would ameliorate some, but not all, of the concerns with applying the Funding Rule to different EGs.

Example 14: *Successor rules and Funding Rule transactions involving different EGs.* D1 is a widely held, publicly traded corporation that owns D2 and S. In Year 1, S lends $100x to D2 in exchange for a D2 note. In Year 2, D2 contributes property to C2, a newly formed corporation, and distributes C2 to D1 in a transaction that qualifies as a reorganization under sections 368(a)(1)(D) and 355. Also in Year 2, D1 contributes C2 to C1, also a newly formed corporation, and distributes C1 to D1's public shareholders in a transaction that qualifies as a reorganization under sections 368(a)(1)(D) and 355. In Year 3, C2 distributes $100x to C1.

In Example 14, because C2 received property from D2 pursuant to a section 368(a)(1)(D) reorganization, C2 is treated as a successor to D2.[169] Similarly, C1 is treated as a successor to D1. D2 is a "funded member" by virtue of the Year 1 loan from S. Because all references to the "funded member" include a reference to any predecessor or successor of such member,[170] C2's distribution of $100x to C1 may be considered a distribution of property to the "funded member's [EG]." It is unclear what policy rationale is served by causing one public company's decision to cause a subsidiary to distribute cash to taint another, independent public company's intercompany debt.

Example 15: *Funding subgroup remains part of same EG.* USP1 owns all of the stock of FS1 and FS2. In Year 1, FS1 lends $100x to FS2 in exchange for an FS2 note. In Year 2, USP1 sells all of the stock of FS1 and FS2 to unrelated USP2. In Year 3, FS2 distributes $100x to USP2.

The Funding Rule appears to apply to Example 15 as well. Based on the policy rationale articulated in the Preamble, applying the Funding Rule to Example 15 seems like an appropriate result. However, we see a distinction between Example 13 and Example 14, on the one hand, and Example 15, on the other hand. In Example 13 and Example 14, the two legs of the Funding Rule transaction do not both occur within the same EG. The corporation making the related-party loan to the funded member is not in the same EG as the member receiving the distribution from the funded member. In Example 15, by contrast, both legs occur within the same EG. With respect to Example 15, this is true even though FS1 and FS2 were owned by the USP1 group at the time of the related-party loan, whereas they are owned by the USP2 group at the time of the distribution. Because the funded member and the funding member are both acquired by USP2, there is potentially a policy rationale for applying the Funding Rule, and the due diligence exercise mentioned above should be less onerous.

Recommendation 51: The Final Regulations should provide that the Funding Rule can apply only if the corporation making the loan to the funded member, and (i) the corporation to which the funded member makes a Funded Distribution, (ii) the corporation from which the funded member acquires EG stock or assets in a Funded Stock Acquisition or (iii) the corporation that receives "other property" or money in a Funded Section 356 Exchange, are members of the same EG.

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[169] Prop. Treas. Reg. § 1.385-3(f)(11)(i).

[170] Prop. Treas. Reg. § 1.385-3(b)(3)(v).

(c) Application of Funding Rule to Treas. Reg. Section 1.1032-3 Transactions

Treas. Reg. section 1.1032-3 provides rules for certain transactions in which a corporation or partnership (the acquiring entity) acquires money or other property in exchange, in whole or in part, for stock of a corporation (the issuing corporation). The regulation applies, for example, to a transaction in which a publicly traded parent corporation contributes its own stock to a subsidiary, which uses the parent stock to acquire property (e.g., assets or stock of a target company in a transaction that does not qualify as a reorganization). The regulation also applies to a parent corporation's use of its own stock as equity compensation for employees of a subsidiary.[171]

In a transaction to which the regulation applies, no gain or loss is recognized on the disposition of the issuing corporation's stock by the acquiring entity. The transaction is treated as if, immediately before the acquiring entity disposes of the stock of the issuing corporation, the acquiring entity purchased the issuing corporation's stock from the issuing corporation for fair market value with cash contributed to the acquiring entity by the issuing corporation (or, if necessary, through intermediate corporations or partnerships). Under this characterization, the acquiring entity's deemed purchase of issuing corporation stock for cash appears to fall within the definition of a Funded Stock Acquisition because the transaction is an acquisition of EG stock in exchange for property.

We see no justification for applying the Funding Rule in these circumstances. Publicly traded companies commonly use parent company stock to compensate employees of the group, regardless of which entity within the group employs the employees. Such routine transactions now would give rise to Funded Distributions or Acquisitions that, under the Per Se Rule, would cause related-party debt issued within the Per Se Period to be recharacterized as stock. This is the case even though such debt demonstrably was not used to fund the acquisition of EG stock; rather, such EG stock would have been contributed down the chain, and the deemed purchase of EG stock would arise solely under the fiction set forth in Treas. Reg. section 1.1032-3(b) that is designed to prevent the recognition of "zero basis" gain.

> Recommendation 52: We recommend that the Government clarify in the Final Regulations that a deemed purchase of EG stock pursuant to Treas. Reg. section 1.1032-3 is not treated as a Funded Distribution or Acquisition.

(d) Retroactive Recharacterization of Mergers and Liquidations Among EG Members

The Funding Rule also can create anomalous results in situations in which the related-party borrowing and the Funded Distribution or Acquisition occur during the same tax year. Under the general timing rule in Prop. Treas. Reg. section 1.385-3(d)(1)(i), when the Funding Rule operates to treat a debt instrument as stock, the debt instrument is treated as stock *when issued*. Under Prop. Treas. Reg. section 1.385-3(d)(1)(ii), however, when the Funded Distribution or Acquisition occurs in a taxable year subsequent to the taxable year in which the

[171] Treas. Reg. § 1.1032-3(e), Ex. 4.

debt instrument was issued, the debt instrument is deemed to be exchanged for stock when the relevant Funded Distribution or Acquisition occurs. The general timing rule can retroactively cause debt to be treated as stock where a Funded Distribution or Acquisition occurs later during the same tax year as the issuance of the debt instrument. This retroactivity can adversely affect the anticipated tax treatment of transactions occurring before the Funded Distribution or Acquisition occurs. These results are illustrated by the following examples.

> Example 16: *Section 368(a)(1)(B) reorganization followed by distribution in subsequent tax year.* P owns all of the stock of FS1, FS2, and FS3. P and FS3 own 50 percent each of FS4. On January 1 of Year 1, FS1 lends $100x to FS2 in exchange for an FS2 note. On July 1 of Year 1, P transfers all of the stock of FS2 to FS4 solely for voting stock of FS4. On July 1 of Year 3, FS2 distributes $100x to FS4.

Under these facts, the Year 1 loan from FS1 to FS2 causes FS2 to be a funded member for purposes of the Funding Rule. The Year 1 transfer of FS2 to FS4 qualifies as a reorganization under section 368(a)(1)(B). When FS2 makes a distribution in Year 3, under Prop. Treas. Reg. section 1.385-3(d)(1)(ii), the distribution causes the FS2 note to be deemed exchanged for stock on July 1, Year 3, the date of the distribution. If the FS2 note does not carry voting rights, then it will be deemed exchanged for nonvoting stock in FS2. Such deemed exchange generally should not prevent the Year 1 transfer of FS2 from qualifying as a section 368(a)(1)(B) reorganization.[172]

> Example 17: *Section 368(a)(1)(B) reorganization followed by distribution in same tax year.* The facts are the same as Example 16, except that FS2 distributes $100x cash to FS4 on December 31, Year 1, instead of in Year 3.

Under Example 17, the general timing rule of Prop. Treas. Reg. section 1.385-3(d)(1)(i) applies. As a result, the Year 1 distribution of cash by FS2 causes the FS2 note to be recharacterized as stock *as of the time of issuance of the note*, i.e., January 1, Year 1. As in Example 16, the note is treated as nonvoting stock in FS2. Because FS4 did not acquire section 368(c) control of FS2 on the July 1, Year 1 transfer of FS2 stock, the transaction does not qualify as a section 368(a)(1)(B) reorganization.[173]

Similar issues arise with other types of transactions intended to qualify as tax free based on the ownership or acquisition of a specified amount of stock.[174]

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[172] Taxpayers would still need to consider the potential application of step transaction principles if a debt instrument recharacterized as nonvoting stock is issued as part of a plan. For purposes of the example, we assume that the Year 3 distribution occurs in a separate transaction from the Year 1 acquisition of FS2.

[173] We note that the qualification of the exchange of FS2 stock for FS4 stock as a reorganization under section 368(a)(1)(B) is not necessarily cured by having issued the FS2 Note with voting rights if the note represented more than 20 percent of FS2's voting power.

[174] See Section X of this Comment Letter for a more detailed discussion on the potential collateral consequences of the Proposed Regulations.

Recommendation 53: We recommend that the Government change the general timing rule in Prop. Treas. Reg. section 1.385-3(d)(1)(i) such that in no event will debt be recharacterized as stock under the Funding Rule before the date on which a Funded Distribution or Acquisition occurs that triggers application of the Funding Rule.

4. Funded Distributions

For purposes of the Funding Rule, the Government appears to have been attempting to categorize most types of tax-free transfers of property under subchapter C as Funded Distributions, successor transactions, or both. Sections 332, 351, 355 and 368 all generally provide paths to tax-free treatment of certain transfers of property to and from corporations. However, for purposes of the Funding Rule, section 332 liquidations are to be treated both as Funded Distributions and as successor transactions. It is unclear whether section 351 transactions are treated as successor transactions, at least, under certain circumstances.[175] Straight Section 355 Transactions are treated as Funded Distributions, while D/355 Transactions are treated as successor transactions.[176] Acquisitive reorganizations under section 368 are generally treated as successor transactions.[177] While the policy goals of the Proposed Regulations may justify treating certain tax-free transactions as Funded Distributions, we do not believe that section 332 liquidations or section 355 transactions should be treated as Funded Distributions for the reasons set forth below.

(a) Section 332 Liquidations

The treatment of section 332 liquidations as Funded Distributions seems inappropriate and possibly unintended, and the Preamble does not address the reasons for such treatment. In general, the Funding Rule is intended to prevent members of an EG from using debt to indirectly engage in transactions the General Rule prevents them from engaging in directly. While a distribution of a note is the principal transaction the General Rule aims to prevent, a loan to an EG Member followed by a section 332 liquidation of such corporation into another member of the EG is not economically similar to such a transaction. In addition, the Government appears to have correctly concluded that upstream reorganizations that are economically indistinguishable from section 332 liquidations should not be treated as Funded Distributions.

Example 18: *Section 332 liquidation.* P owns S1 and S2. In Year 1, S1 loans $100x to S2. In Year 2, S2 merges under state law into P in a transaction that qualifies for tax-free treatment under section 332.[178]

Example 19: *Upstream reorganization.* The facts are the same as in Example 18, except that P then reincorporates half of the S2 assets into newly formed S3 in

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[175] See Section VII.C.3(a) of this Comment Letter for a discussion of whether section 351 transactions should be treated as successor transactions for purposes of the Funding Rule.

[176] Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(A); Prop. Treas. Reg. § 1.385-3(b)(3)(v).

[177] Prop. Treas. Reg. § 1.385-3(b)(3)(v).

[178] *See* Treas. Reg. § 1.332-2(d).

a transaction that qualifies for tax-free treatment under section 351. As a result of the reincorporation, the merger of S2 into P qualifies as a tax-free reorganization under section 368(a)(1)(A) but not (for the sake of argument) as a liquidation under section 332.[179]

Under the Proposed Regulations, the section 332 liquidation in Example 18 is treated by definition as a Funded Distribution. However, the section 368(a)(1)(A) reorganization in Example 19 is not treated as a Funded Distribution. As a result, in Example 18, the Year 1 related-party loan is recharacterized as equity under the Funding Rule. In Example 19, the Year 1 related-party loan continues to be treated as debt. In both Example 18 and Example 19, P is a successor to S2 for purposes of the Funding Rule. The result in Example 18 seems completely inappropriate from a policy perspective, even accepting the policy rationale set forth in the Preamble. Although S2 has borrowed from an EG Member, it has not distributed property other than to a successor. The transaction is substantively identical to a transaction in which P directly borrowed from S1, which would not, without a further Funded Distribution or Acquisition, be subject to recharacterization under the Funding Rule.

> Recommendation 54: The Government should treat section 332 liquidations only as successor transactions for purposes of the Funding Rule, not as Funded Distributions.[180]

(b) Section 355 Distributions

The treatment of section 355 transactions as distributions for purposes of the Funding Rule also seems inappropriate. For reasons that are unclear from the Preamble, the Government determined that a section 355 distribution should be treated differently for purposes of the Funding Rule, depending on whether it is a D/355 Transaction or a Straight Section 355 Transaction. A Straight Section 355 Transaction is treated as a Funded Distribution, while a D/355 Transaction is not. However, the Preamble does not identify a means by which corporations can use either a Straight Section 355 Transaction or a D/355 Transaction to indirectly engage in a transaction that the General Rule would prohibit them from undertaking directly. Moreover, it appears that the Government concluded that a D/355 Transaction should not be treated as a Funded Distribution. The rationale for not treating D/355 Transactions as Funded Distributions should be the same as it is for Straight 355 Transactions.

In addition, if the Government continues to treat Straight Section 355 Transactions as Funded Distributions while not treating D/355 Transactions as Funded Distributions, it will have to address the question of how to treat a D/355 Transaction where the controlled corporation is a pre-existing subsidiary of the distributing corporation. Although we understand the IRS typically has issued private letter rulings treating a spin-off of a preexisting controlled corporation as a D/355 Transaction where any assets are transferred by the distributing

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[179] *See* Treas. Reg. § 1.368-2(k); Rev. Rul. 69-617, 1969-2 C.B. 57.

[180] It is possible that the successor rule could be read as providing that a section 332 liquidation is not a Funded Distribution or Acquisition because the distribution would be between a predecessor and a successor. If that is the intended reading, the Government should clarify as such in the Final Regulations.

corporation to the controlled corporation,[181] the Proposed Regulations elevate this question significantly in importance. Here, because of the different tax consequences under the Proposed Regulations, we encourage the Government to address this issue.

> Recommendation 55: The Government should not treat Straight Section 355 Transactions as Funded Distributions.

5. Serial Recharacterizations due to Funding Rule

We also note that a recharacterization of a debt instrument pursuant to the Funding Rule can result in iterative consequences. As a paradigm example, a distribution in respect of a debt instrument that has been recharacterized as stock may trigger the application of the Funding Rule with respect to other debt.

> Example 20: *Cascading Recharacterization.* P owns all of the stock of S1, S2 and S3. S2 issues a note (the "S2 Note") to S1 in exchange for $100x cash. S2 loans $200x cash to S3 in exchange for a note (the "S3 Note"). S3 distributes property worth $200x to P.

Under Example 20, S3's distribution of $200x property to P is a Funded Distribution by S3. The Funded Distribution by S3 would result in a recharacterization of the S3 Note to S3 stock, which itself could be an acquisition of EG Member stock by another EG Member (S2) for property (i.e., a Funded Stock Acquisition by S2). The Funded Stock Acquisition would be the Funded Distribution or Acquisition by S2 that would cause the recharacterization of the S2 Note into S2 stock.

We note that additional complexity is added if the S2 Note or S3 Note had already been repaid (e.g., overnight lending) at the time of the distribution of property by S3.

We can see circumstances where a cascading recharacterization is consistent with the policy rationale set forth in the Preamble. For example, in Example 20, a loan from S1 to S2, followed by a distribution by S2 would be a prototypical Funding Rule transaction that results in recharacterization of the loan as stock. Such a transaction achieves the same result as causing S1 to lend to S2, then S2 to lend to S3, then S3 to make a distribution, which also arguably should be caught by the Funding Rule. In our view, however, the cascading recharacterization phenomenon inappropriately covers many other benign transactions. Cash pools, once tainted by a recharacterized debt, can cause group-wide recharacterizations of cash pool deposits or borrowings.[182] Moreover, because of the lengthy time period and per se nature of the Per Se Rule, these cascading impacts have the potential to extend for many years, well beyond what could reasonably be viewed as a planned series of transactions with a principal purpose of achieving a result the Government disfavors.

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[181] For a discussion of the issue, see Bailine, "Sections 355(c) and 361(c)-A Rescue Package Is Needed," 36 J. Corp. Tax'n (Mar./Apr. 2009).

[182] For a detailed discussion on the impact of the Proposed Regulations on cash pools, see Section IX of this Comment Letter.

Example 21: *Interest payment on deemed equity treated as a Funded Distribution.* The facts are the same as in Example 20, except that S2 makes a distribution to P that causes a portion of the S2 Note to be treated as equity. When S2 later pays "interest" on such deemed stock, the transaction is a Funded Distribution that can cause a further portion of the S2 Note to be treated as equity.

It should be possible to address any Government concerns with abuse of the rules through intermediaries through an anti-abuse rule or the application of anti-conduit principles rather than subjecting all taxpayers to the unforeseen and difficult to unwind results of serial recharacterizations.

Recommendation 56: We recommend that, for purposes of the Per Se Rule, neither a deemed exchange of debt for equity (by virtue of a recharacterization of the debt under either Prop. Treas. Reg. section 1.385-2 or Prop. Treas. Reg. section 1.385-3), nor any transfer or redemption of or payment with respect to the deemed equity should give rise to a General Rule transaction or Funded Distribution or Acquisition.

6. Limit Application of Funding Rule to Each Member's "Net Funding"

(a) Net Funding Rule

In order to achieve the policy objectives motivating the Funding Rule while permitting ordinary course transactions and bona fide cash pool arrangements, we recommend that the Final Regulations limit application of the Funding Rule to the net funding that an EG Member receives within a taxable year (the "Net Funding Rule"). For this purpose, net funding equals the sum of the member's aggregate borrowings from other EG Members, reduced by the member's loans to other EG Members within a taxable year.

The example below compares the results under the current proposal to the results under the Net Funding Rule.

Example 22: *Funded Distribution out of cash on hand.* In Year 1, Member A borrows $100x from Member B, and Member A lends $95x to Member C. Member A also has $80x of cash on hand. During the Per Se Period, Member A distributes $75x to its parent, Member D. Under the Funding Rule, all $75x of the distribution would be treated as a Funded Distribution. This is the case even though it is clear that the borrowing did not fund the distribution, given that Member A had $80x of cash on hand before borrowing from Member B.

Under the Net Funding Rule, the Funding Rule would apply only to the extent of $5x at the time of the distribution because in Year 1, Member A's net borrowing increases by $5x. We note that if Member A subsequently distributes its $95x of Member C receivables within the Per Se Period, the Net Funding Rule would cause A's funding to increase to $100x. This result is short of a pure tracing rule, and gives effect to the fact that Member A's cash position has increased by $5x.

Recommendation 57: We recommend that the Final Regulations include a Net Funding Rule.

(b) Net Contribution Rule

As proposed, the Funding Rule is indifferent as to whether a funded member's net equity actually decreases as a result of a funding transaction. In this respect, the breadth of the Funding Rule appears to be inconsistent with an underlying philosophy of the Proposed Regulation—that related-party value transfers ought to be based in equity. We believe that if an EG Member receives capital contributions from the start of the Per Se Period through and including the same taxable year as a potential funding transaction, those capital contributions should be taken into account in determining the extent to which the EG Member is funded (the "Net Contribution Rule").[183] Accepting for this purpose the premise of the Funding Rule, we see no policy justification for recharacterizing the gross amount of a borrowing. The following example demonstrates the operation of the Net Contribution Rule.

> Example 23: *Contribution in excess of Funded Distribution.* In Year 1, Member A distributes $75x to its parent, Member D. In Year 2, Member A borrows $100x from Member B. Later in Year 2, Member C, which has net assets with a value of $300x, merges with and into Member A in exchange for $300x worth of Member A stock. Under the Net Contribution Rule, the Funding Rule would not apply in Year 2 because Member A received a capital contribution in Year 2 equal to or in excess of the debt incurred in Year 2.[184]

The same rule would apply to a transaction in which the potential funding transaction occurs in a taxable year preceding what would otherwise be a funded transaction.

Recommendation 58: We recommend the Final Regulations include a Net Contribution Rule.

7. Treatment of Non-Dividend Equivalent Distributions and Similar Transactions

Our previous discussion in Section VII.B.3 above regarding the treatment of non-dividend equivalent distributions and similar transactions for the General Rule applies with equal force to transactions subject to the Funding Rule.

Recommendation 59: We recommend an exception to the definition of Funded Acquisitions or Distributions when the distribution or deemed distribution results in sale or exchange treatment.

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[183] For this purpose, we recommend that the term "capital contribution" would be broadly defined to include any transaction (e.g., a section 351 exchange, a merger, etc.) that increases the equity value of a member. Furthermore, a capital contribution should include transactions in which assets are acquired from persons or entities that are not EG members.

[184] Application of the Net Contribution Rule would remain subject to the rule for predecessors and successors.

D. Interaction between General Rule and Funding Rule

Prop. Treas. Reg. section 1.385-3(b)(5) contains a limited coordination rule between the General Rule and the Funding Rule. Specifically, when a debt instrument that is issued and distributed pursuant to an asset reorganization is recharacterized as stock under the General Rule, the distribution of such stock (which could be viewed under federal income tax principles as non-qualified preferred stock as defined under section 351(g) and thus, "other property" within the meaning of section 356) is ignored for purposes of the Funding Rule. Several examples illustrate additional coordination between the General Rule and Funding Rule.

In Example 1 of Prop. Treas. Reg. section 1.385-3(g)(3), FS lends $100x to USS1 in exchange for USS1 Note A on Date A of Year 1. On Date B of Year 2, USS1 distributes USS1 Note B, with a value of $100x, to FP in a distribution. The example concludes that because USS1 Note B is treated as stock under the General Rule, the distribution of USS1 Note B is not a distribution of property and USS1 Note A is not recharacterized under the Funding Rule.

In Example 3 of Prop. Treas. Reg. section 1.385-3(g)(3), USS1 issues USS1 Note to FP in exchange for 40 percent of the stock of FS. The example concludes that because USS1 Note is treated as stock under the General Rule at the time of issuance, USS1 Note is not treated as debt for purposes of applying the Funding Rule.

Examples 1 and 3 of Prop. Treas. Reg. section 1.385-3(g)(3) demonstrate that the issuance of a debt instrument recharacterized as stock under the General Rule generally does not create a risk that the Funding Rule will be subsequently applied. However, the coordination between the General Rule and Funding Rule is unclear when a debt instrument that would otherwise be subject to the General Rule is not recharacterized as stock by reason of the Current E&P Exception (defined and discussed in greater detail below).

> Example 24: *Recharacterization of previously exempted debt instrument.* FP owns USS1 and USS2. USS1 has $100x of Current E&P for Year 1. In Year 1, FP transfers USS2 to USS1 in exchange for a $100x note ("Note A"). The Current E&P Exception applies to reduce the amount of USS1's acquisition of USS2 to $0, meaning the General Rule does not apply to recharacterize Note A as stock. In Year 2, USS1 has $0 of Current E&P and distributes $50x of property to FP. If the Funding Rule is intended to apply in this scenario, $50x of Note A would be recharacterized as stock under the Funding Rule.

This result—where the note arises in a transaction under the second or third prong of the General Rule—should be contrasted with the result that would occur where the note is issued in a transaction under the first prong of the General Rule (i.e., a note distribution). Specifically, the definition of a PPDI for purposes of the Funding Rule is a debt instrument issued in exchange for property.[185] Thus, if a debt instrument is (i) issued in a distribution with respect to, but not in exchange for, stock of the corporation, and (ii) is not subject to recharacterization under the General Rule by reason of the Current E&P Exception, such debt instrument cannot be subsequently recharacterized as stock under the Funding Rule. Because the issuance of a debt

[185] Prop. Treas. Reg. § 1.385-3(b)(3)(ii).

instrument in a distribution is the baseline transaction upon which Prop. Treas. Reg. section 1.385-3 is based, it seems at odds with the basic policy of the regulation that the issuance of a debt instrument in a distribution would be the only instance in which the Funding Rule could not apply to recharacterize as stock a debt instrument that was not recharacterized under the General Rule by operation of the Current E&P Exception. The following example illustrates this point.

> Example 25: *No recharacterization of note distribution.* FP owns USS1 and USS2. USS1 has $100x of Current E&P for Year 1. In Year 1, USS1 distributes a $100x note ("Note A") to FP. The Current E&P Exception applies to reduce the amount of USS1's distribution to $0, meaning the General Rule does not apply to recharacterize Note A as stock. In Year 2, USS1 acquires USS2 in exchange for property.

Under this revised example, the Funding Rule by definition cannot apply to Note A because Note A is not issued in exchange for property (i.e., it is issued as a distribution).

Because the Funding Rule is intended to backstop the General Rule, in instances in which the Current E&P Exception prevents the General Rule from treating a debt instrument as stock, the Funding Rule also should not apply to treat a debt instrument as a PPDI. Such instrument is not the first "leg" of a bifurcated transaction that would be subject to the General Rule if carried out pursuant to the same plan—the debt instrument is both legs of the transaction and is subject to the General Rule. This recommendation is further supported by the difference between the two preceding examples, where a potentially different, and more taxpayer favorable, result obtains under a transaction described in the first prong of the General Rule than a transaction described in the second or third prong of the General Rule.

> Recommendation 60: We recommend that the Final Regulations explicitly provide that the Funding Rule cannot apply to recharacterize a debt instrument as stock if that debt instrument would have been recharacterized as stock under the General Rule but for the application of the Current E&P Exception.

E. Anti-Abuse Rule

Prop. Treas. Reg. section 1.385-3(b)(4) (the "-3 Anti-Abuse Rule") provides that, in the event that a debt instrument has not been recharacterized under either the General Rule or the Funding Rule, such instrument will be "treated as stock if it is issued with a principal purpose of avoiding the application of [Prop. Treas. Reg. section 1.385-3 or -4]." The -3 Anti-Abuse Rule also applies to recharacterize a non-debt instrument as stock if such instrument was "issued with a principal purpose of avoiding the application of [Prop. Treas. Reg. section 1.385-3 or -4]." The -3 Anti-Abuse Rule provides that examples of a non-debt instrument that may be subject to recharacterization under this rule include "a contract to which section 483 applies [and] a nonperiodic swap payment." Finally, the -3 Anti-Abuse Rule provides a non-exhaustive list of five transactions to which the -3 Anti-Abuse Rule may apply (provided the principal purpose for engaging in each transaction is to avoid the application of Prop. Treas. Reg. section 1.385-3 or -4), including when:

(i) A debt instrument is issued to, and later acquired from, a person that is not a member of the issuer's EG;

(ii) A debt instrument is issued to a person that is not a member of the issuer's EG, and such person later becomes a member of the issuer's EG;

(iii) A debt instrument is issued to an entity that is not taxable as a corporation for federal tax purposes;

(iv) A member of the issuer's EG is substituted as a new obligor or added as a co-obligor on an existing debt instrument; and

(v) A debt instrument is issued or transferred in connection with a reorganization or similar transaction.

We are concerned that the -3 Anti-Abuse Rule is overly broad, especially in light of the numerous safeguards already built in to the General Rule and the Funding Rule. First, the General Rule's applicability to acquisitions of EG Member stock and certain asset reorganizations serves as a backstop to distributions of issuer debt. According to the Preamble, such additions were included in the General Rule because they were "similar in many respects to a distribution of a debt instrument and implicate similar policy considerations."[186] Further, and perhaps more to the point:

> [I]f the proposed regulations addressed only debt instruments issued in a distribution, and not acquisitions of affiliate stock that have the effect of a distribution, taxpayers would readily substitute the latter transaction for the former in order to produce the inappropriate tax result that the proposed regulations are intended to prevent.[187]

In essence, the second and third prongs of the General Rule already serve as a non-rebuttable anti-abuse rule.

Second, the Funding Rule is a further backstop to the General Rule serving, in effect, as a second anti-abuse rule. In fact, the Funding Rule is based off of a similar standard as the -3 Anti-Abuse Rule—that is, the initial transaction in which the debt instrument is issued must be issued "with a *principal purpose* of funding a [Funded Distribution or Acquisition]."[188] Further, as discussed above, such "principal purpose" rule is not even rebuttable if the debt instrument is issued during the Per Se Period.

When layered on to the safeguards described above, the -3 Anti-Abuse Rule is an overbroad rule that chills legitimate transactions. In its current form, there is a lack of clarity as to whether the -3 Anti-Abuse Rule will tolerate the most innocent of structures. The following example demonstrates the overbreadth of the rule.

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[186] Preamble at 20917.

[187] *Id.*

[188] Prop. Treas. Reg. § 1.385-3(b)(3)(ii) (emphasis added).

Example 26: *Decision to borrow from third-party lender.* USP, a domestic corporation, wholly owns CFC, a foreign corporation. CFC is generally profitable and annually makes distributions to USP in excess of its Current E&P. CFC has decided it is going to acquire an unrelated foreign target for cash. CFC, not holding a sufficient amount of cash on hand to effectuate the acquisition, has two options: it may borrow cash from USP in exchange for a CFC note or it may borrow cash from a third-party lender in exchange for a CFC note. The third-party borrowing would result in significantly more transaction costs than if CFC were to borrow from USP. Understanding that if it borrows from USP, the CFC note would likely be recharacterized as CFC stock under the Funding Rule in light of its historical distribution and E&P profile and that it is likely that such profile will continue for at least the next three years, CFC decides to borrow from the third-party lender.

This example is just one of the many types of transactions that could be caught under the overbroad -3 Anti-Abuse Rule as drafted in the Proposed Regulations. We also note that if the CFC note issued in Example 26 was subject to the -3 Anti-Abuse Rule, it is unclear which entity would be treated as owning the recharacterized instrument. It would seem odd to treat the third-party lender as the owner. If such third-party lender were a special tax status entity, the receipt of dividends instead of interest for federal income tax purposes could result in a loss of such entity's special tax status. Further, such third-party lender would have no control over, and may not even know, when CFC engages in a subsequent transaction that ultimately triggers the application of the Funding Rule. Alternatively, deeming another EG Member to be the lender would be arbitrary—especially where multiple EG Members have or where no single EG Member has the wherewithal to be the lender. In our view, the application of the -3 Anti-Abuse Rule to this and other third-party lending transactions is untenable. The Final Regulations should clarify whether such types of transactions are intended to be covered by the -3 Anti-Abuse Rule, and, if so, describe the policy rationale for applying such a rule in these instances.

Recommendation 61: In an effort to place some limitations on the -3 Anti-Abuse Rule in light of both its overbreadth and the fact that there are already significant backstops to the perceived abuse that the Government wishes to curb, we recommend that the Government significantly narrow the scope of the -3 Anti-Abuse Rule. At a minimum, the Government should clarify that the -3 Anti-Abuse Rule does not apply to indebtedness between an EG Member and an unrelated party where the unrelated party is not acting as a conduit (perhaps applying the principles of the anti-conduit regulations in Treas. Reg. section 1.881-3).

F. Prop. Treas. Reg. Section 1.385-3(c) Exceptions

There are two specific exceptions that apply to debt instruments that would otherwise be recharacterized as stock under Prop. Treas. Reg. section 1.385-3: (i) an exception for current year E&P under Prop. Treas. Reg. section 1.385-3(c)(1) (the "Current E&P Exception") and (ii) the Threshold Exception under Prop. Treas. Reg. section 1.385-3(c)(2). There are two additional exceptions that only apply to debt that would otherwise be recharacterized under the Funding Rule: (i) an exception from the Per Se Rule for certain debt instruments that arise in the ordinary course of an issuer's trade or business under Prop. Treas. Reg. section 1.385-3(b)(3)(iv)(B)(*2*)

(the "Ordinary Course Exception") and (ii) an exception for Funded Stock Acquisitions of subsidiary stock by issuance under Prop. Treas. Reg. section 1.385-3(c)(3) (the "Subsidiary Stock Issuance Exception").

1. Current E&P Exception

(a) Summary

The Current E&P Exception applies to debt instruments that otherwise would have been recharacterized as equity under either the General Rule or the Funding Rule. The exception provides that for purposes of applying both the General Rule and the Funding Rule to an EG Member with respect to a tax year, the aggregate amount of any distributions or acquisitions are reduced by an amount equal to the member's current year E&P described in section 316(a)(2) ("Current E&P"). The Current E&P Exception provides an ordering rule such that the reduction described above is applied to such member's distributions or acquisitions based on the order in which the transactions occur.

(b) Comments and Recommendations

(1) Current E&P Exception

We believe that the narrow scope of the Current E&P Exception raises several policy and administrative concerns. First, limiting the Current E&P Exception to Current E&P may provide a perverse incentive to domestic corporate taxpayers. U.S. tax policy has become increasingly focused on efforts to protect its corporate tax base while promoting foreign investment. Further, concerns have been repeatedly voiced as to the over-leveraging of foreign investment in the United States and domestic corporations generally. While the Proposed Regulations may reduce the amount of related-party indebtedness between domestic corporations and their foreign parents, the narrow scope of the Current E&P Exception will result in the levering up of domestic corporations through related-party debt by forcing such entities to distribute their own notes in order to ensure that they maximize the use of the Current E&P Exception. Such distributions, in effect, encourage earnings stripping while limiting the amount of capital domestic entities can access to invest in U.S. assets and employees.

Second, in order to ensure that a member is able to fully use the annual Current E&P Exception, the member is required to determine its Current E&P amount by the end of its tax year. It is not feasible for a corporation to complete a calculation of its Current E&P before the end of the year in which such E&P accrues.

Third, in certain jurisdictions, it is not legally permissible to distribute cash out of current year earnings (sometimes referred to as "interim dividends"). Further, in such jurisdictions, the distribution of a note, like money or other property, is typically also not permitted if the note is not supported by retained earnings (i.e., previous years' earnings).

Fourth, as described below, the narrow scope of the Current E&P Exception can lead to unexpected or inappropriate results in the context of distributions of previously taxed income ("PTI") of CFCs.[189]

> Recommendation 62: We recommend modifying the Current E&P Exception to include both current and accumulated E&P, but only to the extent such accumulated E&P is earned in (i) the member's tax year that includes April 4, 2016 or (ii) all years thereafter.

Such a modification would, in effect, allow for a carryforward of Current E&P to the extent not depleted by the Current E&P Exception in a given tax year. This modification would also ameliorate each of the above concerns. First, the member would not be incentivized to distribute a note to its shareholder each year in the amount of its Current E&P as would be the case under the Current E&P Exception's "use it or lose it" limitation. Second, the member would not have to estimate its Current E&P but, instead, would be afforded the time necessary to calculate its Current E&P from the previous year. Third, if the member is organized in a jurisdiction that does not permit distributions out of current earnings, such member would still be able to qualify for the Current E&P Exception albeit by waiting until the subsequent year to make a distribution.[190]

> Recommendation 63: In the event the Government decides not to modify the exception to allow for the carrying forward of Current E&P to subsequent tax years, we recommend that the amount eligible for the Current E&P Exception for a given tax year should be an amount equal to Current E&P of the current year plus the amount of Current E&P in the previous tax year to the extent such previous year's Current E&P was not counted toward the previous year's Current E&P Exception.

This smaller modification would also address some of the concerns for certain non-U.S. entities organized in jurisdictions that prohibit distributions out of current earnings until after the close of the year and some of the issues relating to distributions of PTI.

(2) Current E&P Exception's Ordering Rule

As stated above, the Current E&P Exception currently applies to distributions or acquisitions based on the order in which they occur. Although this "first come, first serve" approach departs from the section 316 ordering rules requiring proration of Current E&P, we agree that such an approach is more administrable while likely reducing the number of debt instruments subject to bifurcation. As a result, we believe that the "first come, first serve" approach should be retained in the Final Regulations with one modification.

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[189] See Section VII.F.1(b)(3) below of this Comment Letter for a more detailed discussion.

[190] We recognize that some corporations may not have a desire to maximize their use of the Current E&P Exception, and under this proposal could instead accumulate a large Current E&P Exception capacity. A corporation that has accumulated significant E&P after April 4, 2016, may potentially have the ability to use its Current E&P Exception capacity to engage in transactions that would otherwise be subject to Prop. Treas. 1.385-3, and this capacity may be a valuable asset to a potential acquirer. However, we do not believe that this concern outweighs the issues with limiting the Current E&P Exception solely to the amount of Current E&P, as discussed above.

The ordering rule to the Current E&P Exception creates a trap for the unwary. Example 27 and Example 28 highlight the trap.

> Example 27: *Distribution of note followed by distribution of cash.* FP, a foreign corporation, wholly owns USS, a domestic corporation and a calendar year taxpayer. On March 1, Year 1, USS distributes a $100x USS note to FP pursuant to section 301. On June 30, Year 1, USS distributes $100x in cash to FP, also pursuant to section 301. USS does not make any other distributions in Year 1. USS's Current E&P for Year 1 is later determined to be $100x. Under the above mentioned ordering rule, the USS note distribution would not be recharacterized under the General Rule because the Current E&P Exception applies.

> Example 28: *Distribution of cash followed by distribution of note.* The facts are the same as Example 27, except the order of the distributions is reversed. The USS Note would be subject to recharacterization as USS stock under the General Rule. Such a result seems inappropriate—especially in the event that the ordering of such distributions was inadvertent.

> Recommendation 64: We recommend providing the taxpayer with an irrevocable election whereby the taxpayer could elect to which distribution(s) the Current E&P Exception applies.

The default rule would remain the ordering rule as provided in the Proposed Regulations. Further, we acknowledge that a somewhat open-ended election period to account for the tolling of the Per Se Period may afford taxpayers too much flexibility while potentially requiring taxpayers to repeatedly amend prior year tax returns. To limit such uncertainty and potentially inappropriate taxpayer use of hindsight, we recommend requiring that such an election be made with the taxpayer's filing of its final tax return (taking into account extensions) for the tax year in which the debt instrument would otherwise be recharacterized as stock under either the General Rule or the Funding Rule.[191]

> Example 29: *Application of recommended election.* The facts are the same as Example 28, except that upon filing its Year 1 U.S. tax return, USS attaches the appropriate form electing to allocate USS's $100x of Year 1 Current E&P to the USS note distribution. As a result, the default ordering rule would not apply, which would have resulted in recharacterizing the USS note as USS stock. Instead, the USS note would retain its character as debt.

(3) Modification to Current E&P Exception and Distributions of PTI

An area where the Current E&P Exception may lead to unexpected or inappropriate results is in the context of distributions of PTI. Even if transactions between CFCs are exempt

[191] If the Government is not willing to provide the taxpayer with the proposed election regime described above, we would suggest a change to the current ordering rule. Instead of the "first come, first serve" approach, we would suggest having the funded entity's Current E&P first allocated to Prohibited Distributions and Acquisitions and Funded Distributions and Acquisitions on a first come, first serve basis.

from Prop. Treas. Reg. section 1.385-3, as discussed in Section VII.G of this Report, these issues would likely persist because PTI distributions are ultimately between CFCs and their U.S. shareholders. The Current E&P Exception is intended to appropriately balance between preventing tax-motivated transactions among members of an EG and accommodating ordinary course transactions.[192] Because PTI, by its very definition, has already been taxed in the hands of a U.S. shareholder, there is generally no potential for tax avoidance where the income that has already been taxed in the hands of a U.S. shareholder is transferred to that shareholder in a nontaxable transaction. Rather, distributions of PTI are ordinary course transactions that permit the transferring of CFC earnings to their U.S. shareholders, falling squarely within the rationale provided in the Preamble for the Current E&P Exception.[193] Because distributions of PTI do not result in an additional U.S. tax liability, many multinationals annually distribute all of their PTI in the ordinary course of business. Therefore, we believe that the policy rationale behind the Current E&P Exception is particularly strong with respect to PTI distributions. Although we recognize that Prop. Treas. Reg. section 1.385-3 applies to all distributions, not just distributions that are taxable in the hands of the distributee, we believe that the policies of subpart F, particularly with respect to the treatment of PTI, distinguish distributions of PTI from other non-taxable distributions that would remain subject to Prop. Treas. Reg. section 1.385-3.

For the same reasons discussed above with respect to distributions of Current E&P generally, taxpayers may not be able to structure their PTI distributions so as to qualify for the Current E&P Exception. Moreover, where a subpart F inclusion is the result of an investment in U.S. property pursuant to section 956, the transaction itself may not give rise to E&P at all, and the associated PTI account is not created until the year after the inclusion. As a result, such amounts will never qualify for the Current E&P Exception. Example 30 highlights this issue.

> Example 30: *Section 959(c)(1) PTI.* CFC, a CFC wholly owned by USP, a domestic corporation, has significant accumulated E&P, none of which is subpart F income, and issues notes to EG Members in Year 1. CFC lends $100x to USP, such that USP has a $100x inclusion in Year 1 under section 951(a)(1)(B). CFC has $100x of Current E&P during Year 1. If CFC subsequently disposes of its USP loan (i.e., its U.S. property), any distribution of the $100x of PTI will trigger the Funding Rule with respect to the notes issued by CFC to EG Members to the extent it exceeds CFC's Current E&P in the year of the distribution. This is because the PTI from a section 951(a)(1)(B) inclusion only exists as of the beginning of the subsequent tax year. Even though CFC had $100x of Current E&P in Year 1 that was not subpart F income, that Current E&P could not shelter the distribution of the earnings that were included in USP's income in Year 1.

> Recommendation 65: Given the lack of tax motivation for and the ordinary course nature of PTI distributions, we recommend an additional exception to Prop. Treas. Reg. sections 1.385-3(b)(2) and (b)(3) be created for all transactions to the

[192] Preamble at 20924.

[193] *See id.*

extent they are excluded from a U.S. shareholder's income under section 959(a)(1) as distributions of PTI.[194]

Further, it is arguably unclear how the Current E&P Exception applies in the context of tiered CFCs due to the application of section 959(b), which provides that if a lower tier CFC distributes PTI to its CFC parent, the distribution does not result in a second subpart F inclusion to the CFC parent's U.S. Shareholder.

Example 31: *Distribution through tiers of CFCs.* A domestic corporation ("USP") wholly owns a CFC ("CFC 1") that wholly owns another CFC ("CFC 2"), and CFC 1 issues a note to an EG Member in Year 1. CFC 2 earns $100x of subpart F income in Year 1, which is included in USP's income in year 1. In Year 2, CFC 2 distributes $100x to CFC 1, and CFC 1 distributes $100x to USP. Neither CFC has any Current E&P in Year 2 (other than potentially $100x of Current E&P of CFC 1 by reason of receiving the $100x distribution). It is unclear whether CFC 1 has Current E&P in Year 1 from CFC 2's distribution of PTI such that the Current E&P Exception would apply to prevent the distribution to USP from triggering the Funding Rule with respect to the note issued by CFC 1 to an EG Member. Section 959(b) provides that the distribution from CFC 2 is excluded from CFC 1's gross income for purposes of section 951(a). Further, Treas. Reg. section 1.959-3(b)(3) provides that the PTI received by CFC 1 from CFC 2 retains its year and classification.[195] Although these rules do not appear to apply for purposes of calculating CFC 1's Current E&P, the Proposed Regulations are unclear as to whether such a distribution is included in CFC 1's Current E&P for purposes of the Current E&P Exception.

Recommendation 66: We recommend that the Final Regulations clarify that a CFC's Current E&P include distributions received during the year that are excluded from the CFC's gross income under section 959(b).[196]

(4) Mechanical Operation of Current E&P Exception

Recommendation 67: The Final Regulations should include additional examples illustrating the operation of the Current E&P Exception in slightly more complicated fact patterns.

Examples should (i) clarify that if the Current E&P Exception applies to reduce a distribution or acquisition described in the General Rule, the Current E&P Exception also applies

[194] If this recommendation is adopted, a coordination rule would also be required to exclude PTI from the calculation of Current E&P for purposes of the Current E&P Exception.

[195] Although these regulations are still in force, this language primarily relates to the creditability of foreign taxes paid by lower-tier CFCs under the regime that was in place prior to 1986.

[196] This would be consistent with the regulations relating to the E&P limitation on subpart F income under section 952(c). *See* Treas. Reg. § 1.952-1(c)(3), Ex. 1 (PTI received from a lower-tier CFC is included in the Current E&P of the higher-tier CFC in the year of the distribution but then subtracted from the upper-tier CFC's E&P for purposes of calculating the E&P limitation under section 952(c)).

to reduce the same distribution or acquisition from being taken into account under the Funding Rule; and (ii) describe how Current E&P is determined in predecessor/successor scenarios. The examples set forth below illustrate these issues.

> Example 32: *Funded Stock Acquisition in exchange for a note.* USP owns all of the stock of each of CFC1, CFC2 and CFC3. In Year 1, CFC1 acquires all of the stock of CFC3 in exchange for a $100x note issued to USP. CFC1 has $100x of Current E&P in Year 1. In Year 2, CFC2 lends $100x to CFC1. The Year 1 acquisition of CFC3 stock is a General Rule transaction (acquisition of EG Member stock for debt). In addition, the Year 1 acquisition appears to be a Funded Stock Acquisition. Under the Current E&P Exception, the "aggregate amount of distributions that are described in paragraphs (b)(2) or (b)(3)(ii) of this section are reduced" by the amount of CFC1's Current E&P, $100x. Because there is only a single "acquisition," i.e., CFC1's acquisition of CFC3 stock, we read the Current E&P Exception as reducing the amount of such acquisition to zero, meaning that the acquisition is no longer relevant for either the General Rule or the Funding Rule. This result should be clarified in the Final Regulations.[197]

> Example 33: *Current E&P of predecessor.* USP owns all of the stock of each of CFC1, CFC2, and CFC3. Both CFC1 and CFC2 have a calendar taxable year. On January 31, Year 1, CFC1 distributes $100x of cash to USP. On June 30, Year 1, CFC1 merges with and into CFC2 in a reorganization under section 368(a). From January 1 to June 30 of Year 1, CFC1 generates no E&P. However, during its Year 1 taxable year, CFC2 has $100x of Current E&P. On December 31, Year 1, CFC2 borrows $100x from CFC3 in exchange for a CFC2 note. Because the merger of CFC1 into CFC2 is a section 381(a) transaction, CFC1 is treated as a predecessor to CFC2. For purposes of the Funding Rule, references to a "funded member" include references to any predecessor or successor. Because CFC1 is a predecessor to CFC2, a funded member, all references to CFC2 include a reference to CFC1. As a result, CFC2 is treated as having made a $100x distribution. Because the Current E&P Exception applies by reference to the Current E&P of the funded member, we believe that the exception applies under this fact pattern to prevent the CFC2 note from being recharacterized as stock since the "distribution" that is potentially reduced by Current E&P accrued during CFC2's Year 1 tax year, even though the distribution was made by CFC1 and even though CFC1's tax year closes as a result of the June 30 merger. This result should be made explicit in the Final Regulations.

(5) Alternative Metric to Current E&P

As described above, the Current E&P Exception is intended to appropriately balance between preventing tax-motivated transactions among EG Members and accommodating ordinary course transactions.[198] It does so by providing an annual threshold for distributions that

[197] Compare this example to the discussion in Section VII.D, above, regarding whether the USP note could be a PPDI.

[198] Preamble at 20924.

are excepted from the rules of Prop. Treas. Reg. section 1.385-3 based on an annual determination of the capacity of the distributing corporation to make distributions in the ordinary course of its business. However, calculating this threshold based on the E&P of the distributing corporation, in addition to the issues described above, does not necessarily reflect the actual capacity of the corporation to make ordinary course distributions. This is because E&P does not necessarily reflect the distributable cash of a corporation, instead more closely reflecting economic income. Moreover, the use of E&P to calculate this threshold creates disparate treatment of taxpayers depending on whether or not they are engaged in capital intensive businesses. Because of the cost recovery deductions that do not impact annual cash flow available to capital intensive businesses (e.g., depreciation and amortization), the Current E&P of a capital intensive business frequently will be different than the Current E&P of a business that is not capital intensive even though the two businesses are similarly profitable and have a similar level of cash available to make ordinary course distributions. Particularly given the various provisions that accelerate cost recovery deductions in certain circumstances,[199] it would be inconsistent with the policy of such provisions and the intent of Congress to penalize corporations that benefit from such accelerated deductions by limiting their ability to make ordinary course distributions. Although a corporation engaged in a capital intensive business may have greater Current E&P in later years to make up for the lower Current E&P in earlier years, the impact of cost recovery deductions on the Current E&P Exception would be to require such corporation to defer making distributions that would otherwise be made in the ordinary course of its business. Therefore, we believe that it would better advance the stated purpose of the Current E&P Exception if the annual threshold for the exception were calculated based on a more accurate measure of the relevant corporation's annual capacity to make ordinary course distributions than E&P.[200]

To eliminate unfavorable treatment of certain businesses and to better achieve the stated objective of the Current E&P Exception, we recommend that the Current E&P Exception be replaced with an exception that reduces an EG Member's distributions and acquisitions with respect to a given taxable year by an amount equal to such EG Member's adjusted taxable income as described in section 163(j)(6)(A) ("Current ATI").[201] This alternative exception (the "Current ATI Exception") would apply in exactly the same manner as the Current E&P Exception (including the recommendations described above with respect to such exception, where relevant), except for the replacement of Current ATI for Current E&P as the annual amount of the exception. In addition, we would still recommend the other changes we have suggested to the Current E&P Exception be made, only with reference to Current ATI instead of Current E&P. The Current ATI Exception would better achieve the stated purpose of the Current E&P Exception because Current ATI is a more accurate measure of the annual cash available to a corporation for ordinary course distributions than is Current E&P; in fact, Current ATI is

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[199] *See, e.g.*, I.R.C. § 168.

[200] In addition, S Corporations generally are not required to calculate their E&P, and so using E&P as the metric for this exception poses an additional burden on S Corporations they would otherwise not have to bear.

[201] If this proposal is adopted, we recommend that a transition rule be provided for taxpayers that have structured transactions in reliance on the Current E&P Exception. For example, we recommend that the exception apply to include both current and accumulated ATI, but only to the extent such accumulated ATI is earned in (i) the member's tax year that includes April 4, 2016 or (ii) all years thereafter.

specifically intended to reflect the cash flow of the corporation.[202] Further, because depreciation, depletion and amortization deductions are added back to Current ATI, the Current ATI Exception would not penalize taxpayers that benefit from accelerated cost recovery allowances or otherwise treat similarly profitable businesses differently depending on whether or not they are capital intensive. The legislative history to section 163(j) provides that depreciation, depletion and amortization deductions are added back to Current ATI specifically to prevent the disparate treatment of taxpayers depending on whether or not they qualify for cost recovery deductions.[203] Therefore, we believe that Current ATI is a more accurate measure of a corporation's capacity to make ordinary course distributions than Current E&P because Current ATI better reflects the cash flow of the corporation and is not reduced by cost recovery deductions.

> Recommendation 68: We recommend that the Current E&P Exception be replaced with an exception that reduces an EG Member's distributions and acquisitions with respect to a given taxable year by an amount equal to such EG Member's Current ATI.

2. Threshold Exception

(a) Summary

Prop. Treas. Reg. section 1.385-3(c)(2) contains the "Threshold Exception" providing that an instrument will not be treated as stock under any provision of Prop. Treas. Reg. section 1.385-3 if, immediately after such instrument is issued, "the aggregate adjusted issue price of debt instruments held by members of the EG that would be subject to [Prop. Treas. Reg. section 1.385-3(b)] but for the application of [the Threshold Exception] does not exceed $50 million." Once the threshold is exceeded, the Threshold Exception will not apply to any debt instrument issued by members of the EG so long as *any* debt instrument that was previously treated as indebtedness solely because of Prop. Treas. Reg. section 1.385-3(c)(2) remains outstanding. For the purposes of the Threshold Exception, all debt instruments not denominated in U.S. dollars are translated into U.S. dollars at the spot rate on the date of issuance. Finally, Prop. Treas. Reg. section 1.385-3(d)(1)(iii) provides that, in general, a debt instrument that previously qualified for the Threshold Exception is treated as exchanged for stock at the time when the Threshold Exception no longer applies. If, however, the debt instrument is both issued and ceases to qualify for the exception in the same taxable year, the general timing rule of Prop. Treas. Reg. section 1.385-3(d)(1)(i) applies, meaning that the instrument is treated as stock from the date of issuance.

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[202] The preamble to the proposed regulations under section 163(j) explains that the purpose of the various adjustments required in calculating Current ATI "is to modify taxable income to more closely reflect the cash flow of the corporation." 56 Fed. Reg. 27907, 27908-09 (June 18, 1991).

[203] The exclusion of depreciation, amortization and depletion deductions from the calculation of Current ATI was added to section 163(j) in conference in response to concerns that the provision, as originally drafted, "would deny interest deductions in cases where net interest expense exceeds the income threshold not because the corporation is thinly capitalized, but because of year-to-year changes in profitability or in the amount of depreciation, amortization, or depletion." H. Rep. No. 101-386 at 567 (Nov. 21, 1989).

The Threshold Exception is illustrated by Example 17 in Prop. Treas. Reg. section 1.385-3(g)(3). In the example, a CFC distributes a $40 million CFC Note to EG Member FP in Year 1, then USS1, a member of the same EG as CFC and FP, distributes a $20 million USS1 Note to FP in Year 2. The example explains that CFC Note qualifies for the Threshold Exception in Year 1, but fails to so qualify in Year 2. Therefore, CFC Note is deemed exchanged for stock on the date that USS1 Note is issued in Year 2.

The Preamble explains that the Government has determined that the Threshold Exception and the Current E&P Exception "appropriately balance between preventing tax-motivated transactions among members of an EG and accommodating ordinary course transactions."[204] The Preamble also provides that the Threshold Exception is applied after applying the Current E&P Exception, meaning that a debt instrument that would not be treated as equity pursuant to the Current E&P Exception will not count towards the $50 million threshold under the Threshold Exception.[205]

(b) Comments and Recommendations

(1) Interaction between Threshold Exception and EG Attribution

The Threshold Exception interacts with the expansive attribution rules used for defining membership in the EG in a way that appears unintended. Specifically, the Threshold Exception only applies if all debt instruments held by members of the EG that would be subject to Prop. Treas. Reg. section 1.385-3(b) have an aggregate issue price of $50 million or less. Where an EG holds an interest in a partnership, Prop. Treas. Reg. section 1.385-1(b)(3)(ii) provides that section 304(c)(3) attribution applies, which in turn applies a broadened version of attribution under section 318(a). Under section 318(a)(3)(A), and as discussed above, stock owned by a partner is treated as owned by the partnership. The application of section 318(a)(3)(A) can vastly expand the scope of an EG with a partnership in its structure, creating situations where it is impossible for certain EG Members to know whether they satisfy the Threshold Exception.

> Example 34: *Single Threshold Amount for minimally-related groups.* PRS is a U.S. partnership that is owned by multiple investors, including some corporate investors that are the parent entities of multiple wholly-owned subsidiaries, both U.S. and foreign. PRS owns all of the stock of FS1, a foreign corporation. FS1 wholly owns US1 and US2, both U.S. corporations. Under section 318(a)(3)(A), PRS is treated as owning all of the stock owned by its corporate investors, including the stock of their U.S. and foreign subsidiaries. PRS is treated as holding all stock owned by its partners so long as such partners own any interests in PRS, regardless of the size of those interests. Under section 318(a)(3)(C), FS1 is treated as owning all of the stock owned by PRS, including the stock that PRS is deemed to own in its corporate investors' subsidiaries. As a result, the EG that includes FS1, US1 and US2 for purposes of applying the Threshold Exception also includes the subsidiaries of PRS's corporate investors, thereby causing any

[204] Preamble at 20924.

[205] *See* Preamble at 20925.

intercompany debt between the corporate investors' subsidiaries to count toward the $50 million threshold. In many cases, FS1 will not have the power to demand that its corporate investors disclose the extent of their intragroup debts and whether such debts have been recharacterized. Therefore, FS1 cannot know whether debts within the FS1-US1-US2 group would ever qualify for the Threshold Exception (assuming the FS1-US1-US2 group independently would otherwise satisfy the Threshold Exception).

Example 34 illustrates a structure that is commonly used in private equity. It describes just one scenario where the expansive attribution rules of Prop. Treas. Reg. section 1.385-1(b)(3)(ii) make it impossible to determine whether the Threshold Exception is ever satisfied as a practical matter. More specifically, if the Threshold Exception is intended to exempt small businesses from the burdens of understanding and complying with the Proposed Regulations, cases such as the one above will prevent that purpose from being achieved in many circumstances. The next example shows how this issue can have a significant impact on a small business.

Example 35: *Small business included in bank's EG for purposes of Threshold Exception.* A bank treated as a corporation for federal tax purposes co-invests in partnership PRS with a husband and wife. The bank takes a one-percent interest in PRS, while the husband and wife together take a 99-percent interest. The bank wholly owns a number of corporate subsidiaries, and it lends $50,000 of seed money to PRS so the husband and wife can start a business. PRS forms FS1, which forms US1 and US2 to operate the husband and wife's small business in two different locations. When the bank loan comes due, US1, an unprofitable location, borrows $50,000 from US2 in exchange for a US1 note and distributes the proceeds to FS1; FS1 further distributes the $50,000 to PRS to repay the loan. Because of the attribution rules described above, it is impossible for FS1 and its subsidiaries to know whether the US1 note satisfies the Threshold Exception because the bank and its subsidiaries are treated as part of the same EG as FS1, US1, and US2.

Recommendations to limit the attribution rules applicable under Prop. Treas. Reg. section 1.385-1(b)(3)(ii) are described in other sections of this Comment Letter; to the extent such recommendations are adopted, they will ameliorate or eliminate the unintended consequences that arise when the attribution rules are applied in the context of the Threshold Exception. However, even if such recommendations are not adopted with respect to the general definition of the EG, we recommend that a more limited form of attribution apply with respect to the Threshold Exception. In particular, taxpayers such as FS1 in the example above are effectively foreclosed from using the exception. To alleviate this concern, we would recommend providing a limitation to the application of the section 318(a)(3)(A) downward attribution to partnerships for purposes of determining the extent of the EG in applying the Threshold Exception. However, we recognize that providing such a broad exclusion could lead taxpayers to artificially segregate their EGs through the use of blocker partnerships.

Recommendation 69: As described in Recommendation 12, we recommend that section 318(a)(3)(A) attribution apply only from partners that are highly related to

their partnerships, such as a partner that owns at least 80 percent of the interests in a partnership. If, however, Recommendation 12 is not adopted, we strongly recommend at a minimum that section 318(a)(3)(A) attribution apply only from highly-related partners for the purposes of calculating the Threshold Exception.

(2) Cliff Effect of Threshold Exception

The Threshold Exception is currently subject to a cliff effect, meaning that once the EG has outstanding related-party debt in excess of $50 million that would be recharacterized but for Prop. Treas. Reg. section 1.385-3(c)(2), all related-party debt formerly subject to the exception is recharacterized (and not just the debt in excess of $50 million). It appears that the rule was written as a cliff so that only small corporate groups with $50 million or less of intercompany debt would benefit, rather than letting all corporate groups benefit to the extent of $50 million of otherwise recharacterized debt. Although the policy rationale for such a rule may be laudable, it has an economically distortive effect that benefits only small companies with a particular debt profile, thereby disadvantaging mid-sized companies in significant ways.

Consider an EG that has structured its operations in an economically efficient manner, resulting in $45 million of EG debt that would be recharacterized but for the Threshold Exception. Based on the cliff effect, such a group has a substantial tax advantage over a slightly larger EG whose operations would be structured in an economically efficient manner with $55 million of EG debt subject to recharacterization. Instead of both EGs equally enjoying the benefits of a $50 million exception, the smaller EG enjoys a $45 million exception while the slightly larger EG has no exception at all. Alternatively, the smaller EG can retain its economically efficient debt structure under the Threshold Exception, whereas the slightly larger EG must structure its operations in potentially inefficient ways to avoid causing its related-party debt to be recharacterized under Prop. Treas. Reg. section 1.385-3.[206]

Recommendation 70: To prevent disproportionately benefitting only certain mid-size companies, we would recommend eliminating the cliff effect from the Threshold Exception. Instead, the exception should exempt from recharacterization the first $50 million of intercompany debt that would otherwise be recharacterized, and only debt in excess of $50 million would be subject to the General Rule and the Funding Rule.

We recognize that this recommendation may not be wholly harmonious with the goal of benefitting only small businesses. The concerns raised in this subsection have the greatest impact on taxpayers with slightly more than $50 million of EG debt that would be recharacterized, because those taxpayers would be most significantly harmed by losing the entire $50 million exception.

Recommendation 71: If Recommendation 70 is not adopted, we recommend a rule providing that the first $50 million of EG debt is eligible for the Threshold Exception, unless the total amount of EG debt that would be recharacterized is

[206] We also note that these relatively smaller businesses may not have the resources necessary to monitor whether the Threshold Exception applies.

more than $500 million. Under this proposal, once the total amount of EG debt exceeds $500 million, the cliff effect is reintroduced and none of the EG debt is eligible for the Threshold Exception.

3. Ordinary Course Exception

(a) Summary

Prop. Treas. Reg. section 1.385-3(b)(3)(iv)(B)(*2*) provides that the Per Se Rule will not apply to "a debt instrument that arises in the ordinary course of the issuer's trade or business in connection with the purchase of property or the receipt of services" (i.e., the "Ordinary Course Exception"). The Ordinary Course Exception only applies "to the extent that [the debt instrument] reflects an obligation to pay an amount that is currently deductible by the issuer under section 162 or currently included in the issuer's cost of goods sold or inventory," and only "provided that the amount of the obligation outstanding at no time exceeds the amount that would be ordinary and necessary to carry on the trade or business of the issuer if it was unrelated to the lender."[207]

The Preamble explains that the exception is purposefully not intended to apply to intercompany financing, treasury center activities, or capital expenditures.[208] The Preamble further clarifies that a debt instrument eligible for the Ordinary Course Exception may still be treated as having a principal purpose of funding a distribution or acquisition under the Facts and Circumstances Test of Prop. Treas. Reg. section 1.385-3(b)(3)(iv)(A).[209]

(b) Comments and Recommendations

The Ordinary Course Exception achieves a number of policy objectives with respect to the transactions to which it applies. It allows taxpayers to engage in certain types of ordinary-course business activities among members of the EG without fear that they will run afoul of the Per Se Rule. The failure to provide such an exception would have required corporate groups to restructure their everyday related-party transactions in ways that may have been economically inefficient or distortive. For example, a corporate parent and its subsidiary may be engaged in business together, with the subsidiary regularly purchasing inventory from its parent in exchange for short-term trade payables that the subsidiary on-sells to unrelated customers in its local market. Without the Ordinary Course Exception, the subsidiary would effectively be prohibited from making any distributions to its parent without causing the payables to be recharacterized as equity. The following recommendations are made to assist the Ordinary Course Exception in achieving its goal of preventing the Proposed Regulations from disrupting ordinary course intercompany business activities.

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[207] Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(B)(2).

[208] Preamble at 20924.

[209] *See id.*

(1) Clarify Scope of Ordinary Course Exception

The Ordinary Course Exception only applies to debt instruments that "arise in the ordinary course of the issuer's trade or business," and only if the amount outstanding does not exceed "the amount that would be ordinary and necessary to carry on the trade or business of the issuer if it was unrelated to the lender."[210] The latter clause appears to introduce a quantitative limitation to the exception, thereby implying that the more general "arise in the ordinary course" clause is a qualitative restriction. However, it is not clear how or to what this qualitative limitation applies. For example, the qualitative limitation could be interpreted to mean that a debt instrument "arises in the ordinary course" of business if it bears terms identical or similar to debt instruments that the issuer has historically entered into within a certain look-back period. Alternatively, it could mean that a debt instrument only "arises in the ordinary course" if it is used to acquire an asset or procure a service that (i) has been regularly acquired or procured by the issuer for its business in the past or (ii) will in this particular instance be used to achieve some ordinary business objective of the issuer. The language of the exception does not identify whether some, all, or none of these meanings of a debt "arising in the ordinary course of the issuer's trade or business" apply. This uncertainty is compounded because the exception does not explain how a taxpayer could show that it satisfies any of these possible interpretations of the limitation, and such uncertainty is compounded further still because there are no examples in Prop. Treas. Reg. section 1.385-3(g) that show the Ordinary Course Exception being applied. This lack of clarity may prevent taxpayers from utilizing the exception in scenarios to which it is intended to apply, thereby frustrating its purpose.

> Recommendation 72: We recommend clarifying the application of the Ordinary Course Exception through further explanatory text in Prop. Treas. Reg. section 1.385-3(b)(3)(iv)(B)(*2*) and examples.

Our concerns about lack of clarity would also be greatly reduced if the Government adopts the recommendations described below with respect to financing and cash pooling activities.

(2) Expand Application of Ordinary Course Exception to Facts and Circumstances Test

The Ordinary Course Exception is narrowly limited to Prop. Treas. Reg. section 1.385-3(b)(3)(iv)(B)(*2*), meaning that it only excepts debts between EG Members from being recharacterized under the Per Se Rule. This means that such debt instruments (i) are still susceptible to recharacterization under the Facts and Circumstances Test of Prop. Treas. Reg. section 1.385-3(b)(3)(iv)(A); and (ii) must still comply with the Documentation Requirements, or else they will be treated as equity. With respect to the Facts and Circumstances Test, it is difficult to conceive of a situation where a debt instrument satisfies all of the requirements of the Ordinary Course Exception but is nevertheless issued with a principal purpose of funding a distribution or acquisition described in Prop. Treas. Reg. section 1.385-3(b)(3)(ii). Nevertheless, the Preamble warns that the Facts and Circumstances Test can still apply, thereby detracting from one of the Ordinary Course Exception's apparent policy goals of allowing taxpayers to

[210] Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(B)(2).

continue conducting efficient related-party business operations without the uncertainty that their debt instruments may be reclassified as equity. Moreover, the Ordinary Course Exception already contains its own version of an anti-abuse test because it only applies if the amount of the obligation outstanding at no time exceeds the amount that would be ordinary and necessary to carry on the trade or business of the issuer if it was unrelated to the lender.

> Recommendation 73: We recommend that the Ordinary Course Exception apply not only to the Per Se Rule of Prop. Treas. Reg. section 1.385-3(b)(3)(iv)(B)(1), but also to the Facts and Circumstances Test of Prop. Treas. Reg. section 1.385-3(b)(3)(iv)(A).

Such a modification would exempt debt instruments qualifying for the Ordinary Course Exception from the Funding Rule as a whole.

(3) Expand Application of Ordinary Course Exception to Documentation Requirements

As discussed above, one goal of the Ordinary Course Exception appears to be to minimize the disruption that the Proposed Regulations will have on day-to-day purchases of goods and services within an EG. The exception partially achieves this goal by eliminating one way in which debt issued pursuant to everyday related-party operations could give rise to per se stock under the Proposed Regulations. However, as with the exception's failure to reach the Facts and Circumstances Test of Prop. Treas. Reg. section 1.385-3(b)(3)(iv)(A), the policy objective of the Ordinary Course Exception is only partially achieved because the exception fails to extend to the Documentation Requirements of Prop. Treas. Reg. section 1.385-2. If the Ordinary Course Exception does not apply to Prop. Treas. Reg. section 1.385-2, taxpayers will be required to document debts as simple as related-party short-term trade payables as if they were third-party bank loans. This would frustrate the goal of preventing disruption and inefficient distortion of routine movements of goods and services within an EG.

> Recommendation 74: We recommend that the Ordinary Course Exception also apply to Prop. Treas. Reg. section 1.385-2.

It is not anticipated that such debt would be wholly formless as a result of the exception—in that case, the Government would have difficulty verifying whether such debt was ordinary. On the contrary, the general debt-equity principles developed through decades of case law would still apply in determining whether the instrument was treated as debt or equity. Under this case law, documentation of the instrument would either be sufficient for the Government to determine whether the instrument should qualify for the expanded Ordinary Course Exception, or it would be insufficient and the instrument would be treated as equity under common law in any event.[211]

[211] We understand that, in pursuance of the policy of the Proposed Regulations, the Government may nevertheless wish to require some form of documentation of EG debt instruments issued to purchase goods and services in the ordinary course of business. In this regard, the Government could exempt EG debt instruments that qualify for the Ordinary Course Exception from the Documentation Requirements, instead requiring such arrangements to be documented via a master or omnibus agreement that sets forth general governing terms. Thus, for example, a corporation that regularly issues trade payables to members of its EG could be required to create and maintain a

(4) Ordinary Course Exceptions for Certain Financing and Cash Pooling

The Ordinary Course Exception is limited to business activities relating to the purchase of goods and provision of services. The limited scope of the exception fails to account for day-to-day financing activities and businesses of entities that do not supply goods or services, including EGs that structure their activities through the use of cash pooling. For example, the Ordinary Course Exception does not apply to a banking entity that regularly issues loans to both third parties and EG Members. Based on our experience, the Ordinary Course Exception also often will fail to apply to routine intercompany transactions due to its failure to account for ordinary course cash pooling activities, even with respect to EGs that regularly make intergroup sales and payments for services. This is because taxpayers with cash pools typically borrow from the cash pool leader and use the borrowed cash to buy goods or services. The entity providing the goods or services either uses the cash in its business or lends it back to the cash pool leader. In other words, loans for related-party goods and services are often not made directly between the entities providing and receiving the goods and services. Rather, they are frequently routed through the cash pool leader. To the extent that the Ordinary Course Exception is intended to prevent the Proposed Regulations from creating unintended consequences for routine activities commonly and efficiently transacted within an EG, its failure to apply to related-party financing and cash pooling transactions prevents the exception from achieving its goal for a large set of business activities.

We make the following recommendations with the intent of helping the Government achieve its goal of creating an Ordinary Course Exception that does not unduly distort or burden ordinary course business activities, including not only direct intercompany purchases of goods and services, but also financing and cash pooling activities.

(a) Exception for Ordinary Course Financing

As discussed above, the Ordinary Course Exception does not cover companies that engage in external and internal financing in the ordinary course of business. Such an exception is critical to ensure that groups that operate in the financial sector are not disproportionately adversely impacted by the Proposed Regulations compared to EGs that engage in businesses more conducive to related-party sales of goods and services.

> Recommendation 75: We recommend excepting a debt instrument between EG Members from the Funding Rule to the extent that such instrument is issued in the ordinary course of a financing business and bears terms substantially similar to those that the issuer uses and accepts in debt issued to third parties.

This would allow EG Members that act as financial institutions to transact with their affiliates on the same terms as unrelated customers.

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document setting forth the terms of such payables, which we understand to be a practice that some taxpayers currently follow.

(b) Exception for Debt Issued to Facilitate Payments for Goods and Services

The Ordinary Course Exception should be expanded to cover not merely debt issued directly in exchange for specified goods and services, but also debt issued to facilitate the payment for such goods and services. Thus, if a cash pool leader loans funds to an EG Member to purchase services from another EG Member, the Ordinary Course Exception should apply such that the loan is not taken into account for purposes of the Per Se Rule (as well as the Facts and Circumstances Test and the Documentation Requirements, if our recommendations above are adopted).

Moreover, the Ordinary Course Exception should not be premised on the receipt of goods or services from another EG Member. Rather, it should cover any debt instrument issued by one EG Member to another in order to facilitate payment for goods or services from any person (whether or not an EG Member). Thus, for example, EG debt instruments issued to finance purchases of inventory from a third party should be exempted.

> Recommendation 76: We recommend that the Ordinary Course Exception be expanded to cover not merely debt issued directly in exchange for specified goods and services, but also debt issued to facilitate the payment for such goods and services.
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> Recommendation 77: The Ordinary Course Exception should not be premised on the receipt of goods or services from another member of the EG. Rather, it should cover any debt instrument issued by one EG Member to another in order to facilitate payment for goods or services from any person (whether or not a member of the EG).

(c) Safe Harbor Based on Current Assets

To clarify the Ordinary Course Exception and further facilitate efficient cash pooling activities, we recommend that the Government adopt safe harbors that are tied to non-tax metrics. For example, a safe harbor could exempt an entity's EG instruments from the Funding Rule to the extent of such entity's current assets (less cash and cash equivalents). For this purpose, we consider current assets to mean assets that are expected to be converted into cash within a year or a normal operating cycle, whichever is longer. Current assets include cash and cash equivalents, accounts receivable, inventory, marketable securities, prepaid expenses and other liquid assets that can be readily converted to cash.[212]

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[212] Adoption of the current asset safe harbor described above would also allow the Ordinary Course Exception to apply to routine activities that are currently excluded from the limited scope of the exception. As described above, the exception as currently drafted only applies to debt instruments that arise in the ordinary course of the issuer's trade or business in connection with the *purchase of property or the receipt of services* to the extent that such instruments reflect an obligation to pay an amount that is currently deductible by the issuer under section 162 or currently included in the issuer's costs of goods sold or inventory. In addition to financing activities and debt issued to facilitate the purchase of goods and services, both of which are discussed above, the limitations in the Ordinary Course Exception as currently drafted fail to address debt instruments that arise in connection with the routine licensing or renting of property in the ordinary course of the issuer's trade or business. To the extent that the current

Recommendation 78: We recommend a safe harbor for the Ordinary Course Exception based on an EG Member's current assets, which should serve as a proxy for its short-term working capital needs. Alternatively, a safe harbor could be based upon an EG Member's annual expenses.

In either case, the safe harbor could be based on three year averages and could be determined using U.S. GAAP or similar principles (e.g., IFRS), depending on how the taxpayer keeps its books and records.

4. Subsidiary Stock Issuance Exception

Pursuant to Prop. Treas. Reg. section 1.385-3(c)(3), there is an exception to the second prong of the Funding Rule for Funded Stock Acquisitions of subsidiary stock by issuance (i.e., the "Subsidiary Stock Issuance Exception"). Such exception provides that the acquisition of the stock of an EG Member (the "Issuer") by a second EG Member (the "Transferor") will not be treated as an acquisition of EG stock for purposes of the Funding Rule if the acquisition is the result of a transfer of property by the Transferor to the Issuer in exchange for stock of the Issuer and, for the 36-month period following the transfer, the Transferor holds, directly or indirectly (applying the principles of section 958(a) without regard to whether an entity is foreign or domestic),[213] more than 50 percent of the vote and value of the Issuer. The Subsidiary Stock Issuance Exception also provides operating rules for situations where the Transferor ceases to hold sufficient stock of the Issuer within the 36-month window (a "Cessation"). Where a Cessation occurs, the acquisition of Issuer stock is the relevant transaction date for purposes of the Funding Rule, but a debt instrument that existed prior to the Cessation date will only be recharacterized under the Funding Rule to the extent that it is treated as indebtedness as of the Cessation date.

(a) Comments and Recommendations

(1) Holding Period for Issuer Stock

As stated above, the Subsidiary Stock Issuance Exception requires the Transferor to retain more than 50 percent ownership, directly or indirectly, in the Issuer for a 36-month period. We believe that this requirement is unnecessarily restrictive and will pose a significant barrier to effectuating legitimate non-tax-motivated transactions. The Subsidiary Stock Issuance Exception appropriately applies to prevent transactions which are economically different than distributions—namely contributions to controlled corporations—from being treated as

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asset safe harbor described above is not adopted, we recommend that the Ordinary Course Exception be expanded to cover routine licensing and rental activities so that the exception does not disproportionately benefit one industry over another. Moreover, the limitation to expenditures currently deductible under section 162 may be unnecessarily restrictive insofar as it could exclude debt instruments issued by foreign issuers where deducibility under section 162 might not apply or, for example, debt instruments issued for routine capital expenditures where section 263 might apply.

[213] Section 958(a) provides (a) that a person is considered owning stock that it owns directly and (b) that stock held by a foreign entity is considered owned proportionally by the foreign entity's shareholders. By disregarding whether an entity is foreign or domestic, indirect ownership for purposes of the Subsidiary Stock Issuance Exception appears to refer to a person's proportionate share of stock held through all lower-tier entities.

distributions for purposes of the Funding Rule. However, in many situations were a Transferor transfers property to an Issuer, the Transferor may cease to have the requisite ownership of the Issuer during the subsequent 36 months without the initial transfer being economically similar to a distribution. In fact, under the Proposed Regulations, a Transferor may accidentally cease to have the requisite ownership of the Issuer entirely unintentionally if debt of the Issuer is recharacterized as stock owned by another EG Member. Given that the Subsidiary Stock Issuance Exception appears intended to apply to contributions to controlled corporations in exchange for their stock, it is unclear why this exception is not available in many of such transactions.

> Recommendation 79: We recommend that the Subsidiary Stock Exception apply whenever the Transferor owns (applying the principles of section 958(a) without regard to whether an entity is foreign or domestic) more than 50 percent of the vote and value of the Issuer immediately after the transfer without a strict holding period requirement, but instead applying principles under section 351 to determine whether the requisite ownership exists.[214]

Because of the similarities between the Subsidiary Stock Issuance Exception and the requirement under section 351 that the transferors be in control of the transferee corporation, authorities under section 351 can be easily applied in this context. Moreover, given the extensive and developed body of authority under section 351, both the Government and taxpayers will be able to determine with relative ease whether the Subsidiary Stock Issuance Exception is available, and new tests and authorities will not need to be devised. This will make the Subsidiary Stock Issuance Exception administrable while permitting taxpayers the flexibility to change their ownership structures in subsequent years to respond as necessary to changes in circumstances.[215]

(2) Consequences Where Issuer Leaves EG

As described above, where a Transferor ceases to retain more than 50 percent ownership, directly or indirectly, in the Issuer for a 36-month period, the Subsidiary Stock Issuance Exception no longer applies, and debt instruments of the Transferor can potentially be recharacterized as stock under the Funding Rule to the extent they are treated as indebtedness as of the Cessation date. Whether or not the Issuer is an EG Member as of the Cessation date does not matter for purposes of this test, so the Funding Rule can potentially apply to cause a debt instrument to be recharacterized as stock if it funded the acquisition of stock of an Issuer that is

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[214] In addition, in order to improve administrability, the three-year window can be retained but as a safe harbor rather than a per se requirement. Under this safe harbor, where the Transferor transfers property to the Issuer in exchange for Issuer stock and, for the 36-month period following the transfer, the Transferor holds, directly or indirectly (within the meaning of section 958(a)), more than 50 percent of the vote and value of the Issuer, the Subsidiary Stock Issuance Exception will apply, but if the ownership requirement is not satisfied for the full 36-month period, section 351 principles will apply to determine whether the requisite ownership existed immediately after the transfer.

[215] For example, if the transaction by which the Transferor ceases to hold sufficient stock of the Issuer is part of the same plan as the acquisition of Issuer stock, the Subsidiary Stock Issuance Exception will not apply. Conversely, if the transaction by which the Transferor ceases to hold sufficient stock of the Issuer is unrelated to the acquisition of Issuer stock, the Subsidiary Stock Issuance Exception may be available.

not an EG Member as of the Cessation date. This result seems contrary to the stated policy behind the Subsidiary Stock Issuance Exception of preventing transactions which are economically different than distributions from being subject to the Funding Rule.

Therefore, we propose that a debt instrument of the Transferor that funded the acquisition of Issuer stock will only be recharacterized under the Funding Rule if the Issuer and Transferor remain members of the same EG but the Transferor ceases to retain the requisite stock ownership of the Issuer.

> Recommendation 80: We recommend that the Subsidiary Stock Issuance Exception be modified so that if the Issuer is not an EG Member as of the Cessation date, the exception does not cease to apply.

(3) Inapplicability to General Rule

It is unclear why the Subsidiary Stock Issuance Exception applies for purposes of the Funding Rule but not the General Rule. Prop. Treas. Reg. section 1.385-3 applies in the context of acquisitions of EG Member stock because of the economic similarities between such an acquisition and a distribution.[216] The Government appears to have provided for the Subsidiary Stock Issuance Exception because transfers of property to a controlled corporation in exchange for stock in such controlled corporation generally do not have the economic similarities to distributions that other acquisitions of EG Member stock have. However, there is little difference between a transaction in which the Transferor transfers its own note to the Issuer in exchange for Issuer stock and a transaction in which a Transferor transfers cash borrowed from a third EG Member to the Issuer in exchange for Issuer stock—the policy of the Subsidiary Stock Exception applies with equal force in the context of the General Rule as it does in the context of the Funding Rule. The Funding Rule was included in the Proposed Regulations in order to prevent taxpayers from using multi-step transactions to engage in transactions they could not do in one-step transactions by reason of the General Rule,[217] and so it is unclear why the Subsidiary Stock Issuance Exception permits taxpayers to engage indirectly in transactions that they are still precluded from engaging in directly. Moreover, recharacterizing a note issued by the Transferor to the Issuer as stock in the Transferor necessarily results in a complex hook stock arrangement.

> Recommendation 81: We recommend that the Subsidiary Stock Issuance Exception be expanded to apply for purposes of Prop. Treas. Reg. section 1.385-3(b)(2)(ii) in addition to Prop. Treas. Reg. section 1.385-3(b)(3)(ii)(B).

G. Proposed Exceptions to Prop. Treas. Reg. Section 1.385-3 for Certain Transactions between Related Foreign Corporations

1. Overview

As discussed above, we believe that Prop. Treas. Reg. section 1.385-3 is overbroad, attacking related-party lending transactions that would neither afford taxpayers the ability to strip

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[216] Preamble at 20917.

[217] *Id.* at 20918.

U.S. earnings nor enable them to engage in purportedly aggressive repatriation planning. This is particularly concerning in the context of transactions between foreign corporations for several reasons. First, the compliance and administrative burden with respect to Prop. Treas. Reg. section 1.385-3 is increased where the relevant information and documents are located in a foreign country. Second, this can create traps for the unwary given that foreign corporations may not even know of the potential consequences to them under Prop. Treas. Reg. section 1.385-3. Third, the policy concerns discussed in the Preamble—stripping U.S. earnings and aggressive repatriation planning—are focused on cross-border transactions and so are infrequently implicated by transactions that are solely between foreign parties. Finally, Prop. Treas. Reg. section 1.385-3 will significantly increase the compliance burdens for U.S. multinationals with respect to their foreign activities, making U.S. multinationals less competitive and discouraging investment in the United States.

However, we recognize that the Government may not want to exempt all foreign-to-foreign transactions from the application of Prop. Treas. Reg. section 1.385-3, and so we propose two more limited exceptions that we believe, if adopted, will significantly ameliorate the concerns described above without reducing the ability of the Final Regulations to advance the policy goals set forth in the Preamble.

2. Proposed "Relevancy" Standard

(a) Background

As noted above, the Preamble provides that the Proposed Regulations are generally intended to prevent the use of related-party debt instruments: (i) to reduce U.S. source income through interest expense deductions, and (ii) to facilitate repatriation of untaxed foreign earnings without recognizing dividend income.[218] The Proposed Regulations, however, apply without regard to whether the treatment of an instrument as debt or stock is relevant for U.S. federal income tax purposes.[219] Thus, the Proposed Regulations can apply to recharacterize a related-party debt instrument between non-U.S. taxpayers as stock, even though its purported characterization as debt has minimal, if any, relevance for U.S. federal income tax purposes.

The Preamble, in explaining the purpose for the Proposed Regulations, states that the regulations are motivated by the enhanced incentives (i.e., the reduction or elimination of U.S. federal income tax) for related parties to engage in transactions that result in excessive indebtedness.[220] However, this simply cannot be the case when the debt instrument has minimal, if any, U.S. federal income tax relevance. Nor can concerns that an instrument is used to reduce U.S. source income through interest expense deductions or facilitate repatriation of untaxed foreign earnings without recognizing dividend income be present where the instrument lacks U.S. federal income tax relevance.

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[218] Preamble at 20917.

[219] For purposes of this Comment Letter, an instrument is "relevant" if its classification as debt or equity affects the U.S. federal income tax liability of any person or affects any person's U.S. federal income tax reporting obligations. Note that this is the same definition used to determine if an entity's classification for U.S. federal income tax purposes is relevant. Treas. Reg. § 301.7701-3(d)(1)(i).

[220] Preamble at 20914.

Furthermore, when a related-party debt instrument is issued between parties to whom the classification of the instrument as debt or stock is not relevant, those parties may not give proper consideration to the manner in which the debt instrument is issued. It may be that the debt instrument is issued in a manner that causes the debt instrument to be recharacterized as stock, but such a recharacterization would have no significance.

> Example 36: *Debt instrument with no U.S. tax relevance.* FP owns all of the stock of FS and each is a foreign corporation organized under the laws of Country A. FP is the parent corporation of a group of foreign corporations. Neither FP nor FS is a U.S. taxpayer (e.g., neither corporation has income effectively connected with a U.S. trade or business). FS issues a debt instrument to FP in a distribution in Year 5 (the "FS Note"). In Year 10, when the FS Note is still outstanding, USP, a domestic corporation, acquires all of the stock of FP. To determine if (and the extent to which) the FS Note is treated as stock of FS for U.S. federal income tax purposes, USP would need to determine (i) whether FP and FS satisfied the Documentation Requirements, and (ii) if so, whether the Threshold Exception or Current E&P Exception applied to the distribution of the FS Note.

It is likely that FP and FS would not have complied with some aspect of the Documentation Requirements because neither corporation had any reason to take U.S. federal income tax rules into account when the FS Note was issued. Assuming *arguendo* that FP and FS did satisfy the Documentation Requirements, USP would have to reconstruct years of historical transactions to determine whether the Threshold Exception or the Current E&P Exception applied to the FS Note. With respect to the Threshold Exception, USP would have to:

(i) Identify all debt instruments in existence when the FS Note was issued and, for those instruments not denominated in U.S. dollars, convert such instruments into U.S. dollars using the U.S. dollar-denominated currency spot rate on the date of issuance,[221]

(ii) Determine whether, at the time the FS Note was issued and all times subsequent, the aggregate adjusted issue price of all debt instruments that would be recharacterized as stock under Prop. Treas. Reg. section 1.385-3, exceeded $50 million, and

(iii) If the $50 million threshold was not exceeded at any time noted in clause (ii) above, identify whether, at the time the FS Note was issued, there were any outstanding debt instruments that previously benefitted from the Threshold Exception but were subsequently recharacterized as stock as a result of the FP EG subsequently exceeding the $50 million threshold.[222]

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[221] It is also unclear how principal payments of debt instruments not denominated in U.S. dollars are translated into U.S. dollars for purposes of determining the principal amount of such instruments.

[222] For example, if FP also owned FS2 and (i) in Year 1 FS2 had no Current E&P and distributed a $25 million note to FP, (ii) in Year 2 FS2 had no Current E&P and distributed a $30 million note to FP, and (iii) in Year 3 FS2 repaid the $30 million note to FP. If the Year 1 FS2 note was outstanding when the FS Note was issued in Year 5, the FS

With respect to the Current E&P Exception, USP would have to determine FS's E&P and distribution and acquisition activity for the taxable year in which FS Note was issued and the taxable years in which the Per Se Rule applied.

(b) Relevance Exception to General Rule

Even assuming that the above-noted information is obtainable, applying Prop. Treas. Reg. section 1.385-3 to related-party debt instruments that are not relevant for U.S. federal income tax purposes when issued would create an enormous due diligence burden for U.S. taxpayers when acquiring foreign corporations—one which would only be exacerbated in a typical multinational corporate group with hundreds, if not thousands, of debt instruments (including term loans, cash pool balances, trade payables and receivables, and other evidences of indebtedness or items that are treated as debt for U.S. federal income tax purposes). Also, the policy concerns expressed in the Preamble are not present with respect to debt instruments that are not relevant for U.S. federal income tax purposes.

> Recommendation 82: We recommend an exception from the application of the Proposed Regulations for debt instruments that have no U.S. tax relevance at the time of issuance. However, if a related-party debt instrument is issued in a transaction undertaken with a principal purpose of avoiding the Proposed Regulations by taking advantage of this exception (e.g., when a related-party debt instrument is issued as part of a plan (or series of related transactions) pursuant to which the instrument becomes relevant), then the instrument would be subject to the Proposed Regulations.

Structured this way, the exception would alleviate the burden on taxpayers when the concerns raised in the Preamble are not present, but would prevent taxpayers from engaging in transactions with a view to inappropriately use this exception. Such an exception would also be consistent with other similar exceptions elsewhere in the Treasury regulations.[223]

Note would not qualify for the Threshold Exception irrespective of whether the total EG debt instruments issued by the FP EG and otherwise subject to recharacterization as stock exceeded $50 million. *See* Prop. Treas. Reg. § 1.385-3(g)(3), Ex. 17.

[223] For example, Treas. Reg. section 301.7701-3 provides the rules relating to the U.S. federal income tax classification of entities. In general, these rules apply to a business entity from the date such entity was formed. In Treas. Reg. section 301.7701-3(d)(2), however, the U.S. federal income tax classification of an foreign eligible entity whose U.S. federal income tax classification has never been relevant initially will be determined under the default classification rules of Treas. Reg. section 301.7701-3(b)(2) at the time the entity's U.S. federal income tax classification first becomes relevant. This rule effectively provides that a foreign eligible entity whose U.S. federal income tax classification has never been relevant is not subject to the entity classification rules of Treas. Reg. section 301.7701-3 until the first time such U.S. federal income tax classification becomes relevant.

Similarly, Treas. Reg. section 1.338-2(e) provides that a "qualifying foreign purchasing corporation" is not required to file an election under section 338 for a "qualifying foreign target corporation" before the earlier of three years from the acquisition date or 180 days after the close of the taxable year of the qualifying foreign purchasing corporation in which a triggering event occurs. For these purposes, a "qualifying foreign purchasing corporation" is a foreign corporation if, during the acquisition period, such foreign corporation and its affiliates are not "subject to U.S. tax." Treas. Reg. § 1.338-2(e)(1)(ii). Similarly, a qualifying foreign target corporation is a foreign corporation if, during the acquisition period, such foreign corporation and its affiliates are not "subject to U.S. tax." Treas. Reg.

(c) Relevance Exception to Funding Rule

Our discussion above regarding a "relevancy" standard applies with equal force to transactions subject to the Funding Rule. Indeed, Funding Rule transactions—both intercompany borrowings and distributions and acquisitions—are likely to be more common than General Rule transactions, and compliance with the Funding Rule will be significantly more complex than compliance with the General Rule.

Because the Funding Rule contains two components—both the issuance of debt for property and the Funded Distribution or Acquisition—the relevancy exception should also exempt Funded Distributions or Acquisitions by a funded member (including a predecessor or successor) during periods in which the funded member was not "relevant" for U.S. federal income tax purposes.

> Recommendation 83: We recommend an exception to the definition of a Funded Distribution or Acquisition for transactions where the funded member was not relevant at the time of the transaction.

3. Proposed CFC-to-CFC Exception

(a) Background

In addition to the concerns addressed above, the application of Prop. Treas. Reg. section 1.385-3 to loans between related CFCs is contrary to the Congressional policy of advancing the competitiveness of U.S.-based multinationals as indicated in the legislative history to section 954(c)(6). As currently drafted, Prop. Treas. Reg. section 1.385-3 would likely recharacterize a significant portion of debt instruments issued between CFCs. As a result, the Proposed Regulations as written would make foreign affiliated groups of U.S. multinationals less efficient and less competitive while rendering their U.S. tax compliance efforts more complicated and more burdensome to administer.

We believe that the broad application of Prop. Treas. Reg. section 1.385-3 to transactions between related CFCs raises significant policy concerns. Prop. Treas. Reg. section 1.385-3 would disrupt transactions between related CFCs that are currently permitted under section 954(c)(6) (the "Look-Through Rule") while working against the policies espoused by Congress in passing and repeatedly renewing the provision. Although the Look-Through Rule was eventually enacted in May 2006 as part of the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"), versions of the Look-Through Rule appeared in several bills in 2002, 2003, and 2004. Legislative history from that period confirms that Congress believed that international tax rules, and, in particular, the anti-deferral rules of subpart F, excessively interfered with business decisions regarding the deployment of foreign earnings in a U.S.-based multinational's

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§ 1.338-2(e)(1)(iii). A triggering event is defined as an event that causes the qualifying foreign purchasing corporation or any of its affiliates to become "subject to U.S. tax." Treas. Reg. § 1.338-2(e)(1)(iv). Under these regulations, a foreign corporation is subject to U.S. tax in the taxable year it (i) is required to file a U.S. income tax return, or (ii) is, among other things, a CFC. Treas. Reg. § 1.338-2(e)(1)(v).

foreign group.[224] The legislative history also pointed out that the tax burden imposed upon the movement of capital under subpart F at the time was often circumvented by taxpayers through other means such as the check-the-box classification regulations.[225] Because the practical effect of the pre-section 954(c)(6) subpart F regime was to increase taxpayers' transaction costs, the Senate suggested that such road blocks to the movement of non-subpart-F earnings should be removed.[226]

Further, the legislative history outlined a concern that prior law's restrictions on the redeployment of foreign earnings could render U.S.-based multinationals less competitive, noting that most foreign-based multinationals do not encounter such restrictive regimes and can more freely and efficiently structure and fund their foreign investments.[227] When the Look-Through Rule was passed as part of TIPRA, the Ways and Means Committee report and the Joint Committee on Taxation's explanation of the Look-Through Rule included the same policy discussion that was noted in the House legislative history referenced above, reinforcing the Congressional priority that foreign capital move freely between related CFCs.[228]

Upon its passage in 2006, the Look-Through Rule retroactively applied to tax years of corporations beginning after December 31, 2005. Since then, the provision has applied continuously, and now extends to tax years beginning before January 1, 2020.[229] Congress's passage of the provision on five occasions suggests a Congressional consistency in prioritizing the competitiveness of U.S.-based multinationals, a priority that Prop. Treas. Reg. section 1.385-3 could seriously undermine.[230] Although section 954(c)(6) does not in all cases preclude

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[224] *See* S. Rep. 108-192, 39 ("The Committee believes that present law unduly restricts the ability of U.S.-based multinational corporations to move their active foreign earnings from one controlled foreign corporation to another.").

[225] *See* S. Rep. 108-192, 39 ("In many cases, taxpayers are able to circumvent these restrictions as a practical matter, although at additional transaction cost. The Committee believes that taxpayers should be given greater flexibility to move non-Subpart-F earnings among controlled foreign corporations as business needs may dictate.").

[226] *Id.*

[227] *See* H.R. Rep. 108-548, Part 1, 202-03 ("Most countries allow their companies to redeploy active foreign earnings with no additional tax burden. The Committee believes that this provision will make U.S. companies and U.S. workers more competitive with respect to such countries. By allowing U.S. companies to reinvest their active foreign earnings where they are most needed without incurring the immediate additional tax that companies based in many other countries never incur, the Committee believes that the provision will enable U.S. companies to make more sales overseas, and thus produce more goods in the United States."); H.R. Rep. 108-393, 102 (including similar language).

[228] *See* H.R. Rep. 109-304, 45 (including the same "Reasons for Change" as H.R. Rep. 108-548, quoted above at note 227); JCS-1-07, 267 (same).

[229] Although Congress allowed the Look-Through Rule to expire in 2009 and 2013, Congress extended the provision retroactively both times so that it covered all intervening dates. Tax Relief, Unemployment Insurance Reauthorization, And Job Creation Act of 2010, Pub. L. No. 111-312, § 751, 124 Stat. 3296, 3321; American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 323, 126 Stat 2313, 2333.

[230] Congress first passed TIPRA in 2006 and then renewed the Look-Through Rule in 2008, 2010, 2013, and 2015, so this bipartisan rule has been passed by majorities and signed into law by presidents of both political parties. *See* Tax Increase Prevention And Reconciliation Act Of 2005, Pub. L. No. 109-222, § 103, 120 Stat 345; Tax Relief, Unemployment Insurance Reauthorization And Job Creation Act of 2010, Pub. L. No. 111-312, § 751, 124 Stat.

movements of funds between related CFCs from generating subpart F income, the legislative history and repeated renewal of the provision demonstrates a strong Congressional intent to reduce the cost to U.S. multinationals of transferring funds between their CFCs. Therefore, by significantly restricting the ability of U.S. multinationals to lend funds between CFCs, Prop. Treas. Reg. section 1.385-3 is contrary to this Congressional priority.[231]

(b) Description of Proposed CFC-to-CFC Exception

As stated above, we believe that Prop. Treas. Reg. section 1.385-3 is overbroad, applying to taxpayers and transactions that are not at the heart of the Proposed Regulations' purported purpose—to limit taxpayers' abilities to engage in inappropriate earnings stripping and aggressive repatriation structures. Therefore, we suggest that an exception be added to Prop. Treas. Reg. section 1.385-3 for certain transactions between CFCs. The exception would allow related CFCs and partnerships with CFC partners to "move their active foreign earnings from one controlled foreign corporation to another" in a manner consistent with Congressional intent.[232] To that end, we propose a "CFC-to-CFC Exception" whereby a debt instrument of a CFC issued to a related CFC would be exempt from recharacterization as stock under Treas. Reg. section 1.385-3. Due to the general operation of Prop. Treas. Reg. section 1.385-3, this CFC-to-CFC Exception would only apply where the issuer and holder are CFCs that are members of the same EG.

The aggregate treatment of partnerships provided in Prop. Treas. Reg. section 1.385-3(d)(5) would apply for purposes of the CFC-to-CFC Exception such that the treatment of debt instruments issued by or to partnerships would depend on the extent to which the partnerships' partners are CFCs that qualify for the CFC-to-CFC Exception.

The following examples illustrate the application of the CFC-to-CFC Exception. In these examples, USP, a U.S. corporation, directly wholly owns CFC 1 and CFC 3, both CFCs. CFC 1 directly wholly owns CFC 2, which is also a CFC.

> Example 37: *Note distribution between CFCs.* CFC 2 issues its own note to CFC 1 as a distribution. Under the CFC-to-CFC Exception described above, this note would not be recharacterized as equity under Prop. Treas. Reg. section 1.385-3.
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> Example 38: *CFC stock acquired by related CFC.* CFC 3 purchases stock of CFC 2 from CFC 1 in exchange for a CFC 3 note. Under the CFC-to-CFC Exception, the CFC 3 note would not be recharacterized as CFC 3 stock under

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3296, 3321; American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 323, 126 Stat 2313, 2333; Tax Increase Prevention Act Of 2014, Pub. L. No. 113-295, § 135, 128 Stat 4010, 4019.

[231] Although we note that the recharacterization of CFC-to-CFC loans as stock will not necessarily cause subpart F income to be generated, it will increase the complexity and cost of lending between related CFCs generally. Therefore, such recharacterization is inconsistent with the Congressional policy motivating section 954(c)(6) even if it does not necessarily eliminate the specific subpart F benefit provided by the Code section in all cases.

[232] *See* S. Rep. 108-192, 39.

Prop. Treas. Reg. section 1.385-3 because CFC 1 and CFC 3 are members of the same EG.

Recommendation 84: We recommend the Final Regulations include a CFC-to-CFC Exception as described herein.

H. Operating Rules

1. EG Determination Ordering Rule

Prop. Treas. Reg. section 1.385-1(b)(3) defines which entities are members of the EG. Prop. Treas. Reg. section 1.385-3(d)(1)(i) provides the general rule, subject to certain exceptions, for determining when either the General Rule or the Funding Rule applies to recharacterize a debt instrument as stock. Under this general timing rule, the recharacterization occurs when the debt instrument is issued.

As currently drafted, the Proposed Regulations fail to provide a clear statement that the determination of a corporation's EG Member status should be made prior to the application of the rules in Prop. Treas. Reg. section 1.385-3. The uncertainty created by this lack of clarity could result in some taxpayers unnecessarily making determinations as to whether a debt instrument between two entities which are not members of the same EG should be treated as stock, as the deemed stock treatment could result in such entities being members of the same EG.

Recommendation 85: The Proposed Regulations should clarify that the deemed stock resulting from the application of Prop. Treas. Reg. section 1.385-3 is not taken into account when determining which entities are members of a corporation's EG.

2. Exception When Debt Instrument Ceases to Qualify for Threshold Exception

As discussed above, pursuant to the Threshold Exception, a debt instrument is not treated as stock under Prop. Treas. Reg. section 1.385-3(b) if the aggregate adjusted issue price of debt instruments held by members of an EG that would otherwise be recharacterized as stock under such section does not exceed $50 million. Prop. Treas. Reg. section 1.385-3(d)(1)(iii) provides that if a debt instrument ceases to qualify for the Threshold Exception, the debt instrument is treated as stock at the time the threshold is exceeded.

The operating rules should clarify whether the order of repayment of debt instruments, some of which once satisfied the Threshold Exception and others of which did not, is relevant.

Example 39: *Application of Threshold Exception after aggregate debt below $50 million.* Debt A in the amount of $30 million is issued on Date 1, Year 1 and is excepted only by reason of the Threshold Exception. Assume further that Debt B for $40 million is issued on Date 2 in Year 2 and was issued in a distribution subject to the General Rule. Debt B is treated as stock on the date of issuance, and pursuant to Prop. Treas. Reg. section 1.385-3(d)(1)(iii), Debt A is treated as

exchanged for stock on the Debt B issuance date, i.e., Date 2, Year 2.[233] On Date 3, Year 3, Debt B is repaid. It appears that Debt A remains characterized as stock. On Date 4 in Year 4, Debt C for $5 million is issued in a distribution subject to the General Rule. At that time, the total debt outstanding is $35 million. However, because the threshold was previously exceeded, and Debt A, which is a debt instrument that previously was treated as indebtedness solely because of Prop. Treas. Reg. section 1.385-3(c)(2), remains outstanding, it appears that the Threshold Exception is not available. On the other hand, if Debt A had been paid off instead of Debt B, it appears that the Threshold Exception would be available for Debt C because Debt B was never excepted under the Threshold Exception.

We note that if our recommendation at Section VII.F.2(b)(2), above, is adopted, the consequences of this issue will be ameliorated. In any event, the two situations described above should be treated consistently.

Recommendation 86: We recommend that if the Threshold Exception amount is not exceeded at the time of an issuance of a debt, that debt should not be subject to recharacterization until the Threshold Amount is exceeded, irrespective of whether the Threshold Exception amount was previously exceeded and resulted in recharacterization of other debt.

3. Re-Testing of Debt Instruments

Prop. Treas. Reg. section 1.385-3(d)(2) provides that if a debt instrument that is treated as stock under Prop. Treas. Reg. section 1.385-3 leaves the EG either because the debt instrument is transferred to a non-EG Member or because the holder or issuer ceases to be a member of the same EG, then the debt instrument ceases to be treated as stock under Prop. Treas. Reg. section 1.385-3. The Proposed Regulations further provide that all other debt instruments that are not currently treated as stock are re-tested to see if they are treated as funding the distribution or acquisition that was previously treated as funded by the debt instrument that left the group.[234] Prop. Treas. Reg. section 1.385-3(d)(1)(iv) provides that if the *re*-tested debt instrument is treated as stock, it is deemed to be exchanged for stock on the date of the re-testing.

Limitations should be put on the re-testing periods put forth in Prop. Treas. Reg. sections 1.385-3(d)(1)(iv) and (d)(2). As currently drafted, the re-testing period could be years after the Per Se Period.

Example 40: *Re-testing after the end of the Per Se Period.* Debt A is treated as funding a distribution in Year 1. Debt B is issued in the same amount as Debt A in Year 2 and would be treated as funding the Year 1 distribution but for the existence of Debt A. Debt A is treated as stock under Prop. Treas. Reg. section 1.385-3(b). In Year 10, Debt A is transferred outside the EG and therefore, once again, is treated as debt. In Year 10, if Debt B is still outstanding it would need to

[233] *See* Prop. Treas. Reg. § 1.385-3(g)(3), Ex. 17.

[234] *See* Prop. Treas. Reg. § 1.385-3(g)(3), Ex. 7.

be re-tested. It would fail the Per Se Rule due to the distribution in Year 1 (within 36 months of its issuance), and become stock in Year 10.

Extraordinary record keeping, well beyond the normal statute of limitations, would be necessary in order to properly administer this rule, and the risk of potential abuse seems attenuated.

A similar effect occurs under the Subsidiary Stock Issuance Exception. Under this exception, however, the Cessation date is limited. Specifically, the exception ceases to apply only if the Transferor ceases to meet the 50 percent ownership requirement during a 36-month period following the acquisition of the Issuer stock, potentially causing debt to be recharacterized as stock if the acquisition was funded by a debt instrument issued during the Per Se Period determined with respect to the date of the acquisition.

Recommendation 87: We recommend that, like the Subsidiary Stock Issuance Exception, the re-testing period described in both Prop. Treas. Reg. sections 1.385-3(d)(1)(iv) and (d)(2) should be limited to 36 months after the debt is issued.

I. Issues Related to Partnerships

1. Aggregate Treatment of Partnerships

Prop. Treas. Reg. section 1.385-3(d)(5) provides that a controlled partnership, within the meaning of Prop. Treas. Reg. section 1.385-1(b)(1), is treated as an aggregate of its partners (a "Controlled Partnership"). Further, each EG partner, within the meaning of Prop. Treas. Reg. section 1.385-3(f)(7) (an "EG Partner"), is treated as acquiring its proportionate share of the Controlled Partnership's assets and issuing its proportionate share of any debt instrument issued by the Controlled Partnership, computed based on such EG Partner's share of the Controlled Partnership's profits. We recommend that the Final Regulations clarify the application of the Funding Rule under Prop. Treas. Reg. section 1.385-3(b)(3) when an EG Partner issues debt to a Controlled Partnership or holds debt of the Controlled Partnership that may be subject to recharacterization under Prop. Treas. Reg. section 1.385-3.

Example 41: *Debt instrument issued by corporate partner to Controlled Partnership.* Corporation A and Corporation B are members of an EG and own equal partnership interests in Partnership X. Corporation A borrows cash from Partnership X pursuant to a promissory note that is treated as debt under Prop. Treas. Reg. section 1.385-1 and meets the Documentation Requirements. Assume further that Corporation A makes a distribution equal to the principal balance of the promissory note within the Per Se Period. Under the aggregate rule described above, Corporation A and Corporation B would each be treated as holding 50 percent of the promissory note issued by Corporation A for purposes of determining whether the promissory note is subject to recharacterization under Prop. Treas. Reg. section 1.385-3. However, under these facts, Corporation A would be treated as both the issuer and the lender of the promissory note to the extent of Corporation A's 50 percent interest in the profits of the partnership. Under general tax principles, the promissory note would be disregarded to the

extent that Corporation A is both the borrower and the lender (i.e., Corporation A would not be treated as making a loan to itself).

> Recommendation 88: The Final Regulations should clarify that if a debt instrument is issued by an EG Partner to such EG Partner's Controlled Partnership, the debt instrument should not be subject to recharacterization under Prop. Treas. Reg. section 1.385-3 to the extent the EG Partner would be treated as both the borrower and the lender under the aggregate treatment of partnerships set forth in Prop. Treas. Reg. section 1.385-3(d)(5).

As a result, under the facts described above, only 50 percent of the promissory note issued by Corporation A to Partnership X would be subject to recharacterization.

> Example 42: *Debt instrument issued by Controlled Partnership to Corporate Partner.* Corporation A and Corporation B are members of an EG and own equal partnership interests in Partnership X. Partnership X borrows money from Corporation B pursuant to a promissory note that is treated as debt under Prop. Treas. Reg. section 1.385-1 and meets the Documentation Requirements. Corporation B makes a distribution equal to the principal balance of the partnership's promissory note during the Per Se Period. Under the aggregate rule described above, Corporation A and Corporation B could each be treated as issuing 50 percent of the promissory note for purposes of determining whether the promissory note is subject to recharacterization. However, under these facts, Corporation B would be treated both as the lender and the issuer of the promissory note to the extent of Corporation B's 50 percent interest in the profits of the partnership. Like the example above, under general tax principles, the promissory note would be disregarded to the extent that Corporation B is both the lender and the borrower.

> Recommendation 89: The Final Regulations should clarify that if a debt instrument is issued by a partnership to an EG Partner, the debt instrument should not be subject to recharacterization under Prop. Treas. Reg. section 1.385-3 to the extent that the EG Partner would be treated as both the lender and borrower with respect to the debt instrument under the aggregate treatment of partnerships set forth in Prop. Treas. Reg. section 1.385-3(d)(5).

As a result, under the facts described in Example 42, the 50 percent of the promissory note deemed issued by Corporation B under the aggregate treatment of partnerships would not be subject to recharacterization, notwithstanding that Corporation B made a distribution that may otherwise be subject to the Funding Rule. The 50 percent of the promissory note that would be deemed issued by Corporation A to Corporation B would be subject to the Proposed Regulations.

2. Preferred Equity

The Preamble states that the Government is considering rules that would treat preferred equity in a Controlled Partnership as equity in the EG Partners, based on the principles of the aggregate approach in Prop. Treas. Reg. section 1.385-3(d)(5). The Preamble states that the

Government is aware that the issuance of preferred equity by a Controlled Partnership to an EG Member may give rise to similar concerns as debt instruments of a Controlled Partnership issued to an EG Member, and that Controlled Partnerships may, in some cases, issue preferred equity with a principal purpose of avoiding the application of Prop. Treas. Reg. section 1.385-3.

Preferred equity may have similar economics to debt in that it promises a predictable income stream to the recipient and results in an income allocation away from the common equity, reducing the taxable income of the common.[235] In connection with the consideration of preferred equity, we have also considered the treatment of guaranteed payments, which are similar to interest payments in that they are a priority stream of income to the recipient that is generally deductible to the partnership.[236]

Notwithstanding the similarities between debt and preferred equity, we believe they are sufficiently different to warrant different treatment under section 385. Specifically, unlike debt, the issuance of preferred equity is subject to sections 704 and 707, which contain rules to limit abusive transactions. These rules should address any concerns on the use of preferred equity. Although we acknowledge that a CFC may receive a preferred interest that may pull income away from a U.S. EG Member, we think it is unlikely that a funded U.S. EG Member would engage in one of the three transactions listed under Prop. Treas. Reg. section 1.385-3(b)(3)(ii) as a result of the issuance of preferred equity.

> Recommendation 90: We recommend that the Final Regulations should not apply to preferred equity in a Controlled Partnership.
>
> Recommendation 91: If the Government determines it is necessary to provide for the application of an anti-abuse rule to partnership equity, we recommend the Final Regulations contain examples of situations that are not abusive and those that are.

3. Proportionate Share

(a) Capital or Profits Interest

For purposes of Prop. Treas. Reg. section 1.385-3, a Controlled Partnership is treated as an aggregate of its partners.[237] Specifically, Prop. Treas. Reg. section 1.385-3(d)(5)(i) provides that an EG Partner is treated as (i) holding its "proportionate share" of the Controlled Partnership's assets and (ii) issuing its "proportionate share" of any debt instrument issued by the Controlled Partnership. An EG Partner's proportionate share under the Proposed Regulations is "determined in accordance with [its] share of partnership profits,"[238] but the regulations do not

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[235] *E.g., ASA Investerings Partnership v. Comm'r*, T.C. Memo. 1998-305, *aff'd*, 201 F.3d 505 (D.C. Cir. 2000) (Tax Court recharacterized purported partnership interest as a debtor/creditor relationship).

[236] *See, e.g.*, Eric B. Sloan and Matthew Sullivan, *Deceptive Simplicity: Continuing and Current Issues with Guaranteed Payments*, 916 PLI/TAX 124-1 (2011); Paul Carman and Kelley Bender, "Debt, Equity, or Other: Applying a Binary Analysis in a Multidimensional World," 107 J. Tax'n 17 (2007) at 26 ("[G]uaranteed payments statutorily have (at least) one more debt characteristic than preferred stock."

[237] Prop. Treas. Reg. § 1.385-3(d)(5)(i).

[238] *Id.*

define how such profits are determined. For purposes of determining a partner's proportionate share of a nonrecourse debt instrument, a partner's share of partnership profits is a reasonable proxy for the partner's share of the debt when a partnership issues a nonrecourse debt instrument and retains the borrowed funds because the partnership is likely to repay the debt out of partnership profits or turn over the property to satisfy the debt. The same policy necessarily does not apply when a partnership issues a recourse note, because although the intent is to satisfy the note out of partnership profits, upon a default, the partner(s) will be responsible for repaying the debt. Moreover, using a partner's share of profits can be the subject of much uncertainty and might be calculated in up to 25 different ways, according to one partnership practitioner.[239]

Due to the significant impact of the proposed changes, it is imperative that the regulations, when finalized, provide for a clear definition of profits for this purpose.

> Recommendation 92: We recommend that the Final Regulations either (i) provide with specificity the manner in which partnership profits are calculated for purposes of Treas. Reg. section 1.385-3(b)(3), or (ii) consider use of partner capital for purposes of that regulation.[240]

(b) Alternative Application of Profits Interest Test

If the Final Regulations retain the partner's share of partnership profits test for purposes of Treas. Reg. section 1.385-3(b)(3), the Final Regulations should address possible situations that may lead to results that are inconsistent with the intent of the Proposed Regulations, illustrated as follows.

For example, for purposes of determining a partner's proportionate share of a nonrecourse debt instrument, a partner's share of partnership profits is a reasonable proxy for the partner's share of the debt when a partnership issues a nonrecourse debt instrument and retains the borrowed funds because the partnership is likely to repay the debt out of partnership profits. If, instead of retaining the borrowed funds, a partnership distributes the borrowed funds to its partners pro rata based on relative profits and the partners enter into a Funded Distribution or Acquisition as described under Prop. Treas. Reg. section 1.385-3(b)(3) that causes the debt to be treated as stock, defining "proportionate share" based on share of partnership profits is still a reasonable approach, but not under all circumstances.

> Example 43: *Special allocation of items associated with partnership's debt instrument.* Foreign corporation FP wholly owns a second foreign corporation, FS, and a domestic corporation, USS. In Year 1, FS and USS form a partnership, PS, and agree to split profits and losses 50-50. In Year 2, FP loans PS $100x to

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[239] *See* Sheldon I. Banoff, *Identifying Partners' Interests in Profits and Capital: Uncertainties, Opportunities and Traps*, Taxes – The Tax Magazine, 2007, at 207. Consideration could be given to the approach adopted in Treas. Reg. section 1.706-1(b)(4), which applies a specific, mechanical approach in calculating profits interests for purposes of determining a partnership's year end.

[240] We note that use of the partners' capital is not without its own issues. For instance, if debt is recharacterized as equity under section 385, the creditor-turned-equity holder's capital interest would be increased by such amount. In that regard, consideration might be given to an approach that looked to relative capital determined without regard to any such recharacterization.

acquire Asset X. FS and USS agree that FS will be the primary economic beneficiary of Asset X and FS guarantees repayment of the $100x debt. In addition, PS will allocate all items associated with Asset X (including the interest expense on the loan) in a 99-1 proportion (with FS having the 99 percent interest). PS is currently profitable, but Asset X is not expected to generate profits in the first two years. In Year 3, USS makes a $50x distribution to FP. The Funding Rule will be triggered to the extent USS is treated has having issued any of the $100x debt under Prop. Treas. Reg. section 1.385-3(d)(5)(i). In Year 2, when the $100x loan was made, all of PS's profits were allocated 50-50 between FS and USS. Thus, if the IRS looks to the partners' current ownership of PS, it appears that USS will be treated as having made a $50x loan to FP under Prop. Treas. Reg. section 1.385-3(d)(5)(i). Following that fiction, FP will apparently be treated as making a $50x equity contribution to USS (with a conforming adjustment of USS being treated as contributing $50x to PS).

Applying section 385 in this manner ignores USS's lack of a significant economic interest in the loan, the interest deductions generated by the loan and situations where the partnership agreement does not follow the section 704(b) safe harbor. The loan did not increase USS's ability to make a distribution, which is the basis for the Funding Rule. Instead of allocating the loan based on the partners' general interest in profits (50-50), allocating the loan based on either the economic benefit of the Asset X proceeds or on the anticipated allocation of the interest expense on the loan more closely matches the partners' economic interest in the loan.

Example 44: *Funded Distribution by corporate partner.* Foreign corporation FP wholly owns a second foreign corporation, FS, and a domestic corporation, USS. FS and USS form a partnership, PS, as 50-50 partners. In Year 1, USS makes a $60x distribution to FP. In Year 2, FP loans $100x to PS. Applying the aggregate rule of Prop. Treas. Reg. section 1.385-3(d)(5)(i), FS and USS are each treated as issuing a $50x note to FP. Because USS distributed $60x to FP in the prior year, the Funding Rule under Prop. Treas. Reg. section 1.385-3(b)(3) requires the $50x note that USS is deemed to issue to FP to be recharacterized as equity. Accordingly, FP is treated as making a $50x equity investment in USS in Year 2. Presumably, under Prop. Treas. Reg. section 1.385-3(d)(5)(ii), USS then will be deemed to make a $50x capital contribution to PS. The remaining $50x of FP debt is not recharacterized as equity.

There is currently no coordination between the Proposed Regulations and the section 752 debt allocation rules. Presumably, at the end of Year 2, USS's basis will be increased by $25x (beginning basis of $50x, less $25x of converted debt, plus $50x from the deemed capital contribution) while FS's tax basis is reduced by $25x.

Another problem with the partner's share of partnership profits approach arises when the partner's interest in profits changes over time.

Example 45: *Subsequent change in allocation of partnership profits.* Same facts as Example 44, except that in Year 3, PS recapitalizes and now allocates 60 percent of income to USS. If the Government adopts a rule that would create a

continuous testing of the partners' share of the debt under the aggregate rule of Prop. Treas. Reg. section 1.385-3(d)(5)(i), that would mean that USS is now treated as having issued $60x of debt to FP within a three year period of making a $60x distribution to FP. If so, then it appears that the Funding Rule would cause the additional $10x of debt to be recharacterized as an equity investment by FP in USS (along with the additional conforming adjustment of another $10x capital contribution by USS to PS and $40x of remaining debt that would be allocated under section 752).

Moreover, another problem with the partner's interest in partnership profits test is that if the borrowed funds are distributed non-pro rata by the partnership to its partners, determining a partner's proportionate share in accordance with that partner's share of partnership profits may not be appropriate. Therefore, if the Final Regulations retain the partner's share of partnership profits test for purposes of Treas. Reg. section 1.385-3(b)(3), we recommend an alternative approach to determining a partner's proportionate share of a partnership's debt instrument that is subject to the recharacterization rules of the Funding Rule.

This alternative approach would be similar to the tracing rule in Treas. Reg. section 1.707-5(b)(2)(i) for determining a partner's allocable share of a partnership liability ("Tracing Approach"). The rule could provide that a partner's proportionate share of a debt instrument that is subject to the Funding Rule is the sum of (i) the amount of the debt proceeds that is allocable under Treas. Reg. section 1.163-8T to the money transferred to the partner, and (ii) the partner's proportionate share of the debt proceeds not transferred to any partners of the partnership. The operation of the Tracing Approach is illustrated by Example 46.

> Example 46: *Application of Tracing Approach.* FP owns 100 percent of CFC and FS. CFC and FS are equal partners in PRS. On Date A, Year 1, FP lends $100x to PRS in exchange for PRS Note. On Date B, Year 1, PRS distributes $90x to CFC and $10x to FS. Also on Date B, Year 1, CFC and FS distribute $90x and $10x to FP, respectively.

Under Prop. Treas. Reg. section 1.385-3(d)(5)(i), CFC and FS are each treated as issuing $50x of PRS Note, which represents their proportionate share of PRS Note based on their share of partnership profits. Under Prop. Treas. Reg. section 1.385-3(b)(3)(iv)(B)(1), PRS Note is treated as issued with a principal purpose of funding the distributions by CFC and FS. Accordingly, under Prop. Treas. Reg. sections 1.385-3(b)(3)(ii)(A) and 1.385-3(d)(1)(i), CFC could be treated as issuing $50x of stock (presumably limited to its share of PRS Note) to FP while FS could be treated as issuing $10x of stock (presumably limited to the amount of FS's distribution to FP). The rules under the Proposed Regulations do not provide treatment for the $40x that the CFC received in excess of its proportionate share of the PRS Note. Under our recommended Tracing Approach, however, CFC and FS's share of PRS Note that is subject to the Funding Rule is $90x and $10x, respectively. Because under Prop. Treas. Reg. section 1.385-3(b)(3)(iv)(*B*)(*1*) PRS Note is treated as issued with a principal purpose of funding the distributions to CFC and FS, CFC and FP are treated as issuing $90x and $10x of their stock to FP, respectively.

Recommendation 93: If the Final Regulations retain the partner's share of partnership profits test for purposes of Prop. Treas. Reg. section 1.385-3(b)(5), we recommend an alternative approach to determining a partner's proportionate share of a partnership's debt instrument that is subject to Funding Rule.

(c) Timing for Determination of Proportionate Share

In addition to providing the method for calculating a partner's proportionate share in a partnership, the Final Regulations should also specify the timing for determining such proportionate share. Specifically, the share of profits should be determined immediately after the Controlled Partnership issues a debt instrument to or receives a debt instrument from an EG Member. To this end, the Government could provide that, if a partner's share of profits is reduced within one year of the issuance or receipt of a debt instrument, the reduction is presumed to be anticipated, unless the facts and circumstances establish that the decrease in the partner's share of profits was not anticipated. In addition, the Final Regulations could also adopt a rule providing that a reduction in a partner's share of profits will be taken into account if it is part of a plan with a principal purpose of avoiding the regulations under section 385.[241]

Recommendation 94: In addition to providing methods for determining a partner's proportionate share of a partnership, we recommend that the Final Regulations specify the time for determining an EG Partner's proportionate share of a partnership.

4. Debt Distributed to a Partner

The Proposed Regulations are arguably unclear as to the consequences of the distribution by a partnership of its own note to a partner. Although such a note would be treated as issued in part by the other partners in the partnership under the aggregate approach to partnerships in Prop. Treas. Reg. section 1.385-3, the note would not have been issued in any of the transactions subject to the General Rule and would not have been issued in exchange for property as required for the application of the Funding Rule.[242]

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[241] These suggestions are similar to the anticipated reduction rule under Prop. Treas. Reg. section 1.707-5(b)(2)(iii). Specifically, Prop. Treas. Reg. section 1.707-5(b)(2)(iii)(A) provides that for purposes of Treas. Reg. section 1.707-5(b)(2), a partner's share of a liability immediately after a partnership incurs the liability is determined by taking into account a subsequent reduction in the partner's share if (i) at the time that the partnership incurs the liability, it is anticipated that the partner's share of the liability that is allocable to a transfer of money or other consideration to the partner will be reduced subsequent to the transfer; (ii) the anticipated reduction is not subject to the entrepreneurial risks of partnership operations; and (iii) the reduction of the partner's share of the liability is part of a plan that has as one of its principal purposes minimizing the extent to which the partnership's distribution of the proceeds of the borrowing is treated as part of a sale. Prop. Treas. Reg. section 1.707-5(b)(2)(iii)(B) further provides that if within two years of the partnership incurring the liability, a partner's share of the liability is reduced due to a decrease in the net value of the partner or a related person for purposes of Treas. Reg. section 1.752-2(k), the reduction will be presumed to be anticipated, unless the facts and circumstances clearly establish that the decrease in the net value was not anticipated. Any such reduction must be disclosed in accordance with Treas. Reg. section 1.707-8.

[242] We note that the deemed issuance of a note by a partnership in a disguised sale transaction raises additional complexities and would need to be considered further.

Recommendation 95: We recommend that the Final Regulations clarify that the distribution of a partnership's own note to its partners is not subject to Prop. Treas. Reg. section 1.385-3.

The distribution of a note by a partnership to a partner does not pose the same problems that arise upon a distribution of a note from a corporation to its shareholder. The primary, relevant difference is, in the case of a partnership, unlike a corporation, the earnings are includable currently.

5. Treatment of DREs under Prop. Treas. Reg. Section 1.385-3

Prop. Treas. Reg. section 1.385-3(d)(6) provides that if a debt instrument of a DRE is treated as stock under Prop. Treas. Reg. section 1.385-3, then such debt instrument is treated as stock in the entity's "*owner*" (i.e., it applies aggregated principles for purposes of Prop. Treas. Reg. section 1.385-3).

Example 47: *Debt instrument issued by DRE underneath a partnership.* If DRE1 is owned by DRE2, which is owned by Partnership, and Partnership is owned by FS1 and FS2, which are each wholly owned by USP, it is unclear whether a debt instrument of DRE1 that is treated as stock under Prop. Treas. Reg. section 1.385-3 should be treated as stock proportionately in both FS1 and FS2, or as an interest in either DRE2 or Partnership.

Recommendation 96: We recommend that the Final Regulations clarify that if a debt instrument of a DRE is treated as stock under Prop. Treas. Reg. section 1.385-3, such debt instrument should be treated as stock in the first *regarded* owner, but if the first regarded owner is a partnership, then such debt instrument should be treated as stock in the corporate partners of the partnership under the principles of Prop. Treas. Reg. section 1.385-3(d)(5).

VIII. Comments Concerning Treatment of Consolidated Groups

A. Overview

In the Preamble, the Government expresses its intention for interactions among consolidated group members to fall outside the Proposed Regulations:

> [T]he proposed regulations should not apply to issuances of interests and related transactions among members of a consolidated group because the concerns addressed in the proposed regulations generally are not present when the issuer's deduction for interest expense and the holder's corresponding interest income offset on the group's consolidated U.S. federal income tax return.[243]

[243] Preamble at 20914. The Preamble also states that "many of the concerns regarding related-party indebtedness are not present in the case of indebtedness between members of a consolidated group [and, a]ccordingly, the proposed regulations under section 385 do not apply to interests between members of a consolidated group." *Id.* at 20920.

1. General Implementation of Consolidated Group Exception

To effectuate the stated intent, Prop. Treas. Reg. section 1.385-1(e) provides a blanket operating rule that, for purposes of the regulations under section 385,[244] all members of a consolidated group (as defined in Treas. Reg. section 1.1502-1(h))[245] are treated as one corporation.[246] Certain limited embellishments of this broad, single entity rule are found elsewhere in the Proposed Regulations. In Prop. Treas. Reg. section 1.385-2(c)(4)(i), it is stated that, during the time that the issuer and the holder of an applicable instrument are members of the same consolidated group, the applicable instrument is treated as *not outstanding* for purposes of Prop. Treas. Reg. section 1.385-2.[247] It further states that, as a result, Prop. Treas. Reg. section 1.385-2 does not apply to any applicable instrument that is an intercompany obligation as defined in Treas. Reg. section 1.1502-13(g)(2)(ii).[248]

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[244] Per the terms of Prop. Treas. Reg. section 1.385-1(e), the "one corporation" treatment is limited to the section 385 regulations. For instance, Prop. Treas. Reg. section 1.385-2(c)(4)(ii) states that Prop. Treas. Reg. section 1.385-2(c)(4)(i), which otherwise ignores as outstanding an applicable instrument between consolidated group members, does not affect the application of the rules under Treas. Reg. section 1.1502-13(g).

[245] The Preamble similarly states that the Proposed Regulations define a "consolidated group" in the same manner as the consolidated return regulations, and also cross-references Treas. Reg. section 1.1502-1(h). Treas. Reg. section 1.1502-1(h) defines the term "consolidated group" as a group filing (or required to file) consolidated returns for the taxable year. The term "group" means an affiliated group of corporations as defined in section 1504. Treas. Reg. § 1.1502-1(a). An "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is also an includible corporation, but only if the common parent owns directly stock meeting the requirements of section 1504(a)(2) in at least one other includible corporation, and stock meeting the requirements of section 1504(a)(2) in each of the includible corporations (except the common parent) is owned directly by one or more of the other includible corporations. I.R.C. § 1504(a)(1). An "includible corporation" means any corporation except (i) corporations exempt from taxation under section 501, (ii) insurance companies subject to taxation under section 801, (iii) foreign corporations, (iv) corporations with respect to which an election under section 936 is in effect for the taxable year, (v) RICs and REITs subject to tax under subchapter M of chapter 1, and (vi) an S Corporation. I.R.C. § 1504(b).

[246] The Preamble observes that its above-described intent to exclude dealings among consolidated group members is achieved through the treatment of a consolidated group as one corporation under Prop. Treas. Reg. section 1.385-1(e), and the rule of Prop. Treas. Reg. section 1.385-1(e) is restated in Prop. Treas. Reg. sections 1.385-2(c)(4)(i), 1.385-4(a), and 1.385-4(b)(2). *Cf.* Prop. Treas. Reg. § 1.385-1(a) (noting that Prop. Treas. Reg. section 1.385-1 provides operating rules regarding the treatment of certain direct and indirect interests in corporations as stock or indebtedness for federal tax purposes).

[247] This result is echoed in Prop. Treas. Reg. section 1.385-2(c)(4)(ii), which addresses the case of an applicable instrument that ceases to be an intercompany obligation and, as a result, *becomes* an EGI; that is, the instrument is not an EGI while it resides within the consolidated group, presumably based on the requirement in Prop. Treas. Reg. section 1.385-2(a)(4)(ii) that the holder be *another* corporation when compared with the issuer and that, pursuant to Prop. Treas. Reg. section 1.385-1(e), the issuer and holder are viewed as the *same* corporation.

[248] Treas. Reg. section 1.1502-13(g)(2)(ii) provides that an "intercompany obligation" is an obligation between consolidated group members, but only for the period during which both parties are members. An "obligation" of a member is a debt or security of a member. Treas. Reg. § 1.1502-13(g)(2)(i). "Debt of a member" is any obligation of the member constituting indebtedness under general federal tax principles (for example, under nonstatutory authorities, or under section 108, section 163, or Treas. Reg. section 1.1275-1(d)), but not an executory obligation to purchase or provide goods or services). Treas. Reg. § 1.1502-13(g)(2)(i)(A). A "security of a member," which generally should not be relevant for purposes of the Proposed Regulations, is any security of the member described in section 475(c)(2)(D) or (E), and any commodity of the member described in section 475(e)(2)(A), (B), or (C), but not if the security or commodity is a position with respect to the member's stock. Treas. Reg. § 1.1502-

Additionally, the Preamble provides that "[Prop. Treas. Reg. section] 1.385-3 does not apply to a consolidated group debt instrument."[249] The Preamble continues stating "[t]hus, for example, the [Proposed Regulations] do not treat as stock a debt instrument that is issued by one member of a consolidated group to another member of the consolidated group in a distribution."[250]

> Example 48: *Prop. Treas. Reg. section 1.385-3(b)(2) inapplicable to intercompany obligation.*[251] On Date A in Year 1, DS1 issues DS1 Note to USS1 in a distribution. Under Prop. Treas. Reg. section 1.385-1(e), the USS1 consolidated group is treated as one corporation for purposes of Prop. Treas. Reg. section 1.385-3. Accordingly, when DS1 issues DS1 Note to USS1 in a distribution, DS1 is not treated as issuing a debt instrument to another member of DS1's EG in a "distribution" for purposes of Prop. Treas. Reg. section 1.385-3, and DS1 Note is not treated as stock under Prop. Treas. Reg. section 1.385-3.[252]

The Preamble elaborates on the application of Prop. Treas. Reg. section 1.385-3(b)(3) to consolidated groups:

> As a result of treating all members of a consolidated group as one corporation for purposes of applying proposed section 1.385-3, a debt instrument issued to or by one member of a consolidated group generally is treated as issued to or by all members of the same consolidated group. Thus, a debt instrument issued by one consolidated group member to a member of its EG that is not a member of its consolidated group may be treated under the Funding Rule as funding a distribution or acquisition by another member of that consolidated group, even

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13(g)(2)(i)(B). The term "member" means a corporation (including the common parent) that is included in the group. Treas. Reg. § 1.1502-1(b).

[249] Preamble at 20927. The Preamble provides that a "consolidated group debt instrument" is a debt instrument issued by one member of a consolidated group to another member of the same consolidated group. *Id.*

[250] Preamble at 20927.

[251] Except as otherwise stated, the following facts are assumed for purposes of the examples in this Section VIII: (i) "FP" is a foreign corporation that owns 100 percent of the stock of USS1, a domestic corporation, and 100 percent of the stock of FS, a foreign corporation; (ii) USS1 owns 100 percent of the stock of DS1, a domestic corporation; (iii) DS1 owns 100 percent of the stock of DS2, a domestic corporation; (iv) at the beginning of Year 1, FP is the common parent of an EG comprised solely of FP, USS1, FS, DS1, and DS2 (the "FP expanded group"); (v) USS1, DS1, and DS2 are members of a consolidated group of which USS1 is the common parent (the "USS1 consolidated group"); and (vi) all notes are debt instruments described in Prop. Treas. Reg. section 1.385-3(f)(3) and therefore have satisfied any requirements under Prop. Treas. Reg. section 1.385-2, if applicable, and are respected as debt instruments under general federal tax principles. *See also* Prop. Treas. Reg. § 1.385-4(d)(2) (stating that, except as provided in Prop. Treas. Reg. section 1.384-4, it is assumed for purposes of the examples that the form of each transaction is respected for federal tax purposes and that no inference is intended as to whether any particular note would be respected as indebtedness or as to whether the form of any particular transaction would be respected for federal tax purposes).

[252] Prop. Treas. Reg. § 1.385-4(d)(3), Ex. 1(ii). *See also* Prop. Treas. Reg. § 1.385-4(d)(3), Ex. 2(ii) (similar), Ex. 3(ii) (similar), and Ex. 5(ii) (similar).

though that other consolidated group member was not the issuer and thus was not funded directly.[253]

The Preamble cautions taxpayers, however, noting that while the Proposed Regulations do not apply to interests between members of a consolidated group, general federal tax principles continue to apply in determining whether an applicable instrument issued and held by members of the same consolidated group is debt or equity.[254]

2. Dynamic Consolidated Group Membership and Instrument Ownership

The broad "one corporation" concept of Prop. Treas. Reg. section 1.385-1(e) must interact with situations in which an applicable instrument becomes or ceases to be an intercompany obligation, such as when ownership of the obligation changes or if the issuer or holder joins or departs from the consolidated group. To address such instances, special rules are provided in Prop. Treas. Reg. section 1.385-4 concerning the application of the General Rule and the Funding Rule.[255]

(a) Issuer or Holder Departs Consolidated Group but Remains in EG

When a corporation ceases to be a member of the consolidated group but continues to be a member of the EG (such corporation, a "Departing Member"), a debt instrument that is issued or held by the Departing Member is treated as indebtedness or stock pursuant to Prop. Treas. Reg. sections 1.385-4(b)(1)(i) (dealing with exempt instruments) or 1.385-4(b)(1)(ii) (dealing with non-exempt instruments).

Under Prop. Treas. Reg. section 1.385-4(b)(1)(i), any exempt consolidated group debt instrument that is issued or held by the Departing Member is deemed to be exchanged for stock *immediately after* the Departing Member leaves the group. The term "exempt consolidated group debt instrument" ("ECGDI") means any debt instrument that was not treated as stock solely by reason of the Departing Member's treatment under Prop. Treas. Reg. section 1.385-1(e).[256]

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[253] Preamble at 20928.

[254] *Id.* at 20920-21.

[255] *See, e.g.*, Prop. Treas. Reg. § 1.385-3(a) (cross-referencing Prop. Treas. Reg. section 1.385-4 for rules regarding the application of Prop. Treas. Reg. section 1.385-3 to members of a consolidated group); Prop. Treas. Reg. § 1.385-4(a) (noting that Prop. Treas. Reg. section 1.385-4 provides rules for applying Prop. Treas. Reg. section 1.385-3 to consolidated groups when an interest ceases to be a consolidated group debt instrument or becomes a consolidated group debt instrument).

[256] Prop. Treas. Reg. § 1.385-4(b)(1)(i) (also cross-referencing Prop. Treas. Reg. section 1.385-4(d), Ex. 3, for an illustration of this rule). The application of Prop. Treas. Reg. section 1.385-1(e) to members of the consolidated group other than the issuer is irrelevant to this determination. *See, e.g.*, Prop. Treas. Reg. § 1.385-4(d)(3), Ex. 5(ii) (Prop. Treas. Reg. section 1.385-3(b)(3) inapplicable with funded distribution between non-deconsolidated members remains disregarded under Prop. Treas. Reg. section 1.385-1(e)).

It order to be an ECGDI, it appears that the requirements of Prop. Treas. Reg. section 1.385-2 must be satisfied. It also appears that Prop. Treas. Reg. section 1.385-1(d) must not otherwise have recharacterized the instrument absent

Example 49: *Deconsolidation of ECGDI distributor*. On Date A in Year 1, DS1 issues DS1 Note A to USS1 in a distribution. On Date B in Year 2, USS1 lends $100x to DS1 in exchange for DS1 Note B. On Date C in Year 4, FP purchases 25 percent of DS1's stock from USS1, resulting in DS1 ceasing to be a member of the USS1 consolidated group. Under Prop. Treas. Reg. section 1.385-1(e), the USS1 consolidated group is treated as one corporation for purposes of Prop. Treas. Reg. section 1.385-3 until Date C in Year 4. Accordingly, when DS1 issues DS1 Note A to USS1 in a distribution on Date A in Year 1, DS1 is not treated as issuing a debt instrument to a member of DS's EG in a distribution for purposes of Prop. Treas. Reg. section 1.385-3(b)(2), and DS1 Note A is not treated as stock under Prop. Treas. Reg. section 1.385-3 on Date A in Year 1. DS1 Note A is an ECGDI because DS1 Note A is not treated as stock on Date A in Year 1 solely by reason of Prop. Treas. Reg. section 1.385-1(e).[257] Under Prop. Treas. Reg. section 1.385-4(b)(1)(i), immediately after DS1 leaves the USS1 consolidated group, DS1 Note A is deemed to be exchanged for stock.[258]

Under Prop. Treas. Reg. section 1.385-4(b)(1)(ii) any consolidated group debt instrument issued or held by a Departing Member that is *not* an ECGDI (a "non-exempt consolidated group debt instrument," or "non-ECGDI") is treated as indebtedness unless and until the non-exempt consolidated group debt instrument is treated as a PPDI under the Per Se Rule.[259]

Example 50: *Deconsolidation of non-ECGDI issuer*. The facts and analysis are the same as in the preceding example. In addition, DS1 Note B is a non-ECGDI because DS1 Note B, which is issued in exchange for cash, would not be treated as stock even absent the application of Prop. Treas. Reg. section 1.385-1(e) because there have been no transactions described in Prop. Treas. Reg. section 1.385-3(b)(3)(ii) that would have been treated as funded by DS1 Note B in the absence of the application of Prop. Treas. Reg. section 1.385-1(e).[260] Accordingly, under Prop. Treas. Reg. section 1.385-4(b)(1)(ii)(A), DS1 Note B is not treated as stock when DS1 ceases to be a member of the USS1 consolidated

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the application of Prop. Treas. Reg. section 1.385-1(e). How taxpayers are to make this determination is unclear in light of the fact that Prop. Treas. Reg. section 1.385-1(d) determinations are made only by the Commissioner.

[257] In other words, if DS1 had not been subject to Prop. Treas. Reg. section 1.385-1(e), the distribution of Note A would have triggered the application of Prop. Treas. Reg. section 1.385-3(b)(2).

[258] Prop. Treas. Reg. § 1.385-4(d)(3), Ex. 3(ii)(A).

[259] Prop. Treas. Reg. § 1.385-4(b)(1)(ii)(A). Note it is implicit in the definition of a non-ECGDI that the instrument otherwise satisfies the requirements of Prop. Treas. Reg. sections 1.385-1(d) and 1.385-2.

[260] Presumably this result obtains because, absent the application of Prop. Treas. Reg. section 1.385-1(e), DS1 Note A would have been treated as DS1 *stock* under Prop. Treas. Reg. section 1.385-3(b)(2) and, because DS1 stock is not "property" under Prop. Treas. Reg. section 1.385-3(f)(10), the DS1 Note B did not fund a distribution of property as required by Prop. Treas. Reg. section 1.385-3(b)(3)(ii)(A). However, if DS1 had made a payment of "interest" with respect to DS1 Note A, such payment may have been viewed as a "distribution" with respect to the DS1 Note A "equity" and this may have caused DS1 Note B to lose its status as a non-ECGDI.

group, provided there are no distributions or acquisitions described in section 1.385-3(b)(3)(ii) by DS1 that occur later in Year 4 (after Date C).[261]

Example 51: *Deconsolidation of non-ECGDI issuer.* On Date A in Year 1, DS2 lends $100x to DS1 in exchange for DS1 Note. On Date B in Year 1, DS1 distributes $100x of cash to USS1. On Date C in Year 1, FP purchases 25 percent of DS2's stock from DS1, resulting in DS2 ceasing to be a member of the USS1 consolidated group. After DS2 ceases to be a member of the USS1 consolidated group, DS1 and USS1 continue to be treated as one corporation under Prop. Treas. Reg. section 1.385-1(e), such that DS1's distribution of cash to USS1 on Date B in Year 1 continues to be disregarded for purposes of Prop. Treas. Reg. section 1.385-3. Accordingly, DS1 Note is a non-ECGDI because DS1 Note, which is issued in exchange for cash, would not be treated as stock even absent the application of Prop. Treas. Reg. section 1.385-1(e) to DS2, because, taking into account the continued application of Prop. Treas. Reg. section 1.385-1(e) to USS1 and DS1, DS1 Note does not fund any transaction described in Prop. Treas. Reg. section 1.385-3(b)(3)(ii). Accordingly, under Prop. Treas. Reg. section 1.385-4(b)(1)(ii)(A), DS1 Note is not treated as stock when it ceases to be a consolidated group debt instrument, provided there are no distributions or acquisitions described in Prop. Treas. Reg. section 1.385-3(b)(3)(ii) by DS1 that occur later in Year 1 (after Date C).[262]

The respect accorded non-ECGDIs has ancillary consequences under the Proposed Regulations. Specifically, solely for purposes of applying the Per Se Rule, a non-ECGDI is treated as having been issued when it was first treated as a consolidated group debt instrument.[263] For all other purposes of applying Prop. Treas. Reg. section 1.385-3, though, including for purposes of applying Prop. Treas. Reg. section 1.385-3(d), a non-ECGDI is treated as issued by the issuer of the debt instrument *immediately after* the Departing Member leaves the group.[264]

Note that Prop. Treas. Reg. section 1.385-1(c), which governs the treatment of specified deemed exchanges under the Proposed Regulations, does not by its terms extend to the deemed exchanges arising under Prop. Treas. Reg. sections 1.385-4(b)(1), 1.385-4(b)(2), or 1.385-4(c).

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[261] Prop. Treas. Reg. § 1.385-4(d)(3), Ex. 3(ii).

[262] Prop. Treas. Reg. § 1.385-4(d)(3), Ex. 5.

[263] Prop. Treas. Reg. § 1.385-4(b)(1)(ii)(B). *See also* Prop. Treas. Reg. § 1.385-4(d)(3), Ex. 4 (On Date A in Year 1, DS1 issues DS1 Note A to USS1 in a distribution. On Date B in Year 2, USS1 lends $100x to DS1 in exchange for DS1 Note B. On Date C in Year 4, FP purchases 25 percent of DS1's stock from USS1, resulting in DS1 ceasing to be a member of the USS1 consolidated group. On Date D in Year 6, DS1 distributes $100x pro rata to its shareholders ($75x to USS1 and $25x to FP). The per se rule in Prop. Treas. Reg. section 1.385-3(b)(3)(iv)(B)(1) does not apply to DS1 Note B and the distribution on Date D in Year 6 because under Prop. Treas. Reg. section 1.385-4(b)(1)(ii)(B), for purposes of applying Prop. Treas. Reg. section 1.385-3(b)(3)(iv)(B)(1), DS1 Note B is treated as issued on Date B in Year 2, which is more than 36 months before Date D in Year 6.). That is, the issuance of a non-ECGDI commences the running of Per Se Period even though Prop. Treas. Reg. section 1.385-3 otherwise disregards the existence of a non-ECGDI.) For reasons discussed below, we believe this example errs in respecting the Year 2 issuance given the deemed reissuance of DS1 Note B under Treas. Reg. section 1.1502-13(g)(3) when it leaves the USS1 consolidated group.

[264] Prop. Treas. Reg. § 1.385-4(b)(1)(ii)(B).

We recommend that Prop. Treas. Reg. section 1.385-1(c) be revised to clarify its application to these provisions.

As an ancillary consequence of the application of Prop. Treas. Reg. section 1.385-4(b)(1)(i) to the deconsolidation of the holder, the issuer, which is deemed to issue stock to a corporation that is not a member of its consolidated group, could itself deconsolidate if the deemed stock is not described in section 1504(a)(4).

(b) Debt Instrument Departs Consolidated Group but Remains in EG

Solely for purposes of Prop. Treas. Reg. section 1.385-3, when a member of a consolidated group that holds a consolidated group debt instrument transfers the debt instrument to an EG Member that is not a member of the consolidated group,[265] the debt instrument is treated as issued by the issuer of the debt instrument (which is treated as one corporation with the transferor of the debt instrument pursuant to Prop. Treas. Reg. section 1.385-1(e)) to the transferee EG Member on the date of the transfer.[266] To the extent the debt instrument is treated as stock upon being transferred,[267] the debt instrument is deemed to be exchanged for stock *immediately after* the debt instrument is transferred outside of the consolidated group.[268]

> Example 52: *Distribution of consolidated group debt instrument to EG Member.* On Date A in Year 1, DS1 issues DS1 Note to USS1 in a distribution. On Date B in Year 2, USS1 distributes DS1 Note to FP. Under Prop. Treas. Reg. section 1.385-1(e), the USS1 consolidated group is treated as one corporation for purposes of Prop. Treas. Reg. section 1.385-3. Accordingly, when DS1 issues DS1 Note to USS1 in a distribution, DS1 is not treated as issuing a debt

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[265] Because this rule applies only to transfers of the instrument by the holder thereof, it has no application to the assumption by a non-consolidated EG Member of a consolidated group member's obligation to another consolidated group member. It is unclear whether this distinction is deliberate. For instance, the absence of an affirmative rule concerning an assumption by an EG Member of a consolidated group debt instrument ("CGDI") debtor position may reflect the view that such an assumption would trigger the "significant modification" rules of Treas. Reg. section 1.1001-3, presumably resulting in a deemed exchange of the "old" debt instrument for a "new" debt instrument issued by the assuming person. As an example, if FS assumes DS1's obligation to USS1 ("DS1 Note"), Treas. Reg. section 1.1001-3 may regard FS as transferring its own obligation ("FS Note") to DS1, which then uses FS Note to repay DS1 Note. The shift in value from FS to DS1 would give rise to a series of fictional transactions under common law "triangularization" principles (e.g., *Sparks Nugget, Inc. v. Comm'r*, 458 F.2d 631 (9th Cir. 1972), cert. denied, 410 U.S. 928 (1973)) and the Proposed Regulations would then apply to such fictional transactions. Note that additional considerations may be required if DS1 and FS were, at issuance, co-obligors with respect to DS1 Note.

[266] Prop. Treas. Reg. § 1.385-4(b)(2) (also providing that, for purposes of Prop. Treas. Reg. section 1.385-3, the consequences of such transfer are determined in a manner that is consistent with treating a consolidated group as one corporation and thus, for example, the sale of a CGDI to an EG Member that is not a member of the consolidated group will be treated as an issuance of the debt instrument to the transferee EG Member in exchange for property). *See also* Prop. Treas. Reg. § 1.385-4(a) (noting that Prop. Treas. Reg. section 1.385-4 provides rules for applying Prop. Treas. Reg. section 1.385-3 to consolidated groups when an interest ceases to be a CGDI or becomes a CGDI).

[267] Recall that, due to the "one corporation" rule of Prop. Treas. Reg. section 1.385-1(e), Prop. Treas. Reg. section 1.385-1(d) has not yet applied to the instrument and so, upon departing the consolidated group, the EGI must be tested thereunder.

[268] Prop. Treas. Reg. § 1.385-4(b)(2).

instrument to another member of DS1's EG in a "distribution" for purposes of Prop. Treas. Reg. section 1.385-3, and DS1 Note is not treated as stock under Prop. Treas. Reg. section 1.385-3. Under Prop. Treas. Reg. section 1.385-4(b)(2), when USS1 distributes DS1 Note to FP, the USS1 consolidated group is treated as issuing a debt instrument to FP in a distribution. Accordingly, DS1 Note is treated as DS1 stock under Prop. Treas. Reg. section 1.385-3(b)(2)(i). For this purpose, DS1 Note is deemed to be exchanged for stock immediately after DS1 Note is transferred outside of the USS1 consolidated group.[269]

In certain instances, it may appear that Prop. Treas. Reg. sections 1.385-4(b)(1) and 1.385-4(b)(2) apply to the same transaction. For example, if an applicable instrument issued by DS1 (DS1 Note A) is transferred outside the USS1 consolidated group, and if such instrument is treated under Prop. Treas. Reg. section 1.385-4(b)(2) as stock other than section 1504(a)(4) stock, DS1 could depart from the USS1 consolidated group, thereby triggering the application of Prop. Treas. Reg. section 1.385-4(b)(1). Given that the application of Prop. Treas. Reg. section 1.385-4(b)(2) is needed to activate Prop. Treas. Reg. section 1.385-4(b)(1), coupled with the fact that Treas. Reg. section 1.1502-76(b)(1)(ii)(A)(1) (the so-called "end of the day rule") preserves DS1's membership through the end of the day, it appears that Prop. Treas. Reg. section 1.385-4(b)(1) would apply only to other applicable instruments issued or held by DS1 as DS1 Note A would have already been recharacterized as stock.[270]

(c) EG Debt Instrument Enters Consolidated Group

When a debt instrument that is treated as stock under Prop. Treas. Reg. section 1.385-3 becomes a consolidated group debt instrument (i.e., where the issuer or holder joins the same consolidated group as the counterparty, where the debt instrument is acquired by a member of the issuer's consolidated group, or where the issuer's obligations under the debt instrument are assumed by a member of the holder's consolidated group), *immediately before* that debt instrument becomes a consolidated group debt instrument, the issuer is treated as issuing a new debt instrument to the holder in exchange for the debt instrument that was treated as stock in a transaction that is disregarded for purposes of the General Rule and the Funding Rule.[271]

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[269] Prop. Treas. Reg. § 1.385-4(d)(3), Ex. 1. *See also* Prop. Treas. Reg. § 1.385-4(d)(3), Ex. 2 (reaching a similar conclusion where DS1 sells the USS1 Note to FS within 36 months of USS1 making a cash distribution to FP). The Preamble similarly notes that "a debt instrument issued by one consolidated group member to another consolidated group member is treated as stock under the General Rule when the debt instrument is distributed by the holder to a member of the expanded group that is not a member of the same consolidated group, regardless of whether the issuer itself distributed the debt instrument." *Cf.* Treas. Reg. § 1.441-3(h)(1) (treating a consolidated group as a single corporation and treating any consolidated group member stock that is owned outside the group as stock of that issuing corporation).

[270] We note that under Prop. Treas. Reg. section 1.1502-76(b)(1)(ii)(A)(1), DS1 would cease to be a member immediately upon DS1 Note A's change in status (rather than at the end of day), although this should not alter the above described result.

[271] Prop. Treas. Reg. § 1.385-4(c). *See also* Prop. Treas. Reg. § 1.385-4(a) (noting that Prop. Treas. Reg. section 1.385-4 provides rules for applying Prop. Treas. Reg. section 1.385-3 to consolidated groups when an interest ceases to be a CGDI or becomes a CGDI).

B. Comments and Recommendations

Our recommendations with respect to the consolidated group aspects of the Proposed Regulations fall within three categories. First, we make recommendations for additional clarity with respect to the potency of the "one corporation" treatment mandated by Prop. Treas. Reg. section 1.385-1(e) given the potentially significant indirect consequences thereof. Second, we make recommendations concerning applicable instruments that are recharacterized as equity not described in section 1504(a)(4)[272] because such recharacterizations may cause the issuer to "cycle" in and out of consolidated group membership or give rise to other membership issues. Finally, we make recommendations with respect to various segregated issues impacting consolidated groups. These recommendations are discussed in detail below.

1. Potency of "One Corporation" Treatment of Consolidated Groups

(a) Generally

As noted above, Prop. Treas. Reg. section 1.385-1(e) provides that, for purposes of the regulations under section 385, all members of a consolidated group are treated as *one corporation.*[273] This language is susceptible to broad interpretation which may affect the application of the Proposed Regulations generally, as discussed below.

It is unclear whether the drafters intended broad single entity interpretations to emanate from Prop. Treas. Reg. section 1.385-1(e). For instance, Prop. Treas. Reg. section 1.385-2 states that during the time that the issuer and the holder of an applicable instrument are members of the same consolidated group, the applicable instrument is treated as *not outstanding* for purposes of

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[272] We note that, according to the Preamble, the type of stock (e.g., common stock or preferred stock, section 306 stock and stock described in section 1504(a)(4)) that the instrument will be treated as for federal tax purposes is determined by taking into account the terms of the instrument. Stock described in section 1504(a)(4), which is not treated as "stock" for purposes of testing affiliation under section 1504(a), possesses the following terms: (i) it is not entitled to vote; (ii) it is limited and preferred as to dividends and does not participate in corporate growth to any significant extent; (iii) it has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption premium or liquidation premium); *and* (iv) it is not convertible into another class of stock. Presumably most instruments regarded as stock under the Proposed Regulations will not have any voting power; the potential presence of the other three factors, though, will vary from instrument to instrument based on their respective terms. *Cf.* Prop. Treas. Reg. § 1.385-3(g)(3), Ex. 8 (observing that, depending on its terms and other factors, a debt instrument may be treated as stock described in section 351(g)). Bear in mind that an instrument becoming or ceasing to be an intercompany obligation generally will undergo a deemed satisfaction and reissuance, and this could lead to the deemed reissued debt instrument being reissued at a premium or discount. Presumably, such premium or discount will influence the analysis of equity type in the event the debt instrument is recharacterized under the Proposed Regulations, and there may also be consequences under the Documentation Requirements if there is no expectation that the instrument will be repaid in full.

[273] This "one corporation" concept is broader than the hybrid approach taken by the consolidated return regulations of Treas. Reg. section 1.1502-1 *et. seq. See, e.g., Applied Research Assoc., Inc. v. Comm'r*, 143 T.C. 310, 318 (2014) ("The consolidated return regulations are intended to balance . . . 'two countervailing principles of the law relating to consolidated returns.' The first of these principles is that 'the purpose of the consolidated return provisions . . . is to require taxes to be levied according to the true net income and invested capital resulting from and employed in a single business enterprise, even though it was conducted by means of more than one corporation.' . . . . The contrasting second principle is that '[e]ach corporation is a separate taxpayer whether it stands alone or is in an affiliated group and files a consolidated return.'" (citations omitted)).

Prop. Treas. Reg. section 1.385-2, thereby supporting a broad single entity approach to Prop. Treas. Reg. section 1.385-1(e). Also, Prop. Treas. Reg. section 1.385-4(b)(2) envisions an intercompany obligation that is transferred to an EG Member as deemed issued by the "one corporation."[274] Moreover, Prop. Treas. Reg. section 1.1502-72, which reflects the "CERT" rule of section 172(g)(4)(C) that is closely analogous to Prop. Treas. Reg. section 1.385-1(e),[275] utilizes a strong "one corporation" approach.[276]

On the other hand, the Preamble notes that

> [T]he proposed regulations should not apply to issuances of interests and related transactions among members of a consolidated group because the concerns addressed in the proposed regulations generally are not present when the issuer's deduction for interest expense and the holder's corresponding interest income offset on the group's consolidated U.S. federal income tax return.[277]

It further notes that "many of the concerns regarding related-party indebtedness are not present in the case of indebtedness between members of a consolidated group [and, a]ccordingly, the proposed regulations under section 385 do not apply to interests between members of a consolidated group." These statements both suggest that the "one corporation" treatment is less than global in scope and functions only to ensure intercompany interests and transactions don't activate the application of section 385. In addition, Prop. Treas. Reg. section 1.385-4(b)(1)(ii)(B) respects the existence of an intercompany obligation for purposes of applying the Per Se Period under Prop. Treas. Reg. section 1.385-3(b)(3)(iv)(B),[278] and this accorded respect is difficult to reconcile with the non-existence of such debt if a strong "one corporation" interpretation were applied.[279]

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[274] *See also* Prop. Treas. Reg. § 1.385-4(d)(3), Ex. 1(ii) and Ex. 2(ii) (both applying this rule).

[275] Section 172(g)(4)(C) provides that, except as provided by regulations, all members of an affiliated group filing a consolidated return under section 1501 shall be treated as one taxpayer. This "one taxpayer" concept is stronger than that applicable to spouses jointly filing a return; although their taxable income is computed together, "it does not convert two spouses into one single taxpayer." *See Vichich v. Comm'r*, 146 T.C. 12 (2016).

[276] *See, e.g.*, Prop. Treas. Reg. §§ 1.1502-72(a)(2)(i) (treating all members of a group as a single taxpayer for purposes of the CERT rules); 1.1502-72(a)(2)(i) (treating all members of a group as a single taxpayer for purposes of testing for major stock acquisitions); 1.1502-72(f) (treating all members of a group as a single taxpayer for purposes of testing for excess distributions, including the 3-year distribution average, stock issuances, and fair market value); 1.1502-72(d)(1) (treating all members of a group as a single taxpayer for purposes of measuring the 3-year interest deduction history).

[277] Preamble at 20914.

[278] *See also* Prop. Treas. Reg. § 1.385-4(d)(3), Ex. 4 (illustrating this rule).

[279] Also arguably supporting this conclusion is the description of intercompany debt set forth in Prop. Treas. Reg. section 1.385-4(d)(3), Ex. 1 ("[W]hen DS1 issues DS1 Note to USS1 in a distribution, DS1 is not treated as issuing a debt instrument to another member of DS1's expanded group in a distribution for purposes of [Prop. Treas. Reg. section 1.385-3]."), Ex. 2 ("[W]hen USS1 issues USS1 Note to DS1 on Date A in Year 1, USS1 is not treated as a funded member, and when USS1 distributes $200x to FP on Date B in Year 2, section 1.385-2(b)(3) does not apply."), Ex. 3 ("Under [Prop. Treas. Reg. section 1.385-1(e)], the USS1 consolidated group is treated as one corporation for purposes of [Prop. Treas. Reg. section 1.385-3] until Date C in Year 4. Accordingly, when DS1 issues DS1 Note to USS1 in a distribution on Date A in Year 1, DS1 is not treated as issuing a debt instrument to a

It is unclear how these concerns with the "one corporation" rule could most effectively be addressed in the Final Regulations. On the one hand, a strong "one corporation" rule, while having the benefit of being conceptually straightforward, could lend itself to inequitable results (e.g., the "tainting" results described below). On the other hand, a more complex set of rules could selectively limit where the "one corporation" rule is strong and where it's inapplicable, but this approach may be difficult to administer and would require the full universe of potential interactions to be considered (absent a principle-based rule, which would add to the difficulty in administering the rule).

> Recommendation 97: We recommend that certain items be clearly included or excluded from "one corporation" treatment and that a principle-based rule be used to address the items not expressly included or excluded.

In addition, certain "one corporation" issues are specific to particular mechanical aspects of the Proposed Regulations, and so we have provided specific comments and recommendations with respect to the application of the one corporation principle below.

(b) Documentation Requirements and the Bifurcation Rule

Concerning Prop. Treas. Reg. section 1.385-2, the documentation and maintenance requirements pertain to the "issuer" of the applicable instrument. When the issuer, in legal form, is a member of a consolidated group, it is unclear how the "one corporation" rule of Prop. Treas. Reg. section 1.385-1(e) alters—if at all—these documentation and maintenance requirements. Thus, the threshold question is whether the "issuer" is the legal issuer or whether it is the consolidated group as a whole. Resolution of this question is important, for example, in how taxpayers are to make the determination of the ability of the issuer to repay the instrument under Prop. Treas. Reg. section 1.385-2(b)(2)(iii); if the consolidated group is viewed as the "issuer," this would suggest that the economics of the entire consolidated group, even entities that are not owned by the legal issuer, may be considered.[280] This question also arises when determining whether there is a reasonable expectation of repayment for purposes of the Bifurcation Rule. Also, if a strong "one corporation" approach applies, the rules currently make no provision for the impact of members joining or departing from the consolidated group.

> Recommendation 98: We request that the Final Regulations clarify whether the determination of an issuer's ability to repay an instrument for purposes of the Documentation Requirements and the Bifurcation Rule be based on an analysis of

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member of DS's expanded group in a distribution for purposes of [Prop. Treas. Reg. section 1.385-3(b)(2)]."), Ex. 5 ("DS1 and USS1 continue to be treated as one corporation under [Prop. Treas. Reg. section 1.385-1(e)], such that DS1's distribution of cash to USS1 on Date B in Year 1 continues to be disregarded for purposes of [Prop. Treas. Reg. section 1.385-3]."). In each of these examples, the Government could have simply stated that the transaction in question didn't occur for section 385 purposes (e.g., in Example 1, the Government could have merely stated that "when DS1 issues DS1 Note to USS1 in a distribution, DS1 is not treated as issuing a debt instrument"); instead, the Government expanded the statement to be specific about the nonapplicability of particular rules within the Proposed Regulations.

[280] Similarly, if the consolidated group is "one corporation," it is not entirely clear whether each member would be required to separately satisfy each of the four documentation elements of Prop. Treas. Reg. section 1.385-2(b)(2) and the maintenance requirement of Prop. Treas. Reg. section 1.385-2(b)(4).

the single corporate issuer or the entire consolidated group of which it is a member.

(c) Prop. Treas. Reg. Section 1.385-3

Turning to Prop. Treas. Reg. section 1.385-3, the "one corporation" concept affects the General Rule, the Funding Rule and the Current E&P Exception. Turning first to the General Rule, the mechanics of Prop. Treas. Reg. section 1.385-4(b)(2) in part implement the "one corporation" concept of Prop. Treas. Reg. section 1.385-1(e).

Example 53: *Disparate treatment under the General Rule (note distribution).* USS1, which owns a note issued by DS1 ("DS1 Note") distributes to FP in Year 1 a USS1 note ("USS1 Note"). Under Prop. Treas. Reg. section 1.385-3(b)(2), USS1 is treated as having distributed USS1 stock to FP in a transaction presumably governed by section 305.[281] In Year 2, USS1 distributes to FP DS1 Note and DS1 Note is treated as stock pursuant to Prop. Treas. Reg. section 1.385-3(b)(2). Under Prop. Treas. Reg. section 1.385-4(b)(2), DS1 Note is treated as exchanged for stock immediately after DS1 Note is distributed to FP. Presumably, that exchange is not governed by section 305.

In light of the stated "one corporation" conceptual underpinning in the Proposed Regulations with respect to consolidated groups, it is unclear why these two distributions should be treated differently.

Recommendation 99: We recommend that the Final Regulations provide for the same treatment of a distribution by a consolidated group member outside the consolidated group of its own note and a distribution by a consolidated group member outside the consolidated group of a note issued by another member of the consolidated group.

The Funding Rule also is affected by the "one corporation" principle. The Preamble states that "a debt instrument issued by one consolidated group member to a member of its EG that is not a member of its consolidated group may be treated under the Funding Rule as funding a distribution or acquisition by another member of that consolidated group, even though that other consolidated group member was not the issuer and thus was not funded directly."[282] This statement raises questions concerning the consequences of a "tainted" corporation that joins a consolidated group and to a corporation that departs from a "tainted" consolidated group.

Example 54: *Tainted corporation joins a consolidated group.* FP owns 100 percent of the stock of USS2, a domestic corporation that is not a member of the USS1 consolidated group. In Year 1, USS2 makes a cash distribution FP. In Year 2, USS1 acquires USS2, causing USS2 to join the USS1 consolidated group. In Year 3, USS1 borrows cash from FS.

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[281] Immediately before DS1 Note A is distributed, Treas. Reg. section 1.1502-13(g)(3) should apply to cause a deemed satisfaction and reissuance of DS1 Note A.

[282] Preamble at 20928.

The literal application of Prop. Treas. Reg. section 1.385-3(b)(3), in conjunction with the "one corporation" rule of Prop. Treas. Reg. section 1.385-1(e), would appear to treat the Year 3 borrowing as completing a Funding Rule transaction; that is, USS2 made a distribution to an EG Member and the consolidated group of which USS2 is a member engaged in a borrowing from an EG Member.[283]

In light of the increased diligence burden and numerous difficulties faced by consolidated groups that acquire other corporations (e.g., developing appropriate escrows, etc.) our recommendation in Section VII.C.3(b) would provide that a corporation not bring a "taint" with it into an acquiring consolidated group if such consolidated group was not previously part of the same EG as the target corporation. On the other hand, we believe the aforementioned difficulties are more easily managed when the target is already a member of the same EG as the acquiring consolidated group and thus we believe it is not inappropriate to import the "taint" into the acquiring consolidated group.

The same tainting concept works in reverse.

> Example 55: *Tainted corporation departs from a consolidated group.* In Year 1, USS1 distributes $100x cash to FP. In Year 2, FP acquires DS1 such that DS1 departs the USS1 consolidated group. In Year 3, DS1 borrows $100x from FS.

As above, the literal application of Prop. Treas. Reg. section 1.385-3(b)(3), in conjunction with the "one corporation" rule of Prop. Treas. Reg. section 1.385-1(e), would appear to treat the Year 3 borrowing as completing a Funding Rule transaction; that is, the consolidated group of which DS1 was a member made a distribution to an EG Member (the USS1 Group) and DS1 engaged in a borrowing from an EG Member.[284]

For reasons similar to those described above with respect to importing a "taint" into a consolidated group, our recommendation in Section VII.C.3(b) would provide that a departing consolidated group member not take a "taint" with it when being acquired outside of the EG of which it was previously a member. On the other hand, where the departing consolidated group member is being acquired within its current EG, we believe it is not inappropriate to "taint" the departing consolidated group member.[285]

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[283] *Cf.* Prop. Treas. Reg. section 1.1502-72(a)(2)(iv)(A) (treating a consolidated group as an "applicable corporation" when a pre-existing CERT member joins the group). See Section VII.C.3(b) for a more general discussion as to the potential application of the Funding Rue when legs occur in different EGs.

[284] *Cf.* Prop. Treas. Reg. § 1.1502-72(b)(1) (where a consolidated group is an "applicable corporation," a corporation that departs from that group also is treated as an "applicable corporation" unless an election to the contrary is made).

[285] Absent the Departing Member taking a "taint" with it, it would be possible for the Departing Member to be purged of its own taint by reason of the "one corporation" approach. For instance, assume DS1 is owned 80% by USS1 and 20% by another member (CFC) of the expanded group that is not also in the USS1 consolidated group, and assume further that DS1 makes a distribution to CFC before departing the USS1 consolidated group. If DS1 is viewed as part of the USS1 "one corporation," perhaps DS1's distribution history remains behind with USS1 as Prop. Reg. section 1.385-1(e) arguably views the USS1 consolidated group (rather than DS1 specifically) as having made the distribution.

Provided the Final Regulations require a departing consolidated group member to take with it the "taint," the Final Regulations must provide the *amount* of the taint. Using the immediately preceding example as a point of reference, if the rules do require DS1 to take the taint with it upon departure from the USS1 consolidated group (e.g., if DS1 is itself treated as having made a $100x distribution for purposes of applying Prop. Treas. Reg. section 1.385-3(b)(3) to the USS2 consolidated group), a correlative $100x funding reduction to the USS1 consolidated group must be made in order to prevent duplication of the potential application of the Funding Rule (i.e., $100x to the USS1 consolidated group and $100x to the USS2 consolidated group).

> Recommendation 100: In order to prevent duplication, and in order to provide administrability to both the IRS and taxpayers, we recommend that a Departing Member take with it an *allocable portion* of the amount of the taint, with such portion being determined based on the relative fair market value of the Departing Member as compared with the fair market value of the consolidated group from which it departed.[286]

Another aspect of the Funding Rule affected by the "one corporation" principle is the continuity of this principle when Prop. Reg. section 1.385-1(e) ceases to apply. In particular, when determining the potential application of the Funding Rule, one must consider whether transactions that occur within a consolidated group are taken into account when a party or parties to the intercompany transaction cease to be in the consolidated group.

> Example 56: *Distributing corporation departs from a consolidated group.* In Year 1, DS1 makes a $100 cash distribution to USS1, the common parent of a consolidated group of which DS1 is a member. In Year 2, FP, a member of the EG of which the USS1 consolidated group is a part, acquires 25% of the DS1 stock from USS1, causing DS1 to leave the USS1 consolidated group but remain in the same EG. In Year 3, DS1 borrows $100 from FP in exchange for DS1 Note A.

Provided the "one corporation" principle continues to apply to DS1's Year 1 cash distribution to USS1 after DS1 leaves the USS1 consolidated group, DS1's Year 3 borrowing *will not* give rise to the application of the Funding Rule at that time because, although DS1 has undertaken a borrowing from an EG Member, this funding has not been used to undertake a Funded Distribution or Acquisition. On the other hand, if the "one corporation" principle does not continue to apply to DS1's Year 1 cash distribution after DS1 leaves the USS1 consolidated group, DS1's Year 3 borrowing *will* give rise to the application of the Funding Rule at that time because DS1 has undertaken a borrowing from an EG Member and this funding took place within the 72-month period of a Funded Distribution or Acquisition. We believe Prop. Reg. section 1.385-1(e) should be interpreted as providing continuity of the "one corporation" principle subsequent to the period of consolidation with respect to transactions arising within the consolidated group during the period of consolidation.

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[286] *Cf.* Prop. Reg. §1.1502-72(c)(4)(ii) (similarly allocating the corporate equity reduction interest loss among departing consolidated group members otherwise treated as one taxpayer).

Recommendation 101: We recommend that Prop. Reg. section 1.385-1(e) be clarified to indicate that distributions or acquisitions occurring within a consolidated group are disregarded for purposes of the Proposed Regulations subsequent to the period of consolidation.

Finally, the interaction between Prop. Treas. Reg. section 1.385-1(e) and the Current E&P Exception is unclear.

Example 57: *Interaction of Prop. Treas. Reg. section 1.385-1(e) and the Current E&P Exception.* DS1 is a non-wholly-owned member of the USS1 consolidated group and it distributes a DS1 note to its minority shareholder, FP (the parent of USS1). It is not entirely clear whether, for purposes of the Current E&P Exception, Current E&P is limited to DS1's Current E&P or, based on the "one corporation" approach of Prop. Treas. Reg. section 1.385-1(e), is the Current E&P of the entire USS1 consolidated group.

Relatedly, it is not clear how "Current E&P" is computed for a consolidated group for this purpose (e.g., it is unclear whether Treas. Reg. section 1.1502-33 is ignored because Prop. Treas. Reg. section 1.385-1(e) views the consolidated group as just one corporation).[287] Viewing the "one corporation" rule strongly, one may even determine that there is no such thing as consolidated group member stock for purposes of the Proposed Regulations, which in turn produces such results as (i) no reduction to Current E&P for a worthless stock loss on group member stock, and (ii) consolidating acquisitions of target stock being treated as acquisitions of target assets, which produces a step-up or step-down in asset basis the depreciation or amortization of which may affect the Current E&P computation.[288]

Recommendation 102: We recommend that the Final Regulations clarify how to calculate the Current E&P of a consolidated group.

2. Applicable Instruments Recharacterized as Non-Section 1504(a)(4) Stock

As previously noted, when the Proposed Regulations operate to characterize (or recharacterize) an applicable instrument as "stock," such stock may be stock other than stock described in section 1504(a)(4). In such an instance, the stock is not ignored in testing for affiliation, which in turn affects consolidated group membership. As a consequence, the treatment of an applicable instrument as non-section 1504(a)(4) stock under the Proposed

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[287] If DS1 has E&P from a separate return year, does the distribution of such E&P during the taxable year in question increase the consolidated group's Current E&P or does the "one corporation" rule effectively disregard such a distribution? In addition, if a consolidated group member has a non-member stockholder, does that have any dilutive effect on Current E&P? *Cf.* Treas. Reg. § 1.1502-33(b)(3)(ii), Ex. 3 (preventing the "tier-up" of E&P allocable to stock owned outside the consolidated group). Further, with respect to a consolidated return year in which DS1 joins the USS1 consolidated group, is it clear that DS1's E&P (or E&P deficit) with respect to its taxable year that closes on its joining the USS1 consolidated group is excluded from the USS1 consolidated group's Current E&P? *Cf.* Treas. Reg. § 1.1502-21(b)(2) (preventing the carryback of any portion of a CNOL to a consolidated return year that is the numerical equivalent of member's separate return year to which such CNOL may be carried).

[288] Note that resolution of the Current E&P question also affects the Threshold Exception as this rule is applied *after* Prop. Treas. Reg. section 1.385-3(c)(1).

Regulations may affect consolidated group membership in unintended ways.[289] For example, if a related-party debt instrument issued by a member of a consolidated group to a person that is not a member of the same U.S. consolidated group is recharacterized as stock, the issuer could become deconsolidated from the U.S. consolidated group, which could trigger deferred intercompany transactions and excess loss accounts. Further, the deconsolidated member may be prohibited from re-joining the consolidated group for the five-year period following the deconsolidation event.[290]

(a) Bifurcation Rule

Pursuant to Prop. Treas. Reg. section 1.385-1(d)(1), an analysis is required "as of the issuance of the EGI." As discussed in Section V.F.5, it is unclear whether this means that the instrument must be an EGI *at the time it is issued*, or if an instrument that at some point *becomes an EGI* must be analyzed as of its issuance. If the latter, an applicable instrument that is issued outside the MEG and, upon entering the MEG is recharacterized as stock under Prop. Treas. Reg. section 1.385-1(d)), could affect the issuer's membership in a consolidated group completely unrelated to the MEG.

> Example 58: *Applicable instrument entering MEG breaks consolidation retroactively*. P, the common parent of the P consolidated group, owns 80 percent of the outstanding stock value and voting power of S1, a member of the P consolidated group. S1 has an applicable instrument outstanding ("S1 Note A") that was issued in Year 1 to unrelated X and which is respected as indebtedness under general principles. In Year 3, FP acquires P, thereby causing the P consolidated group to join the FP MEG. In Year 4, FS acquires S1 Note A from X, causing S1 Note A to enter the FP MEG. If the Commissioner determines that S1 Note A is in part stock, and if this recharacterization is retroactive to Year 1, P would not have been affiliated with S1 and therefore S1 was never a member of the P consolidated group.

The consequences of this example seem inappropriate. The P consolidated group and S1 clearly engaged in no problematic activity when S1 Note A was issued in Year 1 (indeed, the debt instrument otherwise satisfied general principles at issuance), and yet the retroactive stock recharacterization may affect them nevertheless. Numerous collateral consequences could result, including changes in stock basis and E&P determinations, erroneous application of Treas. Reg. sections 1.1502-13 (concerning intercompany transactions), 1.1502-19 (concerning excess loss accounts), 1.1502-36 (concerning losses on member stock), etc.[291] In light of the severity, difficulty in implementation, unforeseeability and unfairness of this result, we accordingly recommend in Section V.F.5 against such retroactive recharacterizations under Prop. Treas. Reg. section 1.385-1(d).

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[289] In each of the following examples in this Section VIII.B.2, unless otherwise indicated, it is assumed that all applicable instruments treated as stock under the Proposed Regulations are treated as stock that is not section 1504(a)(4) stock.

[290] Treas. Reg. § 1.1502-13(d); Treas. Reg. § 1.1502-19(a), (c)(1)(ii); I.R.C. § 1504(a)(3).

[291] Note that, if S1 were the sole first-tier subsidiary of P, the entire P consolidated group would be retroactively invalidated as there would be no chain of corporations meeting the ownership requirements of section 1504(a)(2).

Similar to the above issue of retroactivity, as discussed in Section VI.C, it is unclear whether the recharacterization under Prop. Treas. Reg. section 1.385-1(d) of an applicable instrument *survives* the departure of the instrument or issuer from the MEG.

> Example 59: *Attempted consolidation with deemed stock creates affiliation-disaffiliation cycle.* USS1 owns 80 percent of the outstanding stock voting power and 79 percent of the outstanding stock value in DS1, and thus D1 is not a member of the USS1 consolidated group. In Year 1, DS1 issues an applicable instrument ("DS1 Note A") to FP and Prop. Treas. Reg. section 1.385-1(d) is applied to regard a portion of DS1 Note A to be stock. In Year 3, USS1 acquires DS1 Note A (a part of which is treated as stock) from FP with the intention of causing DS1 to become a member of the USS1 consolidated group. If the stock recharacterization under Prop. Treas. Reg. section 1.385-1(d) does not survive the consolidation of DS1 (e.g., due to the "one corporation" treatment of Prop. Treas. Reg. section 1.385-1(e)), DS1 immediately deconsolidates from the USS1 consolidated group because USS1 will continues to own only 79 percent of the DS1 stock value. This deconsolidation of DS1 triggers the application of Prop. Treas. Reg. section 1.385-4(b)(1)(i), which then causes the DS1 Note A owned by USS1 to be treated again as stock, which then causes DS1 to reaffiliate with USS1 and potentially reconsolidate with USS1 if the requirements of section 1504(a)(3) are met, which would in turn deconsolidate DS1 upon rejoining the USS1 consolidated group. This consolidation-deconsolidation-reconsolidation cycle continues infinitely.[292]

> Example 60: *Applicable instrument as deemed stock leaving MEG breaks or creates consolidation.* USS1 owns 80 percent of the outstanding stock voting power and 79 percent of the outstanding stock value in DS1, and FP owns an applicable instrument issued by S1 ("DS1 Note A") that Prop. Treas. Reg. 1.385-1(d) regards as stock. The stock characterization of DS1 Note A precludes D1 from being a member of the USS1 consolidated group. In Year 3, FP transfers DS1 Note A outside the MEG to unrelated X. If the stock recharacterization under Prop. Treas. Reg. section 1.385-1(d) does not survive the departure of DS1 Note A from the MEG and DS1 Note A becomes regarded as indebtedness, DS1 could then become affiliated and consolidated with the USS1 consolidated group.

(b) Documentation Requirements

As under Prop. Treas. Reg. section 1.385-1(d), consolidated group membership status may be affected by the interaction of Prop. Treas. Reg. sections 1.385-2 and 1.385-1(e), particularly the non-continuity of the Prop. Treas. Reg. section 1.385-2 stock recharacterization upon joining a consolidated group.

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[292] A similar issue may arise any time when the issuer of an ECGDI leaves the consolidated group, thereby potentially preventing an intended deconsolidation. A similar issue also may arise where a Controlled Partnership borrows money from a corporate partner ("S1") that is "almost" inside a consolidated group and the stock of the corporate partners deemed issued under Prop. Treas. Reg. section 1.385-3(d)(5)(ii) results in S1 joining the consolidated group. *Cf.* Prop. Treas. Reg. § 1.385-3(g)(3), Ex. 14.

Example 61: *Attempted consolidation with deemed stock creates cycle of non-consolidation.* USS1 owns 80 percent of the outstanding stock voting power and 79 percent of the outstanding stock value in DS1, and thus DS1 is not a member of the USS1 consolidated group. In Year 1, DS1 issues an applicable instrument ("DS1 Note A") to FP that would be respected as indebtedness under general principles but is treated as stock under Prop. Treas. Reg. 1.385-2 because DS1 does not have an unconditional obligation to pay a sum certain. In Year 3, USS1 acquires DS1 Note A (which is treated as stock) from FP with the intention of causing DS1 to become a member of the USS1 consolidated group. Under Prop. Treas. Reg. section 1.385-2(c)(2)(ii), DS1 is treated as issuing new, respected indebtedness in exchange for DS1 Note A immediately before DS1 joins the USS1 consolidated group, which in turn results in DS1 never joining the USS1 consolidated group because USS1 continues to own only 79 percent of the DS1 stock value.[293] Because no terms have changed with respect to DS1 Note A, Prop. Treas. Reg. section 1.385-2 causes DS1 Note A to be regarded as stock, which then restarts the cyclical attempted (and prevented) consolidation.[294]

(c) Prop. Treas. Reg. Sections 1.385-3 and 1.385-4

The rules under Prop. Treas. Reg. sections 1.385-3 and 1.385-4 provide a variety of mechanical rules that are susceptible to inappropriate results under certain circumstances, such as where deemed stock is used to consolidate or deconsolidate a corporation. The multiple note ordering rule of Prop. Treas. Reg. section 1.385-3(b)(3)(iv)(B)(3) also may be disrupted with changes in consolidated group status.

Example 62: *Issuance of deemed stock precludes consolidation and purges stock status.* USS1, an includible corporation within the meaning of section 1504(b), owns 80 percent of the outstanding stock voting power and 79 percent of the outstanding stock value of USS2, the common parent of the USS2 consolidated group. USS2 distributes a note ("USS2 Note A") to USS1. Under Prop. Treas. Reg. section 1.385-3(b)(2), USS2 Note A is treated as stock, resulting in the termination of the USS2 consolidated group and the creation of the USS1 affiliated group. Assuming the USS1 affiliated group elects to file a consolidated return, it appears that Prop. Treas. Reg. section 1.385-4(c) applies (i.e., because USS2 Note A was treated as stock under Prop. Treas. Reg. section 1.385-3 and it became a consolidated group debt instrument upon the election), which causes USS2 Note A to be exchanged for "new" USS2 Note A (which is not recharacterized under Prop. Treas. Reg. section 1.385-3(b)(2)) immediately before USS1 joins the consolidated group, thereby precluding the affiliation of USS1

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[293] Similar issues arise where an applicable instrument that is issued by an EG Member that is "almost" a consolidated group member to a member of the consolidated group, and if Prop. Treas. Reg. section 1.385-2(b)(2)(iv) later recharacterizes the instrument as stock and this stock ownership is enough to bring the issuer into the holder's consolidated group.

[294] The "outbound" variation of the fact pattern does not appear to raise the same issues because the debt will essentially spring into existence at such point and the normal operating rules would apply.

with the USS2 consolidated group.[295] As a consequence, the USS2 consolidated group continues and, because "new" USS2 Note A is not recharacterized under Prop. Treas. Reg. section 1.385-3(b)(2), it is respected as indebtedness.[296]

Example 63: *Attempted deconsolidation creates reaffiliation-disaffiliation cycle.* USS1 owns 80 percent of the outstanding stock voting power and stock value of DS1. USS1 also owns an applicable instrument issued by DS1 ("DS1 Note A") that is an exempt instrument under Prop. Treas. Reg. section 1.385-4(b)(1). In an attempt to deconsolidate DS1, USS1 distributes to FP a *de minimis* amount of the DS1 stock value. Under Prop. Treas. Reg. section 1.385-4(b)(1), DS1 Note A is deemed to be exchanged for DS1 stock immediately after the distribution to FP. As a result, USS1 again owns 80 percent of the outstanding stock voting power and stock value of DS1, which then causes DS1 to re-affiliate with USS1 and potentially reconsolidate with USS1 if the requirements of section 1504(a)(3) are met.[297] However, if Prop. Treas. Reg. section 1.385-1(e) then causes DS1 Note A to be disregarded under the "one corporation" principle, DS1 would again deconsolidate and recommence this deconsolidation-consolidation-deconsolidation cycle again.

The apparent result in each of these examples seems inappropriate in that the mechanical rules of the Proposed Regulations should not allow for the existence of endless loops of deemed transactions. Accordingly, we recommend the rules be modified in order to prevent this result.

(d) Recommendation

Given the issues regarding continuity discussed above, we believe that it would be inappropriate to have debt instruments recharacterized as stock under the Proposed Regulations be considered stock for purposes of determining consolidated group membership. Moreover, we believe that this is consistent with the policy behind section 1504(a)(4), which provides that certain stock is not considered stock for purposes of section 1504(a). Section 1504(a)(4) stock is stock that: (i) is not entitled to vote, (ii) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (iii) has redemption and liquidation

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[295] The fiction of Prop. Treas. Reg. section 1.385-4(c) appears to preempt temporally the application of Prop. Treas. Reg. section 1.385-4(b)(1) (dealing with the deconsolidation of an issuer or holder).

[296] That is, the application of Prop. Treas. Reg. section 1.385-4(c) has essentially *purged* the stock taint that was momentarily imposed by Prop. Treas. Reg. section 1.385-3(b)(2) and may now produce deductible interest. Other variations of this example (e.g., where an applicable instrument treated as stock by Prop. Treas. Reg. section 1.385-3(b) is acquired and otherwise causes consolidation, where an S Corporation that owns the common parent of a consolidated group borrows from the group and the debt instrument is treated as an impermissible second class of stock such that the parties may now attempt to elect to file a consolidated return with the former S Corporation as the common parent) produce similar results, and in certain instances (e.g., where a consolidated group member transfers an obligation owing by the common parent to a party such as USS1 in this example, there may be a serial application of Treas. Reg. section 1.1502-13(g)(3), Prop. Treas. Reg. section 1.385-4(b)(2), and Prop. Treas. Reg. section 1.385-4(c), causing transitory satisfactions and issuances of the applicable instrument.

[297] Note that the deemed exchange rule of Prop. Treas. Reg. section 1.385-4(c) would not apply due to the fact that DS1 Note A is treated as stock under Prop. Treas. Reg. section 1.385-4(b)(1) rather than under Prop. Treas. Reg. section 1.385-3.

rights which do not exceed the issue price of such stock, and (iv) is not convertible into another class of stock. Although in many cases, an instrument that is in-form debt that is recharacterized as stock under the Proposed Regulations would appear to qualify as section 1504(a)(4) stock, this may not always be the case.

> Recommendation 103: The Final Regulations should provide that any debt instrument that is recharacterized as stock under the Final Regulations is not considered stock for purposes of section 1504(a) even if the recharacterized instrument would not otherwise qualify as section 1504(a)(4) stock.

3. Segregated Issues Impacting Consolidated Groups

In addition to the more systemic concerns articulated above with respect to the "one corporation" and non-section 1504(a)(4) stock recharacterizations, a number of segregated consolidated return issues and concerns arise throughout the Proposed Regulations, particularly in Prop. Treas. Reg. sections 1.385-3 and 1.385-4.

As noted above, Prop. Treas. Reg. section 1.385-3(b)(3)(iv)(B)(3) provides an ordering rule for applying equity recharacterization among multiple debt instruments. In certain instances, this rule may interact inappropriately with Prop. Treas. Reg. section 1.385-4(b)(1)(ii)(B).

> Example 64: *Multiple instruments ordering rule may unwind prior stock status.* DS1 is owned 80 percent by USS1 and is a member of the USS1 consolidated group and the FP EG. FP owns the remaining 20 percent of DS1. In Year 1, DS1 borrows $100x cash from USS1 in exchange for DS1 Note A, which is a non-exempt CGDI. In Year 2, DS1 makes a $100x cash distribution to FP. In Year 3, DS1 borrows $100x cash from CFC, a member of the FP EG, in exchange for DS1 Note B. The Year 2 distribution and issuance of DS1 Note B constitute a Funding Transaction and DS1 Note B is recharacterized as stock under Prop. Treas. Reg. section 1.385-3(b)(3). Later in Year 3, DS1 leaves the USS1 consolidated group but remains in the FP EG. Under Prop. Treas. Reg. section 1.385-4(b)(1)(ii)(B), DS1 Note A is treated as issued in Year 1. Under Prop. Treas. Reg. section 1.385-3(b)(3)(iv)(B)(3), which provides for testing the earliest issued debt instrument first if two or more debt instruments may be treated as a PPDI, because DS1 Note A was issued before DS1 Note B, it appears that DS1 Note B toggles back to indebtedness treatment and DS1 Note A becomes treated as stock.

The apparent result in this example seems inappropriate in that the mechanical rules of the Proposed Regulations should not, as a matter of administrability for both taxpayers and the Government, permit applicable instruments to toggle back and forth between indebtedness and stock status.

> Recommendation 104: We recommend that, for purposes of the ordering rule of Prop. Treas. Reg. section 1.385-3(b)(3)(iv)(B)(3), debt instruments such as that

described in Example 64 be regarded as issued immediately after deconsolidation.[298]

Also concerning Prop. Treas. Reg. section 1.385-4(b)(1), its breadth encompasses cases in which the issuer and holder simultaneously depart the same consolidated group ("Group 1") and then simultaneously join another consolidated group ("Group 2") where Group 1 and Group 2 are in the same EG (e.g., when two consolidated groups with the same foreign corporation shareholder combine under Treas. Reg. section 1.1502-75(d)(3)). This change in consolidated group location within the broader EG should not affect the view articulated in the Preamble—that is, the concerns addressed in the Proposed Regulations generally are not present when the issuer's deduction for interest expense and the holder's corresponding interest income offset on the group's consolidated U.S. federal income tax return.

> Recommendation 105: We recommend the provision of a "subgroup" exception under which Prop. Treas. Reg. section 1.385-4(b)(1)(ii)(B) would not apply where the issuer and holder together depart one consolidated group and together join another consolidated group within the same EG.[299]

An analogous concept already appears in the general consolidated return regulations dealing with acquisitions of an entire consolidated group,[300] and it also appears more specifically with respect to debtor and creditor members of an intercompany obligation.[301]

Another, more pervasive issue arising with respect to rules of the Proposed Regulations addressing applicable instruments that enter or depart from a consolidated group (i.e., Prop. Treas. Reg. sections 1.385-4(b)(1) (addressing the departure from the consolidated group of the issuer or holder of an intercompany obligation), 1.385-4(b)(2) (addressing the departure of an intercompany obligation from the consolidated group), 1.385-4(c) (addressing a debt instrument that becomes an intercompany obligation), and 1.385-4(e)(3) (addressing the deemed exchange of indebtedness for stock 90 days after finalization of the Proposed Regulations))[302] is the

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[298] We note that properly addressing the interaction of the deemed satisfaction and reissuance rule of Proposed Regulations with Treas. Reg. section 1.1502-13(g) may help alleviate this concern, although it may still arise in the case of certain divisive reorganizations under section 368(a)(1)(D). *See* Treas. Reg. § 1.1502-13(g)(3)(i)(B)(7) (excepting from deemed satisfaction and reissuances certain intercompany obligations distributed under section 361(c)).

[299] We note that under the Proposed Regulations, Prop. Treas. Reg. section 1.385-4(b)(1)(ii)(B) would not apply where the issuer and holder together depart from one consolidated group and together join another consolidated group in a separate EG.

[300] *See* Treas. Reg. § 1.1502-13(j)(5) (treating the acquiring consolidated group as a continuation of the target consolidated group with respect to deferred intercompany transactions); Treas. Reg. § 1.1502-19(c)(3) (preventing the inclusion in income of an excess loss account where the entire consolidated group is acquired by another consolidated group).

[301] *See* Treas. Reg. § 1.1502-13(g)(3)(i)(B)(8) (preventing application of the deemed satisfaction and reissuance of an obligation that ceases to be an intercompany obligation, as discussed below, where the members of an intercompany obligation subgroup leave one consolidated group and join another).

[302] The potential for a deemed exchange under Prop. Treas. Reg. sections 1.385-2(c)(2)(i) (which would apply to an intercompany obligation that leaves the consolidated group), 1.385-2(c)(2)(ii) (which would apply to an applicable instrument that becomes an intercompany obligation), and 1.385-2(c)(4) (which applies to an intercompany

interaction of fictional exchanges under such rules with the fictional transactions arising under Treas. Reg. sections 1.1502-13(g)(3) and 1.1502-13(g)(5). Generally, Treas. Reg. section 1.1502-13(g)(3) creates a deemed satisfaction and reissuance of an obligation that ceases to be an intercompany obligation, and does so immediately before such cessation; Treas. Reg. section 1.1502-13(g)(5) generally creates a deemed satisfaction and reissuance of an obligation that becomes an intercompany obligation, and does so immediately after the obligation enters the consolidated group. In both instances, the deemed satisfaction and reissuance are treated as a transactions separate and apart from the transaction giving rise to the deemed satisfaction and reissuance.[303]

Because the fictional transactions under Treas. Reg. sections 1.1502-13(g)(3) and 1.1502-13(g)(5) will occur at approximately the same time as the deemed exchange under Prop. Treas. Reg. sections 1.385-4(b) or 1.385-4(e)(3), it is possible that one or more of the exchanges could be viewed under general tax principles as transitory and thus disregarded,[304] which in turn would add material uncertainty to the proper treatment of the relevant transactions.

> Recommendation 106: We recommend the Proposed Regulations be amended to provide that any deemed issuances, satisfactions, or exchanges arising under Treas. Reg. section 1.1502-13(g) and Prop. Treas. Reg. sections 1.385-4(b) or 1.385-4(e)(3) as part of the same transaction or series of transactions be respected as steps that are separate and apart from one another, similar to the rules currently articulated under Treas. Reg. sections 1.1502-13(g)(3)(ii)(B) and 1.1502-13(g)(5)(ii)(B).

Relatedly, we note that Prop. Treas. Reg. section 1.385-4(d)(3), Example 4 (discussed above) appears to ignore the application of Treas. Reg. section 1.1502-13(g)(3), which creates a deemed satisfaction and reissuance, "for all Federal income tax purposes," of a deconsolidating intercompany obligation. Had the example properly accounted for Treas. Reg. section 1.1502-13(g)(3), DS1 Note B would have undergone a deemed satisfaction and reissuance on Date C of Year 4,[305] meaning that DS1 Note B would not be respected as issued in Year 2.[306]

> Recommendation 107: We recommend that Prop. Treas. Reg. section 1.385-4(d)(3), Example 4 be revised to reflect properly the impact of Treas. Reg. section 1.1502-13(g).

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obligation that ceases to be an intercompany obligation and thus overlaps with Prop. Treas. Reg. section 1.385-2(c)(2)(i)) should be properly addressed by the rules of Prop. Treas. Reg. sections 1.385-4(b) and 1.385-4(c) and thus do not need to be separately considered.

[303] Treas. Reg. §§ 1.1502-13(g)(3)(ii)(B) and 1.1502-13(g)(5)(ii)(B). Note that these deemed reissuances should be taken into account in applying the effective date rules of the Proposed Regulations.

[304] *See, e.g.*, Rev. Rul. 73-427; 1973-2 C.B. 301; Rev. Rul. 68-602; 1968-2 C.B. 135.

[305] The Per Se Period should commence with this deemed reissuance.

[306] Note that resolution of this point would also affect the issue described above in the example dealing with multiple instruments and how the ordering rule may unwind stock status.

The above described segregated issues highlight some peculiar mechanics within the Proposed Regulations. Other, non-mechanical, issues may arise when the Proposed Regulations operate—as intended—to convert a debt instrument into equity. That is, aside from the predictable consequences that seem to be within the intendment of the Proposed Regulations (such as member deconsolidation when its debt instruments held by non-consolidated EG Members are recharacterized as equity that is not described in section 1504(a)(4) and is of a magnitude sufficient to break affiliation under section 1504(a)(2)), other, less foreseeable, consequences may arise, and it is unclear whether these consequences are, in fact, anticipated. For example, if a consolidated group member issues a debt instrument to an EG Member and such instrument is recharacterized as section 1504(a)(4) stock, the loss and credit limitation rule of section 1503(f) is activated even though this rule was designed to prevent the issuance of auction rate section 1504(a)(4) stock that is supported by a highly rated debt instrument. As another example, any instance in which a consolidated group member issues stock to, transfers (directly or indirectly) stock to, or redeems stock from, an EG Member will trigger under section 1504(a)(5) and Notice 2004-37 a measurement event with respect to a member's satisfaction of the ownership requirements of section 1504(a)(2);[307] thus, the Proposed Regulations in the current form will significantly increase the number of required ownership measurements by the consolidated group.

> Recommendation 108: We recommend that the Final Regulations expressly indicate which ancillary consequences of the "one corporation" treatment of consolidated groups are intended and the policy rationale for such ancillary consequences.

4. Treatment of Partnerships Wholly Owned by Consolidated Group Members

In the case of a partnership that is wholly owned by members of a consolidated group (a "Consolidated Group Partnership"), it is not clear whether the "one corporation" concept causes the partnership to be treated, for section 385 purposes, as though it has a single owner and is thus a DRE.

Prop. Treas. Reg. section 1.385-1(b)(1) provides that a Controlled Partnership means a partnership with respect to which at least 80 percent of the interest in partnership capital or profits are owned, directly or indirectly, by one or more members of an EG. As also discussed above, Prop. Treas. Reg. section 1.385-1(e) provides that for purposes of section 385, all members of a consolidated group are treated as one corporation. These rules, taken together, could be interpreted to mean that a Consolidated Group Partnership is treated as owned by one corporation, thus causing the Consolidated Group Partnership to become disregarded for purposes of Prop. Treas. Reg. sections 1.385-1(d) and 1.385-2, and any applicable instrument issued or held by the Consolidated Group Partnership should be treated as issued or held by one corporation. If, as a result of such treatment, the applicable instrument would be deemed to be both held and issued by the same corporation, the applicable instrument should be disregarded and the Final Regulations should not apply to the applicable instrument.

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[307] Notice 2004-37, 2004-1 C.B. 947.

Although this interpretation might be viewed as inconsistent with the treatment of a partnership as a separate entity under Prop. Treas. Reg. section 1.385-2, it is consistent with the treatment of consolidated group members as a single taxpayer. We note that, although the specific rules set forth in the Proposed Regulations would not apply to an applicable instrument that is deemed to be both held and issued by the same corporation, such an instrument would continue to be subject to the general tax principles regarding the characterization of an interest as debt or equity. We would also highlight that borrowing and lending transactions between a Consolidated Group Partnership and the consolidated group of its partners do not result in a tax benefit because any interest income or expense would be recognized by the members of the consolidated group, either directly or indirectly, through the Consolidated Group Partnership. Further, we note that, to the extent that a Consolidated Group Partnership issues or holds an applicable instrument held or issued, as applicable, by a non-consolidated member of the consolidated group's EG or MEG, the Final Regulations would apply.

We recognize that effectively collapsing a partnership with solely consolidated group members for partners could potentially have far reaching effects. For example, it could be seen as causing includible corporations owned by the partnership to be included in the consolidated group for section 385 purposes. Therefore, our recommendation would only apply for purposes of applying of Prop. Treas. Reg. sections 1.385-1(d) and 1.385-2 to a debt instrument issued by a partnership, and not for any other purposes (e.g., determining which includible corporations are members of a consolidated group for purposes of section 385 or otherwise).

> Recommendation 109: We recommend that the Final Regulations clarify that any applicable instrument issued or held by a Consolidated Group Partnership should be treated as issued or held by one corporation for purposes of Prop. Treas. Reg. sections 1.385-1(d) and 1.385-2.

IX. General Comments on Cash Pooling

A. Background

The Preamble requests comments on whether special rules under section 385 may be warranted for cash pools, cash sweeps and similar arrangements.[308] As currently drafted, the Proposed Regulations will severely impact how treasury and finance groups manage and deploy worldwide cash. For many taxpayers, the Proposed Regulations will make the practice prohibitively expensive.[309] We believe that no material tax policy goal will be furthered by dissuading taxpayers from using internal cash pooling in response to the Proposed Regulations. Rather, we predict that the only significant effects from having taxpayers shift to external investment and funding will be increased credit exposure and non-U.S. tax-related costs to taxpayers. Given the Proposed Regulations' significant adverse impacts on internal cash management and imperceptible tax policy benefits, we believe that one of the Government's top priorities in drafting Final Regulations should be to craft a set of administrable rules that exempt cash pooling and similar arrangements from the regulations' scope. We have proposed seven

[308] Preamble at 20929.

[309] Multiple clients that use cash pooling estimate that compliance with the Proposed Regulations will require significant investment in new systems and hiring new full-time employees.

exceptions to address this issue below. We believe the Government should adopt all of them in the Final Regulations. Before describing those proposed exceptions, however, we first provide some background on cash pooling.[310]

Cash pooling is a centralized approach to treasury generally designed to manage risk, increase margins and increase efficiency.[311] Cash pools are generally used to fund working capital and other short term funding needs of related parties. Although cash pools can facilitate longer term funding, in fact longer term loans are frequently removed from the pool in order to further investment goals and satisfy transfer pricing concerns.

Cash pooling structures are generally subject to a bank agreement that is signed between all of the participants and then occurs automatically. Although credit is likely assessed at the beginning of any such agreement, it is not then continually assessed thereafter. As a result, financially distressed participants may participate for some period of time in a cash pool, but such participation is not generally over a year as most groups prepare forecasts of expected performance and cash projections for all of the entities in a group at least annually.

Cash pooling structures generally take one of two forms: physical pooling (or zero balancing) and notional pooling (or interest compensation).

In a physical pooling system, related companies generally open accounts with the same bank and then at a predetermined time, positive balances of the group are moved automatically to the account of the pool leader, which is a related company and generally a finance entity. The bank also automatically moves balances from the pool leader account into the account of any group members that have negative balances in order to bring those account balances up to zero. The pool leader account will then be paid interest by the bank if it has a positive balance or it will pay interest to the bank if it has a negative balance. Because all of the accounts are essentially combined at the end of each day, the debit or credit interest with the bank can be negotiated to a more favorable rate than if each of the accounts is determined separately.

This type of physical pooling arrangement is generally treated as creating loans to the pool leader or from the pool leader to the borrower each time an amount is moved between accounts in the currency of the account.

Intercompany accounts are then established on the books of the pool leader and each affiliate, reflecting the amounts loaned to and from the pool leader. The pool leader is generally compensated either through a fee charged to each participating entity or through the spread between the rate of interest earned on the aggregated bank account balance and the rate paid out on the intercompany accounts. The debit and credit interest will normally be calculated daily,

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[310] We note that the terms "cash sweep" and "cash pool" generally refer to the same concept, so we use the term "cash pool" throughout this discussion.

[311] Cash pooling mitigates several risks. For example, many taxpayers view internal cash pooling as a method of avoiding sovereign or bank credit risks. That is, cash pooling avoids depositing excess cash in local government securities or banks, both of which carry external default risks. Furthermore, intercompany lending permits groups to more freely move cash amongst affiliates without creating problems under foreign capital control or distributable reserve requirements. In certain countries, for example, such restrictions often make it practically impossible to retrieve cash invested as an equity infusion.

even if paid at less frequent intervals, such as monthly or quarterly. Payment dates are generally addressed in any pooling and/or intercompany documentation.

Notional pooling is a virtual pooling arrangement in which balances are not physically moved between accounts. A notional pooling system provides for all affiliates to maintain separate bank accounts with a single bank, but the debit and credit balances on each account are aggregated, through an agreement with the bank, solely for the purpose of determining the interest rate and fees to be charged. Thus, no amounts are actually transferred between accounts and the balance on each account remains at the end of each day. The bank then debits or credits each account as appropriate. Notably, the balance in the account remains on the books of each participant and each participant continues to have separate rights and obligations with respect to the bank. The affiliates are usually required to provide cross guarantees, to the extent of each respective balance, for the balances of other participating affiliates. This structure does not operationally create intercompany loans because funds are only pooled notionally, but instead retains the structure of bank loans with a guarantee, to the extent of each respective balance, by each participating company.

Notional pooling does not create related-party loans in form or in substance. Importantly, cash does not move between accounts in a notional pooling arrangement. Each of the participating accounts receives a benefit from the arrangement, but that benefit generally flows from the bank to the pool leader or is allocated out by the bank on behalf of the pool leader according to the balances. The proper allocation and treatment of the pooling benefit is unclear, but potentially comprises a benefit to the pool leader for arranging and maintaining the system, a guarantee fee for each affiliate for providing the cross guarantees and a reduction in the debit interest rate charged by the bank as a result of viewing the net account balance on an aggregate basis. That benefit generally accrues to each of the affiliates through some inter-company mechanism, supported by transfer pricing documentation.

It is not clear in a notional pooling arrangement, if not viewed as a direct relationship with the bank, would be considered as a loan between each affiliate and the pool leader or whether it could be considered some series of loans directly between affiliates. In that regard, certain countries could view those transactions differently or may consider them to exist between different companies than anticipated. Differing views could then result in the same economic income being taxed more than once.

Although many corporate groups use cash pooling arrangements as described, significant variations exist as banks offer a number of techniques to facilitate intercompany financing that comply with the differing banking and regulatory authorities in various countries.

The Final Regulations should exempt cash pooling from Prop. Treas. Reg. section 1.385-3 in order to preserve the significant nontax benefits it provides to taxpayers. We recognize the difficulty of defining cash pooling, however, given the variety of such arrangements. Thus, we have attempted to draft mechanical exceptions that, for the most part, do not apply based on whether a loan is part of a cash pool. Thus, certain of these exceptions may apply to non-cash pool loans. We believe, however, that the exceptions have been carefully considered and narrowly tailored and do not present a Trojan Horse for potential abuse. Rather, they are

targeted provisions, intended to narrow the overbroad scope of the Proposed Regulations and, thereby, better align the Proposed Regulations with their stated purpose.

The seven proposed exceptions for cash pooling and similar practices are as follows: (i) limit the application of the Proposed Regulations to section 163 only; (ii) clarify that notional cash pools are exempt; (iii) exempt loans amongst CFCs (i.e., the CFC-to-CFC Exception); (iv) expand the scope of the Ordinary Course Exception; (v) limit the application of the Funding Rule to the amount of a member's "net" intergroup funding (i.e. the Net Funding Rule), and provide a netting rule for contributions and distributions (i.e., the Net Contribution Rule); (vi) limit the cascading effects of the Funding Rule; and (vii) implement a rebuttable presumption for all debt instruments, including cash pooling and similar arrangements.[312] Each of these proposed exceptions is discussed in turn below.

B. Limit Application of Proposed Regulations to Section 163

As discussed in Section IV of this Comment Letter, many of the unintended effects of the Proposed Regulations could be avoided by limiting the impact of a recharacterization of a debt instrument into stock to the availability of interest deductions under section 163 only. In other words, by denying interest deductions with respect to certain related-party debt instruments, the Proposed Regulations would further most, if not all, of the Government's stated policy goals without creating the adverse and unanticipated consequences for taxpayers that are not the objective of the Proposed Regulations. We observe that applying this recommendation to limit the impact of the Proposed Regulations to a disallowance under section 163 would not be an adverse result in the context of cash pooling. Most loans subject to a cash pooling arrangement bear low rates of interest,[313] and many taxpayers would willingly forego any deductions with respect thereto in order to avoid application of the Proposed Regulations in their current form.

C. Clarify that Notional Cash Pools are Exempt

> Recommendation 110: We recommend that the Government clarify that the Proposed Regulations do not apply to notional pooling arrangements that are bank loans in form, except in the rare circumstances in which the -3 Anti-Abuse Rule should be applied (e.g., circumstances in which a taxpayer uses a notional cash pool to effect a third-party loan in form that is an EG debt instrument in substance). Further, the decision to use a notional pooling arrangement rather than a physical pooling arrangement should not trigger the application of the -3 Anti-Abuse Rule.[314]

Rather than providing a definition of a notional cash pool, however, we believe that the better approach is for an exception to focus on such pools' most salient feature: namely, direct creditor's rights against an unrelated bank and vice versa. In other words, the Proposed

[312] As these proposals do not rely on a defintion of a cash pool, all of them except clarifying that notional cash pools are exempt have been proposed elsewhere in this Comment Letter. We briefly discuss these exceptions here to highlight the significant relief that these exceptions could provide to cash pooling and similar arrangements.

[313] One of the main benefits of cash pooling is the ability to garner lower financing costs.

[314] See Example 26 and related discussion.

Regulations should clarify that third-party loans bearing creditor's rights with respect to a third party are not subject to the regulations, unless the -3 Anti-Abuse Rule applies.

D. CFC-to-CFC Exception

As discussed in Section VII.G of this Comment Letter, we recommend that loans between related CFCs should be exempted from the application of the Proposed Regulations. This exception would resolve many of the issues posed by the Proposed Regulations with respect to physical cash pools of U.S. multinationals, which tend to segregate their U.S. and foreign cash pools in order to prevent withholding tax issues and exposures under section 956.

E. Expand Scope of Ordinary Course Exception

As discussed in Section VII.F.3(b)(4)(b) of this Comment Letter, we recommend that the Ordinary Course Exception be expanded to debt issued to fund the acquisition of goods or services. This expansion would resolve many of the issues posed by the Proposed Regulations with respect to physical cash pools, as many of such transactions are frequently routed through the cash pool leader.

F. Limit Application of Funding Rule to Each Member's "Net Funding"

In Section VII.F.3(b)(4) of this Comment Letter, we discuss limiting the Funding Rule to the "net funding" that a member receives within a taxable year (i.e. the Net Funding Rule). For this purpose, net funding equals the sum of the member's aggregate borrowings from other members, reduced by the member's loans to other members. Another exception that we discuss would provide that a transaction otherwise constituting a Funding Rule transaction would be netted against capital contributions made in the same taxable year in which the Funding Rule transaction would otherwise be treated as occurring (the Net Contribution Rule). Application of the Net Funding Rule and the Net Contribution Rule would remain subject to the -3 Anti-Abuse Rule.

If adopted, the Net Funding Rule would alleviate many of the concerns relating to cash pools because a member's routine, and, in some cases, daily, borrowing and lending to and from the pool would not be treated as a funding. We believe that an exception such as this is necessary to ensure that U.S. multinationals that use cash pooling for legitimate business reasons are able to continue this method of funding their business operations. Without it, the Proposed Regulations, if finalized, would severely penalize U.S. business operations that bear no relation to the Proposed Regulations' objectives. Furthermore, to the extent the Government has concerns over the challenges of defining a cash pool, the Net Funding Rule addresses that concern by attaching consequences to the substance of an arrangement. Finally, while we acknowledge that this exception may be viewed as expansive, the breadth of the exception is driven by the breadth of the Funding Rule and the need to extend relief to bona fide business arrangements.

Similarly, the Net Contribution Rule responds to the breadth of the Funding Rule, and also responds to the policy concerns underlying it—if a member's net equity does not in fact change within a taxable year because the member incurs related-party debt but also receives

capital contributions[315] that are equal to or greater than the debt that is incurred, we see little policy justification for applying the Funding Rule to that member.[316] Like the Net Funding Rule, the Net Contribution Rule facilitates continued use of cash pooling and similar arrangements by giving taxpayers a way of managing the broad reach of the Proposed Regulations.

G. Limit Cascading Effects of Funding Rule

As discussed in Section VII.C.5 of this Comment Letter, the Funding Rule can have cascading effects such that a single loan that is recharacterized as stock can eventually taint all of the loans within a cash pool. This is the case because payments with respect to the recharacterized debt instrument that would otherwise be characterized as interest are characterized as distributions with respect to stock, potentially implicating the Funding Rule under Prop. Treas. Reg. section 1.385-3(b)(3)(ii)(A). Furthermore, the recharacterized instrument should qualify as stock of an EG Member, thus implicating the Funding Rule under Prop. Treas. Reg. section 1.385-3(b)(3)(ii)(B). Once the Funding Rule recharacterizes a single debt instrument, this process can apply iteratively until all of the loans within a cash pool have been recharacterized. The consequences of such recharacterizations can be significant in our view and do little to advance the stated tax policy goals of the Proposed Regulations.

In order to prevent this result, as discussed in Section VII.C.5 of this Comment Letter, we recommend that the Funding Rule not be triggered by acquisitions of, or payments with respect to, debt instruments that have been recharacterized as stock under either Prop. Treas. Reg. section 1.385-2 or Prop. Treas. Reg. section 1.385-3. In other words, Prop. Treas. Reg. sections 1.385-3(b)(3)(ii)(A) and (B) should not apply to transactions with respect to stock that is debt in form and has been recharacterized under the Proposed Regulations. Thus, by limiting the impact of the Funding Rule to a single iteration, this exception should further limit the application of the Funding Rule to the types of transactions that implicate the Government's policy concerns addressed by the Funding Rule.

H. Implement Rebuttable Presumption for Funding Rule Purposes

In Section VII.C.2(a) of this Comment Letter, we recommend a revision to the Funding Rule to provide a rebuttable presumption that a debt instrument is issued with a principal purpose of funding a distribution or acquisition. If this general recommendation is accepted, this rebuttable presumption would also apply to cash pooling and similar arrangements. In light of the widespread, routine use of cash pooling arrangements that exhibit a low potential for abuse and lack the significant policy concerns intended to be addressed by the Proposed Regulations, we would expect the facts and circumstances surrounding the vast majority of such arrangements to be sufficient to rebut the above-referenced presumption. Thus, allowing taxpayers the

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[315] For this purpose, we recommend that the term "capital contribution" would be broadly defined to include any transaction (e.g., a section 351 exchange, a merger, etc.) that increases the equity value of a member. Furthermore, a capital contribution should include transactions in which assets are acquired from persons or entities that are not EG Members.

[316] The fact that the Proposed Regulations recharacterize debt as equity shows that the Government believes that related-party capital transfers are equity. This reinforces the conclusion that actual equity infusions should be recognized and should be given "credit."

opportunity to produce evidence to refute the presumption of the existence of a PPDI would resolve many of the concerns specific to cash pooling arrangements discussed above.

X. Ancillary Issues Related to Recharacterization of Debt Instruments

A. Guidance Addressing Collateral Consequences of Proposed Regulations

The Preamble provides that "while [the] [Proposed Regulations] are motivated in part by the enhanced incentives for related parties to engage in transactions that result in excessive indebtedness in the cross-border context, federal income tax liability can also be reduced or eliminated with excessive indebtedness between domestic related parties."[317] The Preamble further provides that in the cross-border context, a related-party debt instrument can facilitate: (i) U.S. base-erosion by foreign-parented multinationals because the associated interest deductions reduce U.S. source income; and (ii) the repatriation of untaxed foreign earnings by domestic-parented multinationals because the associated interest deductions reduce CFC E&P and the instrument's principal can be repaid without the U.S. creditor recognizing dividend income.[318] The Proposed Regulations, therefore, generally are intended to deny tax-benefitted status to certain related-party debt instruments by: (i) eliminating the obligor's ability to claim a deduction, either in whole or in part, for interest paid with respect to a related-party debt instrument; and (ii) treating the obligor's repayment of a related-party debt instrument as a stock redemption, the likely effect of which is that the repayment is characterized for U.S. federal income tax purposes as a distribution of property with respect to the obligor's stock.[319] The Proposed Regulations, however, go well beyond neutralizing the U.S. federal income tax benefits associated with related-party debt instruments because the regulations recharacterize related-party debt instruments as stock for *all* U.S. federal income tax purposes. This broad approach, as discussed below, has far-reaching adverse collateral U.S. federal income tax consequences that are unrelated to the U.S. base erosion or foreign earnings repatriation concerns noted in the Preamble.

B. Collateral Consequences Regarding Alternative Corporate Tax Regimes

1. In General

The Proposed Regulations' recharacterization of related-party debt instruments as stock could prevent a corporation from qualifying for one of the Code's alternative corporate tax regimes. Indeed, a corporation generally is only able to qualify for these regimes if it satisfies strict requirements regarding the identity of its shareholders, the type of equity it has outstanding, or the type of assets it owns—these regimes include: (i) joining a U.S. consolidated group,[320] (ii) electing to be taxed as an S Corporation, and (iii) qualifying as a REIT.[321] If the Proposed

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[317] Preamble at 20914.

[318] Preamble at 20917.

[319] I.R.C. §§ 302(d) and 301(c).

[320] See Section VIII.B.2 for a discussion of the impact of the Proposed Regulations on the ability of a corporation to join a consolidated group.

[321] *See* I.R.C. § 856(c)(3) (requiring at least 75 percent of its gross income be derived from, among other things, interest on obligations secured by mortgages on real property or interests in real property). Dividends from stock of

Regulations recharacterize debt issued by a corporation subject to one of these regimes as stock, the regulations could cause the corporation to fail to qualify under its respective regime, which would likely result in detrimental consequences to the corporation and/or its shareholders.[322]

> Example 65: *Termination of S Corporation election.* SSC, an S Corporation, owns all of the stock of P, a domestic corporation and common parent of a U.S. consolidated group. In Year 1, SSC borrows money from P in exchange for a note (the "SSC Note"). If the SSC Note is later recharacterized as stock under the Proposed Regulations, the SSC Note could be treated as a second class of SSC stock, which would terminate SSC's S Corporation election.[323] Additionally, even if the SSC Note was not treated as a second class of SSC stock, its treatment as stock would cause SSC to have a non-individual shareholder, which also would terminate SSC's S Corporation election.[324] As a result of the termination of SSC's S Corporation election, SSC's taxable year would close on the day before the election terminates, and SSC generally would be ineligible to elect status as an S Corporation until the fifth taxable year following the first taxable year in which the termination is effective.[325] SSC, therefore, would be a taxed as a Subchapter C corporation—i.e., SSC would be subject to corporate-level U.S. federal income tax instead of the flow-through treatment afforded to S Corporations.

The adverse consequences that result from the termination of SSC's S Corporation election are further exacerbated by the fact that it could be years before SSC becomes aware of the termination.

> Example 66: *Termination of S Corporation election.* Same facts as Example 65 except that (i) in Year 3 SSC reasonably believes that it has sufficient Current E&P to make a cash distribution with respect to its stock without causing the SSC Note to be treated as stock under the Funding Rule, but (ii) in Year 6, on audit,

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a corporation are not included in section 856(c)(3) (other than from other REITs) and thus count against this requirement. A REIT may therefore hold a debt instrument that is secured by real property that is recharacterized as equity under the Proposed Regulations, thus causing income that would have otherwise been included in section 856(c)(3) to fall outside section 856(c)(3).

[322] We note that these are other special regimes under the Code that could be impacted by the Proposed Regulations including, but not limited to, the rules pertaining to regulated investment companies ("RICs") and real estate mortgage investment conduits ("REMICs").

[323] Specifically, a corporation is not eligible to be an S Corporation if, among other things, it has more than one class of stock. I.R.C. § 1361(b)(1)(D). We also note that following the termination of SSC's election to be treated as an S Corporation, it is eligible to join P's consolidated group. If it did join, then the recharacterized debt instrument would be deemed exchanged for a new debt instrument in a transaction disregarded for purposes of Prop. Treas. Reg. section 1.385-3(b), thus eliminating the non-individual shareholder and second class of stock that caused the election to terminate in the first place. Prop. Treas. Reg. § 1.385-4(c).

[324] Specifically, a corporation is not eligible to be an S Corporation if, among other things, it has a shareholder that is a Subchapter C corporation. I.R.C. § 1361(b)(1)(B).

[325] I.R.C. §§ 1362(d)(2); 1362(e); 1362(g). We note that the S Corporation election may not terminate if it is determined that such termination was inadvertent, but this generally requires a ruling from the IRS. I.R.C. § 1362(f). We also note that the five-year limitation on re-making the S Corporation election may be effectively waived by the IRS. I.R.C. § 1362(g).

SSC's Current E&P for Year 3 is reduced such that it is less than the amount of the Year 3 cash distribution. If SSC's S Corporation election is terminated retroactive to Year 3 (i.e., because it has a second class of stock or a non-individual shareholder), SSC would have filed incorrect U.S. federal income tax returns and not paid any corporate-level income tax during the period that SSC's S Corporation election was no longer valid and, thus, SSC may be subject to penalties and interest.[326]

> Recommendation 111: We recommend that related-party debt instruments treated as stock under the Proposed Regulations' not be treated as "stock" for purposes of disqualifying a corporation from one of the Code's alternative corporate tax regimes, including qualifying as an S Corporation or a REIT.[327]

2. Clarify Application of Straight Debt Safe Harbor

As discussed previously, to qualify as an S Corporation, among other requirements, a corporation is only permitted to have a single class of stock outstanding.[328] The Subchapter S Revision Act of 1982,[329] however, added a "straight debt safe harbor" provision (the "Straight Debt Safe Harbor") which is effective for taxable years beginning after December 31, 1982. Pursuant to section 1361(c)(5), straight debt ("Straight Debt") is not treated as a second class of stock for purposes of section 1361(b)(1)(D). Straight Debt is defined as:

> [A]ny written unconditional promise to pay on demand or on a specified date a sum certain in money if:
>
> (i) The interest rate and interest payment dates are not contingent upon profits, the borrower's discretion, or similar factors;
>
> (ii) There is no convertibility (directly or indirectly) into stock; and
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> (iii) The creditor is an individual (other than a nonresident alien), an estate, a trust [qualified to hold stock in an S Corporation] or a person which is actively and regularly engaged in the business of lending money.[330]

As also discussed previously, when debt is recharacterized as stock under the Proposed Regulations, it is recharacterized for "all federal income tax purposes."[331] Such a result is at

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[326] I.R.C. § 6651.

[327] This recommendation is consistent with Recommendation 103 (eligibility to join a consolidated group) and Recommendation 113 (status as a CFC).

[328] I.R.C. § 1361(b)(1)(D).

[329] Pub. L. No. 97-354, 96 Stat. 1669.

[330] I.R.C. § 1361(c)(5)(B).

[331] *See* Prop. Treas. Reg. § 1.385-3(b)(1) ("To the extent that a debt instrument is treated as stock under [the General Rule, the Funding Rule or the related ordering rules under Prop. Treas. Reg. section 1.385-3(b)(4)], it is treated as stock for all federal tax purposes."); Prop. Treas. Reg. § 1.385-2(a)(1) ("If the [documentation and maintenance]

odds with the Straight Debt Safe Harbor. In our view, Congress was clear that debt instruments satisfying the Straight Debt Safe Harbor are not to be treated as stock for purposes of determining whether the single class of stock requirement of section 1361(b)(1)(D) is met.

First, Congress enacted the safe harbor approximately 13 years after enacting section 385 understanding that it had previously granted Treasury the authority to promulgate regulations to assist in determining whether a corporate instrument should be treated as debt or stock for tax purposes. If Treasury could override the Straight Debt Safe Harbor with section 385 regulations, it would render passage of section 1361(c)(5) virtually irrelevant. For example, there is no requirement to document that S Corporation debt has creditor rights to qualify such debt as Straight Debt yet S Corporation debt may be recharacterized as stock under Prop. Treas. Reg. section 1.385-2(b)(2)(ii) if such documentation is lacking. Congress had no such intention.

Second, we note that there is a long-standing rule of statutory interpretation—*lex specialis derogat legi generali*—providing that a law governing a specific subject matter (*lex specialis*) overrides a law that governs only general matters (*lex generalis*). This rule has been widely applied to the Code "without regard to priority of enactment."[332] Further the IRS has consistently accepted this rule of statutory construction in its own guidance.[333] Both sections 385 and 1361(b)(1)(D) address the classification of a purported debt instrument as debt or equity. Section 385 generally applies for all federal income tax purposes while section 1361(b)(1)(D) only applies for purposes of determining whether the single class of stock requirement is satisfied. In our view, there is no question that the Straight Debt Safe Harbor governs a more specific subject matter than section 385 and, as a result, supersedes the Proposed Regulations for purposes of determining whether an S Corporation-issued instrument violates the single class of stock requirement under section 1361(b)(1)(D).

> Recommendation 112: We recommend that the Government clarify that if S Corporation-issued debt is recharacterized as stock under the Proposed Regulations, such recharacterization does not apply for purposes of the single class of stock requirement of section 1361(b)(1)(D).

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requirements of this section are not satisfied with respect to an EGI the substance of which is regarded for federal tax purposes, the EGI will be treated as stock.").

[332] *Bulova Watch Co. v. United States*, 365 U.S. 753, 757 (1961); *see also Winter v. Comm'r*, 135 T.C. 12, 33 (2010) ("[W]here two statutes conflict, specific laws govern general ones."); *Zhang v. United States*, 89 Fed. Cl. 263, 275 (2009) ("[A] specific statute controls over a general one without regard to priority of enactment."); *First Nationwide Bank v. United States*, 431 F.3d 1342, 1348 (Fed. Cir. 2005) ("As a principle of statutory interpretation, a specific provision prevails against broader or more general provisions, absent clear contrary intent.").

[333] *See, e.g.*, ILM 200947035 (July 9, 2009) ("It is a well established rule that a specific statute controls over a general one without regard to priority of enactment."); TAM 9538007 (Sept. 22, 1995) (similar); Rev. Rul. 90-17, 1990-1 C.B. 119 (similar); GCM 39119 (Jan. 19, 1984) (similar); GCM 35,636 (Jan. 28, 1974) (similar).

C. Collateral Consequences Regarding Outbound Investments[334]

1. Impact on CFC Status

The Proposed Regulations' recharacterization of related-party debt instruments could have adverse collateral consequences with respect to outbound investments by a domestic corporation, including affecting a foreign corporation's status as a CFC. A foreign corporation is a CFC if, on any day during its taxable year, more than 50 percent of its voting power or value is owned, within the meaning of section 958(a) or (b), by "U.S. shareholders." A "U.S. shareholder" is, with respect to a foreign corporation, any U.S. person that owns, within the meaning of section 958(a) or (b), 10 percent of the foreign corporation's voting power. Since CFC status is defined by reference to a U.S. shareholder's ownership interest in a foreign corporation, the Proposed Regulations' recharacterization of related-party debt instruments as stock could cause a foreign corporation to cease to be, or become, a CFC.

> Example 67: *Termination (or beginning) of CFC status.* FP, a foreign corporation, directly owns all the stock of USP, a domestic corporation, and Finco, a foreign corporation. USP and FP directly own the following interests in FJV, a foreign corporation: (i) USP and FP each own 50 percent of FJV's common stock and (ii) USP owns all of FJV's nonvoting preferred stock—i.e., USP owns 50 percent of FJV's voting power and more than 50 percent of FJV's value. If Finco loans money to FJV in exchange for a debt instrument that is recharacterized as stock under the Proposed Regulations, FJV would lose CFC status if the recharacterized stock caused USP to own less than 50 percent of FJV's value. Conversely, if instead FP owned all of FJV's preferred stock and USP loaned money to FJV, FJV could become a CFC.

In Example 67 above, FJV's CFC status could affect USP's U.S. federal income tax liability in several ways. First, USP only would be required to include in income its pro rata share of FJV's subpart F income if FJV is a CFC. Second, if USP subsequently disposed of its FJV stock either in a taxable sale or tax-free reorganization, USP's income inclusions with respect to such exchanges could be affected by FJV's CFC status. Each of these consequences is further exacerbated by the fact that it could be years before FJV's CFC status is determined with certainty.

> Example 68: *Retroactive section 1248 inclusion.* FP, a foreign corporation, directly owns all the stock of USP, a domestic corporation, and Finco, a foreign corporation. USP and FP directly own the following interests in FJV, a foreign corporation: (a) USP and FP each own 50 percent of FJV's common stock, and (b) USP owns all of FJV's nonvoting preferred stock—i.e., USP owns 50 percent of FJV's voting power and more than 50 percent of FJV's value. In Year 1, Finco loans money to FJV and the loan, if treated as stock, would cause FJV to no longer be treated as a CFC. In Year 2, FJV makes a distribution on its preferred

[334] Although we note that there is some overlap between these recommendation and the proposed CFC-to-CFC Exception described in Section VII.G, that exception would not eliminate these concerns, and so these recommendations should be accepted even if that exception is adopted.

stock that FJV believes is covered by the Current E&P Exception. In Year 3 FJV reincorporates in another foreign jurisdiction in a tax-free reorganization under section 368(a)(1)(F) (an "F Reorganization"). In Year 5 it is determined on audit that FJV's Year 2 Current E&P is less than the amount FJV believed correct when it made the Year 2 distribution.

If the Finco loan is retroactively recharacterized as stock from the date of the Year 2 distribution, FJV's F Reorganization would cause USP to include in income as a dividend the entire "section 1248 amount"[335] (as defined by Treas. Reg. section 1.367(b)-2(c)) with respect to its FJV stock because (i) USP would be deemed to exchange its "old" FJV stock for "new" FJV stock in connection with the reorganization, and (ii) "old" FJV would have been a CFC within the preceding five years and "new" FJV would not be a CFC.[336] Furthermore, USP would have to file amended U.S. federal income tax returns for the period that FJV was not a CFC to remove from its income any subpart F income attributable to its investment in FJV during such period.

Recommendation 113: We recommend that debt recharacterized as stock under the Proposed Regulations not be taken into account for purposes of determining a foreign corporation's status as a CFC.

2. Impact on Foreign Tax Credits

(a) Section 902 Deemed-Paid Foreign Tax Credits

The Proposed Regulations' recharacterization of related-party debt instruments also could affect domestic corporations' ability to claim section 902 foreign tax credits for payments made with respect to the recharacterized instruments. Under section 902, a domestic corporation generally is able to claim a credit against its U.S. federal income tax liability for certain amounts of foreign income taxes paid or accrued by certain foreign subsidiaries. More specifically, when a domestic corporation owns at least 10 percent of the voting stock of a foreign corporation (a "Section 902(a) Shareholder") and receives a dividend from such corporation, the Section 902(a) Shareholder is eligible to claim foreign tax credits with respect to a proportionate amount of the foreign income taxes paid or accrued by such foreign corporation.[337] Section 902(b) extends the application of this "deemed-paid" foreign tax credit to dividends paid by certain lower-tier foreign corporations to upper-tier foreign corporations provided certain ownership requirements are met. Specifically, section 902(b)(1) provides that an upper-tier foreign corporation that receives a dividend from a lower-tier foreign corporation will be deemed to have paid the same proportionate share of the foreign income taxes paid by the lower-tier foreign corporation as would be determined if such upper-tier foreign corporation were a domestic corporation if: (i) the

[335] The "section 1248 amount" generally is defined as the net positive E&P, if any, that would have been attributable to a foreign corporation's stock and includible as a dividend under section 1248 if the foreign corporation's stock was sold by the exchanging shareholder. Treas. Reg. § 1.367(b)-1(c)(1).

[336] Treas. Reg. § 1.367(b)-4(b)(1)(i).

[337] I.R.C. § 902(a).

upper-tier foreign corporation owns 10 percent or more of the voting stock of the lower-tier foreign corporation, and (ii) both foreign corporations are members of a "qualified group."[338]

For purposes of determining a domestic corporation's eligibility to claim a section 902 foreign tax credit with respect to dividends received from a foreign corporation, ownership of the foreign corporation's stock is determined on an entity-by-entity basis (i.e., stock ownership by related entities is not aggregated for purposes of determining whether the 10 percent voting stock threshold is satisfied).[339] For example, in *First Chicago Corp. v. Comm'r*,[340] five members of an affiliated group of corporations owned, in the aggregate, at least 10 percent of a foreign corporation, but none of the corporations individually owned at least 10 percent of the foreign corporation. The U.S. Tax Court ruled that because none of the corporations individually owned at least 10 percent of the foreign corporation, none of the corporations could claim section 902 foreign tax credits.[341]

A related-party debt instrument that is recharacterized as stock under the Proposed Regulations generally will not have voting power for purposes of section 902 (i.e., it will generally be treated as non-voting stock). In some circumstances (e.g., where the holder of the recharacterized instrument is a domestic corporation that also owns at least 10 percent of the voting stock of the issuer of the instrument), the recharacterization of the instrument as stock under the Proposed Regulations does not impact the amount of section 902 foreign tax credits that can be claimed by the holder of the instrument with respect to payments on the instrument. However, in other circumstances (e.g., where the holder of the recharacterized instrument is a domestic corporation that does not actually own at least 10 percent of the voting stock of the issuer of the instrument), payments with respect to the recharacterized instrument will not carry section 902 foreign tax credits.[342] Rev. Rul. 74-459[343] provides an example of a situation where the holder of a recharacterized instrument may not be eligible to claim section 902 foreign tax credits with respect to payments on the instrument. In that ruling, P, a domestic corporation,

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[338] Section 902(b)(2) defines a "qualified group" as a foreign corporation described in section 902(a) (a foreign corporation in which a domestic corporation owns at least 10 percent of the voting stock) and any other foreign corporation if: (i) the domestic corporation indirectly owns at least five percent of the voting stock of the lower-tier foreign corporation paying the dividend through a chain of foreign corporations connected through stock ownership of at least 10 percent of their voting stock, and (ii) the lower-tier corporation paying the dividend is not below the sixth-tier in the ownership chain beginning with the first-tier foreign corporation; the flush language of section 902(b)(2) provides that in addition to meeting the preceding requirements, fourth-, fifth-, and sixth-tier foreign corporations must be CFCs and the domestic corporation must be a U.S. shareholder with respect to such CFCs.

[339] *But see* Rev. Rul. 71-141, 1971-1 C.B. 211 (concluding that two corporations that were equal partners in a partnership that owned 40 percent of the stock of a foreign corporation would each be treated as owning 20 percent of the foreign corporation for purposes of section 902).

[340] 96 T.C. 421 (1991).

[341] *See also* Rev. Rul. 85-3, 1985-1 C.B. 222 (concluding that five corporations that were members of an affiliated group and that each owned 2.5 percent of the voting stock of a foreign corporation were ineligible to claim foreign tax credits under section 902).

[342] We note that similar consequences could result under section 902(b) if the issuer and the holder of the recharacterized instrument was each a foreign subsidiary corporation of a domestic corporation, but the holder did not own other stock of the issuer representing at least 10 percent of the voting stock of the issuer.

[343] 1974-2 C.B. 207.

owned all of the stock of S1, a foreign corporation, and 75 percent of the nonvoting stock of S2, a foreign corporation. S1 owned 50 percent of the voting stock of S2. S2 paid a dividend to P with respect to its nonvoting stock in S2. The ruling concludes that P is not entitled to section 902 foreign tax credits with respect to the payments on S2's nonvoting stock, notwithstanding that P indirectly owned 50 percent of the voting stock of S2.[344] The result in Rev. Rul. 74-459 would appear to be the same if the nonvoting stock owned by P was instead a debt instrument that had been recharacterized as stock under the Proposed Regulations. Similar results could happen between lower-tier CFCs if debt recharacterized as stock under the Proposed Regulations caused the ostensible obligor foreign corporation to pay a dividend to a foreign corporation that was not a member of the same qualified group.

Furthermore, the amount of the section 902 foreign tax credit is generally equal to an amount of foreign income taxes that bears the same ratio to the foreign corporation's "post-1986 foreign income taxes" ("Foreign Taxes") as the amount of the dividend bears to the foreign corporation's "post-1986 undistributed earnings."[345] Thus, for example, a dividend paid by the foreign corporation to a shareholder that is not eligible to claim a section 902 foreign tax credit effectively eliminates the amount of Foreign Taxes that can be claimed by other shareholders as section 902 foreign tax credits. Accordingly, if the holder of a debt instrument that is recharacterized as stock under the Proposed Regulations is not eligible to claim section 902 foreign tax credits (e.g., a foreign corporation), payments with respect to such instrument may reduce the foreign issuer's post-1986 undistributed earnings, effectively causing section 902 foreign tax credits that could otherwise have been claimed with respect to the other stock of the foreign issuer to disappear.

> Example 69: *Debt instrument of CFC held by related CFC that is not a Section 902(a) Shareholder.* USP directly owns all of the stock of CFC1 and CFC2. CFC2 transfers $100x to CFC1 in exchange for a CFC1 Note (a traditional debt instrument with no voting rights) that is recharacterized as stock under the Proposed Regulations. On January 1, Year 1, CFC1 has $140x of accumulated E&P and $28x of Foreign Taxes. In Year 1, CFC1 pays a $10x "dividend" with respect to the CFC1 Note to CFC2. In Year 2, CFC1 distributes a $10x "dividend" with respect to the CFC1 Note to CFC2. On December 31, Year 3, CFC1 "redeems" the CFC1 Note for $110x (consisting of $10x of accrued "dividends" and $100x of "principal"). In Year 4, CFC1 distributes a $10x dividend with respect to USP's CFC1 stock. At the end of Year 5, CFC2 distributes a $130x dividend with respect to USP's CFC2 stock at a time when CFC2 has $130x accumulated E&P and no Current E&P. CFC1 does not earn any Current E&P in Year 1, Year 2, Year 3 or Year 4.

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[344] Specifically, the ruling concludes that section 902(b), which the ruling describes as providing a deemed paid foreign tax credit with respect to lower-tier CFCs, is contingent upon the dividend being distributed through a chain of corporations possessing voting stock ownership in the distributing corporation. Thus, because the dividend from S2 was distributed directly to P with respect to its nonvoting stock, no foreign tax credit under section 902 was available.

[345] I.R.C. § 902(a).

Under current law, "dividend" payments on the recharacterized CFC1 Note would not carry with them section 902 foreign tax credits. However, foreign taxes paid with respect to those "dividend" payments would be removed from CFC1's Foreign Taxes. As a result, USP would only be able to claim foreign tax credits for the $2 of Foreign Taxes attributable to the dividend in Year 4, even though USP takes into income all $140x of CFC1's accumulated profits.

We believe that the above-discussed results are inappropriate and that the Final Regulations should provide that if the issuer of a recharacterized debt instrument is a foreign corporation, the recharacterized debt instrument is not treated as "stock" for purposes of section 902. Accordingly, payments made with respect to such instrument would not be treated as dividends for purposes of section 902 even though such payments would reduce the foreign corporation's post-1986 undistributed earnings.[346] The regulations should make clear that any earnings reduced as a result of these payments should not be treated as earnings "otherwise removed" in Treas. Reg. section 1.902-1(a)(8) and, accordingly, should not result in a reduction of the foreign tax pool of the distributing entity. Accordingly, the holder of the instrument would not be deemed to have paid any portion of the issuer's Foreign Taxes, and section 902 would apply to dividends received by the owner of the issuer's voting stock in the same way as if the debt instrument had not been recharacterized under section 385. That is, if a domestic corporation owns at least 10 percent of the issuer's voting stock and receives a dividend, then it would be deemed to have paid the same proportion of the issuer's Foreign Taxes as it would have been deemed to pay if the debt instrument had not been recharacterized (i.e., the proportion that the amount of the dividend bears to the issuer's post-1986 undistributed earnings (as reduced by the amount of payments with respect to recharacterized debt)).

We believe that such an approach will preserve the issuer's Foreign Taxes in most instances in which the Proposed Regulations recharacterize a debt instrument as stock. We acknowledge that in the case of repayment of a recharacterized debt instrument, this approach could potentially result in an enhanced foreign tax pool because the repayment would reduce E&P for U.S. tax purposes but would not reduce foreign taxes under local law.[347] Given that the Proposed Regulations mandate recharacterization and include a prohibition on affirmative use, we do not believe that this concern outweighs the benefits afforded by the recommendation not to treat payments on recharacterized debt as dividends for purposes of section 902. However, if, for example, the Final Regulations do not include the prohibition on affirmative use, the Government could, using its authority under section 909(e)(2), consider applying certain principles of section 909 to address concerns about enhancement of foreign tax credits. [348]

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[346] Post-1986 undistributed earnings are ordinarily not reduced by distributions made during the taxable year. Treas. Reg. § 1.902-1(a)(9)(i).

[347] Unlike the repayment of the principal on a recharacterized debt instrument, allocating issuer E&P to what may be in form interest payments and under the Proposed Regulations may be treated as section 301(c)(1) distributions with respect to such instrument should not result in any enhancement of foreign tax credits because whether the payment is viewed as interest expense under local law or a dividend for federal income tax purposes the result would be the same—a reduction in the issuer's E&P in an amount equal to such payment/distribution.

[348] For example, a possible approach would be to treat the portion of the issuer's Foreign Taxes that would have been attributable to the "repayment" but for this special rule as "split taxes" and, thus, taken into income only if and when the E&P attributable to the repayment is taken into account by a corporation that is both a member of the

We believe that this approach is more administrable and reaches more appropriate results than would be reached by treating the recharacterized debt as issuer voting stock for section 902 purposes, because the instrument likely will not provide the holder with voting rights with respect to the issuer. Thus, if the instrument was simply treated as issuer voting stock, the Final Regulations would need to include rules ascribing a particular amount of voting power to the recharacterized instrument, or would need to adopt a rule that treats the holder as owning voting stock by attribution from other related persons. We believe that the recommended approach is more consistent with the statutory scheme of section 902, which requires direct ownership of the requisite 10 percent of voting stock and does not permit aggregation of less than 10 percent stock interests, even in the case of a consolidated group.

> Recommendation 114: We recommend that payments with respect to debt instruments that are recharacterized as stock under the Final Regulations not be treated as dividends for purposes of section 902.

(b) Foreign Tax Credit Splitter Arrangements

The Proposed Regulations' recharacterization of related-party debt instruments as stock also could cause the recharacterized instrument to be a "foreign tax splitter arrangement."[349] Section 909 defers a foreign tax credit with respect to foreign income taxes arising in a "foreign tax credit splitter arrangement," including a "U.S. equity hybrid instrument."[350] These foreign income taxes are generally deferred until the taxable year in which the "related income" is taken into account.[351]

A U.S. equity hybrid instrument is an instrument that is treated as equity for U.S. federal income tax purposes but is treated as debt (or otherwise entitles the issuer to a deduction) for foreign income tax purposes.[352] A U.S. equity hybrid instrument is a foreign tax credit splitter arrangement if (i) under the laws of the jurisdiction of the issuer and holder, the instrument gives rise to income and deductions, respectively; (ii) the income inclusion by the holder results in foreign income taxes paid or accrued; and (iii) the events giving rise to the income inclusion and deductions do not result in an income inclusion for U.S. federal income tax purposes.[353]

For purposes of a U.S. equity hybrid instrument that is a foreign tax credit splitter arrangement, the related income is income of the issuer in an amount equal to the amounts giving

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issuer's EG and a Section 902(a) Shareholder of a member of the issuer's qualified group. *See* I.R.C. § 909(e)(2) (providing that "[t]he Secretary may issue such regulations or other guidance as is necessary or appropriate to carry out the purposes of [section 909], including regulations or other guidance which provides for the proper application of [section 909] with respect to *hybrid* instruments." (emphasis added). For a more detailed background of the section 909 foreign tax credit splitter arrangement rules, see Section X.C.2(b) of this Comment Letter.

[349] Preamble at 20929.

[350] I.R.C. § 909(a); Treas. Reg. § 1.909-2(b)(3)(i).

[351] Treas. Reg. § 1.909-2(a)(2).

[352] Treas. Reg. § 1.909-2(b)(3)(i)(D).

[353] Treas. Reg. § 1.909-2(b)(3)(i)(A)(1)-(3).

rise to the foreign income taxes that are deductible by the issuer for foreign tax purposes, determined without regard to the issuer's actual income or earnings.[354]

> Recommendation 115: We recommend that the Final Regulations include an exception to section 909 for debt instruments that are recharacterized thereunder as stock.

We believe section 909 is intended to address situations where taxpayers intentionally enter into splitter arrangements. Because the Proposed Regulations recharacterize debt instruments as stock in certain circumstances, the regulations have the effect of creating a U.S. equity hybrid instrument where, under general U.S. federal income tax principles, none would have existed. It may be argued that this exception would provide a "back door" into precisely the types of arrangements that section 909 is intended to address. The Proposed Regulations, however, include provisions that prevent a taxpayer from affirmatively using the regulations with a principal purpose of reducing its U.S. federal income tax liability and, thus, it appears as though any concerns over such an exception could be easily addressed.[355]

> Recommendation 116: If the Final Regulations do not contain an exception to section 909 for recharacterized debt instruments, we believe that additional guidance under section 909 is warranted given the predictable increase in U.S. equity hybrid instruments.

For example, Treas. Reg. section 1.909-2 currently does not address what happens to the deferred foreign income taxes when the instrument ceases to be a U.S. equity hybrid instrument. Thus, we request additional guidance on what happens to the deferred foreign income taxes when a debt instrument recharacterized as stock under the Proposed Regulations is no longer treated as stock because it leaves the EG (i.e., the debt instrument ceases to be a U.S. equity hybrid instrument).

D. Collateral Consequences Regarding Inbound Investments

1. Impact on Treaty Qualification

The Proposed Regulations' recharacterization of related-party debt instruments also could adversely affect inbound investments by foreign corporations by preventing foreign corporations from obtaining the benefits of a U.S. income tax treaty.

> Example 70: *Debt instrument issued by subsidiary of publicly traded company.* UKP, a publicly traded UK corporation, directly owns all the stock of UKS, a UK corporation, and Finco, a non-UK foreign corporation. UKS owns all the stock of USP, a domestic corporation. Finco loans fund to UKS (the "UKS Loan").

If the UKS Loan is recharacterized as stock under the Proposed Regulations, it could cause UKS to fail the so-called "publicly traded subsidiary test" of the limitation on benefits

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[354] Treas. Reg. § 1.909-2(b)(3)(i)(C).

[355] Prop. Treas. Reg. §§ 1.385-2(d) and -3(e).

("LOB") article of the U.S.-UK Income Tax Treaty[356] (the "UK Treaty"). This test generally provides that a UK corporation is a "qualified resident" for purposes of the UK Treaty and, thus, entitled to all treaty benefits, if at least 50 percent of its vote and value are directly or indirectly owned by five or fewer publicly traded companies that are residents of the United States or the United Kingdom.[357] However, in the case of indirect ownership, each intermediate owner must also be a U.S. or UK resident.[358] Accordingly, if the UKS Loan represented more than 50 percent of UKS's value (i.e., a commercial debt-to-equity ratio of more than one-to-one), UKS would not satisfy the publicly traded subsidiary test and, assuming UKS does not qualify for benefits of the UK Treaty under an alternative test in the UK Treaty's LOB article, dividends paid by USS to UKS would be subject to a 30 percent U.S. withholding tax, not the UK Treaty's zero percent rate that would apply if UKP directly owned all of UKS's stock for U.S. federal income tax purposes.[359] This result could deter foreign investment into the United States even though the instrument in question does not have any U.S. federal income tax effect. Moreover, this result is not unique to the UK Treaty and could occur under several in-force U.S. income tax treaties.[360]

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[356] Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxation On Income And On Capital Gains (July 24, 2001), as amended by the protocol signed July 19, 2002.

[357] UK Treaty, art. 23(2)(c)(ii).

[358] UK Treaty, art. 23(2)(c)(ii).

[359] We note that UKS could qualify for the UK Treaty's zero percent dividend withholding tax rate if UKS (i) owned 80 percent (by vote) of USP prior to October 1, 1998, (ii) satisfies the so-called "derivative benefits test" of the UK Treaty's LOB article, or (iii) receives relief from competent authority under paragraph six of the UK Treaty's LOB article. UK Treaty, art. 10(3)(a)(i)-(iii). Unlike the publicly traded subsidiary test, there is currently no requirement in the derivative benefits test of the UK Treaty that intermediate owners be residents of the *United States or the United Kingdom*. UK Treaty, art. 23(3). Accordingly, UKS could satisfy the UK Treaty's derivative benefits test if less than 50 percent of its gross income is paid or accrued to persons that are not equivalent beneficiaries—this may not be the case given the UKS Loan. Alternatively, UKS could fail to satisfy the derivative benefits test if there was a minority investor in UKP that caused UKS to fail the derivative benefits test's ownership prong.

We also note that while the UK Treaty's derivative benefits test does not require intermediate owners to be residents of the United States or the United Kingdom, the derivative benefits test in the recent U.S. Model Income Tax Convention (the "2016 U.S. Model") would only be satisfied where each intermediate owner was a resident of the United States or the other contracting state (here, the United Kingdom). 2016 U.S. Model, art. 22(4). Since the 2016 U.S. Model represents Treasury's current treaty negotiation position, the Proposed Regulations may have an even larger impact on treaty qualification.

[360] For example, the following treaties require intermediate owners to be a "resident" of the United States or the applicable Contracting State: Convention Between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxation On Income, as amended by the Protocol entered into on September 27, 2001, art. 16(2)(c)(ii) (Aug. 6, 1982); Convention Between Canada and the United States of America With Respect to Taxes on Income and on Capital, as amended by the Protocol and Exchange of Notes entered into on June 14, 1983, and the Protocols of March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007, art. XXIX A(2)(d) (Sept. 26, 1980); Convention Between the Federal Republic of Germany and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, as amended by the Protocol entered into on June 1, 2006, art. 28(2)(c)(bb) (Aug. 29, 1989); Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and

Even more troubling is that the Treasury Technical Explanation of the UK Treaty (the "Technical Explanation")[361] appears to interpret the UK Treaty's publicly traded subsidiary test as requiring that an intermediate owner not only be a resident of the United States or the United Kingdom, but also that it own at least 50 percent of *each class of stock* of the subsidiary corporation being tested.[362] Thus, if the UKS Loan was recharacterized as nonvoting preferred stock, the application of the Technical Explanation's interpretation of the UK Treaty would result in UKS failing to satisfy the publicly traded subsidiary test irrespective of the amount of the UKS Loan.[363] Generally, a technical explanation to a U.S. income tax treaty is merely the Government's unilateral interpretation of the in-question treaty and, thus, not a binding interpretation of the treaty.[364] The Technical Explanation's interpretation of the UK Treaty's publicly traded subsidiary test nonetheless creates significant ambiguity because taxpayers would be unsure as to whether the Government would try to enforce this interpretation on audit.

2. Impact on Section 892 Qualification

Further, the Proposed Regulations' recharacterization of related-party debt instruments could also adversely affect inbound investments by preventing foreign corporations from qualifying as "controlled entities" under Treas. Reg. section 1.892-2T(a)(3) (each, a "Controlled Entity"). In general, section 892 provides that certain income received by a foreign government is exempt from U.S. federal income tax.[365] Under Treas. Reg. section 1.892-2T(a), the term "foreign government" means, among other things, a Controlled Entity of a foreign sovereign. To be a Controlled Entity, the corporation must, among other things, be (i) wholly owned (directly or indirectly through other Controlled Entities) by the foreign sovereign, and (ii) organized under the laws of the foreign sovereign by which it is owned.[366]

Capital, as amended by the Protocols entered into on December 8, 2004, and January 13, 2009, art. 30(2)(c)(ii) (Aug. 31, 1994); Convention Between the Kingdom of the Netherlands and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, as amended by the Protocols of October 13, 1993, and March 8, 2004, art. 26(2)(c)(ii) (Dec. 18, 1992).

[361] Department of the Treasury Technical Explanation of the Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxation On Income And On Capital Gains.

[362] Technical Explanation, art. 23 (stating that the publicly traded subsidiary test requires that 50 percent of each class of the company's shares, not merely the class or classes accounting for more than 50 percent of the company's votes and value, must be held by publicly-traded companies that are residents of the United States or the United Kingdom. Thus, the publicly traded subsidiary test considers the ownership of every class of shares outstanding, while the so-called "publicly traded corporation test" only considers those classes that account for a majority of the company's voting power and value).

[363] Technical Explanation, art. 23; *but see* note 362.

[364] *See Snap-On Tools v. United States*, 26 Cl. Ct. 1045 (1992), *aff'd*, 26 F.3d 137 (Fed. Cir. 1994) (refusing to rely on Treasury's technical explanation to a former version of a U.S.-UK income tax treaty); *Xerox Corp. v. United States*, 41 F.3d 647 (Fed. Cir. 1995), *rev'g*, 14 Cl. Ct. 455 (1988) (same).

[365] I.R.C. § 892(a).

[366] Treas. Reg. § 1.892-2T(a)(3).

To illustrate the potential for the Proposed Regulations to prevent a foreign corporation from qualifying as a Controlled Entity, consider the following example:

> Example 71: *Debt instrument issued by Controlled Entity.* The government of Country X ("XGov") owns all the stock of FSub1, a foreign corporation organized under the laws of Country X (i.e., FSub1 is a Controlled Entity), and FSub2, a foreign corporation organized under the laws of Country Y (i.e., FSub2 is not a Controlled Entity). FSub 1 owns all of the stock of FSub 3, a foreign country organized under the laws of Country X. FSub 3 holds U.S. portfolio investments. If FSub 2 lends money to FSub 3 in exchange for a note and that note is recharacterized as stock under the Proposed Regulations, FSub 3 would no longer be indirectly wholly owned by XGov through other Controlled Entities and, thus, FSub 3 would no longer qualify as a Controlled Entity. As a result, FSub 3 would be subject to U.S. federal income tax on its U.S. portfolio investments as the income from the portfolio investments would no longer qualify for the section 892 exemption.

3. Conclusion

The Proposed Regulations, as noted above, are generally intended to recharacterize related-party debt instruments as stock to address U.S. base-erosion and repatriation concerns—neither of which is implicated in the above-discussed scenarios. Accordingly, we believe that the Proposed Regulations should not be applied to deter foreign investment in the United States in instances that do not undermine the regulations' stated policy objectives.

> Recommendation 117: We recommend that related-party debt instruments recharacterized as stock under the Proposed Regulations not be treated as "stock" for purposes of determining whether (i) a foreign corporation satisfies a test in the LOB article of an in-force income tax treaty, or (ii) a foreign corporation is a Controlled Entity.

E. Section 246(c)(4) and Rev. Rul. 94-28[367]

When a debt instrument is recharacterized as stock under the Proposed Regulations, payments on the instrument are generally recharacterized as distributions with respect to stock. This recharacterization effectively denies the interest expense deduction that the issuer would otherwise be able to claim (subject to section 163(j) and other interest deduction disallowance and limitation rules). This effective denial of interest expense deductions is precisely one of the goals of the Proposed Regulations.

However, recharacterizing a debt instrument as stock has collateral consequences that give rise to double-taxation. One such example is the effective denial of dividends-received deductions.

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[367] 1994-1 C.B. 86.

Under section 243, a corporation is generally entitled to a deduction with respect to dividends it receives from other domestic corporations that are not members of its consolidated group.[368] Additionally, under section 245, a corporation is generally entitled to a deduction with respect to certain portions of dividends it receives from certain foreign corporations.[369]

Section 246 specifies special rules and limitations on the dividends-received deduction of sections 243 and 245. For example, under section 246(c), a taxpayer must, among other things, own the stock for which a dividends-received deduction is claimed for a minimum period to be eligible to claim a dividends-received deduction. In the case of common stock, the minimum holding period is 45 days during the 91-day period beginning on the date that is 45 days before the date on which the stock becomes ex-dividend with respect to the dividend for which a dividends-received deduction is claimed.[370] In the case of preferred stock, the minimum holding period is 90 days during the 181-day period beginning on the date that is 90 days before the date on which such stock becomes ex-dividend with respect to the dividend for which a dividends-received deduction is claimed.[371]

For purposes of applying the minimum holding period rules, section 246(c)(4) provides that the holding period is "appropriately reduced" for any period in which the taxpayer's risk of loss with respect to the stock is diminished. A taxpayer has a diminished risk of loss with respect to the stock it owns if, among other things, the taxpayer has an option to sell, is under a contractual obligation to sell, or has made a short sale of, substantially identical stock.[372]

In Rev. Rul. 98-24,[373] the IRS evaluated whether section 246(c)(4) applied to an instrument that afforded the holder creditor rights and was not stock for corporate law purposes but was treated as stock for federal income tax purposes. The revenue ruling concluded that the holder's right to the principal at maturity is an option to sell, or a contractual obligation to sell, the instruments under section 246(c)(4)(A). As a result, the revenue ruling concluded that section 246(c)(4) applied to reduce the holding period on the instrument, thus preventing the holder from claiming a dividends-received deduction for payments on the instrument.

Furthermore, section 901(k) applies standards similar to those of section 246(c)(4) in setting a minimum holding period requirement for purposes of being entitled to claim a foreign tax credit with respect to withholding taxes on dividends under sections 901 and 902.

For a debt instrument to be subject to the Proposed Regulations, the instrument first must be respected as debt after the application of federal tax principles and, if in the case of debt recharacterized under Prop. Treas. Reg. section 1.385-3, satisfy the Documentation Requirements. Under federal tax principles, one of the significant factors to consider when

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[368] I.R.C. § 243(a), (c).

[369] I.R.C. § 245(a).

[370] I.R.C. § 246(c)(1)(A).

[371] I.R.C. § 246(c)(2).

[372] I.R.C. § 246(c)(4)(A).

[373] 1994-1 C.B. 86.

classifying an instrument as debt or stock is the presence or absence of creditor rights.[374] Similarly, as discussed above, one of the requirements of Prop. Treas. Reg. section 1.385-2 is that there be written documentation establishing that the holder has creditor rights. Further, under Prop. Treas. Reg. section 1.385-1(d), to the extent that there is an unrecharacterized portion of the debt instrument, such instrument is also likely to have creditor rights. Thus, as a result of the Proposed Regulations, many of these recharacterized instruments will have creditor rights and, based on Rev. Rul. 98-24, would be subject to section 246(c)(4). As a result, payments on a recharacterized instrument under the Proposed Regulations, although treated as dividends for all purposes of the Code, are almost per se ineligible for the dividends-received deduction of sections 243 or 245, particularly with respect to instruments recharacterized under Prop. Treas. Reg. section 1.385-3.[375] Although a debt instrument that is recharacterized as stock under the Proposed Regulations may not be subject to section 246(c)(4) is where (i) the instrument is respected as debt under federal tax principles and, if applicable, Prop. Treas. Reg. section 1.385-1 and -2, and (ii) the instrument does not contain creditor rights, this instance is likely to be rare for instruments that are recharacterized under the Proposed Regulations.

The Proposed Regulations are not intended to address whether an instrument is truly debt or stock for federal tax purposes. In fact, the Proposed Regulations, in general, only apply if a debt instrument is respected as debt under federal tax principles. In contrast, Rev. Rul. 94-28 described an instrument that, under federal tax principles, is properly treated as stock. As a result, we believe it is inappropriate to extend the holding of Rev. Rul. 94-28 to debt instruments that are recharacterized as stock under Prop. Treas. Reg. section 1.385-3.

> Recommendation 118: We recommend that the Final Regulations state that the creditor rights associated with a recharacterized debt instrument are not taken into account for purposes of applying sections 246(c)(4) and 901(k).

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[374] *See, e.g., Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972) (identifying the right to enforce the payment of principal and interest as a factor to consider in classifying an instrument as debt or equity); *Gokey Props., Inc.*, 34 T.C. 829, 835 (1960), aff'd, 290 F.2d 870 (2d Cir. 1961) ("The right to enforce the payment of interest is one of the requisites of a genuine indebtedness."); Notice 94-47, 1994-1 C.B. 357 (identifying whether the holders of the instruments possess the right to enforce the payment of principal and interest as a factor to consider in classifying an instrument as debt or equity); *see also* Preamble at 20916 (stating that the Documentation Requirements are intended to evidence "four essential characteristics of indebtedness" and that these characteristics are drawn from case law).

[375] We note that where a note is distributed by a corporation to its common stock holders, under section 1223, the holding period of the preferred stock includes the period for which the common stock had been held (assuming that the holder's risk of loss on the common stock was long enough and was not reduced). In this regard, section 246(c)(3)(B) indicates that the provisions of section 1223 other than paragraph (3) thereof apply for purposes of determining the holding period of stock. Section 1223(4) addresses the holding period of stock received without the recognition of income under section 307. While the text of the Proposed Regulations does not state that section 305(a) applies to a note issued by a corporation to a shareholder, the Preamble and Examples 1 and 13 of Prop. Treas. Reg. section 1.385-3(g)(3) state that such a corporation is treated as distributing its stock to its shareholder in a distribution that is subject to section 305. It follows that under section 1223(4) the holding period for the note would include the period for which the common stock has been held. Thus, it appears likely that the period for which the taxpayer had held the common stock before the distribution may permit the taxpayer to satisfy section 246. However, the Proposed Regulations can recharacterize debt instruments received in a wide range of contexts other than as a distribution with respect to common stock, and in many of those cases it will not be possible to satisfy the holding period requirement of section 246(c).

F. Collateral Consequences Regarding Qualification for Nonrecognition Treatment

The Proposed Regulations' recharacterization of related-party debt instruments as stock could turn a transaction that otherwise qualifies for nonrecognition treatment under the Code into a transaction that does not qualify for nonrecognition treatment. For example, to qualify for nonrecognition treatment under section 351, the transferor group must control (within the meaning of section 368(c)) the transferee corporation immediately after the transfer.[376] Section 368(c) defines control as the ownership of stock representing at least 80 percent of total combined voting power of all classes of stock entitled to vote, and at least 80 percent of the total number of shares of all other classes of stock. For these purposes, Rev. Rul. 59-259 concluded that "at least 80 percent of the total number of shares of all other classes of stock" means at least 80 percent of the total number of shares of each class of nonvoting stock.[377]

It is likely that a debt instrument that is recharacterized under the Proposed Regulations would be treated as a separate class of nonvoting stock. As a result, the Proposed Regulations may frequently impact the ability to satisfy the definition of control under section 368(c), thus impacting the ability of a transaction to qualify for nonrecognition treatment.

> Example 72: P, a domestic corporation, owns all of the sole class of stock of FS1, a foreign corporation. P also owns all of the stock of FS2, a second foreign corporation. In Year 1, FS1 borrows money from FS2 in exchange for an FS1 note, a debt instrument with no voting rights. In Year 2, FS1 distributes cash to P which causes a portion of the FS1 note held by FS2 to be recharacterized as FS1 stock. In Year 3, P transfers property to FS1 in a transaction that would qualify under section 351 but for the application of the Funding Rule of the Proposed Regulations. Assume that the transfer of property by P to FS1 also qualifies for the exception from section 367 under section 367(a)(3). Because a portion of the note held by FS2 is recharacterized as a class of FS1 nonvoting stock, P's transfer to FS1 in Year 3 cannot qualify under section 351 because P does not control FS1 (within the meaning of section 368(c)).

The adverse consequences that result from the failure of P's transfer to qualify under section 351 are further exacerbated by the fact that it could be years before it is determined that FS1 had a separate class of nonvoting stock outstanding at the time of the Year 3 transfer. Specifically, FS1 may believe that it has sufficient Current E&P in Year 2 to make the cash distribution without causing the FS1 note held by FS2 to be recharacterized as FS1 stock, only to have its E&P for Year 2 adjusted as a result of an audit in a later year.

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[376] *See also* I.R.C. § 368(a)(1)(B) (requiring, among other requirements, the acquiring corporation to acquire target stock representing section 368(c) control); I.R.C. § 368(a)(1)(D) (requiring, among other requirements, that the transferor corporation, one or more of its shareholders, or any combination thereof, is in control (within the meaning of section 368(c) in a reorganization to which section 355 applies, and within the meaning of section 304(c) in a reorganization to which section 354 applies); I.R.C. § 368(a)(2)(E) (requiring the former shareholders of the target corporation to have received voting stock of the controlling corporation in exchange for an amount of stock constituting section 368(c) control of the target corporation).

[377] 1959-2 C.B. 115.

Recommendation 119: We recommend that related-party debt instruments treated as stock under the Proposed Regulations not be taken into account for purposes of determining control under section 368(c).

G. Interaction of Proposed Regulations and Fast-Pay Regulations

The Proposed Regulations' recharacterization of related-party debt instruments as stock could result in such instruments being subject to Treas. Reg. section 1.7701(l)-3 (the "Fast-Pay Regulations"). The Fast-Pay Regulations can recharacterize certain multi-party stock investments for U.S. federal income tax purposes if the investments are part of a "fast-pay arrangement." A "fast-pay arrangement" is any arrangement in which a corporation has "fast-pay stock" outstanding for any part of its taxable year.[378] Stock is "fast-pay stock" if it is "*structured* so that dividends (as defined in section 316) paid by the corporation with respect to the stock are economically (in whole or in part) a return *of* the holder's investment (as opposed to only a return *on* the holder's investment)."[379] In determining whether stock is "fast-pay stock," redemptions that are treated as distributions to which section 301 applies (by reason of section 302(d)) are generally not taken into account unless there is a principal purpose of achieving the same economic and tax effect as a fast-pay arrangement.[380] With respect to any fast-pay stock, all other stock in the issuing corporation, including significantly different fast-pay stock, is considered "benefitted stock."[381]

A fast-pay arrangement is subject to recharacterization if (i) the issuer of the fast-pay stock is a RIC or a REIT, or (ii) the Commissioner determines that a principal purpose for the

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[378] Treas. Reg. § 1.7701(*l*)-3(b)(1).

[379] Treas. Reg. § 1.7701(*l*)-3(b)(2)(i) (emphasis added). "Unless clearly demonstrated otherwise, stock is presumed to be fast-pay stock if - (A) It is structured to have a dividend rate that is reasonably expected to decline (as opposed to a dividend rate that is reasonably expected to fluctuate or remain constant); or (B) It is issued for an amount that exceeds (by more than a *de minimis* amount, as determined under the principles of [Treas. Reg. section] 1.1273-1(d)) the amount at which the holder can be compelled to dispose of the stock." Treas. Reg. § 1.7701(*l*)-3(b)(2)(i). "The determination of whether stock is fast-pay stock is based on all the facts and circumstances, including any related agreements such as options or forward contracts." Treas. Reg. § 1.7701(*l*)-3(b)(2)(ii). The term "related agreements" is defined for these purposes to "include[ ] any direct or indirect agreement or understanding, oral or written, between the holder of the stock and the issuing corporation, or between the holder of the stock and one or more other shareholders in the corporation." Treas. Reg. § 1.7701(*l*)-3(b)(2)(ii).

[380] Treas. Reg. § 1.7701(*l*)-3(b)(2)(ii). This provision was added to the Fast-Pay Regulations in response to comments on the prior proposed Fast-Pay Regulations, which asserted that the blanket application of the prior proposed Fast-Pay Regulations to all section 302(d) redemptions was inappropriate. T.D. 8853, 65 Fed. Reg. 1310 (Jan. 10, 2000), corrected by 65 Fed. Reg. 1636 (Mar. 28, 2000). The preamble to the Fast-Pay Regulations agreed that such application was inappropriate, but recognized "that eliminating all such arrangements from the scope of the regulations would render the regulations meaningless." *Id.* The preamble to the Fast-Pay Regulations, to this end, noted that "[l]ittle difference exist[ed] between a fast-pay arrangement resulting from redemptions structured to be dividends and a fast-pay arrangement resulting from dividends structured to be a return of the holder's investment." *Id.* The Fast-Pay Regulations also include an example that applies the regulations to section 302(d) redemptions of common stock where (i) the redeeming corporation's shareholders (one of which is tax-exempt) agree from the outset that the annual redemptions of the tax-exempt shareholder will occur at a fixed price for ten years and (ii) the redemptions are expected to be dividends under sections 301 and 302. Treas. Reg. § 1.7701(*l*)-3(e), Ex. 3.

[381] Treas. Reg. § 1.7701(*l*)-3(b)(3).

fast-pay arrangement is the avoidance of any tax imposed by the Code.[382] The Commissioner's determination that a principal purpose of a fast-pay arrangement is the avoidance of U.S. tax applies to all parties to the fast-pay arrangement.[383]

A fast-pay arrangement typically has three parties: (i) the corporation that issues the fast-pay stock and the benefitted stock (the "Conduit"); (ii) the investor that invests in the Conduit's fast-pay stock (the "Investor"), which typically is not subject to U.S. federal income tax on earnings from its investment in the Conduit; and (iii) the benefitted shareholder that invests in the Conduit's benefitted stock (the "Sponsor"), which is typically subject to U.S. federal income tax on the return from its investment in the Conduit. The Fast-Pay Regulations, if applicable, recharacterize the relationships between the parties to a fast-pay arrangement as follows:[384]

(i) The Sponsor is deemed to issue a financial instrument (the "Instrument") to the Investor in *exchange for cash*. The Instrument is deemed to have the same terms as the fast-pay stock—i.e., the Instrument is not per se debt.[385]

(ii) The Sponsor is deemed to contribute the cash deemed received from the issuance of the Instrument to the Conduit.

(iii) The Conduit's distributions with respect to the fast-pay stock are deemed to be made with respect to the benefitted stock.

(iv) The Sponsor is deemed to use the deemed distributions received with respect to the benefitted stock to repay the Instrument (the "Repayment").

(v) The relationship between the Conduit and the Investor is ignored, and the Conduit is merely viewed as the Sponsor's paying agent with respect to the Instrument.

This recharacterization generally results in the following U.S. federal income tax consequences: (i) the Conduit's deemed distributions with respect to the benefitted stock are treated as dividends to the Sponsor to the extent of the Conduit's current or accumulated E&P and (ii) the Repayment is treated as either interest or a property distribution and, thus, potentially a dividend, depending upon whether the Instrument is treated as debt or equity for U.S. federal income tax purposes. As such, the Sponsor (i) is subject to U.S. federal income tax on its return on investment in the Conduit, and (ii) depending on the Instrument's U.S. federal income tax characterization, may be entitled to a deduction for the Repayment.

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[382] Treas. Reg. § 1.7701(*l*)-3(c)(1).

[383] Treas. Reg. § 1.7701(*l*)-3(c)(1).

[384] Treas. Reg. § 1.7701(*l*)-3(c)(2).

[385] The preamble to the Fast-Pay Regulations stated the following in response to three comments to the prior proposed Fast-Pay Regulations "After careful consideration of the comments, the IRS and Treasury Department have decided against characterizing the financing instruments in the final regulations. Although debt characterization may be appropriate in some cases, in other cases *it will be more appropriate to characterize the financing instruments as equity or something else*. Thus, the rule in the proposed regulations is retained." 65 Fed. Reg. 1311 (emphasis added).

A transaction that is the same as, or substantially similar to, a transaction involving a fast-pay arrangement is a "listed transaction."[386] Accordingly, taxpayers and material advisors may need to disclose a fast-pay arrangement or any transaction that is substantially similar to a fast-pay arrangement.[387]

We believe it is inappropriate to apply the Fast-Pay Regulations to related-party debt instruments recharacterized as stock under the Proposed Regulations. As a threshold matter, a related-party debt instrument subject to recharacterization as stock under the Proposed Regulations is not "structured" so that dividends paid by the Conduit with respect to the fast-pay stock (i.e., the recharacterized instrument) are economically a return of the ostensible Investor's investment (as opposed to solely a return on the Investor's investment). Indeed, the recharacterized instrument is *structured* as a debt instrument and, thus, any payments with respect to the instrument are *structured* to be repayments of principal and interest. Consequently, the Proposed Regulations' recharacterization is the only reason that the payments with respect to the related-party debt instrument are characterized as dividends under the Fast-Pay Regulations. Accordingly, the application of the Fast-Pay Regulations to a related-party debt instrument recharacterized as stock under the Proposed Regulations relies on a Government-mandated recharacterization regime (i.e., the Proposed Regulations) to apply another recharacterization regime (i.e., the Fast-Pay Regulations)—a result we believe is inappropriate because the application of the Fast-Pay Regulations is clearly predicated on *taxpayers* affirmatively "structuring" transactions as fast-pay stock.

Second, the Fast-Pay Regulations are intended to address concerns raised by conduit financing arrangements where the Conduit issues *equity interests* that are in whole or in part economically self-amortizing.[388] The related-party debt instruments subject to recharacterization as stock under the Proposed Regulations, in contrast, are in-form *debt instruments* and, thus, by definition, are in whole or in part self-amortizing.[389] We believe it is inappropriate to recharacterize a related-party debt instrument as stock and then use the terms of the instrument to further recharacterize the stock as fast-pay stock, because the parties, in structuring the instrument as debt, fully intended the instrument to be treated as debt for commercial purposes and, thus, had no choice as an economic matter to make the instrument self-amortizing in whole or in part.

Third, unless fast-pay stock is issued by a RIC or REIT, the Commissioner can only recharacterize a fast-pay arrangement if "*a principal purpose* for the structure of the fast-pay arrangement is the avoidance of any tax imposed by the [Code]."[390] As detailed above, related-party debt instruments can only be treated as fast-pay stock after first being recharacterized as

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[386] Notice 2009-59, 2009-2 C.B. 170.

[387] Treas. Reg. §§ 1.6011-4 and 301.6111-3.

[388] Notice 97-21, 1997-1 C.B. 407.

[389] We note that a debt instrument with a bullet payment may not be considered "self-amortizing" because the issuer is only required to pay interest over the term of the instrument, with the entire principal balance due upon maturity. Although it is not entirely clear, it is conceivable that a debt instrument with a bullet payment is within the scope of the Fast-Pay Regulations.

[390] Treas. Reg. § 1.7701(*l*)-3(c)(1)(ii) (emphasis added).

stock under the Proposed Regulations.[391] Thus, the Proposed Regulations, not the taxpayers' purpose, create the potential for tax avoidance. We believe it is improper to impute an improper principal purpose of tax avoidance to taxpayers where the potential for tax avoidance is created by a Government-mandated recharacterization.

Fourth, the application of the Fast-Pay Regulations to related-party debt instruments recharacterized as stock under the Proposed Regulations creates unnecessary complexity and significant ambiguity.

> Example 73: *Application of the Fast-Pay Regulations to recharacterized debt instrument.* FP directly owns all the stock of USP, a domestic corporation, and FDE, a foreign DRE. USP directly owns all the stock of CFC1, a CFC. If FP sells FDE to CFC1 in exchange for a note (the "CFC1 Note"), the CFC1 Note will not be recharacterized as stock under the General Rule, but will instead be subject to the Funding Rule. Thus, if CFC1 subsequently distributed property with respect to its stock in the Per Se Period in a year that it did not have Current E&P, the CFC1 Note would be recharacterized as stock under the Funding Rule. If the CFC1 Note is also subject to the Fast-Pay Regulations, presumably, the FDE sale will be further recharacterized as if: (i) FP transferred cash equal to the fair market value of FDE to USP in exchange for an Instrument, (ii) USP transferred the cash received from FP to CFC1, and (iii) CFC1's payments on the CFC1 Note would be treated as up-the-chain payments from CFC1 to USP with respect to the benefitted stock (i.e., CFC1's common stock) and from USP to FP with respect to the Instrument.

As a threshold matter, this recharacterization does not completely explain the substance of the FDE sale because it ends with CFC1 owning cash, not FDE. Thus, a further step is necessary to fully explain the substance of the FDE sale: CFC1 must be deemed to use the cash contributed to CFC1 by USP to purchase FDE from FP. This further step may resolve the Fast-Pay Regulations' inability to accurately explain the substance of the FDE sale, but there does not appear to be any authority for this further step as it is not contemplated by the Fast-Pay Regulations.

Although not entirely clear, one potential application of the Fast-Pay Regulations would be for the rules to apply to the FDE sale in the following manner: (i) assuming the terms of the CFC1 Note supported treating the note as debt for general U.S. federal income tax purposes,[392]

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[391] Presumably, this potential for tax avoidance could exist because the recharacterized related-party debt instrument's putative interest payments are treated as property distributions and putative principal payments are treated as stock redemptions—i.e., dividends paid with respect to the recharacterized instrument represent a return of the holder's investment, rather than a return on the holder's investment.

[392] We note that it is unclear how the Documentation Requirements would apply, if at all, to USP's Instrument. Presumably, these requirements would not apply to the Instrument because the Instrument is not actually issued by USP. These requirements have no practical application to the USP Instrument because (i) USP does not have an unconditional binding legal obligation to pay a sum certain to FP; (ii) FP does not have creditor rights with respect to USP as a result of the Instrument; (iii) USP's financial wherewithal to repay the Instrument is irrelevant; and (iv) in the event that CFC1 does not repay the CFC1 Note (i.e., USP is not considered to repay the Instrument), FP cannot assert creditor rights with respect to USP (e.g., renegotiate the Instrument to mitigate the breach). Accordingly, if the Fast-Pay Regulations were to apply to related-party debt instruments recharacterized as stock

USP's Instrument would not be recharacterized as stock under the General Rule because it is deemed issued for cash, (ii) the Subsidiary Stock Issuance Exception would apply to prevent USP's deemed contribution of cash to CFC1 from triggering the Funding Rule with respect to USP's Instrument,[393] (iii) the payments from CFC1 to USP would be treated as a property distribution with respect to the benefitted stock, and (iv) the payments from USP to FP would be treated as interest and principal payments with respect to the Instrument unless the Funding Rule applied to recharacterize the Instrument as stock. Thus, the combined application of the Proposed Regulations and the Fast-Pay Regulations to the CFC1 Note would eliminate a related-party debt instrument between CFC1 and FP and create a related-party debt instrument between USP and FP—i.e., the regulations merely move the related debt instrument from the actual issuer to the shareholders of the issuer. This result highlights the different policy objectives of the Proposed Regulations and the Fast-Pay Regulations: the former are intended to treat certain related-party debt instruments are stock, whereas the latter are intended to treat certain stock interests as a debt instrument (albeit of another person).

Finally, if the Fast-Pay Regulations are applied to related-party debt instruments recharacterized as stock under the Proposed Regulations, such instruments would be considered "listed transactions." "Listed transactions" are generally transactions that the Government has determined to be tax avoidance transactions and identified by notice, regulation, or other form of published guidance.[394] As noted above, a related-party debt instrument recharacterized as stock under the Proposed Regulations should not be considered a "tax avoidance transaction" in a manner similar to a fast-pay arrangement, because the question of "tax avoidance" (i.e., repayments of the instrument are characterized as dividends attributable to the issuer's E&P) results solely from the Government-mandated fiction in the Proposed Regulations. Accordingly, and similar to the above comment, we believe it is inappropriate to consider the Proposed Regulations' mandatory recharacterization as creating a tax avoidance motive for the parties to the related-party debt instrument

For the above-discussed reasons, we believe is inappropriate to apply the Fast-Pay Regulations to related-party debt instruments recharacterized as stock under the Proposed Regulations.

> Recommendation 120: We recommend that the Final Regulations include a provision that related-party debt instruments recharacterized as stock thereunder are not subject to further recharacterization under the Fast-Pay Regulations.
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> Recommendation 121: We recommend that the Final Regulations include a provision that expressly provides that a related-party debt instrument recharacterized thereunder as stock is not a "listed transaction" for purposes of Notice 2009-59 because the recharacterized stock is not the same or substantially similar to a "fast-pay arrangement."

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under the Proposed Regulations, it should be made clear that Prop. Treas. Reg. section 1.385-2 should be applied with respect to the CFC1 Note, not the Instrument.

[393] We note, however, that this may not always be the case (e.g., the ostensible Sponsor did not have the requisite section 958(a) or (b) ownership of the ostensible Conduit).

[394] Treas. Reg. § 1.6011-4(b)(2).

The Proposed Regulations, as noted above, include provisions that prevent a taxpayer from affirmatively using the regulations with a principal purpose of reducing its U.S. federal income tax liability and, thus, it appears as though any concerns over such an exception could be easily addressed.[395]

[395] Prop. Treas. Reg. §§ 1.385-2(d) and -3(e).