



Section of Taxation

4th Floor
1050 Connecticut Ave., N.W.
Washington, DC 20005-1022
202-662-8670
FAX: 202-662-8682
E-mail: tax@americanbar.org

July 13, 2016

OFFICERS

Chair

George C. Howell, III
Richmond, VA

Chair-Elect

William H. Caudill
Houston, TX

Vice Chairs

Administration

Charles P. Rettig
Beverly Hills, CA

Committee Operations

Thomas J. Callahan
Cleveland, OH

Continuing Legal Education

Joan C. Arnold
Philadelphia, PA

Government Relations

Peter H. Blessing
New York, NY

Pro Bono and Outreach

C. Wells Hall, III
Charlotte, NC

Publications

Julie A. Divola
San Francisco, CA

Secretary

Catherine B. Engell
New York, NY

Assistant Secretary

Katherine E. David
San Antonio, TX

COUNCIL

Section Delegates to the

House of Delegates

Richard M. Lipton
Chicago, IL

Armando Gomez
Washington, DC

Last Retiring Chair

Armando Gomez
Washington, DC

Members

Megan L. Brackney
New York, NY

Lucy W. Farr
New York, NY

Mary A. McNulty
Dallas, TX

John O. Tannenbaum
Hartford, CT

Stewart M. Weintraub
West Conshohocken, PA

Alan I. Appel
New York, NY

Larry A. Campagna
Houston, TX

T. Keith Fogg
Villanova, PA

Kurt L.P. Lawson
Washington, DC

Cary D. Pugh
Washington, DC

John F. Bergner
Dallas, TX

Thomas D. Greenaway
Boston, MA

Robert F. Mann
Eugene, OR

Carol P. Tello
Washington, DC

Gary B. Wilcox
Washington, DC

LIAISONS

Board of Governors

Pamela A. Bresnahan
Washington, DC

Young Lawyers Division

Travis A. Greaves
Washington, DC

Law Student Division

Melissa M. Gilchrist
Hamtramck, MI

DIRECTOR

Janet J. In
Washington, DC

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

The Honorable Mark Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on Proposed Regulations under Section 385

Dear Messrs. Koskinen, Wilkins, and Mazur:

Enclosed please find comments on proposed guidance under section 382 regarding treatment of certain interests in corporations as stock or indebtedness ("Comments"). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,

George C. Howell, III
Chair, Section of Taxation

Enclosure

cc: William M. Paul, Deputy Chief Counsel (Technical), Internal Revenue Service
Marjorie A. Rollinson, Associate Chief Counsel (International), Internal Revenue Service
Anne O. Devereaux, Deputy Associate Chief Counsel (International), Internal Revenue Service

Mark E. Erwin, Branch Chief (International Branch 5), Internal Revenue Service
John J. Merrick, Senior Counsel, Office of Associate Chief Counsel (International), Internal Revenue Service
Raymond J. Stahl, Assistant to the Branch Chief (International Branch 5), Internal Revenue Service
D. Peter Merkel, Senior Technical Reviewer (International Branch 5), Internal Revenue Service
Karen Walny, Attorney-Advisor (International Branch 5), Internal Revenue Service
Barbara E. Rasch, Senior Technical Reviewer (International Branch 2), Internal Revenue Service
Rose E. Jenkins, Attorney-Advisor (International Branch 2), Internal Revenue Service
Robert H. Wellen, Associate Chief Counsel (Corporate), Internal Revenue Service
Alison G. Burns, Deputy Associate Chief Counsel (Corporate), Internal Revenue Service
Emily S. McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
Robert B. Stack, Deputy Assistant Secretary (International Tax Affairs), Department of the Treasury
Danielle E. Rolfes, International Tax Counsel, Department of the Treasury
Douglas L. Poms, Deputy International Tax Counsel, Department of the Treasury
Brenda L. Zent, Special Advisor, Office of International Tax Counsel, Department of the Treasury
Kevin C. Nichols, Senior Counsel, Office of International Tax Counsel, Department of the Treasury
Thomas C. West, Tax Legislative Counsel, Department of the Treasury
Krishna P. Vallabhaneni, Deputy Tax Legislative Counsel, Department of the Treasury
Ossie Borosh, Senior Counsel, Office of Tax Legislative Counsel, Department of the Treasury
Brett York, Attorney-Advisor, Office of Tax Legislative Counsel, Department of the Treasury

**AMERICAN BAR ASSOCIATION
SECTION OF TAXATION**

**Comments on Proposed Guidance under Section 385 Regarding
Treatment of Certain Interests in Corporations as Stock or
Indebtedness**

The following comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by William Alexander of the Corporate Tax Committee of the Section of Taxation (the “Committee”). Substantive contributions were made by Jennifer Alexander, Alan Appel, Jason Bazar, Didi Borden, Jasper Cummings, Julie Divola, Eric Elfman, Robert Gordon, Chip Harter, Michael Hirschfeld, Philip Hirschfeld, Sam Kaywood, Summer Ayers Lepree, Scott M. Levine, Eric Miller, Thomas J. Nichols, William Pauls, Anthony Picchione, M. Kristan Rizzolo, Jeff Romero, Jeffrey L. Rubinger, Christopher Schoen, Michael B. Shulman, Robert C. Stevenson, John K. Sweet, Drew Tidwell, Matthew White, and Philip Wright. The Comments were further reviewed by R. David Wheat as Council Director for the Committee, and by Peter Blessing, the Vice Chair (Government Relations) of the Section.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact: William Alexander
william.alexander@skadden.com
(202) 371-7230

Date: July 13, 2016

EXECUTIVE SUMMARY

On April 4, 2016, the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”, and collectively with Treasury, the “Government”) issued proposed regulations under section 385¹ that, if finalized in their current form, would make sweeping changes to the characterization of instruments issued by a corporation that were traditionally treated as indebtedness for U.S. federal income tax purposes (the “Proposed Regulations”). The Proposed Regulations represent a stark departure from a century of federal income tax law on the treatment of such instruments, and, as a result, we are concerned with the abbreviated comment period being afforded with respect to such sweeping changes. As discussed herein, the Proposed Regulations pose numerous problems and merit careful reconsideration. Many of our recommendations are made in the alternative in the event that another recommendation is not accepted, and we hope that it is generally obvious when that is the case. Capitalized terms used but not defined in this Executive Summary are defined elsewhere in these Comments.

The recommendations discussed in our Comments include:

Bifurcation Rule

1. If the bifurcation rule under Proposed Regulation section 1.385-1(d) (the “Bifurcation Rule”) is retained, consider establishing a threshold amount. Alternatively, reconsider whether the Bifurcation Rule serves a significant tax policy objective.
2. If retained, the Bifurcation Rule should clearly articulate the conditions for its application and state its rule in a manner that would allow taxpayers a basis to

¹ Unless otherwise indicated, references to “section” are, as the numbering indicates, to a section of the Internal Revenue Code of 1986, as amended (the “Code”), the Treasury Regulations thereunder, or the Proposed Regulations.

reasonably assess their potential tax exposure and provide guidelines for its assertion by revenue agents..

3. Revise the Bifurcation Rule to limit the Service's ability to bifurcate an instrument to cases in which the borrower has insufficient equity capital to support the issuance of the entire debt and possibly other specific criteria.
4. Clarify that the Bifurcation Rule is not to be applied to a debt instrument deemed reissued under Regulation section 1.1001-3 to a greater extent than the Bifurcation Rule could have applied to the original instrument, provided that the modifications to the instrument are consistent with the terms that an unrelated creditor might have agreed to if it were the lender.
5. Provide that, to the extent any instrument issued by a QSub or QRS is bifurcated, the equity component is to be treated as a stock interest in the owning corporation.
6. Consider whether the equity portion of any instrument issued by a disregarded entity (other than a QSub or QRS) or a controlled partnership that is bifurcated should be treated as a partnership interest or as stock of the corporate owner or partner.
7. Modify the Bifurcation Rule to apply only to debt instruments between members of an expanded group and eliminate the modified expanded group concept. To the extent that the modified expanded group concept is retained, it should be clarified that instruments issued by non-corporate entities, other than disregarded entities and partnerships controlled by corporations, are never bifurcated.
8. Clarify how payments on a bifurcated instrument are to be allocated between the two resulting instruments.

Documentation Rule

9. Provide that failure to comply with the documentation requirements of Proposed Regulation section 1.385-2 (the "Documentation Rule") does not automatically change the characterization of an instrument, but rather creates a presumption that can be rebutted with strong evidence.

10. Modify the Documentation Rule to focus on satisfying evidentiary standards, rather than substantive legal standards for debt/equity testing.
11. Provide for testing of expectation of payment for revolvers and lines of credit at the time they are put in place, provided they are in writing and commercially reasonable.
12. Clarify that, if the expanded group instrument (“EGI”) permits interest to be paid in kind or otherwise added to the outstanding loan balance without a cash payment, the documentation requirement will be fulfilled by journal entries that show the amount of the accrued interest being added to the outstanding loan balance.
13. Provide that, in the case of an EGI that is significantly modified, the modified debt should be respected as debt so long as the terms are consistent with the terms that an unrelated lender would agree to if it were the creditor.
14. Clarify that the Documentation Rule is satisfied so long as the taxpayer creates and maintains documentation, before the applicable deadline that on its face satisfies the relevant criteria. Once a taxpayer has demonstrated documentation that satisfies the Documentation Rule on its face, then the Service should make the debt/equity determination on the merits.
15. Provide ordinary course exceptions and a de minimis threshold to the Documentation Rule.
16. Provide that nonrecourse debt and contingent payment instruments will not automatically fail the unconditional obligation to pay a sum certain requirement.
17. Provide that the compliance deadlines for documenting any debt or arrangement start with the filing date of the first relevant federal income tax return and thereafter be set at the filing date of any further relevant federal income tax return.
18. Provide a relief standard for failed documentation that can be satisfied on a self-reporting basis and that takes into account the documentation failures that are likely to occur in practice.

19. Provide that, to the extent any instrument issued by a QSub or QRS is recharacterized under the Documentation Rule, the equity is to be treated as a stock interest in the owning corporation.
20. Consider whether the equity portion of any instrument issued by a disregarded entity (other than a QSub or QRS) or a controlled partnership that is recharacterized under the Documentation Rule should be treated as a partnership interest or as stock of the corporate owner or partner.
21. Provide that journal entries alone are not sufficient to meet the Documentation Rule.
22. Clarify that the Documentation Rule does not apply to instruments that are *per se* indebtedness under an applicable tax rule.
23. Clarify that, solely for purposes of determining the deadline for satisfying the documentation requirements, the debt should be deemed issued at the time it becomes an EGI.
24. Raise the dollar thresholds for, or otherwise limit, the application of the Documentation Rule.

General/Funding Rules

25. Reconsider the approach in Proposed Regulation section 1.385-3 (the “General/Funding Rules”) in favor of an approach based on the reasons why related-party debt might not normatively qualify as debt, rather than the context of the creation and use of such debt.
26. If the Government does not change the overall approach as suggested in the recommendation above, adopt a more targeted approach to Proposed Regulation section 1.385-3 that would apply the General/Funding Rules only to distributions of debt instruments and purchases of hook stock and adopt an appropriate anti-abuse rule under which stock acquisitions or intercompany asset reorganizations could be recharacterized.

27. Alternatively, or in addition, to the above recommendation, limit the effect of the recharacterization to disallowance of interest deductions.
28. If the *per se* rule contained in Proposed Regulation section 1.385(b)(3) (the “Funding Rule”) is retained, reduce the time period to no more than 12 months before or after the related Prohibited Transaction.
29. Provide credit for equity infusions in the application of the General/Funding Rules.
30. Adopt an exception for intra-expanded group acquisitions of stock or asset reorganizations (and the Funding Rule relating to these transactions) for which the taxpayer can show a business purpose for moving the stock or assets.
31. Adopt an exception for intra-expanded group transactions that are part of the same plan as an acquisition from an unrelated third party.
32. Exempt section 355 distributions and liquidations from treatment as distributions of property for purposes of the Funding Rule.
33. Adopt an “inadvertent termination” procedure that would permit taxpayers to reverse the effects of debt recharacterized under the Funding Rule by eliminating the debt (through repayment or cancellation).
34. Reconsider the conclusion reached in Revenue Ruling 94-28, 1994-1 C.B. 86, or at least provide that such ruling does not apply where debt has been recharacterized under the Funding Rule.
35. Clarify that debt recharacterized under the Funding Rule will not be treated as a fast-pay stock arrangement by virtue of its repayment feature.
36. Exclude deemed transactions occurring pursuant to other sections of the Code or regulations, such as Regulation section 1.1032-3, from the scope of the Funding Rule.

37. Clarify that recharacterization under the Funding Rule will not itself trigger application of the step-transaction or substance-over-form doctrines.
38. Exclude instruments that are treated as *per se* debt pursuant to other sections of the Code or regulations, such as regular interests in REMICs, from the scope of the General/Funding Rules.
39. Provide that a repayment of a recharacterized debt instrument cannot itself trigger the application of the Funding Rule.
40. Provide that none of the Bifurcation Rule, the Documentation Rule or the General/Funding Rules will result in the creation of “hook” stock.
41. Provide that the Funding Rule does not apply to instruments that are repaid prior to the purported funding event.
42. Limit the definition of expanded group to require that both legs of a transaction triggering the Funding Rule occur in the same expanded group, or provide that note issuances not be treated as funding a Prohibited Transaction where two separate groups combine or separate, and one leg occurs in one group and the other leg occurs in the other group.
43. Clarify that the acquisition of an unrelated entity that becomes a part of the expanded group should not be treated as an acquisition of stock of an expanded group member.
44. Limit application of the *per se* rule contained in the Funding Rule to predecessors or successors that become predecessors or successors within the same 72-month period.
45. Limit the predecessor/successor rule to section 381(a) transactions and expressly exclude separations under section 355.

46. Correct Example 12 of Proposed Regulation section 1.385-3(g)(3) if the immediately preceding Recommendation regarding the definition of predecessor/successor is not adopted.
47. Clarify that the definition of predecessor/successor is exclusive by removing “including.”
48. Clarify when the Current E&P Exception is applied with respect to predecessors/successors.
49. Limit application of the General/Funding Rules to transactions that are debt or distributions in form.
50. Clarify how payments on a bifurcated instrument are to be allocated between the two resulting instruments.
51. Clarify the mechanics for situations in which debt of a disregarded entity is treated as equity of its owner.
52. Modify the anti-abuse rule so that, if it applies, it merely subjects the debt to the other regulatory rules instead of automatically recharacterizing the debt.
53. Expand the coordination rule of Proposed Regulation section 1.385-3(b)(5) to exclude any debt instrument issued in a transaction described in Proposed Regulation section 1.385-3(b)(2) (the “General Rule”) from being subject to the Funding Rule.

Exceptions to the General/Funding Rules

54. Modify the Current E&P Exception to include 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) any subsequent year; alternatively, provide that the Current E&P Exception for a given tax year is 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.
55. Clarify the ordering rule to provide that the full amount of Current E&P is available to reduce transactions subject to the General/Funding Rules.
 56. If the above recommendation is not adopted, provide for an irrevocable election to specify the distribution(s) to which the Current E&P Exception applies.
 57. Limit the application of section 318(a)(3)(A) downward attribution to partnerships for purposes of applying the Threshold Exception.
 58. Modify the Threshold Exception to provide that the first \$50 million of expanded group debt instruments ("EGDIs") is eligible for the Threshold Exception for EGDIs up to \$200 million; after \$200 million, the exception would have a cliff effect.
 59. Expand the scope of the Ordinary Course Exception.
 60. Clarify the interaction between the qualitative and quantitative aspects of the Ordinary Course Exception.
 61. Exempt debt instruments eligible for the Ordinary Course Exception from the principal purpose test of Proposed Regulation section 1.385-3(b)(3)(iv)(A) so that ordinary course debt instruments are completely exempt from the Funding Rule.
 62. Expand the Ordinary Course Exception to cover specified financing activities.
 63. Replace the strict holding period requirement under the Subsidiary Stock Issuance Exception with application of principles under section 351 to determine whether the requisite ownership exists immediately after the transfer.

64. Modify the Subsidiary Stock Issuance Exception so that if the Issuer is not an expanded group member as of the Cessation Date, the exception continues to apply.
65. Adopt an exception to the Funding Rule for debt with a stated maturity or due date of less than one-year.
66. Adopt 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 Proposed Regulation section 1.385-3.
67. Consider, as an additional exception to the General/Funding Rules, a proportional debt exception to Proposed Regulation section 1.385-3 under which a debt instrument would not be recharacterized to the extent the issuing member’s net indebtedness does not exceed its proportional share of the expanded group’s third-party indebtedness.
68. Adopt an exception to the rules of the Proposed Regulations for a debt instrument issued pursuant to a plan under which it will be held by an unaffiliated person or entity.
69. Adopt an exception to the General/Funding Rules for a distribution of a partnership’s own note to its partners.
70. Clarify the Transition Rule for the General/Funding Rules.

Cash Pooling

71. Provide that an upfront umbrella or omnibus agreement satisfies the general documentation requirements for cash pooling arrangements.
72. Exempt qualified cash pools from the application of Proposed Regulation section 1.385-3 conditioned on certain limitations on the net balance that a participant may owe.

73. If the Government rejects a blanket exemption for cash pools, prevent iterative application of the Funding Rule to qualified cash pools.
74. If the Government rejects a blanket exemption for cash pools, provide that a CP Head or an unrelated party lending to a CP Head should not be treated as a conduit under section 7701(l) and Regulation section 1.881-3.

Relatedness

75. Use section 1563 rather than section 1504 as the starting point for defining an expanded group.
76. Consider whether to include brother-sister or just parent-subsidary groups.
77. If our Recommendation to start from section 1563 is not adopted, clarify how section 304(c)(3) applies for purposes of determining indirect ownership of a partnership interest and provide guidance on how “proportionately” should be determined for purposes of section 318(a)(2)(A) and (3)(A).

Consolidated Group Rules

78. Clarify that any applicable instrument issued or held by a partnership that is wholly owned by members of the same consolidated group is treated as issued or held by the one corporation that is the consolidated group for purposes of the Documentation Rule.
79. Clarify that the specific consolidated group member that is the actual issuer of the instrument be treated as the issuer for purposes of the Documentation Rule.
80. Address the inconsistent treatment of a distribution of a parent or subsidiary note outside the consolidated group and clarify the application of section 305.

81. Provide that a corporation that joins or leaves a consolidated group does not carry with it a “taint” of a leg of a funding transaction if the corporation and the consolidated group were not previously part of the same expanded group (if the corporation is joining) or do not remain part of the same expanded group (if the corporation is departing). If the taint does carry over pursuant to the Final Regulations, provide rules for computing the amount of the taint.
82. Clarify that transactions occurring within a consolidated group are disregarded for purposes of applying the regulations after consolidation.
83. Allow a consolidated group member that is making an acquisition or distribution that is not funded directly to demonstrate that the Funding Rule should not apply because the proceeds from the EGI can be segregated from the consolidated group member making the acquisition or distribution..
84. Clarify how the Current E&P Exception applies to a consolidated group.
85. Expand the “consolidated group” exception reflected in Proposed Regulation section 1.385-1(e) to apply to a group of domestic entities meeting the ownership requirements of section 1504(a)(2) and connected through common ownership by a domestic corporation.
86. Provide certain clarifications with respect to the scope of the “one corporation” rule applicable to members of a consolidated group.
87. Limit the impact of recharacterizations to prevent an issuer from “cycling” in and out of consolidated group membership or to give rise to other consolidated group membership issues.
88. Limit the impact of recharacterizations to prevent an instrument from “toggling” back and forth between debt and stock under the ordering rule in Proposed Regulation section 1.385-3(b)(3)(iv)(B)(3).
89. Adopt a “subgroup” exception under which Proposed Regulation section 1.385-4(b)(1)(ii)(B) would not apply where the issuer and holder together depart one consolidated group and join another within the same expanded group.

90. Provide that any deemed issuances, satisfactions, and/or exchanges arising under Regulation section 1.1502-13(g) and Proposed Regulation section 1.385-4(b) or - 4(e)(3) as part of the same transaction or series of transactions be respected as separate steps and revise Example 4 in Proposed Regulation section 1.385-4(d)(3) accordingly.
91. Clarify that certain ancillary consequences of the conversion of debt into equity are intended.

S Corporations

92. Exclude S corporations from the expanded group.
93. In the alternative, clarify and confirm that the Proposed Regulations would not apply in determining the qualification of an S corporation and a QSub as such, and that such qualification would continue to be determined pursuant to section 1361 of the Code and the regulations promulgated thereunder.
94. Consider similar relief for REITs.

Insurance Companies

95. Broaden the consolidated group rule of Proposed Regulation section 1.385-1(e) to cover “orphan” life insurance companies, *i.e.*, life insurance companies that are members of the affiliated group (without regard to the application of section 1504(b)(2)), but that are not yet members of the consolidated group (as defined in Regulation section 1.1502-1(h)).
96. Amend the Ordinary Course Exception to cover payables arising from intragroup insurance and reinsurance transactions.
97. Modify the Current E&P Exception for insurance companies, which generally are unable to make distributions without receipt of regulatory approval.

98. Revise the documentation requirements of Proposed Regulation section 1.385-2(b)(2) to incorporate the long-standing principle that an insurance company's required receipt of regulatory approval before repaying a debt instrument does not vitiate the conclusion that such debt instrument constitutes an unconditional and legally binding obligation to pay a sum certain on demand or at one or more fixed dates.
99. Exclude payables arising from intragroup insurance and reinsurance transactions from any possible expansion of the Documentation Rule to other than "in form" debt instruments.

Partnerships and DREs

100. Provide that the Final Regulations do not apply to preferred equity or limit the application to preferred equity of Applicable Partnerships.
101. Exclude preferred equity from the scope of the anti-abuse rule.
102. Exclude partnership interests from the scope of the Final Regulations.
103. Adopt a Tracing Approach to determine a partner's allocable share of a partnership's debt instrument that is subject to recharacterization.
104. Provide that a subsequent reduction in a partner's share of profits will be taken into account in determining the amount of partnership debt attributed to such partner if, at the time of the partnership's issuance or receipt of the debt instrument, the partner's reduction in its share of profits is anticipated. Provide a safe harbor based on "liquidation value" for purposes of determining a partner's share of profits and corresponding share of the partnership's debt instruments.
105. Clarify that if a debt instrument of a disregarded entity is treated as stock under the General/Funding Rules, it should be treated as stock of the first regarded owner, or corporate partner in the case of an owner that is a partnership.

TABLE OF CONTENTS

	<u>Page</u>
I. Background	1
A. Background on Section 385	1
B. The Proposed Regulations	2
II. Comments on the Proposed Regulations	4
A. General Comments on the Proposed Regulations.....	4
B. The Bifurcation Rule.....	4
1. Overall Approach.....	4
2. Clarify that Regulation section 1.1001-3(f)(7)(ii)(A) Applies to Prevent Bifurcation of Deemed Reissued Debt Instruments.....	8
3. Scope of Potential Application of the Bifurcation Rule	10
4. Use the Expanded Group Standard for Purposes of Applying the Bifurcation Rule.....	12
5. Prevent Bifurcation of Debt Issued by a QSub or QRS from Causing the Issuer to Be Treated as a Corporation.....	13
6. Ordering of Payments on a Bifurcated Instrument	14
C. The Documentation Rule	15
1. The General Approach.....	15
2. Standards for Determining Whether the Documentation Rule is Satisfied	19
3. When to Test for Whether There Is a Reasonable Expectation of Repayment.....	21
4. Ordinary Course Transactions	23
5. Nonrecourse Debt Instruments and Contingent Payment Debt Instruments.....	23

6.	Deadlines for Contemporaneous Documentation	24
7.	Reasonable Cause	24
8.	Debt Involving Disregarded Entities and Controlled Partnerships.....	25
9.	EGIs With No Documentation Other Than Journal Entries	25
10.	Failure to Honor the Terms of an EGI (the Fourth Documentation Requirement)	26
11.	Applicability Thresholds.....	27
12.	Effective Date Issues.....	28
D.	The General/Funding Rules	29
1.	Summary of Regulations.....	29
2.	Concerns about the Overall Concept of Proposed Regulation section 1.385-3	31
(a)	Historic Treatment of Debt and Equity.....	32
(b)	The Retirement of Group Equity as the Dispositive Factor	33
(c)	Stock and Asset Acquisitions.....	36
(d)	Recommendation	37
3.	Concerns about the Operation of Proposed Regulation section 1.385-3	38
(a)	Per se Rule	38
(b)	No Credit for Equity Infusions	39
(c)	The Proposed Regulations Treat Similar Transactions and Instruments Differently.....	41
(d)	The Proposed Regulations Will Disrupt Ordinary Business Transactions Not Motivated by Tax Benefits	45

(i)	Recharacterization Can Negatively Affect Unrelated Transactions or Classifications of Entities	45
(ii)	Purchase of parent stock by operating subsidiary used for compensatory purposes	47
(iii)	Short-term/overnight loans that regularly roll over	48
(iv)	Ordinary financial transactions would be impacted	48
(e)	Statutory Debt Provisions	48
(f)	Iterative Consequences of Funding Rule	49
(g)	Loss of Foreign Tax Credits and Treaty Benefits	50
(h)	Recharacterized Debt Creates Complex Ownership Structures	50
(i)	Funding and Repayment in the Same Year	51
(j)	Exits/Entrances into the Expanded Group	51
(k)	The Predecessor/Successor Rule	53
(l)	Transactions that are not Debt or Distributions in Form	54
(m)	Repayments of Bifurcated Notes	55
(n)	Effect of “Assumption” of Disregarded Entity Debt Treated as Stock of its Owner	56
(o)	No Affirmative Use Rule	57
(p)	Anti-Abuse Rule	57
(q)	Correct Example 12 of Proposed Regulation section 1.385-3(g)(3)	58
(r)	Provide that a debt instrument issued in a General Rule transaction cannot also be treated as a debt instrument subject to the Funding Rule.	58

4.	Exceptions.....	59
(a)	Current E&P Exception	59
(i)	Scope of the Current E&P Exception	59
(ii)	Current E&P Exception’s Ordering Rule	60
(iii)	Distributions of Previously Taxed Income from CFCs.....	62
(b)	The Threshold Exception	63
(i)	Interaction Between Threshold Exception and Expanded Group Attribution.....	64
(ii)	Cliff Effect of the Threshold Exception.....	66
(c)	Ordinary Course Exception.....	67
(i)	Clarify the Scope of the Ordinary Course Exception	68
(ii)	Expand Application of the Ordinary Course Exception to the Principal Purpose Test and the Documentation Requirements.....	69
(iii)	Provide an Ordinary Course Exception for Ordinary Course Financing Activities	69
(iv)	Consider Exceptions or Limitations on Ordinary Course Debt Based on Other Characteristics.....	70
(d)	Subsidiary Stock Issuance Exception	70
(i)	Holding Period for Issuer Stock.....	71
(ii)	Consequences Where the Issuer Leaves the Expanded Group	72
(e)	Additional Exceptions.....	73
(i)	Short-Term Debt Exception	73
(ii)	CFC-to-CFC Exception	73

(iii)	Proportional Debt Exception.....	76
(iv)	Debt Intended to Leave the Expanded Group.....	76
(v)	Debt Distributed to a Partner	77
5.	Transition Rule Issues.....	77
E.	Additional Comments	79
1.	Recommendations Relating to Cash Pooling Arrangements	79
(a)	The Nature of Cash Pools and Similar Arrangements.....	79
(b)	Effect of the Proposed Regulations on Cash Pools.....	81
(c)	Recommendations	85
2.	Recommendations Relating to Consolidated Groups	87
(a)	Overview and Proposed Expansion of the Consolidated Group Exception	87
(b)	“One Corporation” Issues	93
(i)	Partnership with All Consolidated Group Partners	94
(ii)	Documentation and Maintenance Requirements Under Proposed Regulation section 1.385-2.....	95
(iii)	Application to the General Rule	96
(iv)	Application to the Funding Rule.....	97
(1)	Treatment of Pre-Consolidation Transactions	97
(2)	Continuation of the “One Corporation” Principle on Disaffiliation	99
(3)	Disaggregating Activities of Consolidated Group Members in Certain Circumstances	100

(v)	The Current E&P Exception	100
(c)	Applicable Instruments Recharacterized as non- Section 1504(a)(4) Equity	101
(i)	Impact of Proposed Regulation section 1.385-1(d) on Consolidated Group Membership	102
(ii)	Impact of Proposed Regulation section 1.385-2 on Consolidated Group Membership	104
(iii)	Impact of Proposed Regulation sections 1.385-3 and 1.385-4 on Consolidated Group Membership	104
(iv)	Recommendation	106
(d)	Discrete Issues Impacting Consolidated Groups	106
(i)	Interaction with Ordering Rule in Proposed Regulation section 1.385-3(b)(3)(iv)(B)(3)	106
(ii)	Subgroup Exception Under Proposed Regulation section 1.385-4(b)(1)(ii)(B)	107
(iii)	Interaction with Fictional Transactions Under Regulation section 1.1502-13(g)	108
(iv)	Unintended Consequences of Conversion of Debt into Equity	109
3.	Recommendations Relating to S Corporations	110
(a)	S Corporations Generally	110
(i)	Summary	110
(ii)	Recommendation	111
(b)	Qualification as an S Corporation and QSub	113
(i)	Summary	113
(ii)	Recommendation	114
(c)	Real Estate Investment Trusts	116

4.	Recommendations Relating to Relatedness	117
(a)	In General.....	117
(b)	Relatedness Recommendations.....	118
(i)	Section 1504 Definition	118
(c)	Definition of a Controlled Partnership.....	119
(i)	Clarify Reference to Section 304(c)(3).....	119
(ii)	Guidance on Proportionality	120
5.	Recommendations Relating to Insurance Companies.....	121
(a)	Overview of Recommendations.....	121
(b)	Existing Regulatory Framework Severely Restricts the Ability of Insurance Companies To Incur Indebtedness.....	123
(i)	Insurance Regulation in the United States	124
(ii)	Insurance Regulation Outside of the United States	125
(c)	Recommended Changes to the Proposed Regulations	126
(i)	Broaden the One Corporation Rule To Cover Orphan Lifecos	126
(ii)	Amend the Ordinary Course Exception to Cover Payables Arising from Intragroup Insurance and Reinsurance Transactions	131
(1)	Reinsurance Transactions Generally.....	131
(2)	Funds Withheld Transactions	133
(3)	Other Intragroup Insurance and Reinsurance Transactions	136
(4)	Recommendation	136

(iii)	Modify the Current E&P Exception for Insurance Companies	137
(iv)	Revise the Proposed Documentation Requirements for Debt Instruments Issued by Insurance Companies	139
(v)	Exclude Payables Arising from Intragroup Insurance and Reinsurance Transactions from any Possible Expansion of the Documentation Rule	140
6.	Recommendations Relating to Partnerships Under the General/Funding Rules	141
(a)	Preferred Equity	141
(b)	Proportionate Share.....	144
(c)	Debt Instruments Issued by Controlled Partnership, in General.....	147
(d)	Treatment of DREs	153

DISCUSSION

I. Background

A. Background on Section 385

The characterization of an instrument as debt or equity for U.S. federal income tax purposes has historically depended upon the facts and circumstances at the time of issuance. Section 385(a) authorizes the Treasury to issue regulations to determine whether an interest in a corporation is to be treated as stock or debt (or as in part stock and in part debt). Section 385(b) goes on to provide that such regulations “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,” and that such regulations may include the following five 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 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.

Treasury and the Service previously issued regulations under section 385, but these regulations were withdrawn before becoming effective, leaving taxpayers to rely on an expansive body of case law to determine whether an instrument is to be treated as stock or debt. Under such case law, in determining whether a particular instrument evidences a debtor-creditor or shareholder-corporation relationship, courts have set forth a number of factors that must be evaluated and have weighed the relative importance of these factors in light of the particular facts and circumstances of the case under examination.² Courts have not found any one factor to be controlling; rather, courts generally analyze an instrument by examining all of its characteristics to reach a final determination as to whether the instrument is debt or equity.³

² See, e.g., *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946). See also William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 404-412 (1971).

³ See, e.g., *Plantation Patterns, Inc. v. Commissioner*, 29 T.C.M. (CCH) 817, 825, 1970 T.C.M. (P-H) ¶ 70,182, at 908 (“No single factor is controlling and each case must be decided upon its own peculiar facts.” (citing *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946))); *John Kelley Co.*, 326 U.S. at 530 (“There is no one characteristic, not even exclusion from management, which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts.”).

In Notice 94-47,⁴ the Service listed the following eight factors to consider when making a debt/equity determination: (1) whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future; (2) whether holders of the instruments possess the right to enforce the payment of principal and interest; (3) whether the rights of the holders of the instruments are subordinate to the rights of general creditors; (4) whether the instruments give the holders the right to participate in the management of the issuer; (5) whether the issuer is thinly capitalized; (6) whether there is identity between the holders of the instruments and stockholders of the issuer; (7) the label placed on the instruments by the parties; and (8) whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency or financial accounting purposes.⁵ Although the Service may consider factors other than those listed in Notice 94-47, these eight represent the factors most commonly considered for any debt/equity analysis.

B. The Proposed Regulations

On April 4, 2016, Treasury and the Service released proposed regulations under section 385. While framed as part of a package of guidance addressing inversion transactions, the Proposed Regulations apply more broadly to related-party indebtedness without regard to whether the parties are domestic or foreign or inverted companies. The preamble to the Proposed Regulations ("Preamble") notes that excessive indebtedness between domestic related parties can also reduce federal income tax liability.⁶

⁴ 1994-1 C.B. 357.

⁵ The Courts of Appeals for various federal circuits have also cited certain other factors as relevant in making a debt/equity determination. *See, e.g., Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968) (setting forth 16 factors to be applied in making a debt-equity determination); *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625 (6th Cir. 1986) (setting forth 11 factors including some similar to those considered by the Third Circuit in *Fin Hay Realty* as well as the presence of a sinking fund and the extent to which advances are used to acquire capital assets). Other factors indicating that treatment of an instrument as debt is appropriate have been noted by the Staff of the Joint Committee on Taxation when it contemplated the issue, including the existence of security to ensure the payment of interest and principal. Staff of J. Comm. on Taxation, 101st Cong., 1st Sess., *Federal Income Tax Aspects of Corporate Finance Structures*, 35 (JCS-1-89) (Comm. Print 1989); *see also* Staff of J. Comm. on Taxation, 112th Cong., 1st Sess., *Present Law and Background Relating to Tax Treatment of Business Debt*, 15-18 (JCX-41-11) (Comm. Print 2011) (listing 11 commonly cited factors).

⁶ *See* Notice of Proposed Rulemaking, *infra* note 37, at 81 Fed. Reg. 20,914.

If finalized in their current form, the Proposed Regulations would make sweeping changes to the characterization of instruments issued by a corporation to a related party that were previously treated as indebtedness under the rules discussed above.

The Proposed Regulations can broadly be broken into three sets of rules. First, the Bifurcation Rule provides that the Service may treat certain instruments that are in the form of debt as in part indebtedness and in part stock to the extent they are properly treated as such under general debt/equity testing principles.⁷ In particular, the Bifurcation Rule can potentially apply to any EGI, as modified by Proposed Regulation section 1.385-1(d)(1). An EGI is an instrument that is in form a debt instrument issued by a member of an expanded group and held by a member of the same expanded group.⁸ Proposed Regulation section 1.385-1(d)(2) modifies the definition of EGI to apply to instruments issued and held by members of a modified expanded group.⁹ The term “expanded group” generally refers to an affiliated group as defined in section 1504(a), with certain modifications to expand its scope, including by counting indirect stock ownership under the rules of section 304(c)(3). The term “modified expanded group” is defined in the same manner as the expanded group, but adopting a 50% ownership threshold, and adding further potential noncorporate members.

Second, the Documentation Rule provides that an EGI is treated as stock for U.S. federal income tax purposes if certain documentation and information requirements are not satisfied.¹⁰

Third, the Proposed Regulations provide a regime whereby certain instruments that would otherwise be treated as indebtedness for U.S. federal income tax purposes are instead treated as stock of the issuer to the extent such instruments are issued in certain specified transactions or issued with a principal purpose of funding, or are treated by the Proposed Regulations as being issued with a principal purpose of funding, such specified transactions.¹¹ This regime consists of a General Rule and the Funding Rule.

⁷ See generally Prop. Reg. § 1.385-1(d), 81 Fed. Reg. 20,912, 20,931 (2016).

⁸ Prop. Reg. §§ 1.385-1(d)(2), 1.385-2(a)(4), 81 Fed. Reg. at 20,931.

⁹ Prop. Reg. §§ 1.385-1(d)(2), 1.385-2(a)(4), 81 Fed. Reg. at 20,931.

¹⁰ See generally Prop. Reg. § 1.385-2, 81 Fed. Reg. at 20,931.

¹¹ See generally Prop. Reg. § 1.385-3, 81 Fed. Reg. at 20,934.

II. Comments on the Proposed Regulations

A. General Comments on the Proposed Regulations

In a statement reported in the Daily Tax Report of June 29, 2016, a Treasury spokesperson said that the Treasury "will carefully consider all comments before finalizing the rules as swiftly as possible. ... This is a process we take seriously and we continue to encourage thoughtful comments that suggest solutions to any concerns."

The Section of Taxation welcomes the commitment of Treasury and the Service to fully review and analyze all comments. We endeavor to provide helpful comments to assist the Government with its work. In light of the complexity of the Proposed Regulations and their wide-ranging and often unexpected consequences, and given the short comment period, our Comments may not always suggest complete solutions to our concerns. Many will require careful consideration by the Government of whether and how to change the Proposed Regulations, given all of the potential ramifications.

Accordingly, we strongly urge Treasury and the Service to take the time necessary to evaluate and develop these rules, even if that means that the final version of the Proposed Regulations ("Final Regulations") cannot be issued as swiftly as the Treasury would have desired, and even if all or parts of the rules must be repropounded. We note that the April 4, 2016, effective date of Proposed Regulation section 1.385-3 has the effect of deterring targeted transactions pending the adoption of final rules, allowing Treasury and the Service time to study and develop responses to all of the comments that are received.

B. The Bifurcation Rule

1. Overall Approach

Under Proposed Regulation section 1.385-1(d),

[T]he Commissioner may treat an EGI . . . as in 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 §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."

As noted in the Preamble, under existing law, "the Commissioner generally is required to treat an interest in a corporation as either wholly indebtedness or wholly equity."

We appreciate the concern expressed in the Preamble that the "all or nothing" nature of the debt/equity analysis effectively limits the Government's ability to challenge the debt characterization of an instrument that is, for example, slightly more debt-like

than equity-like. Nevertheless, we have concerns about the proposed rule from both a theoretical and practical standpoint. At a minimum, the operative rule does not clearly or accurately express the manner in which we believe it is intended to operate. Moreover, the population of taxpayers potentially subject to the rule may not be well-aligned with the presumed purposes of the rule.

As a threshold matter, we note that the Bifurcation Rule is the one proposed rule that has no size or dollar thresholds, and therefore is potentially applicable to a broad range of taxpayers. If the Documentation Rule has its intended effect of imposing discipline on larger taxpayers, which it should (even if our proposals for revisions are accepted), adjustments to those taxpayers under the Bifurcation Rule may be less likely to occur (depending on the criteria). Thus, in practice, we expect the Bifurcation Rule to be more relevant to taxpayers not covered by those rules, including a substantial number of smaller corporate groups, which are excused from compliance with the Documentation Rule. Many, probably the majority, of these taxpayers by number are S corporations, which should not be thought of as part of the corporate tax base at all (and which we separately request later in these Comments be excluded from the scope of the Proposed Regulations).¹²

Accordingly, if the Bifurcation Rule is retained, we recommend that a threshold amount be established. Alternatively, we suggest that reconsideration be given as to whether the Bifurcation Rule serves an important tax policy objective.¹³

We recognize that Congress specifically authorized bifurcation under certain circumstances in 1989. And we understand that the capital markets have come to blur the distinctions between debt and equity instruments. Even so, as a theoretical matter, it is not clear to us why existing law, whereby an instrument's classification is determined in its entirety based on the predominant character of the instrument, ultimately is not the right answer from a tax policy perspective. Under existing law and the Proposed Regulations, the Service has the right to seek to treat as equity in its entirety an instrument that is more equity-like than debt-like. Bifurcation authority could allow it to avoid the practical and resource issues involved in litigating such cases. However, the

¹² S corporations account for roughly three-quarters of all filed corporate income tax returns. Elsewhere in these Comments, we urge you to remove S corporations and qualified S corporation subsidiaries ("QSubs") from the scope of all of the Proposed Regulations. That would mitigate these concerns for S corporations but not for all small businesses. Most C corporation returns are filed by closely held small businesses.

¹³ We also note that, because the Bifurcation Rule would have the least effect on multinational tax planning, the government should not feel any sense of urgency regarding its adoption as a final rule.

Preamble refers to exercising such authority where an instrument is more debt-like than equity-like. If such an instrument is not to be treated entirely as debt, in theory, such bifurcated treatment should be equally appropriate for an instrument that is slightly more equity-like. Such a regime of general bifurcation, however, even if just in close cases, would introduce great uncertainty to the tax system.

Even if bifurcation of instruments in the form of debt into part debt and part equity may be justified in certain cases as a policy matter, the proposed Bifurcation Rule presents serious practical concerns.

We recommend that the Final Regulations address the ambiguities in the statement of the general rule and provide standards for how it should be applied. The general rule provides that "[t]he Commissioner may [bifurcate an EGI] to the extent that an analysis, as of the issuance of the EGI, of the relevant facts and circumstances concerning the EGI ... 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."¹⁴ The effect of the Service's determination is not completely clear from this language. We do not believe that the Government intended that the Service's determination be binding and that a court would simply review whether the Service made a determination to bifurcate (though we understand that the standard of review may need to be consistent with the presumed objective of narrowing the scope of possible litigation). Application of any Bifurcation Rule should be determined by reference to an ascertainable standard that can be subject to review.¹⁵ Any Bifurcation Rule should clearly articulate the conditions for its application and state clear guidelines for a revenue agent to apply and a court to review. It should be stated in a manner from which one could determine the appropriate amount of principal and interest for the debt component.

Another problematic aspect of the statement of the rule involves the requirement that the instrument "under general federal tax principles ... is properly treated for federal tax purposes as indebtedness in part and stock in part." As noted in the legislative history to section 385 and the Preamble, general federal tax principles largely do not support the bifurcation of single instruments, including in the example provided in the text of the regulation. The rule could not have been intended to apply to a null set. The

¹⁴ Prop. Reg. § 1.385-1(d)(1).

¹⁵ We agree that a taxpayer should be barred from bifurcating a single instrument on its own motion and that any such bifurcation should be initiated by the Service. This is an appropriate application of section 385(c) principles, to the extent not simply a direct application of section 385(c).

Government must have meant something other than general federal tax principles as the guidepost.

The legislative history suggests a variety of circumstances under which the Government might seek to treat an instrument as part debt and part equity, including deferral of payments and a relatively high interest rate.¹⁶ The proposed Bifurcation Rule is not textually limited, but the only example given is where the debt cannot be expected to be satisfied in full. We note that the rule does not appear to be directed at debt with equity kickers or contingent interest. Its application would not be limited to related parties (even at the reduced 50% threshold) if this were the intent.¹⁷

We do believe that bifurcation can reasonably be applied to debt issued by thinly capitalized issuers, as illustrated in the example in the Proposed Regulations, and recognize that the purpose of the rule (and the 1989 Code amendment) may have been to address the practical difficulties and resource constraints on litigating such cases. But we recommend that the rule be revised to focus on that situation and that the Service's ability to bifurcate an instrument in such cases be limited to circumstances in which the

¹⁶ "For example, such treatment may be appropriate in circumstances where a debt instrument provides for payments that are dependent to a significant extent (whether in whole or in part) on corporate performance, whether through equity kickers, contingent interest, significant deferral of payment, subordination, or an interest rate sufficiently high to suggest a significant risk of default." House Ways & Means Committee Explanation of the Revenue Provisions of the Revenue Reconciliation Bill of 1989 (Sept. 14, 1989), at 91; Senate Finance Committee Report on the Revenue Reconciliation Bill of 1989 (Oct. 4, 1989), at 91. Compare I.R.C. § 279.

¹⁷ Even though bifurcation can theoretically apply to a convertible or contingent payment instrument (by separating out the embedded option or contingent feature), we believe that it would be inappropriate for the Bifurcation Rule to be applied in such a case. Neither section 385(a) nor the proposed Bifurcation Rule contemplates the treatment of an instrument as part debt and part derivative (with the exception that the 1989 legislative history refers to contingent interest), and we believe that it would be inappropriate to bifurcate such an instrument into part debt and part stock when such treatment would not properly reflect the instrument's economics. Moreover, the case law (in the absence of regulations) has clearly provided for the treatment of unitary convertible or contingent payment instruments as debt instruments in full and has not separated out the option or derivative component from the debt. It is noteworthy that the first set of proposed regulations relating to contingent payment debt instruments required that each such instrument be bifurcated into a non-contingent debt instrument and a derivative. That approach was ultimately determined to be unworkable as a general rule. It is difficult to see why such an approach would be more suitable in the case of related party debt; while limiting taxpayers' right to assert bifurcation avoids taxpayer manipulation concerns, providing a one-way bifurcation right would effectively allow the Government to impose on taxpayers bifurcated treatment or non-bifurcated treatment solely depending on which is less taxpayer favorable.

borrower has insufficient equity capital to support the issuance of the entire debt¹⁸ or other specific, narrowly defined factors are present. In such a case, if the Service determined not to challenge the entire amount and instead to exercise bifurcation authority, the amount of the debt should be reduced to the amount an unrelated lender would have lent under the circumstances.¹⁹ The remainder could be recharacterized as equity. Generally, the amount treated as equity would be the smallest amount that, when added to the borrower's existing equity capital, would properly support a third-party loan of the remaining amount of the instrument. We believe that such a rule would appropriately address the Government's concerns, while providing taxpayers with at least some degree of certainty.

2. Clarify that Regulation section 1.1001-3(f)(7)(ii)(A) Applies to Prevent Bifurcation of Deemed Reissued Debt Instruments

It is unclear whether the Bifurcation Rule may be applied to a debt instrument that is deemed reissued due to a significant modification of its terms under Regulation section 1.1001-3²⁰. The determination of whether a deemed reissued instrument is properly characterized as debt generally is made by taking into account all of the factors relevant to such a determination. Regulation section 1.1001-3(f)(7)(ii)(A) (the "Credit Quality Look-Back Rule"), however, provides that

[I]n making a determination as to whether an instrument resulting from an alteration or modification of a debt instrument will be recharacterized as an instrument or property right that is not debt, any deterioration in the financial condition of the obligor between the issue date of the debt instrument and the

¹⁸ Reference to the amount of principal that can be repaid should take into account reasonably anticipated refinancings to the extent third parties may do so.

¹⁹ In the case of any modification or refinancing of a loan to an issuer whose credit quality has weakened, the circumstances would take into account what an unrelated lender might do to work out a troubled loan.

²⁰ Regulation section 1.1001-3(f)(7) contains a flaw that needs to be addressed independently of EGI considerations. In the case of two or more significant modifications of a debt instrument, the rule as currently in effect permits a look-back only to the creditworthiness of the debtor at the time of the issuance of the obligation being modified, which is the date of the previous significant modification. If the borrower was already in financial distress at the time of the earlier significant modification, this means that upon the second modification the debt would no longer qualify. To allow the rule to operate as intended in such cases, the look-back should be to the time the original debt was issued, not the reissued debt being modified. Of course, if this clarification is made, it increases the need for a special rule for EGIs as described in the text immediately following.

date of the alteration or modification (as it relates to the obligor's ability to repay the debt instrument) is not taken into account.

Thus, in order to avoid imposing "a significant barrier to restructuring distressed debt instruments" and further burdening financially troubled issuers, the Credit Quality Look-Back Rule provides that, except where there is a change in obligor, the debt/equity determination generally is made without taking into account any deterioration in the financial condition of the obligor. It is unclear whether the Credit Quality Look-Back Rule similarly applies in determining whether the Service is permitted to bifurcate an instrument under the Bifurcation Rule upon the occurrence of a significant modification of the instrument to a greater extent than it would have been permitted to bifurcate the original instrument.

We believe that the policy rationale for the Credit Quality Look-Back Rule should apply equally to prevent bifurcation of a debt instrument deemed reissued under Regulation section 1.1001-3. The Credit Quality Look-Back Rule applies to prevent equity characterization only where a deemed reissued debt instrument would otherwise be recharacterized as equity in full due to a deterioration of the issuer's financial condition. Because the Credit Quality Look-Back Rule prevents deemed reissued instruments that might otherwise be recast as equity in full from being so recharacterized, it is difficult to see what policy justification would exist for allowing such instruments to be partially but not fully recharacterized as equity under the Bifurcation Rule.

Nevertheless, we are mindful that the rationale for the Credit Quality Look-Back Rule may be less compelling where a debt instrument held by a party related to the issuer is modified in a manner that a third-party lender would not have permitted. In other words, because the Credit Quality Look-Back Rule was intended to remove an impediment to workouts of distressed debt, we believe it is fair for a related party lender to benefit from the rule in the same circumstances permitted to an unrelated party. But that rationale is less convincing where an instrument is modified in a manner that is not consistent with the terms that would have been agreed to by a reasonable unrelated party.

Accordingly, we recommend that the regulations clarify that the Bifurcation Rule is not to be applied to a debt instrument deemed reissued under Regulation section 1.1001-3 to a greater extent than the Bifurcation Rule could have applied to the original instrument, but that this rule will apply only where the modifications to the

instrument are consistent with the terms that a reasonable unrelated creditor might have agreed to if it were the lender.²¹

3. Scope of Potential Application of the Bifurcation Rule

The potential application of the Bifurcation Rule is limited by the definition of a modified expanded group and its interaction with the operative rule. The rule applies to any EGI between members of a modified expanded group and a modified expanded group can include noncorporate issuers. But the operative rule asks if the instrument should be treated as “stock” under general federal tax principles, and only a corporation can issue stock.²² This corrects some potential over-inclusiveness of the application to instruments between modified expanded group members. Bifurcation should not apply to noncorporate issuers simply because they own interests in corporations. It is important that this effect be preserved even if the operative rule is revised.

The Government may consider applying the operative rule to debt issued by disregarded entities and partnerships that are owned by corporations. The operative rule, as currently phrased, would not create stock in noncorporate entities, with the result that instruments issued by a QSub or a qualified REIT subsidiary (a “QRS”) are potentially subject to bifurcation under the test as proposed but instruments issued by other disregarded entities or partnerships are not. As we discuss below, QSubs and QRSs should not have their characterization placed at risk by this rule.

The operative rule as proposed would not bifurcate debt issued by partnerships or disregarded entities that would become partnerships on addition of a second equity

²¹ A corresponding change to Regulation section 1.1001-3(f)(7)(ii), that would limit the application of the Credit Quality Look-Back Rule in the case of debt held by a related party to situations where the modifications are consistent with what a reasonable unrelated lender might have agreed to, may be appropriate.

²² General tax principles also would not typically create hook equity interests. If a shareholder also holds the corporation's note and there is a concern about the corporation's ability or intention to satisfy it, that note might be treated as equity. If the corporation holds the shareholder's note and there is a concern about the shareholder's ability or intention to satisfy it, that note would not be treated as equity but rather would be disregarded, so that the shareholder typically would be treated as having received a distribution when it received the proceeds or when it became clear that the shareholder would not repay the note. All three of the proposed rules mandate a binary choice between debt and stock, creating hook and cross-chain stock ownership under circumstances where the substance-based traditional analysis would instead find a distribution or distribution and contribution. Under these circumstances, we recommend that regulations under section 385 provide for results comparable to those obtained under general tax principles.

owner, even if those entities are owned by corporations. This result may be acceptable. However, we recognize that applying the Bifurcation Rule to debt issued by a corporation and not to debt issued by its disregarded entities would create a significant discontinuity in the application of the rule. Thus, if the Bifurcation Rule is retained, we recommend that the Bifurcation Rule apply to EGIs issued by disregarded entities and partnerships.

Our members, however, have different points of view on whether a recharacterized EGI should be treated as stock in the owner of the disregarded entity or stock in the partner in the partnership, as the case may be, or treated as an interest in a partnership. Section 385 does not authorize the Treasury to issue regulations converting a debt instrument into a partnership interest. Any such treatment would have to be supported as a general interpretation of the provisions of the Code. Accordingly, some members believe that, given the Treasury's authority constraints, and to mitigate against some of the collateral damage that results from a change in status of a disregarded entity, to the extent any instrument issued by a disregarded entity or controlled partnership is to be bifurcated into part equity, the equity should be treated as a stock interest in the owning or controlling corporation.²³

Those members recognize that this treatment will require the use of look-through principles in the case of disregarded entities owned by controlled partnerships and in the case of tiered partnerships. It will also require adjustments if the corporate owner directly or indirectly disposes of its interest in the disregarded entity or controlled partnership. (These rules will also be necessary under the General/Funding Rules, where similar treatment of flow-through entities was proposed.) Nevertheless, those members think any attendant complexity is justified to produce what is, in the end, a less intrusive result.

Other members believe that Treasury has authority to treat any recharacterized debt issued by a disregarded entity or partnership as an interest in a partnership, either as a general interpretation of the Code or perhaps under the regulatory grant of authority under section 707(a)(2). Treating the recharacterized debt as equity in the issuer is consistent with common law principles governing the characterization of an instrument as debt or equity and yields results similar to those that would occur, with respect to the Documentation Rule, if there were a substantive failure to qualify as debt because of the instrument's formal or credit characteristics. These members also believe that creating a different recharacterization of an instrument depending on whether an instrument fails to meet the substantive standards of a debt/equity analysis or the Documentation Rule will

²³ This issue also exists under the Documentation Rule, and we advocate a similar range of views in that context.

lead to confusion and traps for the unadvised. In addition, appropriate adjustments will be necessary if the instrument is recharacterized as stock. These appropriate adjustments can be quite complex and have their own unintended consequences, e.g., the application of the anti-deferral rules of subchapter K. Even those members that recommend that any recharacterized debt be treated as an interest in a partnership, however, believe that a general interpretation of the Code would not be sufficient authority to support *per se* equity treatment if certain requirements of the Documentation Rule were lacking (e.g., the timing requirements and perhaps the requirement for written documentation of the issuer's financial position).

4. Use the Expanded Group Standard for Purposes of Applying the Bifurcation Rule

Unlike the rules contained in Proposed Regulation section 1.385-2 and -3, which apply to debt instruments between members of an “expanded group,” the Bifurcation Rule may apply to any debt instrument between members of a “modified expanded group.” The definitions of those two terms generally are the same, except that the modified expanded group term uses a 50% (rather than 80%) relatedness standard. The Preamble provides no rationale for the use of a lower standard for purposes of the Bifurcation Rule, simply stating that the lower standard “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.”²⁴ While it is true that many Code provisions utilize a 50% standard for relatedness, many others use an 80% standard for such a purpose. It is unclear why the Bifurcation Rule was singled out for use of a lower relatedness standard, because the rationale for the Bifurcation Rule would appear to raise the same types of issues as the rules in Proposed Regulation section 1.385-2 and -3. In addition, having two different standards for different parts of the section 385 regulatory regime is confusing and makes an already complex set of regulations more complex than necessary for no clear policy reason. Therefore, we recommend that the Bifurcation Rule be modified to apply only to debt instruments between members of an expanded group and that the modified expanded group concept be eliminated. To the extent the modified expanded group concept is retained, it should be clarified that instruments issued by non-corporate entities, other than disregarded entities and controlled partnerships owned by corporations, are never bifurcated.

²⁴ The Preamble references the use of a 50% relatedness standard in a number of Code provisions, including sections 304(c), 318, 267(b) and 302(b)(2).

In addition, we note that the modified expanded group definition creates distinctions that appear to be unintended. For example, if an individual makes a loan to a corporation wholly owned by the individual, the individual and corporation are part of a modified expanded group if the corporation owns 50% or more of the stock of one or more corporations, but otherwise apparently (as currently drafted) are not part of a modified expanded group. If our recommendation to eliminate the modified expanded group concept is adopted, this distinction would no longer exist (because an individual and a corporation are never part of an expanded group).²⁵ Further comments on the determination of “relatedness” under the Proposed Regulations are provided in Part II.E.4 below.

Finally, we note that, because the Bifurcation Rule has no size or dollar thresholds and can apply to small businesses, changes to the definition of an expanded group, which, in turn, impact the modified expanded group definition, could have the effect of extending the reach of the Bifurcation Rule exponentially beyond the universe of taxpayers potentially affected by the proposed rule. For example, the number of closely-held corporations in a brother-sister relationship may be far greater than the number of closely-held corporations with a regarded corporate subsidiary, which is a minimum condition for an expanded group, and therefore a modified expanded group, under the Proposed Regulations.

5. Prevent Bifurcation of Debt Issued by a QSub or QRS from Causing the Issuer to Be Treated as a Corporation

A corporate entity that satisfies the requirements for treatment as a QSub or 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 an S corporation or a real estate investment trust (“REIT”)(as appropriate). If a debt instrument of a QSub or QRS that is owned by a member of a modified expanded group other than its parent corporation is treated as part debt and part equity under the Bifurcation Rule, the QSub or QRS generally would no longer meet the requirement for disregarded entity treatment and thus would be considered a corporation for tax purposes. We believe such a result would be inappropriate, particularly given the lack of certainty regarding the application of the Bifurcation Rule and the fact that it will always be applied retroactively as an audit adjustment. The stakes here are much higher than just interest deductions. As a result, we recommend that, if a debt instrument issued by a QSub or QRS is treated as part

²⁵ Of course, alternatively, the Final Regulations could clarify the definition of modified expanded group to cover an individual owning a single corporation. Based on our reading of the Bifurcation Rule as drafted, however, this would vastly expand its proposed reach.

equity under the Bifurcation Rule, such equity should be treated as issued by the S corporation or REIT that owns the QSub or QRS. Thus, the application of the Bifurcation Rule in such a case would not disqualify the issuing entity from QSub or QRS treatment. Further comments on the impact of the Proposed Regulations on S corporations are discussed in Part II.E.3 below.

6. Ordering of Payments on a Bifurcated Instrument

When an instrument is bifurcated under the Bifurcation Rule, a fiction is created whereby for tax purposes the issuer is treated as having issued a debt instrument and an equity instrument, notwithstanding the fact that the legal form of the instrument is a unitary debt instrument. It is unclear how payments on the instrument should be allocated between the debt component and the equity component. Guidance is needed on the proper allocation of such payments.²⁶

There is no good answer to this question. A single instrument with embedded debt and equity portions is considerably less attractive to the issuer and holder than two separate instruments, one of each, no matter how the payment stream is allocated.

One potential approach would be to treat payments on a bifurcated instrument as being made on the debt component and the equity component on a pro rata basis. For example, assume that Issuer issues a note of \$100 with an interest rate of 8% per annum to a member of its modified expanded group and that the debt is bifurcated by the Service into \$75 of debt and \$25 of equity. Under a pro rata approach, when Issuer pays \$8 of interest on the note in Year 1, the payment would be treated as \$6 of interest on the debt component and a \$2 distribution on the equity component. Similarly, if Issuer made a \$40 prepayment on the instrument, the payment would be treated as a payment of \$30 of principal on the debt component and a payment of \$10 of the liquidation preference on the equity component. This approach would be reasonably straightforward in its application, but would be at odds with what would typically happen if the issuer had actually issued separately debt and equity. This is because debt instruments by their terms often would not permit distributions to be made on equity of the issuer while amounts due on the debt instruments remain unpaid. And this approach could trigger a dividend withholding tax as well as distributions that would have to be taken into account under the Funding Rule discussed below.

²⁶ A similar issue exists for instruments that would be bifurcated under Proposed Regulation section 1.385-3.

Another approach, which would entail increased complexity but would be more consistent with the customary seniority of debt instruments, would be to treat payments on the instrument as made in the following order: (i) accrued interest on the debt, (ii) accrued dividends on the equity, (iii) unpaid principal on the debt until paid and (iv) liquidation preference on the equity. Under a third possible approach, payments on a bifurcated instrument could be treated as satisfying both interest and principal of the debt component before any payments would be treated as made on the equity component. That is, payments on the instrument would be treated as made in the following order: (i) accrued interest on the debt, (ii) unpaid principal on the debt until paid, (iii) accrued dividends on the equity, and (iv) liquidation preference on the equity.

Ultimately, we recommend that pro rata be the default or, perhaps, mandatory, treatment because it is simpler, even if the consequences could include the imposition of a dividend withholding tax and distributions for purposes of the Funding Rule.²⁷ Consideration should also be given to allowing the issuer to elect its allocation, giving it some of the flexibility it would have had if it had designed two separate instruments. This may be particularly appropriate under the Bifurcation Rule, where the taxpayer may have made payments before the Service proposed bifurcation. However, although the considerations may be somewhat different under the Funding Rule, if the Funding Rule is maintained, it is not clear to us that it is worth having two different regimes to govern the treatment of bifurcated instruments.

C. The Documentation Rule

1. The General Approach

Proposed Regulation section 1.385-2 sets forth documentation requirements necessary for certain EGIs to be treated as debt for federal tax purposes. The Documentation Rule applies only to interests that are issued in the form of debt.²⁸ In addition, the Documentation Rule applies only to larger affiliated groups, i.e., where: (i) the stock of any member of the expanded group is publicly traded; (ii) all or any portion of the expanded group's financial results are reported on financial statements with total assets exceeding \$100 million; or (iii) the expanded group's financial results are reported

²⁷ The pro rata approach is particularly complex under the Funding Rule because payments allocated to the equity component would be distributions that potentially convert more debt to equity under the Funding Rule. See *infra* part II.D.3(m).

²⁸ Prop. Reg. § 1.385-2(a)(4)(i)(A).

on financial statements that reflect annual total revenue that exceeds \$50 million.²⁹ Instruments in the form of debt between members of an affiliated group filing a consolidated federal income tax return are excluded.

The Documentation Rule requires documentation and information to be maintained with respect to four categories:³⁰

1. A binding obligation to repay the funds advanced;
2. Creditor's rights to enforce the terms of the EGI, which must include rights superior to shareholders to share in the assets of the issuer upon liquidation or dissolution;
3. A reasonable expectation that the advanced funds can be repaid, which may be demonstrated by, for example, cash flow projections, financial statements, asset appraisals, and debt/equity ratios; and
4. Actions evidencing a genuine debtor-creditor relationship, which may include documentation of any payments (such as wire transfers or bank statements) and efforts to enforce the terms of the EGI or renegotiate the EGI in the event of nonpayment.

The documentation generally must be prepared no later than 30 calendar days after the date of the relevant event in the case of the first three categories. Documentation supporting the fourth category, however, may be prepared up to 120 calendar days after the payment, event of default, acceleration event, or similar event occurs.³¹ The proposed regulations provide special rules for revolving credit or open account obligations and cash pooling arrangements. For revolving credit or open account obligations, enabling documents must be maintained as well as documentation of any principal balance.³² For cash pooling arrangements, documentation governing the ongoing operation, including the relevant legal rights and responsibilities, must be maintained.³³

²⁹ Prop. Reg. § 1.385-2(a)(2)(i).

³⁰ Prop. Reg. § 1.385-2(c)(2).

³¹ Prop. Reg. § 1.385-2(b)(3)(i).

³² Prop. Reg. § 1.385-2(b)(3)(iii)(A).

³³ Prop. Reg. § 1.385-2(b)(3)(iii)(B).

If a taxpayer's failure to comply with the requirements is attributable to reasonable cause, "appropriate modifications may be made to the requirements" in determining whether the requirements are satisfied.³⁴

We understand the Government's general concern with poorly documented EGIs. Moreover, we acknowledge that, in our experience, the documentation and financial analysis of EGIs are often much weaker than they should be, and in some cases non-existent. Nevertheless, we have serious concerns with the overall approach taken by the Documentation Rule in Proposed Regulation section 1.385-2 for several reasons.

First, the Documentation Rule goes far beyond what is required to accomplish its apparent tax policy objective. Many failures of taxpayers to properly document EGIs are harmless, causing no loss of revenue to the U.S. tax system. Debtors that are not creditworthy, and hence could not borrow from unrelated lenders, are most often in a loss position for tax purposes, and so the improper interest deductions generally produce no tax savings. Of course, some insolvent debtors do recover, and in those cases the interest deductions and the ability to repay principal rather than make a distribution can become valuable, but this is relatively rare and certainly not a systemic problem.

The principal case that is of potential concern is the overly leveraged U.S. subsidiary of a foreign parent. In this case, the third documentation requirement will force taxpayers to undertake a contemporaneous analysis of the creditworthiness of the borrower rather than waiting until the transaction is challenged on audit. And if this analysis shows that an aggressive amount of debt cannot be supported, the taxpayer will have to reduce the amount of leverage to a supportable level. This would admittedly be an improvement in the tax system, but the approach taken by the Documentation Rule to achieve this result comes at a great cost to many other transactions.

Second, the *per se* equity recast imposed by the Documentation Rule is in most cases unduly harsh. If and when the Proposed Regulations are adopted in final form, well-advised taxpayers will comply with the new rules (and abstain from transactions that cannot comply), so most failures by taxpayers to comply with the Documentation Rule requirements will be inadvertent. To treat every improperly documented EGI as equity and every repayment of such an obligation as a distribution and/or contribution to capital is far too heavy a price to pay for a documentation failure that in most cases could have been cured by some attention to the applicable rules. The price is particularly heavy if an EGI issued by a disregarded entity to a member other than its owner is recharacterized as

³⁴ Prop. Reg. § 1.385-2(c)(1).

equity. In that case, upon recharacterization, the entity would become a partnership for tax purposes but would not have filed a tax return as such.

Third, the *per se* equity recast imposed by the Documentation Rule is in many cases inappropriate. For example, if applied in cases of typical short-term debt (even outside of a trade payable context), the instruments generally would have no equity features in a section 385 sense at all. As a second example, a profitable corporation sells goods or services to an insolvent affiliate and takes back an account receivable that is in practice uncollectible from that affiliate, the proper recast is either that the EGI is implicitly guaranteed by the common parent, hence properly characterized as debt of the parent followed by a capital contribution to the insolvent subsidiary,³⁵ or simply a distribution by the seller to the common parent and a contribution down to the insolvent purchaser. Creating cross-chain equity ownership does not accurately account for the substance of such an arrangement. As another example, if a subsidiary lends money to a parent and there is no documentation of the obligation to repay, the proper recast is a simple distribution, not an investment by the subsidiary in “hook stock” of the parent. As mentioned in connection with the Bifurcation Rule, these concerns apply equally to each of the three proposed rules.

In view of the foregoing considerations, we recommend that the Final Regulations take a fundamentally different approach to the consequences of failing to meet the documentation requirements. We believe that the Government can accomplish its objectives more appropriately with a regulation that provides that (1) a failure to meet the documentation requirements creates a strong presumption that the obligation is not debt for tax purposes and (2) the taxpayer can overcome this presumption only with clear and convincing evidence, and only if the taxpayer has consistently treated the obligation as debt for tax purposes.³⁶ Further, the nature of the recast of an arrangement not treated as debt should be not be rigidly specified, so that a recast as equity will apply only in appropriate circumstances. This will leave open the possibility of a recast as a distribution and/or capital contribution or true indebtedness of an explicit or implicit guarantor.

³⁵ See, e.g., *Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (5th Cir. 1972).

³⁶ For purposes of the latter requirement, we suggest that the regulations state explicitly that a failure by the taxpayer to apply the imputed interest rules to interest-free intercompany accounts or other accounts with below-market interest rates should not be considered inconsistent tax treatment, *i.e.*, only an affirmatively taken position inconsistent with debt treatment should be counted against the taxpayer for this purpose.

We recognize that the automatic recast as equity in the Documentation Rule is motivated in large part by the authority of section 385, which is limited to determining whether an interest in a corporation is stock or indebtedness. However, in our view, this does not justify treating an EGI as stock when clearly it is not stock in substance. Further, assuming that section 385 is broad enough to justify the Documentation Rule as currently proposed, we think that the authority is broad enough to permit exceptions, as well as to justify a regulation that specifies that an EGI is not debt in certain circumstances without necessarily recharacterizing it as equity in those circumstances.

2. Standards for Determining Whether the Documentation Rule is Satisfied

As a preliminary matter, we note that the Preamble indicates that the Proposed Regulations intend "to treat the timely preparation and maintenance of ... documentation as necessary factors to be taken into account."³⁷ Rather than merely being "taken into account," these factors in fact are phrased in terms of legal requirements that the taxpayer must "establish." This, in effect, elevates them to super-factors as a matter of substantive law. The factors so elevated generally tend to be important and are sometimes dispositive under a traditional debt/equity analysis, but all are not universally dispositive in the manner stated in the Documentation Rule.

While not entirely clear, we do not believe that Treasury and the Service intended to eliminate the traditional analysis by requiring instruments to include certain terms and be contemporaneously documented. We think that it is important that the Final Regulations clarify that the Documentation Rule is only a requirement that the taxpayer create and maintain documentation that on its face meets the requirements of the rule. In other words, under such circumstances, an instrument could not be validly challenged under the Documentation Rule alone simply because of the content or the quality of the analysis in the documentation. Of course, the Service would remain free to challenge the status of the instrument as debt on substantive grounds, but would not be able to invoke a *per se* recast under the Documentation Rule.

For example, suppose an instrument governed by foreign law gives the holder rights that are similar but not identical to the creditor's rights afforded under U.S. law. If the governing instrument or applicable foreign statute sets forth the holder's rights, we believe that should fulfill the second documentation requirement, regardless of whether

³⁷ Notice of Proposed Rulemaking, *Treatment of Certain Interests in Corporations as Stock or Indebtedness*, 81 Fed. Reg. 20,912, 20,920 (Apr. 8, 2016).

those rights would be viewed as sufficiently close to traditional creditor's rights to satisfy the corresponding substantive test.

Similarly, the clear objective of the third documentation requirement³⁸ is to require expanded groups to undertake an analysis of the borrower's ability to repay the loan at the time of the loan and to document that analysis to facilitate audits of whether the borrower was sufficiently creditworthy. While we support this objective (subject to the concerns expressed above), we think it is important that the Final Regulations clarify that the documentation requirement is satisfied so long as the taxpayer creates and maintains reasonably contemporaneous documentation that illustrates the ability of the borrower to repay the loan. Thus, if the taxpayer has such documentation created in good faith, the quality of the documentation (including, for example, the fact that a debt capacity memorandum may be marked "draft") would be irrelevant for purposes of determining whether the taxpayer satisfied the documentation requirement. As noted above, the quality and reasonableness of the analysis would be relevant to the substantive analysis of whether the debt should be respected as debt.

One possible solution is for the Final Regulations to state explicitly that the taxpayer is not required to establish compliance with any particular legal standard. That is, the documentation requirement would be satisfied if the taxpayer had contemporaneous written documentation: (1) from which one can determine the material terms of the arrangement, including the amount owing and the rights and remedies of the holder to obtain payment; (2) that contain an analysis of the ability of the issuer to satisfy its obligations under the instrument at the time of issuance; (3) that record payments under the instrument; and, perhaps, (4) that briefly explain the conduct of the parties upon any failure to meet the obligations under the instrument. Further guidance should clarify that the condition can be satisfied in part by using words that have a particular significance under clearly applicable local law (for example, "note," "promise to pay," etc.) without having to expressly incorporate the applicable rules of local law into the documentation or memorializing their effect.

If this approach were adopted, it would not be necessary to adopt special rules for workout situations, where a creditor acting at arm's length might well agree to modify or refinance a debt that is not expected to be repaid in full. In such a case, the file would merely have to explain why this was the best the creditor thought it could do. If the structure of the rule is retained as proposed, an exception should be adopted for this situation.

³⁸ Prop. Reg. § 1.385-2(b)(2)(iii), 81 Fed. Reg. at 20,932.

If this approach is not adopted, the Final Regulations should clarify that the third documentation requirement does not change substantive law as to when the borrower's creditworthiness is tested. As discussed below, we think that the Final Regulations should provide further guidance on this important substantive point. But regardless of whether these recommendations are implemented, the proper place for such guidance is in an applicable substantive rule, and the Final Regulations should not make substantive changes implicitly through the Documentation Rule.

Similarly, with respect to the requirement to record payments, we request clarification that, if the EGI permits interest to be paid in kind or otherwise added to the outstanding loan balance without a cash payment, the documentation requirement will be fulfilled by journal entries that show the amount of the accrued interest being added to the outstanding loan balance. In other words, it should be made clear that the documentation requirement does not impose a requirement that interest be payable currently in cash or otherwise change the substantive law governing EGIs.

3. When to Test for Whether There Is a Reasonable Expectation of Repayment

The third documentation requirement is that the taxpayer needs to document, as of the time of the issuance of the EGI, "a reasonable expectation that the issuer intended to, and would be able to, meet its obligations pursuant to the terms of the applicable instrument." If the basic structure of this rule is left intact, we believe that this requirement should be clarified in various respects.

First, for revolvers and lines of credit, expectation of payment should be tested at the time the revolver or line is put in place, provided that the terms are in writing and commercially reasonable. To make such a rule more easily administrable, the Government might consider granting a safe harbor that respects revolvers having a term of two years or less and imposing a maximum term of five years.

Second, for EGIs payable on demand, we believe that periodic retesting is appropriate. An EGI demand loan may be valid debt at the time it is originally issued, but if allowed to remain outstanding past the point when an unrelated creditor would demand repayment, it arguably ceases to be valid debt for tax purposes.³⁹ On the other hand, a rule that requires continuous retesting of EGIs payable on demand would be burdensome and unadministrable. In our view, a reasonable compromise would be to require testing EGIs payable on demand for reasonable expectation of repayment at the

³⁹ See, e.g., *Cuyuna Realty v. United States*, 382 F.2d 298 (Ct. Cl. 1967).

time of issuance and at the end of any tax year in which the obligor becomes insolvent (measured on the basis of the taxpayer's financial statements or in any other reasonable manner). In the latter case, we suggest applying the same treatment as we suggest below for debt with payment defaults, which is that the EGI would cease to be treated as valid debt for tax purposes at the end of the second consecutive year in which the obligor remains insolvent.

Third, for EGIs that are “rolled over” or otherwise have a change in terms that would be considered a significant modification, we think the interaction between the Documentation Rule and Regulation section 1.1001-3(f)(7) should be clarified. The Documentation Rule states that an EGI must be tested at the time of issuance, which would include a rollover or significant modification, but the Credit Quality Look-Back Rule provides that, in testing whether a significantly modified debt instrument remains debt for tax purposes, the decline in the borrower's creditworthiness between the time of the issuance of the original debt and the time of the modification can be ignored.⁴⁰ If the section 385 rule controls, it unjustly nullifies the application of Regulation section 1.1001-3(f)(7) in the case of EGIs, while if the latter controls without limit, it would allow related parties to extend troubled EGIs indefinitely. In our view, an intermediate position is appropriate. We recommend that the Final Regulations provide⁴¹ that, in the case of an EGI that is significantly modified, the modified debt should be respected as debt so long as the terms are consistent with the terms that an unrelated lender would agree to if it were the creditor. To make this rule more easily administrable, we would also recommend that an extension of the term of an EGI for up to the lesser of the original term or three years be exempt from a retesting of the creditworthiness of the borrower.

Finally, to deter taxpayers from issuing EGIs with unusually long fixed terms chosen to postpone re-application of the creditworthiness test, we think that it would be appropriate to issue a regulation under section 385 (separate from the Documentation

⁴⁰ Regulation section 1.1001-3(f)(7) contains a flaw that needs to be addressed independently of EGI considerations. In the case of two or more significant modifications of a debt instrument, the rule as currently in effect permits a look-back only to the creditworthiness of the debtor at the time of the issuance of the obligation being modified, which is the date of the previous significant modification. If the borrower was already in financial distress at the time of the earlier significant modification, this means that upon the second modification the debt would no longer qualify. To allow the rule to operate as intended in such cases, the look-back should be to the time the original debt was issued, not the reissued debt being modified. Of course, if this clarification is made, it increases the need for a special rule for EGIs as described in the text immediately following.

⁴¹ An amendment to Regulation section 1.1001-3(f)(7) might also be appropriate.

Rule) stating that, in determining whether an EGI is debt for tax purposes, a fixed term that is longer than the term that would be granted by an unrelated lender will be considered a significant equity factor. To make this rule more easily administrable, we would suggest that the rule provide a safe harbor of five years. In addition, in the case of an EGI with a term of more than, e.g., 15 years, we suggest that the Documentation Rule provide that the EGI would have to be reevaluated for creditworthiness at least once every, e.g., 15 years, even if not significantly modified at that time.

4. Ordinary Course Transactions

Consistent with our view that most EGIs are non-abusive, we believe the Final Regulations should provide an exception from the Documentation Rule for certain EGIs that arise in the ordinary course of business between expanded group members and for obligations below a *de minimis* threshold. This is particularly critical if the Government does not adopt our suggestion to change the consequences of a documentation failure from a *per se* recast to a presumption. We note that, even with an exception for ordinary course transactions, the Service would remain free to challenge any such obligations under common law principles in appropriate cases. Ordinary course transactions generally have at least some documentation, although it may be of the "for services rendered" variety. We note that general tax principles would not always create a stock interest if the Service successfully challenges the taxpayer's assertion that an EGI arose in an ordinary course transaction.

We think the same considerations generally are applicable under the Documentation Rule and the General/Funding Rules, discussed at greater length below. However, depending on how various issues are resolved under the General/Funding Rules, there may be some concerns unique to the Documentation Rule. For example, the guidance should clarify whether an invoice is in form a debt instrument. We recommend that it not be so treated. If it is, guidance should be provided as to how the documentation requirements can be satisfied. In addition, regardless of how routine financial transactions are treated under the General/Funding Rules, one should never have to document the creditworthiness of a regulated financial institution like a bank or insurance company.

5. Nonrecourse Debt Instruments and Contingent Payment Debt Instruments

The Final Regulations should clarify that a nonrecourse debt instrument will be treated as meeting the "unconditional obligation to pay a sum certain" requirement as long as the debt is secured by property and the holder of the instrument has the right to foreclose or otherwise take the property upon a failure to make the required payments under the instrument. Similarly, the Final Regulations should provide that an EGI does not fail to meet the sum certain requirement merely because it calls for one or more contingent payments in addition to its fixed payments. As these are substantive points, we suggest that they be made outside the section that contains the Documentation Rule.

6. Deadlines for Contemporaneous Documentation

The judgments required under a debt/equity analysis should be made by business people before the fact, in accordance with applicable case law. Because it is unlikely that business people acting on their own without tax counseling would generate all of the documentation required by the Documentation Rule within the required time periods, and given the stakes involved, well-advised corporate groups will employ specialized personnel dedicated to maintaining compliance. In general, systems will be created, if not in place, to track the arrangements subject to the rule and complete the record. Nevertheless, we fear that, as drafted, the tight deadlines present too great of a burden for taxpayers and create traps for the less well advised.

We recommend that the compliance deadlines for any debt or arrangement start with the filing date of the first relevant federal income tax return and thereafter be set at the filing date of any further relevant federal income tax return. Although the documentation might not be exactly contemporaneous, this should afford enough time for a corporate tax department to review its situation and complete its files. If the analysis does not support debt, the taxpayer will know before filing its return.⁴² These deadlines would also make it easier to assure compliance by new entrants into the expanded group, for example new controlled foreign corporations (“CFC”s), which would otherwise require special relief.⁴³

7. Reasonable Cause

If the Government does not accept our suggestion to replace the automatic equity recast with a presumption, the operation of the Documentation Rule’s reasonable cause exception will become critical. It is of critical importance that taxpayers understand when they can invoke an exception to self-reporting an instrument as stock. Reference to penalty practice is not helpful in this regard. We think it is important that the Government provide relief that clearly is available in a self-assessment context.⁴⁴ The

⁴² Consideration might be given to allowing taxpayers to repair their situation within this deadline through retroactive reformation of the arrangement into one that would have sufficient equity in order to allow the remaining debt to qualify as debt.

⁴³ A CFC is any foreign corporation if more than 50% of the vote and value of the stock of such corporation is owned (or considered owned under the constructive ownership rules of section 958(b)) by United States shareholders on any day during the taxable year of the foreign corporation. I.R.C. § 957(a).

⁴⁴ We doubt that the Service has the resources to administer relief through ruling requests under Regulation sections 301.9100-1 *et seq.*

Proposed Regulations' standard for establishing reasonable cause (by reference to the principles of Regulation section 301.6724-1) is not tailored to the types of documentation failures that should provide a strong basis for relief. Various possibilities for relief present themselves, some of which might be based more on substantive criteria (that is, the strength of the taxpayer's case for debt on the merits) or on the types of factors employed in the reasonable cause inquiry (inadvertence, inexperience, etc.).

8. Debt Involving Disregarded Entities and Controlled Partnerships

The Final Regulations should clarify that debt that is disregarded for tax purposes (*i.e.*, debt between a disregarded entity and its tax owner) need not comply with the documentation requirement. Also, the Final Regulations should clarify that the documentation requirements do not apply to an EGI from one member of a consolidated group to a disregarded entity owned by another member of the same group for the same reasons that debt between consolidated group members is excluded generally.

As discussed earlier with respect to the Bifurcation Rule, and for the same reasons, some of our members believe that debt of a disregarded entity or a controlled partnership generally should be recharacterized as stock of its owner or corporate partners and other members believe that such debt should be treated as a partnership interest. None of our members believe that such debt should be treated as stock in a disqualified QSub or QRS.

9. EGIs With No Documentation Other Than Journal Entries

The Proposed Regulations reserve the treatment of EGIs that are not in form indebtedness. Presumably the intention was to leave open the legal documentation requirements for sale-repurchase contracts ("repos") and perhaps production payments, REMIC regular interests and other instruments that are not in form debt but are treated as debt by a specific tax rule. This carve-out might be construed as exempting EGIs that have no written documentation and are evidenced only by ledger or journal entries or by internal balance sheets showing payable and receivable balances. If the Final Regulations continue to have an exception for EGIs that are not debt in form, they should clarify that the exception does not extend to EGIs that have no documentation other than such journal or ledger entries or balance sheets.

The Final Regulations should also clarify that the documentation requirements do not apply to instruments that are *per se* indebtedness under an applicable tax rule.

10. Failure to Honor the Terms of an EGI (the Fourth Documentation Requirement)

The fourth documentation requirement⁴⁵ is divided into two parts: compliance and non-compliance. The first part requires that the parties to an EGI document the payments of principal and interest on the EGI. The second part requires that, in the event of a default or other non-compliance with the terms of the instrument, the parties document the holder's "reasonable exercise of the diligence and judgment of a creditor."

We are generally comfortable with the first part of the requirement. Our only comment on that prong of the test is, as noted above, to request that the Final Regulations clarify that if the EGI permits interest to be paid in kind or otherwise added to the outstanding loan balance without a cash payment, the documentation requirement will be fulfilled by journal entries that show the amount of the accrued interest being added to the outstanding loan balance. In other words, it should be made clear that the documentation requirement does not impose a change in the substantive law governing EGIs. This is particularly important if the Government does not adopt our general recommendation to clarify that the Documentation Rule does not impose any new substantive requirements, only that documentation be maintained.

In contrast, we believe that the second part of the fourth requirement that deals with defaults may be unrealistic, depending on how it is construed. We do not believe that the tax law should require a related creditor to behave in exactly the same way that an unrelated lender would.

Furthermore, the test can be unduly harsh. As proposed, a default that remains uncured for 120 days without documentation of renegotiated terms or a statement indicating the creditor's agreement on the basis of the specified facts to waive the default causes the EGI to be automatically recast as equity in all cases. While it certainly does not represent best practice for related parties to miss payment deadlines for periods of months, such lapses have occurred as a result of inattention rather than inability to pay. And in cases of such inattention, there certainly will be no documentation. Deeming debt to be transformed into equity as a result of a single incidence of carelessness at least seems to us to be inappropriate.

On the other hand, we acknowledge that some test is appropriate to assure that the parties to an EGI cannot blithely ignore the terms of the obligation over a significant

⁴⁵ Prop. Reg. § 1.385-2(b)(2)(iv), 81 Fed. Reg. 20,912, 20,935 (Apr. 8, 2016).

period of time without tax consequences. The case law clearly supports such a test.⁴⁶ We would encourage the Government to refine the relevant substantive rule governing exercise of creditor rights, and relocate it as part of the relevant facts and circumstances analysis outside the Documentation Rule.

We recommend that the Government consider the following two-part approach. First, the failure of a debtor to make a required payment on an EGI would not cause the EGI to cease to qualify as debt until two years from the date of the first missed payment, regardless of whether the parties formally document the creditor's forbearance. This will allow the parties to cure inadvertent failures to pay on time as well as give a reasonable period to work out payment terms for troubled debtors, consistent with the forbearance period permitted by Regulation section 1.1001-3(c)(4)(ii). Second, at or before the end of this two-year period, the debtor must either cure the default or, if this is not possible, the parties must negotiate additional credit terms or an amendment to the terms of the EGI that are consistent with the terms that an unrelated creditor would be willing to grant, or cancel the indebtedness. If the debtor is in sufficient financial distress that it would not be possible to obtain such additional credit or an amendment from an unrelated creditor, or if the parties let the two-year period lapse without putting revised terms in place, the EGI should be reclassified as equity at the end of the two-year period. In this case, we would support a *per se* reclassification because the parties have had the opportunity to avoid cross-chain equity or other inappropriate results by a restructuring during the two-year period.

11. Applicability Thresholds

The Documentation Rule provides applicability thresholds designed to limit its application to larger businesses. Having such thresholds is reasonable given that the rule imposes a considerable compliance burden that will be expensive for taxpayers to satisfy. Non-publicly traded corporations are subject to the Documentation Rule if they have over \$100 million of total assets or \$50 million of annual revenue on any recent financial statement for or within their expanded group. In some cases, this threshold may be too low. For example, even a very small bank may have \$100 million of gross assets, and one busy supermarket might sell \$50 million a year. Because these are low margin businesses, they will feel the cost of compliance more acutely. We suggest raising these thresholds, or adding additional limiting criteria (perhaps based on net worth or net profits), to provide relief to these types of businesses.

⁴⁶ *Laidlaw Transp., Inc. v. Commissioner*, 75 T.C.M. (CCH) 2598, 1989 T.C.M. (RIA) ¶ 98,232; *Estate of Mixon v. Commissioner*, 464 F.2d 394 (5th Cir. 1972), 13th factor.

12. Effective Date Issues

The first three documentation requirements of the Documentation Rule apply when an EGI is issued. While this is reasonable in most circumstances, we are aware of two circumstances in which a special rule is appropriate. First, a U.S. corporation might acquire a group of foreign corporations that have intercompany indebtedness and no previous association with our tax system. That group would have had no reason to comply with the requirements of the Documentation Rule prior to acquisition by the U.S. purchaser. In such a case, the EGIs of the purchased group should be given some reasonable period after the acquisition to put in place the documentation required by the Documentation Rule. Our general suggestion above—that the Documentation Rule should apply as of the due date of the first relevant federal income tax return—is especially important in this context.

Second, an EGI between two members of a U.S. consolidated group might be sold to an expanded group member outside the U.S. consolidated group. In that case, the debt is deemed satisfied and reissued at the time of the sale for its fair market value under Regulation section 1.1502-13(g)(3). The debt also becomes an EGI for the first time upon the sale because debt within a U.S. consolidated group is not subject to the Documentation Rule. The regulations should make clear that for purposes of determining the deadline for satisfying the Documentation Rule, the debt should be deemed issued at the time it becomes an EGI.

In both cases, however, the Final Regulations should clarify that the third documentation requirement does not change the substantive law as to when the borrower's creditworthiness should be tested. This is particularly important if the Government does not accept our general suggestion above to make it clear that the Documentation Rule does not impose any substantive requirements.

Even if the Final Regulations do adopt these suggestions, we think that they should contain a substantive rule providing that, in the first case described above, each borrower's creditworthiness must be tested as of the time the debt was originally issued (subject to possible retesting as described above), not at the time it became subject to the Documentation Rule. We believe this represents current law (in the second case, because the deemed satisfaction and reissuance under Regulation section 1.1502-13(g)(3)(ii) is not an occasion on which the debtor's creditworthiness is retested). However, we do not think it is necessary for the Final Regulations to address this question directly as it would seem outside the scope of this regulations project.

Finally, we expect any final version of the Documentation Rule will be different enough from that in the Proposed Regulations that taxpayers will need time to adopt procedures that can only be determined upon the publication of the Final Regulations, and taxpayers should be given enough time to understand and to design systems to comply with the Final Regulations before the Documentation Rule becomes applicable.

D. The General/Funding Rules

1. Summary of Regulations

Proposed Regulation section 1.385-3 automatically recharacterizes certain related-party debt as equity. The base transaction targeted by the Proposed Regulations is the distribution of a debt instrument (“debt dividend”). The Preamble notes that inverted and foreign parented groups use debt dividends to create interest deductions in the U.S. without investing new capital, and U.S. parented groups use it to repatriate earnings from CFCs without tax liability.⁴⁷ Thus, the General Rule in Proposed Regulation section 1.385-3(b)(2) recharacterizes such debt instruments as equity.⁴⁸

Generally speaking, the other transactions that are recharacterized by the Proposed Regulations seem to be viewed as versions of, or avenues to potentially achieve effects similar to those of, debt dividends.⁴⁹ The General Rule also recharacterizes debt as equity to the extent it is issued by a corporation to a related party (i) in exchange for expanded group stock (*e.g.*, in a section 304 transaction); or (ii) in exchange for property in an asset reorganization, but only to the extent that the note would be treated as boot in the reorganization,⁵⁰ because they are economically similar to a debt dividend and could, similar to a debt dividend, operate to convert what otherwise would be a distribution into a sale or exchange transaction without having any meaningful non-tax effect.⁵¹

The Proposed Regulations also contain the Funding Rule that recharacterizes debt as equity if it was issued with a principal purpose of funding one of the three types of transactions covered by the General Rule (*i.e.*, a distribution of property, purchase of stock of a related party, or an intragroup asset reorganization, collectively the “Prohibited Transactions”). The Preamble states that without the Funding Rule, taxpayers could use a multi-step transaction to achieve economically similar outcomes to the Prohibited Transactions.⁵² The Proposed Regulations provide a *per se* rule that a debt instrument is

⁴⁷ See *id.* at 81 Fed. Reg. at 20,917.

⁴⁸ Prop. Reg. § 1.385-3(b)(2)(i), 81 Fed. Reg. at 20,935.

⁴⁹ See Notice of Proposed Rulemaking, *supra* note 37, at 81 Fed. Reg. 20,917–18.

⁵⁰ Prop. Reg. § 1.385-3(b)(2)(ii), (iii), 81 Fed. Reg. at 20,935.

⁵¹ See Notice of Proposed Rulemaking, *supra* note 37, at 81 Fed. Reg. 20,917–18.

⁵² See *id.* at 20,918.

issued with a principal purpose if it is issued by the funded member during the period beginning 36 months before the funded member engages in one of the Prohibited Transactions and ending 36 months after.⁵³ The Preamble states that such a rule is necessary because money is fungible and it is difficult for the Service to establish the principal purpose of internal transactions.⁵⁴

There are two exceptions that apply to debt instruments that would otherwise be recharacterized as stock under Proposed Regulation section 1.385-3: (i) an exception for current year earnings and profits under Proposed Regulation section 1.385-3(c)(1) (the “Current E&P Exception”), and (ii) a threshold exception under Proposed Regulation section 1.385-3(c)(2) (the “Threshold Exception”). The Current E&P Exception provides that the aggregate amount of any distributions or acquisitions that are treated as Prohibited Transactions are reduced by an amount equal to the member’s current year earnings and profits described in section 316(a)(2) (“Current E&P”). The Threshold Exception excludes an instrument if, immediately after such instrument is issued, the aggregate adjusted issue price of debt instruments held by expanded group members that would be subject to Proposed Regulation section 1.385-3 but for the Threshold Exception does not exceed \$50 million. Once the threshold is exceeded, however, the Threshold Exception will not apply to any debt instrument issued by expanded group members so long as *any* debt instrument that was previously treated as indebtedness solely because of Proposed Regulation section 1.385-3(c)(2) remains outstanding.

There are two additional exceptions that only apply to debt that would otherwise be recharacterized under the Funding Rule: (i) an exception for certain debt instruments that arise in the ordinary course of an issuer’s trade or business under Proposed Regulation section 1.385-3(b)(3)(iv)(B)(2) (the “Ordinary Course Exception”), and (ii) an exception for funded acquisitions of subsidiary stock by issuance under Proposed Regulation section 1.385-3(c)(3) (the “Subsidiary Stock Issuance Exception”). The Ordinary Course Exception excludes 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. It applies only to the extent that it represents an obligation to pay an amount that is currently deductible by the issuer as an ordinary and necessary business expense or is included in the issuer’s cost of goods sold or inventory, and only if the amount of the obligation 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.” The Subsidiary Stock Issuance Exception applies to an acquisition of the stock of an

⁵³ Prop. Reg. § 1.385-3(b)(3)(iv)(B), 81 Fed. Reg. at 20,935.

⁵⁴ See Notice of Proposed Rulemaking, *supra* note 37, at 81 Fed. Reg. 20,923.

expanded group member (the “Issuer”) by a second expanded group member (the “Transferor”) if, for the 36-month period following the transfer, the Transferor holds, directly or indirectly, more than 50% of the voting power and value of the Issuer’s stock.

Debt owed between members of an affiliated group filing a consolidated federal income tax return is excluded from the General/Funding Rules while the obligor and creditor remain members of such group.

2. Concerns about the Overall Concept of Proposed Regulation section 1.385-3

We recognize that earnings stripping is a serious concern worthy of attention by Treasury.⁵⁵ Our tax system should not render foreign enterprises the preferred bidders for domestic companies and assets. Foreign ownership should not excuse domestic corporations from paying their fair share of the income tax.

We also believe that section 385 can provide Treasury and the Service with a powerful tool that can legitimately be used against earnings stripping through excessive related-party debt. Section 385 could also be deployed against excessive related-party debt used to repatriate cash held offshore.

The approach proposed in the General/Funding Rules, however, represents a radical departure from the notion of debt as understood for purposes of the federal income tax over the last century. Moreover, as discussed further herein, automatic recharacterization of debt as equity for all federal income tax purposes can have far-reaching and unintended consequences. For that reason, we believe that the Treasury should reconsider the approach in Proposed Regulation section 1.385-3 in favor of an approach based on the reasons why related-party debt might not normatively qualify as debt, rather than the context and consequences of the creation and use of such debt. Alternatively, we would at least ask that the approach be reconsidered in favor of rules that more narrowly targets the Government’s expressed concerns. Although the bulk of our Comments relate to more technical aspects of the Proposed Regulations, we feel constrained to first express this view.

Because classification under section 385 has many more consequences than simply the availability of interest deductions, it should be employed with a view toward

⁵⁵ We say this in the context of an income tax system that provides different treatment for debt and equity and that has foregone most opportunities to tax foreign investors on domestic source interest. The merits of these features are outside of the scope of these Comments.

giving taxpayers rules under which they can predict and manage the consequences of their actions. In the end, the intricacy of certain aspects of the General Rule and the Funding Rule, intended to foreclose any potential abuse, become self-defeating if the practical effect is that taxpayers and advisors who have to grapple with them cannot explain them adequately or even understand them fully, or if taxpayers can adopt alternative approaches, including, but not limited to, borrowing from the external credit market with the same ultimate tax effect.

(a) Historic Treatment of Debt and Equity

From the earliest days of the income tax, our tax statutes have used the words "stock," "dividends," "indebtedness," and "interest" without precise definitions. Because our tax system does not allow income tax consequences to be dictated merely by formal labels, this lack of precision has resulted in a certain amount of uncertainty and controversy. Congress responded to this by authorizing the Treasury to issue regulations to determine whether an interest in a corporation is stock or indebtedness.

Although the Treasury is not bound to rely on any particular factor or factors, including those listed in the statute, in enacting section 385, Congress presumably intended that the terms "stock" and "indebtedness" would retain their traditional meanings. The concept of debt involves a debtor owing money to a creditor. Decades of case law reflect an inquiry into whether the purported debtor really owes the money. In a few fact patterns, an interest deduction has been denied on third party debt on, in effect, an economic sham basis.⁵⁶

The Proposed Regulations provide rules for characterizing debt between related parties. Related-party debt has always raised special concerns. The tensions between unrelated parties acting at arm's length tend to assure a level of genuineness to the arrangements they negotiate. Related parties do not operate under the same constraints. Accordingly, they can be tempted to lend more than the borrower's credit would justify, or for a longer maturity than an outside lender would accept, or on easier terms, in form or in practical enforcement, than are commercially normal.

⁵⁶ *Winn-Dixie Stores v. Commissioner*, 113 T.C. No. 21 (1999), *aff'd*, 254 F.3d 1313 (11th Cir. 2001); *Lee v. Commissioner*, 155 F.3d 584 (2d Cir. 1998); *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966) (interest deduction disallowed on debt "that cannot with reason be said to have purpose, substance, or utility apart from [its] anticipated tax consequences." Each of these situations can be distinguished as involving a self-contained transaction that was uneconomic taking into account the pretax interest expense.

A creditor achieves a return of and on its investment through rights to payment of specified amounts, rather than participation in corporate governance. A shareholder generally exercises influence over the return of and on its investment through rights to participate in corporate governance and with no or limited rights to obtain particular payments. A related party may be indifferent to the type and source of its rights, having access to both.

For these reasons, there can be such a thing as too much related-party debt. Proposed Regulation section 1.385-2 responds to these concerns with substantiation requirements. The Treasury could easily write regulations that impose limitations on "too much," "too long," or "too easy." One might debate the wisdom of particular metrics or rules,⁵⁷ but not the fact that rules framed around these considerations respond to the particular concerns raised by debt between related parties, whether in the context of inbound, outbound, or wholly domestic transactions.

We note, moreover, that the United States has high nominal corporate tax rates. Any rule limited to related-party debt will not prevent the leveraging of domestic corporations for earnings stripping or the leveraging of foreign corporations for repatriation. The incentives would remain and the external credit market will exist to satisfy them. To some extent, taxpayers (particularly privately-held companies that are not subject to the external leverage limitations imposed by the public capital markets) will adapt to a rule like that proposed by borrowing from third parties. The scope of the General/Funding Rules indicates that the Government is willing to tolerate the amount of borrowing available from third parties for these purposes.

(b) The Retirement of Group Equity as the Dispositive Factor

In order to address concerns with earnings stripping and repatriation transactions, Proposed Regulation section 1.385-3 would impose limitations on corporate group indebtedness on a newly conceived basis, one different than the traditional criteria. The rules would apply to instruments "that otherwise would be treated as indebtedness for

⁵⁷ One example of a measure that relates to too much related-party debt and that was suggested by Professor Stephen Shay in his open letter to Secretary Lew published in Tax Notes is based on a corporate group's indebtedness to unrelated parties as a measure for how much related-party debt is appropriate. Stephen Shay, *Mr. Secretary, Take the Tax Juice Out of Corporate Expatriations*, 144 TAX NOTES (TA) 473 (July 28, 2014). Another example is the debt-to-equity ratio limits that would have been imposed by the 1980 proposed regulations. Prop. Reg. §§ 1.385-1 to -12, 45 Fed. Reg. 18959, 18973 (Mar. 24, 1980).

federal income tax purposes."⁵⁸ That is, it applies to debt where the purported debtor really does owe the money.

The underlying premise of Proposed Regulation section 1.385-3 appears to be that, in the Government's view, the economic and legal distinction between intercompany debt and equity⁵⁹ is too thin to allow the income tax benefit of an interest deduction to be achieved in certain circumstances involving intercompany transactions within corporate groups, and thus has an anti-abuse aura to it. A base case circumstance is where a note issuance to another corporate group member results in an outflow of corporate equity to such other group member. Treasury and the Service freely acknowledge that the proposed rules depart from the concepts of debt and equity that have developed under the case law over the last century.

The Preamble relies on *Talbot Mills v. Commissioner*,⁶⁰ and *Sayles Finishing Plants, Inc. v. United States*⁶¹ for the proposition that the lack of new capital investment is a critical factor in determining whether debt of a closely held corporation should be respected as such.⁶² These cases provide at best ambiguous support for the underlying theory of Proposed Regulation section 1.385-3. In his seminal article on corporate debt, William Plumb describes "no new capital" as a "mere rhetorical makeweight" invoked "in cases where the substantive factors strongly negated true debt."⁶³

The holding in *Kraft Foods Co. v. Commissioner*,⁶⁴ on the other hand, applied the conventional meaning of the term "debt" even in the context of an intercompany

⁵⁸ Prop. Reg. § 1.385-3(a), 81 Fed. Reg. at 20,934.

⁵⁹ Presumably, the Government's assessment takes into account factors such as the principle of equitable subordination where significant third party creditors exist.

⁶⁰ 146 F.2d 809 (1st Cir. 1944), *aff'd sub nom, John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946).

⁶¹ 399 F.2d 214 (Ct. Cl. 1968).

⁶² Notice of Proposed Rulemaking, *supra* note 37, at 81 Fed. Reg. 20,917.

⁶³ William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 552 (1971) (this notion is discussed in the portion of his article labeled "False Gods and Rhetoric"). For example, the *Talbot Mills* case involved debt that the corporation could subordinate at will to other debt and paid a rate of interest that varied significantly with corporate profits.

⁶⁴ 232 F.2d 118 (2d Cir. 1956).

distribution of debentures. The proposed General/Funding Rules represent a significant departure from this approach, in that their premise is that debt can be defined by the context in which it is created and used. This is so significant a departure from the historical analysis and the ideas expressed by Congress in enacting section 385 that it raises serious concerns about whether the General/Funding Rules are a valid exercise of the Treasury's authority under section 385(a).

The Preamble states that “[i]n many contexts, a distribution of a debt instrument similar to the one at issue in *Kraft* lacks meaningful non-tax significance,” and that, “although 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.”⁶⁵ Although the change--the addition of formal terms and rights of debt--that occurs when equity is replaced with debt may seem insignificant, that formal distinction is given effect when a company is capitalized.⁶⁶ It is hard to see why the presence of creditor's rights can be so important upon the initial investment but of no significance if added at a later date, even if there is no new investment at that later date. Clearly it is considered significant if the creditor is not a member of the same expanded group as the borrower.⁶⁷ A widely-held public corporation can dividend out debentures pro rata to its shareholders. A widely-held public corporation can buy back a significant block of its stock for its note. A widely-held public corporation can and frequently does borrow from unrelated lenders to support its dividend or stock buy-back program. All of these withdraw capital that could otherwise compound within the corporate equity base, and erode the equity base through interest payments. None of these transactions runs afoul of the Proposed Regulations. It is not clear why the third party comparator holds for related party debt on an initial investment, but not on a recapitalization.

⁶⁵ Notice of Proposed Rulemaking, *supra* note 37, at 81 Fed. Reg. 20,917.

⁶⁶ See Staff of J. Comm. on Taxation, 111th Cong., 2d Sess., *Technical Explanation of the Revenue Provisions Contained in the “American Workers, State and Business Relief Act of 2010,” as Passed by the Senate on March 10, 2010*, 189-90 (JCX-11-10) (Comm. Print 2010) (providing that the economic substance doctrine does not apply “to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages [including] . . . the choice between capitalizing a business enterprise with debt or equity”).

⁶⁷ The result of applying the General/Funding Rules suggests that the Treasury and the Service believe that the *Kraft* result should be changed if the holder of the note is a corporation, but may be accepted if the holder is an individual. *Kraft* would also remain good law for issuing corporations whose expanded groups do not issue more than \$50 million of related-party debt for prohibited purposes.

Further, the Funding Rule can result in the recharacterization of an instrument even where issued in connection with new funding. The "Fact Sheet" for the Proposed Regulations states that "[t]he Proposed Regulations generally do not apply to related-party debt that is incurred to fund actual business investment, such as building or equipping a factory." This will not be true in various situations in which the taxpayer does not plan appropriately (or has no choice), because the Funding Rule ignores the actual use to which the proceeds of related-party debt are put.⁶⁸

For these reasons, we believe that the Government should reconsider the overall approach of the General/Funding Rules. Although the Proposed Regulations are intended to address serious tax policy concerns, we believe the General/Funding Rules are framed around an inquiry not contemplated by section 385 or appropriate from an overall tax policy perspective.

(c) Stock and Asset Acquisitions.

As noted above, the Proposed Regulations also apply to debt issued in connection with expanded group stock acquisitions or as boot in related party reorganizations. There is a meaningful economic difference in these transactions as compared to a debt dividend because new capital is introduced into the issuing corporation (i.e., the corporation issuing debt will own the stock or assets of an expanded group member). Nevertheless, the Preamble states that "[s]uch transactions do not change the ultimate ownership of the affiliate, and introduce no new operating capital to either affiliate." The latter sentence that no new operating capital has been introduced to either affiliate is incorrect, unless the selling and acquiring affiliates are being viewed as a single economic unit. For instance, if S1 purchases all of the stock of S2 from P in exchange for a note, S1 on a standalone basis clearly has new capital in the form of its 100% ownership in S2 following the transaction. This is true whether P is the sole shareholder of S1, or an unrelated corporation. In order to build a conceptual bridge between a debt dividend and, for example, a section 304 transaction, the Preamble notes that "[r]ecognizing the economic

⁶⁸ If the potential investor already operates in this country through domestic corporations, it would be subject to the proposed Funding Rule. Assume that a well-capitalized, creditworthy domestic subsidiary of a foreign parent proposes to build a factory that costs more than \$1000 and that the foreign parent will provide \$1000 of the financing in exchange for a note. If, two years before, the subsidiary distributed \$250 in a year in which it had \$50 of Current E&P, \$200 of the new financing will be treated as funding the distribution, not the factory. In the less likely case that the potential investor would be a first-time entrant into the U.S., it would have no preexisting exposure to the Funding Rule. It would have an incentive to fund its investment with as much debt as possible, but, having no preexisting equity base in the U.S., traditional debt/equity principles would prevent it from funding entirely with debt.

similarities between purchases of affiliate stock and distributions, Congress enacted section 304 and its predecessors to prevent taxpayers from acquiring affiliate stock to convert what otherwise would be a taxable dividend into a sale or exchange transaction.” This conflates the focus of section 304 and the concern posed by a debt dividend. Section 304 treats certain related party stock sales as a dividend to the *selling shareholder* because the *selling shareholder* has not experienced a meaningful reduction in its direct and indirect ownership in the target corporation. The fact that the selling shareholder may have dividend treatment does not, in turn, mean that no new operating capital has been introduced into the acquiring corporation, viewed as a standalone entity.

Similar statements can be made regarding the issuance of debt as boot in a reorganization. Clearly, in a reorganization new capital is received by the acquiring corporation, and thus the transaction is meaningfully distinguishable from a debt dividend transaction. In addition, a reorganization transaction requires, as a matter of qualification, a non-tax business purpose,⁶⁹ which may ameliorate Treasury’s concerns that such transactions are undertaken purely for tax planning purposes.

Further, the Proposed Regulations draw an arbitrary distinction between related party asset purchases that are pursuant to a reorganization, versus a stand-alone transaction. For example, if S1 buys a truck from S2 as a stand-alone purchase, that transaction is not subject to the Proposed Regulations, whereas if the acquisition was pursuant to a reorganization of S2 into S1, the transaction would be caught. Similar to the acquisition of EG member stock, it is difficult to justify why the tax consequences to the selling party are relevant in determining whether an instrument is debt.

Accordingly, as explained below, we recommend that Treasury and the Service not subject EG stock acquisitions or intercompany asset reorganizations to the General/Funding Rules.

(d) Recommendation

It appears that the Government was primarily concerned about debt dividends and closely related transactions that could facilitate earnings stripping and repatriation. However, redefining debt and equity to address those transactions as proposed would be a fundamental change in the tax law viewed more broadly. We recommend that the Service and Treasury reconsider the overall approach employed in the General/Funding Rule. If the Government believes it is appropriate to use section 385 to combat the use of

⁶⁹ See Reg. § 1.368-1(b).

related-party debt because it can be abused in these contexts, we recommend adhering more closely to considerations traditionally applied to question related-party debt.

Aside from our concerns about the underlying concept, we note that the proposed General/Funding Rule is complex, imposes a significant compliance burden that requires each affected corporation to monitor its and its affiliates activities over a considerable period of time, and can have large disruptive effects on transactions between affiliates. We strongly believe in the benefits of simplification of the tax system where possible, and note that the General/Funding Rules take a giant step in the opposite direction.

If the Government cannot be persuaded to start with a different concept, we at least recommend that Treasury and the Service adopt a more targeted approach to address the transactions of concern. For example, the Final Regulations could apply the General Rule only to debt dividends (and the acquisition of hook stock for debt, which is also identified as a transaction of concern in the Preamble)⁷⁰ and adopt an anti-abuse rule in which the other transactions identified in the General and Funding Rules would be recharacterized only if they were entered into with a principal purpose of avoiding the debt dividend rule.

Alternatively, or in addition, the Final Regulations could limit the effect of the recharacterization to the disallowance of a deduction for interest expense on the recharacterized debt.⁷¹

These changes would go a long way in mitigating many of the far-reaching effects of recharacterizing debt as equity that are identified in these Comments.

The remainder of these Comments focuses on the more technical issues with the Proposed Regulations in the event that their basic approach is retained.

3. Concerns about the Operation of Proposed Regulation section 1.385-3

(a) Per Se Rule

The Proposed Regulations provide a *per se* nonrebuttable presumption that a debt instrument will be recharacterized as equity under the Funding Rule if it is issued by the

⁷⁰ See Notice of Proposed Rulemaking, *supra* note 37, at 81 Fed. Reg. 20,917–18.

⁷¹ Although section 385 permits Treasury to determine debt and equity for all federal tax purposes, we do not believe they are precluded from determining debt and equity for more limited purposes.

funded member during the period beginning 36 months before the funded member engages in one of the Prohibited Transactions and ending 36 months after. As discussed further in these Comments, this rule leads to numerous complexities, traps for the unwary, and unintended consequences. In addition, six years is an extremely long time in the commercial world to have to track every single movement of cash and property within an expanded group.

We understand Treasury's concerns about backstopping debt dividends and the fungibility of cash, but we do not believe that either concern justifies such a harsh rule. Indeed, it is arguable that the *per se* rule goes beyond the authority granted in section 385, which requires that the debt/equity determination be based on factors. The *per se* rule does not allow for the consideration of factors that would show that the relevant transactions do not represent a disguised form of a General Rule transaction.

We believe that the Government's interests can be protected with either a principal purpose test as noted above, or a rebuttable presumption that would allow the taxpayer to establish that the facts and circumstances do not warrant application of the rule.

In addition, even if a *per se* rule were to be retained, we do not think a six-year period is needed to protect against the fungibility of cash. The point of the rule is to recharacterize debt that potentially funds a Prohibited Transaction. It is highly unlikely that a taxpayer would incur debt to fund a transaction occurring three years before or after the Prohibited Transaction, even taking into account the fungibility of cash. We believe the period should be shorter — not more than 12 months before or after the Prohibited Transaction.

(b) No Credit for Equity Infusions

The Preamble states that its concern with the transactions that are recharacterized is that there is no new capital. Nonetheless, the Proposed Regulations track all equity outflows over a 72-month period on a gross basis and generally provide no credit for equity infusions during the same period. This treatment is hard to justify in light of the stated purpose. And it creates anomalies because it is inconsistent with what happens when the General/Funding Rules recharacterize an instrument. Furthermore, by not providing credit for equity infusions, the Proposed Regulations will create a strong incentive for taxpayers to maximize the use of related party debt.

Example 1 (Equity Infusion). Assume that, two years ago, foreign parent, FP, received a dividend from its domestic subsidiary, USS, of \$50 in excess of USS's Current E&P. FP now intends to lend USS \$1,000 to finance the expansion of its business. Under the Proposed Regulations, \$50 of the loan would be recharacterized as stock, \$950 would remain treated as debt, and the prior \$50 distribution would then be neutralized against recharacterizing future loans by FP to USS.

If, instead of lending \$1,000, FP buys \$50 of USS stock from USS and lends USS \$950, the \$50 equity infusion is of no consequence. Fifty dollars of the \$950 loan is recharacterized as stock. That recharacterization neutralizes the prior distribution from tainting future loans. These results would obtain even if FP invested \$950 for stock and only \$50 for debt.

Only if FP invested all \$1,000 as equity would it avoid any recharacterization. But in that case, the prior \$50 distribution would remain active to recharacterize any future attempt at lending until 36 months elapse from the distribution.

Thus, FP would be incentivized to maximize the amount of funds advanced through a loan in order to mitigate the effect of recharacterization of a portion of the loan as equity.

As noted earlier in our Comments, holding a bifurcated instrument is almost always less desirable than holding two separate instruments, one equity and one debt. The Funding Rule has a propensity to create bifurcated instruments. In our example, the taxpayer could not avoid bifurcation by directly investing \$50 for stock, even though that result would be consistent with the policy goals of the General/Funding Rules. As self-help, the best the taxpayer could do is issue two debt instruments sequentially, one for \$50, which will be recharacterized, and the second for \$950. Unfortunately, because the notes would otherwise have to be debt for tax purposes, the note destined to be treated as stock will have terms typical of debt, denying the taxpayer the flexibility normally associated with stock investments.⁷²

We recommend that the Final Regulations provide an exception from recharacterization to the extent of all equity infusions from the expanded group into the issuer during the same period that equity outflows are taken into account, or at least up until the point where the instrument would otherwise first be recharacterized under the Proposed Regulations (whether that be the making of the loan or a later distribution). Because the premise of the Proposed Regulations is that certain transactions (e.g., related party stock acquisitions and asset reorganizations) are not genuine equity inflows, to the extent the Final Regulations maintain that position, those transactions would not be treated as equity infusions, but equity infusions into those target entities during the window period should count positively.

⁷² These terms might also jeopardize entitlement to a dividends received deduction or foreign tax credit.

(c) The Proposed Regulations Treat Similar Transactions and Instruments Differently

The Proposed Regulations treat economically similar transactions and instruments differently. As illustrated by the examples below, a section 304 transaction is treated differently depending on whether the General Rule or the Funding Rule applies, section 355 transactions with and without a D reorganization are treated differently, and liquidations and upstream reorganizations are treated differently. This suggests that the rules may not be sufficiently tailored to achieve their stated purposes and thus present traps for unwary taxpayers.

Example 2 (section 304 Transaction). Assume a U.S. company, USP, owns all of the stock of two CFCs, CFC1 and CFC2. CFC 1 owns all of the stock of CFC3, and CFC2 owns all of the stock of CFC4. CFC2 wants to acquire the stock of CFC3 from CFC1, but depending on precisely how the acquisition is funded, the consequences are different, notwithstanding that the parties are in essentially the same economic position. In the first scenario, CFC2 acquires the stock of CFC3 from CFC1 for a note. In the second and third scenarios, CFC2 acquires the stock of CFC3 for cash funded by prior loans—in the second scenario, CFC2 received a loan from its subsidiary, CFC4, 12 months earlier; in the third scenario, CFC2 received a loan from its parent, USP, upon its initial capitalization more than three years ago.

In all three scenarios, CFC2 has acquired the stock of CFC3 and CFC2 has a note outstanding. However, the tax consequences under the Proposed Regulations are significantly different. In the first scenario, Proposed Regulation section 1.385-3(b)(2)(ii) applies to treat the note as equity and, therefore, section 304 does not apply.⁷³ In the second scenario, the note issued by CFC2 is a principal purpose debt instrument under the *per se* rule of Proposed Regulation section 1.385-3(b)(3)(iv)(B)(1) because it was issued by the funded member within 36 months before the stock acquisition. Accordingly, the note issued to CFC4 is recharacterized as equity, but the acquisition of stock by CFC2 in the section 304 transaction is not affected. In the third scenario, because the note was issued to USP more than three years ago, both the note issued to USP and the section 304 transaction are unaffected.

Example 3 (Section 355 Distributions). A section 355 distribution without a divisive D reorganization is treated as a distribution of property triggering the Funding Rule, but a section 355 distribution with a divisive D reorganization is not. For example, assume a foreign parent, FP, owns all of the stock of a U.S. distributing company, USD.

⁷³ See Prop. Reg. § 1.385-3(g)(3), Ex. 3, 81 Fed. Reg. 20,912, 20,938 (Apr. 8, 2016).

USD had previously borrowed money from FP in exchange for a note. Two years later, USD distributes the stock of a controlled subsidiary, USC, holding an old and cold active trade or business to FP in a transaction that satisfies the requirements of section 355, including the corporate business purpose requirement. If USD engages in a preliminary D reorganization by either forming USC or contributing assets to a pre-existing USC, the section 355 distribution is treated as part of the divisive D reorganization and thus does not cause USD's debt instrument to be treated as a principal purpose debt instrument.⁷⁴ However, if all of the business assets were already owned by USC, so a preliminary D reorganization is not necessary, the section 355 distribution would be treated as a distribution of property triggering the Funding Rule and, thus, USD's debt instrument would be recharacterized as equity.

Example 4 (Liquidations). A liquidation is treated as a distribution of property triggering the Funding Rule, but an upstream reorganization is not. A section 332 may implicate the Funding Rule in numerous, and ostensibly, unintended ways. Assume that P owns S1 and S2, S2 owns S3, and S3 owns S4. In January of Year 1, S1 loaned \$100 to each of S2 (the S2 Note) and S3 (the S3 Note). In December of Year 1, S3 checks-the-box to liquidate (the S3 liquidation). The S3 liquidation creates a few potential issues under the Proposed Regulations.

Is S3's deemed distribution of all of its assets and liabilities to S2 in exchange for S2's shares of S3 stock either a distribution by S3, or an acquisition of EG member stock by S3 (i.e., S3's acquisition of its own stock)? The Preamble indicates that the term distribution is intended to be interpreted broadly, and provides an example of a redemption, indicating that it is both a distribution and an acquisition of EG member stock.⁷⁵ Thus, the S3 Note would be equity of S3 *upon issuance*. How does this characterization affect the tax characterization of the S3 deemed liquidation? Presumably S3 is deemed to distribute assets to both S1 and S2. If the S3 Note does not qualify as section 1504(a)(4) stock, then the liquidation will not qualify as tax free under section 332 and S3 would have to recognize section 336 gain on a pro rata portion of each of its assets.

The Proposed Regulations also draw a distinction between acquisitions of stock of EG members and acquisitions of assets of EG members.

⁷⁴ See Prop. Reg. § 1.385-3(b)(3)(ii)(A), (B), -3(g)(3), Ex. 8, 81 Fed. Reg. at 20,935, 20,939.

⁷⁵ See Notice of Proposed Rulemaking, *supra* note 37, at 81 Fed. Reg. 20,922.

Example 5 (Acquisition of LLC). Assume a foreign parent, FP, owns all of the stock of a foreign subsidiary, FS, and all of the stock of a U.S. subsidiary, USS. FS owns all of the interests in a U.S. LLC and sells the interests to USS for a note. If U.S. LLC is a disregarded entity, the sale is treated as a sale of assets and the note is not recharacterized, but if U.S. LLC is a corporation, the sale is a sale of stock described in Proposed Regulation section 1.385-3(b)(2)(ii), and the note is recharacterized as equity. There is yet a third alternative if the interests in U.S. LLC are sold, and then U.S. LLC checks the box to be treated as a disregarded entity. In that case, the transaction is a D reorganization described in Proposed Regulation section 1.385-3(b)(2)(iii), and the note is recharacterized as equity.

Finally, the Proposed Regulations place a premium on the form of third-party acquisitions.

Example 6 (Acquisition of Unrelated Target). Assume a foreign parent, FP, owns all of the stock of a U.S. subsidiary, USS. USS would like to acquire the stock of an unrelated U.S. target, UST, using cash from FP. If FP acquired UST for cash and sold it to USS for a note, the note would be recharacterized as equity under Proposed Regulation section 1.385-3(b)(2)(ii). On the other hand, if USS borrowed money from FP and used it to acquire UST, the note would not be recharacterized.

Example 7 (Acquisition of Bonds). If a company issues \$1,000x of bonds to the public, and \$50x are acquired in the market by an EG member, the \$50x of bonds may be recharacterized as stock if coupled with a distribution in excess of Current E&P or other defunding transaction of the issuer, even though identical bonds held by third parties are respected as debt. On the other hand, if the EG member loaned \$50 to the issuer so that the issuer could redeem its bonds in the market, the loan would not be recharacterized.

As illustrated by these examples, the Proposed Regulations draw some lines, but the reason for these lines is not clear. The preamble to the Proposed Regulations suggests that Proposed Regulation section 1.385-3 was motivated largely by the Government's concern about the lack of non-tax significance surrounding debt dividends. The preamble notes that no new assets or operating capital are being introduced into the group, yet the tax benefits are significant.⁷⁶ The rules regarding acquisitions of EG member stock, internal asset reorganizations, and the funding of any of these transactions were intended to backstop the debt dividend rule.⁷⁷ However, a debt dividend is meaningfully different

⁷⁶ See *id.* at 20,917–18.

⁷⁷ See *id.*

from an EG member's borrowing to acquire stock or assets. When an EG member acquires stock or assets for a note, it is acquiring something of equal value, and its equity value does not change as it does in a debt dividend. The location of assets and tax attributes has historically been significant, even in consolidated groups,⁷⁸ and ignoring the location could explain some of the anomalous results in the examples above.

We recommend that the Final Regulations adopt an exception for intra-EG acquisitions of stock or asset reorganizations (and the Funding Rule relating to these transactions) for which the taxpayer can show a business purpose for moving the stock or assets. For example, the movement of stock or assets in Examples 2 or 5, above, may be helpful to align subsidiaries geographically or move assets to associated operating businesses. Such an exception is consistent with the stated purpose of the Proposed Regulations to prevent issuances of debt instruments that lack non-tax significance. Finally, we recommend that the Final Regulations adopt exceptions for intra-EG transactions that are part of the same plan as an acquisition from an unrelated third party (such as in Examples 6 and 7, above). Third-party acquisitions involve the introduction of new assets into the EG and, thus, do not present the same concerns as purely intra-EG transactions. Further, we recommend that the Final Regulations not treat section 355 distributions or liquidations (as in Examples 3 and 4, above) as distributions of property for purposes of the Funding Rule. There appears to be no policy reason for treating these tax-free transactions different from tax-free asset reorganizations for purposes of the Funding Rule. Section 355 or liquidating distributions cannot be "funded" by a cash loan and thus, cannot raise the fungibility concerns raised in the preamble.⁷⁹ In addition, a section 355 distribution is supported by its own non-tax business purpose,⁸⁰ and a liquidation must be pursuant to a plan of liquidation with a purpose to terminate corporate affairs.⁸¹

⁷⁸ See Reg. § 1.1502-13.

⁷⁹ See Notice of Proposed Rulemaking, *supra* note 37, at 81 Fed. Reg. 20,923.

⁸⁰ See Reg. § 1.355-2(b).

⁸¹ See Reg. § 1.332-2(c), -4(a)(1).

(d) The Proposed Regulations Will Disrupt Ordinary Business Transactions Not Motivated by Tax Benefits

(i) Recharacterization Can Negatively Affect Unrelated Transactions or Classifications of Entities

We also believe that treating a recharacterized note as equity for all U.S. tax purposes can lead to harsh and potentially unintended consequences.

If debt is recharacterized as equity, then transactions that would otherwise qualify for certain tax-free treatment under sections 351, 368, 332, and 355, among other sections, can result in unexpected adverse consequences because of the failure to satisfy control requirements. In addition, debt recharacterization may also adversely affect ownership thresholds, which may affect affiliation, CFC status, and ownership changes under section 382.

Example 8 (Subsequent section 351 Transaction). Assume that a U.S. parent company, USP, owns all of the stock of two foreign subsidiaries, FS1 and FS2. In Year 1, FS2 issues a note to FS1, which is recharacterized as equity under the Funding Rule of Proposed Regulation section 1.385-3(b)(3). In Year 2, USP contributes appreciated property to FS2. Because the FS2 note is likely to be recharacterized as nonvoting stock, USP will not satisfy the section 368(c) control requirement,⁸² and the Year 2 contribution will not qualify as tax-free under section 351. One possible solution to this issue would be to provide that such debt recharacterized as equity is not stock for purposes of section 368(c).

Example 9 (Disaffiliation). Assume that a foreign parent, FP, owns all of the stock of a U.S. company, USP. USP is the common parent of a consolidated group consisting of two U.S. subsidiaries, USS1 and USS2. FP loans USS2 money in exchange for USS2's note in Year 1. In Year 2, USP pays a cash dividend to FP. Because USP, USS1, and USS2 are treated as a single corporation,⁸³ the dividend triggers the Funding Rule, and the USS2 note is recharacterized as equity.⁸⁴ If the USS2 note represents

⁸² A corporation is considered to control another corporation for purposes of section 368(c) if it owns stock possessing 80% of the total combined voting power of all classes of stock entitled to vote in the second corporation and at least 80% of the total number of shares of each of the other classes of stock of that corporation. I.R.C. § 368(c); Rev. Rul. 59-259, 1959-2 C.B. 115.

⁸³ Prop. Reg. § 1.385-1(e), 81 Fed. Reg. 20,912, 20,931 (Apr. 8, 2016).

⁸⁴ Prop. Reg. § 1.385-3(b)(3), 81 Fed. Reg. at 20,935.

greater than 20% of the value of USS2, and the USS2 note is not Section 1504(a)(4) stock, then USS2 becomes disaffiliated from the USP consolidated group. Elsewhere we have suggested that recharacterization under the General/Funding Rules should not cause disaffiliation.

Debt recharacterization may also cause disqualification of certain types entities. For example, REITs may not hold more than 25% of the value of their assets in securities of taxable REIT subsidiaries (“TRSs”) unless the securities are qualifying assets because they are debt obligations secured by a mortgage on real property.⁸⁵ If mortgage debt issued by a TRS to its parent REIT is recharacterized as equity, it could cause the REIT to lose its tax status. Similarly, S corporations may not have outstanding more than one class of stock, so if the recharacterized debt creates a different class of stock, the S corporation could lose its tax status.

These consequences seem particularly harsh because they are unrelated to the stated concerns about earnings stripping or repatriation. In addition, they present traps for the unwary in that companies may not even realize they have engaged in a Prohibited Transaction and would not have engaged in the subsequent tax-free transaction or an intercompany transaction with an EG member had they known it would not qualify.

We recommend that Treasury and the Service consider adopting an “inadvertent termination” procedure that would permit taxpayers that find themselves in these scenarios to reverse the effects of the recharacterized debt, within a certain time period following discovery by the taxpayer, by eliminating the debt (through repayment or cancellation).

In addition, no dividends-received deduction may be available with respect to a payment on a recharacterized note because (at least in the Service’s view) the existence of creditor rights may toll the holding period under section 246.⁸⁶ In addition, to the extent that payments on a recharacterized note are eligible for the dividends-received deduction, the repayment of the note could be an extraordinary dividend under section 1059. It is difficult to discern a good policy reason for the denial of the dividends-received deduction in these circumstances, where the creditor remedies are between related parties and those very creditor remedies are otherwise being ignored in determining the debt/equity status of the note. Although beyond the scope of these Proposed Regulations, we believe that Treasury should reconsider the conclusion reached

⁸⁵ I.R.C. § 856(c)(4)(B)(ii).

⁸⁶ Rev. Rul. 94-28, 1994-1 C.B. 86.

in Revenue Ruling 94-28, 1994-1 C.B. 86, or at least provide that it does not apply where debt has been recharacterized under these Proposed Regulations.

Finally, a recharacterized note raises the question whether it may be treated as fast-pay preferred stock due to the repayment being treated as a section 302(d) redemption. The possibility of a note being treated as fast-pay preferred is particularly concerning because it can thereby trigger listed transaction consequences.⁸⁷ However, the fast-pay regulations provide: “Stock is not fast-pay stock solely because a redemption is treated as a dividend as a result of section 302(d) unless there is a principal purpose of achieving the same economic and tax effect as a fast-pay arrangement.”⁸⁸ Because the Proposed Regulations may not be affirmatively used by a taxpayer, there is no reason to believe that taxpayers will use the Proposed Regulations (and their associated recharacterization of a repayment of debt as a section 302 transaction) to achieve the economic and tax effect of a fast-pay arrangement, or that taxpayers will otherwise use the Proposed Regulations for a tax avoidance purpose. Therefore, we recommend that the Final Regulations clarify that recharacterized notes will not be treated as a fast-pay arrangement by virtue of their repayment feature.

(ii) Purchase of parent stock by operating subsidiary used for compensatory purposes

Regulation section 1.1032-3 provides that under certain circumstances, when a subsidiary issues parent stock or options for compensatory purposes, such issuance is treated *as if* the parent contributed cash to the subsidiary which the subsidiary then uses to purchase the stock or options from the parent immediately before the subsidiary grants the stock options for compensatory purposes. If the subsidiary receives a loan from an EG member within the 36-month period before or after the compensatory grant is made, the deemed acquisition of stock under Regulation section 1.1032-3 might be considered to trigger the Funding Rule, in which case the note would be recharacterized as equity.⁸⁹

If the subsidiary actually buys the parent stock for an intercompany note, the note likely would be recharacterized as stock under the General Rule.⁹⁰

⁸⁷ Notice 2009-59, 2009-31 I.R.B. 170.

⁸⁸ Reg. § 1.7701(l)-3(b)(2)(ii).

⁸⁹ Prop. Reg. § 1.385-3(b)(3)(ii)(B), 81 Fed. Reg. at 20,935.

⁹⁰ Prop. Reg. § 1.385-3(b)(2)(ii), 81 Fed. Reg. at 20,935.

We recommend that deemed transactions occurring pursuant to other Code sections or regulations, such as Regulation section 1.1032-3, be excluded from the scope of the Funding Rule.

(iii) Short-term/overnight loans that regularly roll over

A short-term, often overnight, loan that regularly rolls over, if recharacterized as equity, could be treated as a recurring dividend. The daily repayment and reissuance results in a daily dividend, which has the effect of moving earnings and profits among related parties in ways that may not be anticipated or desirable from a policy perspective. If the loans are cross-border, they could result in daily withholding payments, which creates an additional administrative and tax burden. We recommend an exclusion from the Funding Rule for short-term loans (*e.g.*, less than a year).

In addition, it is unclear whether step transaction or substance-over-form principles should apply to “equity” with a short contemplated life. Generally, debt that is issued and repaid in a short time frame is respected as debt (or at least not disregarded merely because it was issued and repaid in a relatively short time frame). However, if equity is issued with a plan or expectation that it will be redeemed shortly thereafter, under substance-over-form authorities the stock may be disregarded as transitory.⁹¹

(iv) Ordinary financial transactions would be impacted

Foreign currency hedges and other hedges of loans would no longer qualify as hedges if the underlying debt were recharacterized as equity.⁹² In addition, if a funding company is a section 475 dealer, outstanding debt to EG members that is recharacterized as stock can no longer be marked to market.⁹³

(e) Statutory Debt Provisions

The Code treats certain instruments as debt instruments. For example, pursuant to a statutory straight debt safe harbor, certain S corporation debt shall not be treated as a

⁹¹ See, *e.g.*, *InterTAN, Inc. v. Commissioner*, 87 T.C.M. (CCH) 767, 2004 T.C.M. (RIA) ¶ 2004-001, *aff'd*, 117 F. App'x 348 (5th Cir. 2004).

⁹² I.R.C. § 988(c)(1)(B); Reg. § 1.1221-2(b)(2).

⁹³ Reg. § 1.475(b)-1(b).

second class of stock.⁹⁴ Regular interests in real estate mortgage investment conduits (“REMICs”) are statutorily treated as debt.⁹⁵ In addition, certain production payments are treated as mortgage loans under section 636. We do not believe that the Proposed Regulations were intended to override these statutory provisions,⁹⁶ and it would be helpful if the Final Regulations would clarify that point.

(f) Iterative Consequences of Funding Rule

The recharacterization of debt as equity under the Funding Rule can cause other debt to be recharacterized as equity solely because of the first recharacterization and thus have an iterative effect.

Example 10 (Iterative Notes). Assume that a U.S. parent, USP, owns all of the stock of two CFC operating companies, CFC1 and CFC2, and all of the stock of a centralized treasury company, FinCo. In Year 1, CFC1 distributes a \$100 dividend to USP. In Year 2, CFC1 draws \$100 cash from FinCo, and CFC2 deposits \$150 cash into FinCo. In Year 3, CFC1 deposits \$100 cash into FinCo as a repayment of its Year 2 loan, and CFC2 withdraws \$100 cash from FinCo as a partial repayment by FinCo of CFC2’s Year 2 loan. Because CFC1’s borrowing from FinCo in Year 2 occurred within 36 months of CFC1’s distribution, the debt is recharacterized as equity under the funding rule. As a result, FinCo would be treated as having acquired stock of an EG member (CFC 1) in Year 2. FinCo’s acquisition of CFC 1 stock would recharacterize \$100 of CFC2’s loan to FinCo as equity of FinCo in Year 2. In Year 3, FinCo’s repayment of a portion of its \$150 loan to CFC 2 (which would be part debt (\$50), part stock (\$100)), could be treated as a redemption by FinCo of a portion of its equity held by CFC 2, which would have the effect of recharacterizing all or a portion of the remaining \$50 loan owing to CFC 2 as stock of FinCo.

Iterative recharacterizations are not limited to the centralized cash management vehicles, but these vehicles present particularly complex issues under Proposed Regulation section 1.385-3. This example presents an unrealistically simplified set of facts. In the real world, cash draws and deposits can occur daily, thus resulting in an extremely complex set of iterative recharacterizations. We recommend that the Final

⁹⁴ I.R.C. § 1361(c)(5).

⁹⁵ I.R.C. § 860B(a).

⁹⁶ Indeed, we do not believe that section 385 provides Treasury with the authority to override more specific statutory provisions that treat instruments as debt.

Regulations turn off the iterative consequences by providing that a repayment of a recharacterized debt instrument cannot itself trigger the application of the Funding Rule.⁹⁷

(g) Loss of Foreign Tax Credits and Treaty Benefits

Section 902 applies to allow an indirect foreign tax credit when the shareholder owns 10 percent of the voting stock of the subsidiary corporation. Any recharacterized debt likely would not constitute voting stock and therefore could cause a loss of foreign tax credits when interest payments/dividends are paid on the note or the note is repaid and deemed redeemed.⁹⁸ Even if the creditor otherwise owned voting stock in the issuer, the reasoning in Revenue Ruling 94-28, 1994-1 C.B. 86, which we think should be reconsidered, might be viewed as also denying any foreign tax credits with respect to any payments on the recharacterized instrument.⁹⁹ We recommend that the Final Regulations provide that foreign tax credits (in either case) will not be denied on recharacterized instruments.

In addition, if the funding company is in a different jurisdiction from the funded company, recharacterization of debt could impact the funded company's eligibility for treaty benefits under a limitation of benefits provision as a result of the ownership requirements for subsidiaries of publicly traded companies, for the 50-50 ownership base erosion test, and for derivative benefits, as well as for the zero dividend withholding tax rate. Dividends on recharacterized debt generally would not be eligible for the 5% dividend withholding tax rate.

(h) Recharacterized Debt Creates Complex Ownership Structures

Recharacterization of related-party debt as equity results in creation of inefficient cross-chain ownership if the recharacterized debt is held by a brother-sister company, or hook stock if the recharacterized debt is held by a subsidiary. The fact that the Proposed

⁹⁷ In addition, as discussed in section II.E.1 of these Comments, we recommend that cash pooling arrangements be excluded from the Final Regulations. However, this does not obviate the need for relief from the iterative consequences of the Funding Rule.

⁹⁸ Reg. §1.902-1(a)(8).

⁹⁹ See I.R.C. § 901(k) (6) (incorporating the rules of section 246(c)(4)).

Regulations would potentially create hook stock is ironic since the Preamble criticizes hook stock as typically possessing almost no non-tax significance.¹⁰⁰

In addition, the recharacterization of debt for U.S., but not foreign, tax purposes creates a hybrid instrument that could potentially have adverse foreign tax consequences and adversely affect treaty benefits. This result is also inconsistent with anti-BEPS initiatives (BEPS Action 2).

Limiting the consequences of the debt recharacterization to interest deductions would avoid these complex ownership structures. If such an exception is not adopted, we recommend that the Final Regulations at least provide that these rules will not result in the creation of hook stock.

(i) Funding and Repayment in the Same Year

Under the timing rules of the Proposed Regulations, if a debt instrument is recharacterized, it is recharacterized at the time it is issued, unless the debt instrument funds a distribution or acquisition that occurs in a subsequent year.¹⁰¹ Thus, if a funding note is repaid before, but in the same year as, the distribution or acquisition, it is still recharacterized as equity. In this situation, even taking into account the fungibility of money, in no sense has the “funding note” actually funded the distribution or acquisition.

More broadly, however, as described in Part II.D.4(e)(i) of these Comments, we think that Treasury should consider a broader exception for shorter term loans between EG members, as such loans are much more likely to be made for cash management reasons than for tax planning purposes. We therefore recommend that there be an exception to the Funding Rule for debt that is issued and repaid within a one-year period or prior to the distribution or acquisition it would otherwise be treated as having funded.

(j) Exits/Entrances into the Expanded Group

When a member of an EG makes a distribution of property to another member of its EG, and in a subsequent year the member is acquired by a different EG, future

¹⁰⁰ See Notice of Proposed Rulemaking, *supra* note 37, at 81 Fed. Reg. 20,917–18.

¹⁰¹ Prop. Reg. § 1.385-3(d)(1), 81 Fed. Reg. 20,912, 20,936 (Apr. 8, 2016). If the distribution or acquisition occurs in a subsequent year, the debt instrument is deemed to be exchanged for stock when the distribution or acquisition occurs. Prop. Reg. § 1.385-3(d)(1)(ii), (g)(3), Ex. 9, 81 Fed. Reg. at 20,936, 20,939.

borrowings by the acquired member (now owned in the new EG) could seemingly be treated as having funded the pre-acquisition distribution to a member of the old EG.

Example 11 (Funding and Prohibited Transaction Occur in Different EGs).

Assume that a U.S. parent, USP, owns all of the stock of two subsidiaries, S1 and S2. In Year 1, S1 makes a \$100 distribution of property to USP. Later in Year 1, USP sells S1 to X, an unrelated corporation, and within 36 months, S1 borrows \$100 from Y, a wholly owned subsidiary of X and member of the same EG as S1. Under the Funding Rule, it appears the S1 note would be recharacterized as equity because S1 made a distribution of property to a member of its EG (P), and S1 issued a debt instrument to a member of its EG (Y) within 36 months of each other. Because the Proposed Regulations do not provide rules regarding the timing of testing status as an EG member, entirely unrelated transactions undertaken in separate EGs would be swept up in the Proposed Regulation. As is shown here, S1's borrowing from Y cannot have funded the distribution to P.

Example 11.1 (Funding and Prohibited Transaction Occur in Different EGs).

Assume the same facts of Example 11, except that in Year 1, S2 loaned \$100 to S1. In Year 2, USP sells S1 and S2 to X. In Year 3, S1 makes a \$100 distribution to X. Similar to Example 11, the Proposed Regulations would seem to convert S2's loan to S1 into equity in Year 3. However, it's hard to imagine that S2 made the loan in Year 1 with a principal purpose of funding the Year 3 distribution to X given that X was not the owner of S1 nor had any relationship with S1 or S2 at the time the loan was made. Furthermore, X would have to undertake significant diligence on the S1 and S2 loan, which may require information not available to X, in order to determine whether S1's loan would be recharacterized as equity.

We recommend that the scope of the Funding Rule be limited such that the entire transaction resulting in a recharacterization of debt, including both legs of a transaction triggering the Funding Rule, occur in the same expanded group. However, if the Final Regulations do not adopt that recommendation, we believe that Final Regulations should at least provide that note issuances should not be treated as funding a Prohibited Transaction in situations where two separate groups combine or separate if (i) one leg of the transactions occurred in one group prior to the combination of the groups or after the separation of the groups, and (ii) the other leg of the transaction occurred in the other group (whether before or after the combination or separation).

In addition, we recommend that the Final Regulations clarify that the acquisition of an unrelated entity that becomes a part of the expanded group should not be treated as an acquisition of stock of an expanded group member— relatedness should be measured immediately before the transaction.

(k) The Predecessor/Successor Rule

The Proposed Regulations treat a predecessor or successor to a funded member as if it were the funded member.¹⁰² The rule appears to apply regardless of when the transaction occurs that created the predecessor or successor.

Example 12 (Predecessor Created Outside the 72-Month Window). Assume that a U.S. parent, USP, owns all of the stock of three foreign subsidiaries, FS1, FS2, and FS3. FS1 lends \$100 to FS2 in Year 1. In Year 3, FS3 makes a distribution of \$100 to USP. In Year 10, FS2 acquires FS3 in a D reorganization, making FS3 the predecessor of FS2 because the loan and cash distribution occurred within 36 months. It would appear that the note issuance literally would be treated as a funding of the cash distribution, despite the lack of identity between FS2 and FS3 at the time of either leg of the funding transaction or during the 72-month period.

We do not believe this result is intended and recommend that Final Regulations limit the application of the nonrebuttable presumption within the 72-month period to predecessors/successors that became predecessors or successors within that 72-month period.

In addition, under a literal reading of the rule, it appears that the predecessor/successor status continues even after the predecessor/successor cease to be members of the same expanded group, and therefore transactions in the separate expanded groups can affect one another's debt instruments. This issue is prevalent in the context of a section 355 transaction as illustrated by the following example.

Example 13 (Predecessor Post Spin-Off). Assume that a U.S. parent, USP, owns all of the stock of a foreign distributing company, FD. In Year 1, FD contributes assets to a newly formed subsidiary, FC, and distributes the stock of FC to USP in a section 355 transaction. FC is treated as a successor of FD.¹⁰³ That same year, USP contributes the FC stock to a newly formed subsidiary, Spinco, along with some additional assets, and distributes the stock of Spinco to its public shareholders in a section 355 transaction. In Year 10, when USP wholly owns FD, and Spinco wholly owns FC, FC distributes cash to Spinco and FD borrows money from a financing subsidiary of USP in exchange for the FD Note. Under the Funding Rule, the FD Note appears to be treated as stock because it

¹⁰² Prop. Reg. § 1.385-3(b)(v), 81 Fed. Reg. at 20,935.

¹⁰³ Prop. Reg. § 1.385-3(f)(11)(i), 81 Fed. Reg. at 20,938.

was issued to the financing subsidiary within 36 months of the cash distribution by FD's successor, FC.

We recommend that the Final Regulations limit the terms predecessor and successor to transactions described in section 381(a) and not treat the distributing and controlled corporations as a predecessor/successor in the context of a spin-off with a D reorganization.¹⁰⁴

Finally, we note that the Proposed Regulations define the term “successor” and “predecessor” in a non-exclusive manner (using the term “including”), thus leaving significant uncertainty about what circumstances would trigger the application of the rule. We recommend that the Final Regulations remove the word “including” to clarify this.

It is also not clear whether or how the Current E&P Exception interacts with the predecessor/successor rule. For example, the predecessor/successor rule provides that “for purposes of this paragraph (b)(3), references to the funded member include references to any predecessor or successor of such member.”¹⁰⁵ Although the Current E&P Exception is contained in paragraph (c)(1), it applies “for purposes of applying paragraphs (b)(2) and (b)(3) of this section to a member of an expanded group with respect to a taxable year.” Thus, applying the rules of (c)(1) (the Current E&P Exception) are necessary to fully apply the rules of (b)(2) and (b)(3) to a funded member.

Example 14 (Application of Current E&P Exception to Predecessor). Assume the same facts as Example 12. Assume further than in Year 3 when FS3 makes the \$100 distribution to USP, FS2 has no Current E&P, but FS3 has \$100 of Current E&P. Does the fact that FS3 is a predecessor to FS2 mean that FS2 had \$100 of Current E&P in Year 3? And if so, what is the effect of the Year 10 reorganization? Does the \$100 loan from FS2 turn back into debt retroactively?

We recommend that Final Regulations clarify when the Current E&P Exception is applied with respect to predecessors/successors.

(l) Transactions that are not Debt or Distributions in Form

There are a number of uncertainties (and traps for the unwary) related to the application of the Proposed Regulations to instruments, transactions, and relationships

¹⁰⁴ Note that the Proposed Regulations also apply the predecessor/successor rules to G reorganizations. *See id.*

¹⁰⁵ Prop. Reg. §1.385-3(b)(v), 81 Fed. Reg. at 20,935.

that are not in form debt but may be treated as debt for U.S. federal tax purposes.¹⁰⁶ For instance, a significant nonperiodic payment on a swap between two related parties may be treated as an embedded loan.

Similarly, there are concerns about transactions that may not be distributions in form but may be treated as distributions under U.S. federal tax principles. For instance, if on audit of a prior year, the Service made a section 482 adjustment that resulted in a deemed dividend,¹⁰⁷ could such adjustment cause an intercompany debt to be treated as equity? We recommend that the Final Regulations apply the General/Funding Rules only to debt and distributions in form, similar to the Bifurcation and Documentation Rules.

(m) Repayments of Bifurcated Notes

The Proposed Regulations do not indicate how to determine the allocation of payments on or partial repayments of a note that is treated as part debt and part equity under these rules. As noted in our discussion under the Bifurcation Rule, there is no good answer to this question, but we believe that pro rata payments should at least be the default, if not the mandatory, treatment, and that consideration should be given to allowing the taxpayer to elect an alternative allocation. We note that if repayment of a bifurcated instrument is treated as a pro rata principal payment and section 302 redemption, the repayment could trigger an iterative recharacterization as illustrated by the following example.

Example 15 (Partial Repayment of Bifurcated Note). Assume that a U.S. parent, USP, owns all the stock of two subsidiaries, S and T. USP loans \$100 to S for a \$100 note, and S buys the T stock in a section 304 transaction when S has \$40 of Current E&P. Under the Proposed Regulations, \$40 of the note will be treated as debt, and \$60 will be treated as equity. Assume that S later (when it has no Current E&P) repays \$50 of the note, and it is treated as a \$20 debt repayment and \$30 equity redemption. In that case, the \$30 redemption is itself a distribution. Does this recharacterize \$30 of the “debt” leg as equity? Does this recharacterization happen before or after S is deemed to repay \$20 of the debt?

As discussed in Part II.D.3(f) of these Comments, we recommend that the Final Regulations provide that repayments cannot trigger the Funding Rule. Such a rule would

¹⁰⁶ Compare the documentation rule in Proposed Regulation section 1.385-2, which applies only to instruments that are, in form, debt.

¹⁰⁷ See, e.g., Rev. Rul. 69-630, 1969-2 C.B. 112.

reduce the iterative recharacterizations. In addition, as noted in Part II.D.3(d)(i) of these Comments, the treatment of any debt as nonvoting equity will likely cause shareholders within an EG to not directly have section 368(c) control of their subsidiaries. This issue is further exacerbated in the case of a bifurcated note because it may be difficult to eliminate the non-voting equity portion of the loan.

Example 16 (Bifurcated Equity Treated as Nonvoting Stock). Assume that a U.S. parent, USP, owns all the stock of two subsidiaries, S1 and S2. In Year 1, S2 loans \$100 to S1, and S1 makes a distribution of \$100 to P, believing it will have \$100 of Current E&P in Year 1. In Year 2, S1 determines it had \$95 of Current E&P in Year 1, causing \$5 of the note to S2 to be treated as nonvoting preferred equity. Under any approach, it will be difficult for S1 to eliminate this \$5 of nonvoting stock. If a repayment of the \$100 note to S2 is treated as pro rata debt repayment/equity redemption, the portion allocated to equity redemption would create a distribution under Proposed Regulation section 1.385-3(b)(3) that would (absent Current E&P) recharacterize an equal portion of the remaining debt as equity (so that S1 would continue to have \$5 of nonvoting equity). Similarly, if the repayment is of debt first, S1 would have to repay the entire \$95 of debt before it could redeem the \$5 of nonvoting equity. Lastly, even if S2 could elect to treat the repayment as first a redemption of the \$5 of nonvoting equity, the redemption would create a distribution under Proposed Regulation section 1.385-3(b)(3) that would (absent Current E&P) recharacterize an equal portion of the remaining debt as equity (so that S1 would continue to have \$5 of nonvoting equity).

We also note that giving taxpayers credit for equity infusions would allow taxpayers to design stock and debt instruments with terms better suited to their needs than those obtained by forcing them to create debt instruments that will be recharacterized in whole or in part, while still maintaining the same overall limits on the amount of indebtedness for tax purposes.

(n) Effect of “Assumption” of Disregarded Entity Debt Treated as Stock of its Owner

The Proposed Regulations do not provide mechanics for situations in which debt of a disregarded entity is treated as equity of its owner¹⁰⁸ and the disregarded entity is subsequently transferred within the EG.

Example 17 (Recharacterization of Disregarded Entity Debt). Assume that a U.S. parent, USP, owns all the stock of two subsidiaries, S1 and S2, and S1 owns a

¹⁰⁸ See Prop. Reg. § 1.385-3(d)(6), 81 Fed. Reg. at 20,937.

disregarded entity, DRE, and S3. In Year 1, S2 loans \$100 to DRE, and S1 distributes \$100 to P. In Year 2, S2 contributes DRE to S3 in a section 351 contribution. As a result of the loan and distribution, in Year 1, DRE's \$100 note would be treated as stock of S1. The regulations do not address the mechanics of what happens when DRE becomes a disregarded entity of S3. Is S1 deemed to swap its S2 stock for S3 stock? What are the parameters for determining whether the DRE note is equity or debt of S3 for tax purposes? What is S2's basis in its S3 stock following the contribution?

(o) No Affirmative Use Rule

The Proposed Regulations provide that the rules do not apply if a taxpayer enters into a transaction that would otherwise be subject to these rules “with a principal purpose of reducing the federal tax liability of any member of the expanded group.”¹⁰⁹ Because of the principal purpose component of this rule, we think that a taxpayer who inadvertently issues a debt instrument that would otherwise be recharacterized under the Proposed Regulations must, upon discovering the issue, treat such an instrument as equity even prior to a challenge by the Service. However, we think that it would be helpful if Final Regulations would clarify this point.

In addition, the rules give no indication of how to measure a reduction in the federal tax liability of any member, and whether the calculation takes into account increases in the federal tax liability of other members. For instance, assume there is a distribution of a \$100x note from CFC to USP where CFC has \$10x of Current E&P. If the note is respected, USP would have \$10 of dividend income, but if the note were treated as stock of the CFC, section 305 would apply to the distribution, resulting in no dividend income. Could this have a principal purpose of reducing USP's tax liability?

(p) Anti-Abuse Rule

The anti-abuse rule is broad and automatically converts debt into stock rather than just subjecting the debt to the General/Funding Rules of the Proposed Regulations. Further, the anti-abuse rule appears to apply to a debt instrument even if it is not held by a member of the expanded group. We think the scope of the anti-abuse rule should be narrowed and clarified. For example, it would be inappropriate to recharacterize a bank loan obtained by a taxpayer that would have otherwise borrowed on an intercompany basis but chose not to do so solely because an intercompany borrowing would trigger recharacterization under the General/Funding Rules. On the other hand, disregarding third-party participants acting solely as a conduit between two members of an expanded

¹⁰⁹ Prop. Reg. § 1.385-3(e), 81 Fed. Reg. at 20,937.

group seems entirely appropriate. In addition, we recommend that the Final Regulations provide that, if the anti-abuse rule applies, such rule merely subjects the debt to the other rules of the regulation rather than automatically recharacterizing the debt.

- (q) Correct Example 12 of Proposed Regulation section 1.385-3(g)(3)

In Example 12 in the Proposed Regulations, FS lends \$100 to USS1 in exchange for the USS1 Note. USS1 then transfers \$20 to CFC for CFC stock (in a subsidiary contribution that is not treated as an acquisition of affiliate stock under Proposed Regulation section 1.385-3(b) by virtue of Proposed Regulation section 1.385-3(c)(3)). CFC later acquires stock of FS from FP in exchange for \$50. Under the successor rule of Proposed Regulation section 1.385-3(f)(11)(ii), CFC is a successor to USS1 to the extent of the value of the expanded group stock acquired by USS1 from CFC in the funding transaction – here, \$20. The example concludes that CFC’s purchase of FS stock from FP causes the USS1 Note to become a principal purpose debt instrument that is deemed exchanged for stock. It seems that only \$20 of the USS1 Note should be converted to equity.

In Part II.D.3(k) of these Comments, we have recommended that predecessors and successors be limited to section 381(a) transactions. To the extent that recommendation is not adopted and this example is retained in the Final Regulations, it should be corrected.

- (r) Provide that a debt instrument issued in a General Rule transaction cannot also be treated as a debt instrument subject to the Funding Rule.

As noted above, the General Rule may convert debt into equity if it is issued in exchange for expanded group stock (*e.g.*, in a section 304 transaction) or as boot in a reorganization. However, under the Current E&P Exception (discussed further below) a debt instrument issued in a General Rule transaction, such as a section 304 transaction, may nevertheless remain debt if the Current E&P exception applies. In certain cases, a debt instrument issued in a General Rule transaction could also be treated as a principal purpose debt instrument subject to the Funding Rule. Consider the following example:

Example 18. Debt instrument issued in a General Rule transaction also treated as a principal purpose debt instrument. Assume USP owns two CFCs, CFC 1 and CFC 2. In Year 1, CFC 1 has \$100 of Current E&P and acquires all of the stock of CFC 2 from USP in exchange for \$100 of cash and a \$100 note (the CFC 1 Note). In isolation, the issuance of the CFC 1 Note in exchange for \$100 of CFC 2 stock is a General Rule transaction. However, because CFC 1 has \$100 of Current E&P, the \$100 General Rule transaction is reduced to \$0. Thus, the CFC 1 Note would, absent the application of the Funding Rule, be respected as debt. However, the CFC 1 Note appears to meet the definition of a principal purpose debt instrument because it is issued by CFC 1 (funded

member) to a member of CFC 1's EG (USP) for property (the stock of CFC 2) with a principal purpose of funding the acquisition of CFC 2 stock for cash (because it was issued within 36 months of CFC 1's cash acquisition of CFC 2 stock).

Under the Proposed Regulations, it appears that a debt instrument can simultaneously be subject to the General Rule and the Funding Rule. This is an inappropriate extension of these rules, however. As this example clearly illustrates, the CFC 1 Note could not have funded CFC 1's cash acquisition of CFC 2 stock. We recommend that the coordination rule of Proposed Regulation section 1.385-3(b)(5) be expanded to exclude any debt instrument issued in a General Rule transaction from being subject to the Funding Rule. For example, the definition of a principal purpose debt instrument could be modified to exclude a debt instrument issued in a transaction described in the General Rule.

4. Exceptions

(a) Current E&P Exception

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. We understand that it is intended to ameliorate the application of those Rules given the expansive form in which they exist in the Proposed Regulations.

The Current E&P 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 that are treated as Prohibited Transactions are reduced by an amount equal to the member's Current E&P.

(i) Scope of the Current E&P Exception

We believe that limiting the scope of the Current E&P Exception to Current E&P raises several policy and administrative concerns. First, it may provide a perverse incentive to domestic corporate taxpayers to distribute debt up to the amount of Current E&P. U.S. tax policy has become increasingly focused on efforts to protect the corporate tax base while promoting foreign investment. Further, concerns have been repeatedly voiced as to the over-leveraging of foreign investment in the U.S. and of domestic corporations generally. However, the narrow scope of the Current E&P Exception will result in the leveraging up of domestic corporations through related-party debt by forcing such entities to distribute their own notes 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 invest in U.S. assets and employees.

Second, to ensure that an EG 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. Such a calculation is not feasible for many companies, which cannot calculate

Current E&P during the taxable year for either lack of information or because their business results are subject to change even late in the year. In some cases, the calculation cannot be made until months after the close of the taxable year.

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 also not permitted if the note is not supported by retained earnings (*i.e.*, previous years’ earnings).

As a result of the above-mentioned policy and administrative concerns, we recommend modifying the Current E&P Exception to include 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) any subsequent year. Such a modification would, in effect, prospectively 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 in the following 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. On the other hand, a foreign acquiring corporation would be able to benefit from the accumulated E&P in leveraging the target.

In the event the Final Regulations do not 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 provide less flexibility, so it might still encourage some distribution of notes, but it would at least address the inability to compute Current E&P and the inability of certain non-U.S. entities to make distributions in jurisdictions that prohibit distributions out of current earnings until after the close of the year.

(ii) Current E&P Exception’s Ordering Rule

The Current E&P Exception provides an ordering rule such that the reduction for Current E&P is applied to such member’s Prohibited Transactions based on the order in which the Prohibited Transaction occurs. Although this “first come, first served” 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

served approach should be retained in the Final Regulations with the modifications discussed below.

The way the Proposed Regulations are written, the full amount of Current E&P is available to reduce Prohibited Transactions on a first come, first served basis, and Current E&P described in section 316(a)(2) is not reduced by ordinary distributions that are not subject to the General/Funding Rules.

Example 19 (Current E&P Ordering Rule). FP, a foreign corporation, wholly owns USS, a domestic corporation. On March 1, Year 1, USS distributes a \$100x note to FP. But for Proposed Regulation section 1.385-3, the USS note would be characterized as debt for U.S. federal income tax purposes. On June 30, Year 1, USS distributes \$100x in cash to FP. 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 ordering rule in the Proposed Regulations, the USS note distribution would not be recharacterized under the General Rule because the Current E&P Exception applies.

Even if the order of the distributions were reversed, the answer does not appear to change under the language of the Proposed Regulations, because the full amount of Current E&P is available to reduce transactions subject to the General Rule (\$100 USS note) and the Funding Rule (none). We understand that this result was not intended based on public remarks by officials from Treasury. If the Government were to change the Final Regulations to apply the ordering rule to all distributions, the USS note would be subject to recharacterization as USS stock under the General Rule if the USS note followed the cash distribution.

Such a result puts a premium on sourcing distributions within a taxable year and thus seems inappropriate.

Therefore, we recommend clarifying the rule as written. If the Government decides to apply the ordering rule to all distributions, 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 as provided in the Proposed Regulations would remain the ordering rule. Further, we acknowledge that a somewhat open-ended election period to account for the tolling of the 36-month period following the issuance of a debt instrument 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 equity under either the General Rule or the Funding Rule.

(iii) Distributions of Previously Taxed Income
from CFCs

An area where the Current E&P Exception may lead to unexpected or inappropriate results is in the context of distributions of previously taxed income (“PTI”)¹¹⁰ by CFCs. As illustrated in Example 20, where a subpart F inclusion is the result of an investment in U.S. property pursuant to section 956, the PTI does not exist until the year after the inclusion, and so such amounts will never qualify for the Current E&P Exception.

Example 20 (PTI after Subpart F Inclusion). 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 makes an investment in U.S. property (within the meaning of section 956) such that USP has a \$100 inclusion in Year 1 under section 951(a)(1)(B). If CFC subsequently disposes of its U.S. property, any distribution of the \$100 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 Year 2. Therefore, even if CFC has \$100 of Current E&P in Year 1 that is not subpart F income, that Current E&P can never be used to shelter the distribution of the earnings that were included in USP’s income in Year 1.

Further, it is unclear how the Current E&P Exception applies in the context of tiered CFCs. Section 959(b) 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 21 (Tiered CFCs). Assume that a domestic corporation, USP, wholly owns a CFC, CFC 1, which wholly owns another CFC, CFC 2, and that CFC 1 issues a note to an EG member in Year 1. CFC 2 earns \$100 of subpart F income in year 1, which is included in USP’s income in Year 1. In Year 2, CFC 2 distributes \$100 to CFC 1, and CFC 1 distributes \$100 to USP. Neither CFC has any Current E&P in Year 2. Although CFC 1 receives the \$100 distribution in the same year that it distributes \$100 to USP, 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.

¹¹⁰ PTI generally refers to the earnings and profits of a foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a) to the extent they have not yet been distributed to such United States shareholder. I.R.C. § 959(a).

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, Regulation section 1.959-3(b)(3) provides that the PTI received by CFC 1 from CFC 2 retains its year and classification.¹¹¹

Although these rules do not appear to apply for purposes of calculating CFC 1's Current E&P, the result is not entirely clear. Therefore, even if the other comments suggested in this section are not adopted, we recommend that the Final Regulations clarify that a CFC's Current E&P for purposes of the Current E&P Exception include distributions received during the year that are excluded from the CFC's gross income under section 959(b). This would be consistent with the regulations relating to the E&P limitation on subpart F income under section 952(c).¹¹²

(b) The Threshold Exception

Proposed Regulation section 1.385-3(c)(2) contains an exception referred to as the Threshold Exception, providing that an instrument will not be treated as stock under any provision of Proposed Regulation section 1.385-3 if, immediately after such instrument is issued, "the aggregate adjusted issue price of debt instruments held by members of the expanded group that would be subject to [Proposed Regulation 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 expanded group so long as *any* debt instrument that was previously treated as indebtedness solely because of Proposed Regulation section 1.385-3(c)(2) remains outstanding. Proposed Regulation 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 Proposed Regulation section 1.385-3(d)(1)(i) applies, meaning that the instrument is treated as stock from the date of issuance.

The Threshold Exception is illustrated by Example 17 in Proposed Regulation section 1.385-3(g)(3). In the example, a CFC distributes a \$40 million CFC Note to

¹¹¹ 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.

¹¹² See 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 higher-tier CFC's E&P for purposes of calculating the E&P limitation under section 952(c)).

expanded group member FP in Year 1, and USS1, a member of the same expanded group 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 because the \$50 million threshold is exceeded. Therefore, CFC Note is deemed exchanged for stock on the date that USS1 Note is issued in Year 2.

The Preamble explains that Treasury has determined that the Threshold Exception and the Current E&P Exception “appropriately balance between preventing tax-motivated transactions among members of an expanded group and accommodating ordinary course transactions.”¹¹³ 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.¹¹⁴

(i) Interaction Between Threshold Exception
and Expanded Group Attribution

The Threshold Exception interacts with the broad attribution rules used for defining membership in the expanded group in a way that appears unintended. Specifically, the Threshold Exception only applies if all debt instruments held by members of the expanded group that would be subject to Proposed Regulation section 1.385-3(b) have an aggregate issue price of \$50 million or less. Where an expanded group holds an interest in a partnership, Proposed Regulation 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), 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 expanded group with a partnership in its structure, creating situations where it is impossible for certain group members to know whether they satisfy the Threshold Exception.

Example 22 (Interaction of Partnership Attribution and the Threshold Exception). 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

¹¹³ Notice of Proposed Rulemaking, *supra* note 37, at 81 Fed. Reg. 20,924.

¹¹⁴ *See id.* at 20,925.

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 expanded group 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 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 PRS's 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 22 illustrates a structure that is commonly used in private equity. It describes just one scenario where the expansive attribution rules of Proposed Regulation 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 excuse 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.

Recommendations to limit the attribution rules applicable under Proposed Regulation section 1.385-1(b)(3)(ii) are described in Part II.E.4 of these comments; 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 expanded group, 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 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 expanded group in applying the Threshold Exception. However, we recognize that providing such a broad exclusion could lead taxpayers to artificially segregate their expanded groups through the use of blocker partnerships. Therefore, we recommend that section 318(a)(3)(A) attribution apply only with respect to partners that are highly related to their partnerships, such as a partner that owns at least 80% of the interests in a partnership. Alternatively, or additionally, a partnership could be treated as owning only the percentage of stock held by its partners in proportion to their relative interests in the partnership.

(ii) Cliff Effect of the Threshold Exception

The Threshold Exception is currently subject to a cliff effect, meaning that once the expanded group has outstanding intragroup debt in excess of \$50 million that would be recharacterized but for Proposed Regulation section 1.385-3(c)(2), all intragroup 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 other smaller companies in significant ways. It also adds significant complexity by requiring that previously issued debt be recharacterized as equity.

Consider an expanded group that has structured its operations in an economically efficient manner, resulting in \$45 million of EGDIs 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 expanded group whose operations would be structured in an economically efficient manner with \$55 million of EGDI subject to recharacterization (or the same sized group, perhaps in a different industry that can support slightly more EGDI). Instead of both expanded groups equally enjoying the benefits of a \$50 million exception, the smaller expanded group enjoys a \$45 million exception while the slightly larger expanded group has no exception at all. Alternatively, the smaller expanded group can retain its economically efficient debt structure under the Threshold Exception, whereas the slightly larger expanded group must structure its operations in potentially inefficient ways to avoid causing its related-party debt to be recharacterized under Proposed Regulation section 1.385-3.¹¹⁵

To prevent disproportionately benefitting only certain smaller companies, we recommend eliminating the cliff effect from the Threshold Exception. Instead, the exception would 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. Nonetheless, it would be more administrable in that taxpayers could test the debt at the time it is issued and not have to revisit that debt at a later date. The concerns raised in this subsection have the greatest impact on taxpayers with slightly more than

¹¹⁵ Having less access to sophisticated tax advice, small businesses would be less likely to know whether the Threshold Exception applies.

\$50 million of EGDI that would be recharacterized, because those taxpayers would be most significantly harmed by losing the entire \$50 million exception. Therefore, as an alternative to providing a \$50 million threshold for all taxpayers, the Final Regulations could provide a rule that the first \$50 million of EGDI is eligible for the Threshold Exception, unless the total amount of EGDI that would be recharacterized is more than \$200 million (or a similar higher threshold). Under this proposal, once the total amount of EGDI exceeds \$200 million, the cliff effect is reintroduced and none of the EGDI is eligible for the Threshold Exception.

(c) Ordinary Course Exception

The Ordinary Course Exception provides that the *per se* rule in Proposed Regulation section 1.385-3(b)(3)(iv)(B)(1) 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.” 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.”¹¹⁶

The Preamble explains that the exception is purposefully not intended to apply to intercompany financing, treasury center activities, or capital expenditures.¹¹⁷ The Preamble further states 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 Proposed Regulation section 1.385-3(b)(3)(iv)(A).¹¹⁸

The Ordinary Course Exception is intended to achieve a number of policy objectives with respect to the transactions to which it applies. It seeks to allow taxpayers to engage in certain types of ordinary-course business activities among members of the expanded group without fear that they will run afoul of the *per se* rule. The failure to provide such an exception would require corporate groups to restructure their everyday intragroup transactions in ways that might be economically inefficient or distortive. For

¹¹⁶ Prop. Reg. § 1.385-3(b)(3)(iv)(B)(2), 81 Fed. Reg. 20,912, 20,935 (Apr. 8, 2016).

¹¹⁷ Notice of Proposed Rulemaking, *supra* note 37, at 81 Fed. Reg. 20,924.

¹¹⁸ *See id.*

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. However, we recommend that it be broadened so that it can be used more widely by businesses that do not keep inventories for all or most of their activities, such as real estate or financial services businesses. Subject to reasonable limitations, any goods or services should be acceptable, as should routine financial transactions.

(i) Clarify the Scope of the 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.”¹¹⁹ 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.

It is also not clear how the quantitative limit applies. Does it impose a historical ceiling on the amount of debt? Does it limit the debt to the issuer’s proportionate share of the group’s external debt?

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 there are no examples in Proposed Regulation section 1.385-3(g) that illustrate the

¹¹⁹ Prop. Reg. § 1.385-3(b)(3)(iv)(B)(2), 81 Fed. Reg. at 20,935.

Ordinary Course Exception. This lack of clarity may prevent taxpayers from utilizing the exception in scenarios to which it is intended to apply, thereby frustrating its purpose. We recommend clarifying the Ordinary Course Exception through further explanatory text in Proposed Regulation section 1.385-3(b)(3)(iv)(B)(2) and examples.

(ii) Expand Application of the Ordinary Course Exception to the Principal Purpose Test and the Documentation Requirements

The Ordinary Course Exception is narrowly limited to Proposed Regulation section 1.385-3(b)(3)(iv)(B)(2), meaning that it only excepts debts between expanded group members from being recharacterized under the *per se* rule. This means that such debt instruments (i) are still susceptible to recharacterization under the general principal purpose test of Proposed Regulation section 1.385-3(b)(3)(iv)(A), and (ii) must still comply with the documentation rules of Proposed Regulation section 1.385-2, or else they will be treated as equity. With respect to the principal purpose 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 Proposed Regulation section 1.385-3(b)(3)(ii). Yet, 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 continue conducting efficient intragroup 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. In light of this, to avoid unnecessary questions as to how the rules operate, we recommend that the Ordinary Course Exception apply to not only the *per se* rule of Proposed Regulation section 1.385-3(b)(3)(iv)(B)(1), but also the principal purpose test of Proposed Regulation section 1.385-3(b)(3)(iv)(A), so that ordinary course debt instruments are exempt from the Funding Rule as a whole.

(iii) Provide an Ordinary Course Exception for Ordinary Course Financing Activities

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. 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 expanded group, its failure to apply to intragroup financing transactions prevents the exception from achieving its goal for a large set of business activities.

Reluctance to provide an exception for financing activities is understandable because of the difficulty of distinguishing routine financing from financing engaged in with the principal purpose of funding a distribution or acquisition. However, such an exception is critical to ensure that groups that operate in the financial sector or heavily utilize intragroup financing for economically efficient, non-tax motivated reasons are not disproportionately punished by the Proposed Regulations compared to expanded groups that engage in businesses more conducive to intragroup sales of goods and services. For example, a corporation that issues credit cards or leases equipment to unrelated parties should be able to issue credit cards or lease equipment to its affiliates without implicating the Funding Rule. A commercial bank should be allowed to accept deposits from its affiliates.

There are many possible approaches to creating an ordinary course exception for financing activities. We recommend an exception for an instrument issued in the ordinary course of a financing business that bears terms substantially similar to those that the issuer uses and accepts in debt issued to third parties. This would allow expanded group members that act as financial institutions to transact with their affiliates on the same terms as unrelated customers.

(iv) Consider Exceptions or Limitations on
Ordinary Course Debt Based on Other
Characteristics

The best way to assure that an expanded ordinary course exception is not turned into a vehicle for unlimited financing is to provide safe harbors or limitations based on characteristics that prevent abuse. For example, short-term financing should not be problematic if even overall balances are sustained through repeated transactions. Accordingly, an EGI issued for goods or services settled (including by netting against other EGIs), or a routine financing due, within a reasonable time (perhaps a year) should not create a problem under the Funding Rule.

If the Treasury and Service were concerned that an expanded ordinary course exception could allow ever increasing balances to be generated between related parties, it might consider imposing an aggregate limit rather than category-based restrictions. A limitation based on the greater of total current assets or historic annual expenses would ensure that the overall balance bore a relationship to business needs and did not spiral out of control. Conversely, an amount below these thresholds might serve as a reasonable safe harbor.

(d) Subsidiary Stock Issuance Exception

The Subsidiary Stock Issuance 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),¹²⁰ more than 50% 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.

(i) Holding Period for Issuer Stock

As stated above, the Subsidiary Stock Issuance Exception requires the Transferor to retain more than 50% 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 distributions for purposes of the Funding Rule. However, in many situations in which 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 cease to have the requisite ownership of the Issuer entirely unintentionally if debt of the Issuer is recharacterized as stock. Given that the Subsidiary Stock Issuance Exception appears intended to apply to contributions to controlled corporations in exchange for their stock, this exception should be more broadly available to these transactions.

Therefore, we recommend that the 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% of the vote and value of the Issuer immediately after the transfer without a strict holding period requirement, but instead applying principles under

¹²⁰ Section 958(a) provides that (a) a person is considered owning stock that it owns directly, and (b) 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.

section 351 to determine whether the requisite ownership exists immediately after.¹²¹ 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 Service and taxpayers will have a basis to determine 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 more administrable while permitting taxpayers the flexibility to change their ownership structures in subsequent years to respond as necessary to changes in circumstances.¹²²

(ii) Consequences Where the Issuer Leaves the Expanded Group

As described above, where a Transferor ceases to retain more than 50% 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, and 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 entity that is 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. It is also inappropriate to recharacterize outstanding debt as equity solely because the parties became *unrelated*.

¹²¹ 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.

¹²² 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% 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.

Therefore, 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 continues to apply. Under this modification, a debt instrument of the Transferor that funded the acquisition of Issuer stock would 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.

(e) Additional Exceptions

(i) Short-Term Debt Exception

Beyond the cash pooling arrangements discussed in section II.E.1 of these Comments, businesses often use intercompany short-term loans to meet the immediate cash-flow needs of affiliates. For example, to improve its balance sheet for financial reporting purposes, a borrower on a third-party revolver loan might borrow from a temporarily cash-rich affiliate to allow for the repayment of such revolver loan shortly before quarter-end, and then repay such intercompany borrowing early in the subsequent quarter by drawing on the revolver loan. Because not all intercompany financing arrangements can be arranged through a formal cash pooling arrangement and because short-term lending generally does not present the kind of tax planning opportunities that Treasury is concerned with here, we propose that the Funding Rule provide an exception for loans that are repaid within one year of issuance.

(ii) CFC-to-CFC Exception

As discussed above, we believe that Proposed Regulation section 1.385-3 is overbroad, affecting related-party lending transactions that would neither afford taxpayers the ability to strip U.S. earnings nor enable them to engage in purportedly aggressive repatriation planning. As discussed below, the application of Proposed Regulation section 1.385-3 to loans between related CFCs is inconsistent with the Congressional policy of advancing the competitiveness of U.S.-based multinationals as indicated in the legislative history of section 954(c)(6). As currently drafted, Proposed Regulation section 1.385-3 would substantially hinder the ability of foreign affiliated groups of U.S. multinationals to redeploy cash, and would render their U.S. tax compliance efforts much more complicated and more burdensome to administer.

We believe that the broad application of Proposed Regulation section 1.385-3 to transactions between related CFCs raises significant policy concerns. Proposed Regulation section 1.385-3 would interfere with transactions between related CFCs that are currently permitted under section 954(c)(6) (the “Look-Through Rule”), and thus

appear to us to work 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”),¹²³ 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 foreign group.¹²⁴ 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.¹²⁵ 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.¹²⁶

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.¹²⁷ 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 Senate

¹²³ Pub. L. No. 109-222, 120 Stat. 345.

¹²⁴ See S. Rep. No. 108-192, at 39 (2003) (“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.”).

¹²⁵ See S. Rep. No. 108-192, at 39 (2003) (“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.”).

¹²⁶ *Id.*

¹²⁷ See H.R. Rep. No. 108-548, pt. 1, at 202-03 (2004) (“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. No. 108-393, at 102 (2003) (including similar language).

legislative history referenced above, reinforcing the Congressional priority that foreign capital move freely between related CFCs.¹²⁸

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, 2020.¹²⁹ Congress's passage of the provision on five occasions suggests a Congressional consistency in prioritizing the ability of U.S.-based multinationals to redeploy earnings among CFCs, a priority that Proposed Regulation section 1.385-3 could seriously undermine.¹³⁰ Therefore, by significantly restricting the ability of U.S. multinationals to lend funds between CFCs, Proposed Regulation section 1.385-3 is contrary to this Congressional priority.

We recommend 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 Proposed Regulation section 1.385-3.¹³¹ Due to the general operation of Proposed Regulation 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 expanded group. This exception would allow related CFCs and partnerships with CFC partners to "move their active foreign earnings from one controlled foreign corporation to another"¹³² in a manner consistent with Congressional intent.

¹²⁸ See H.R. Rep. No. 109-304, at 45 (2005) (including the same "Reasons for Change" as H.R. Rep. No. 108-548, quoted above at note 127); Staff of the J. Comm. on Taxation, 110th Cong., 1st Sess., *General Explanation of Tax Legislation Enacted in the 109th Congress*, 267 (JCS-1-07) (Comm. Print 2007) (same).

¹²⁹ 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.

¹³⁰ 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.

¹³¹ If Treasury is concerned about applying the CFC-to-CFC exception to first-tier CFCs, the Final Regulations could limit the exception to debt issued to a CFC if either (i) one of the CFCs controls, directly or indirectly (within the meaning of section 958(a)), the other CFC, or (ii) both CFCs are controlled, directly or indirectly (within the meaning of section 958(a)), by the same CFC. However, we believe that applying the CFC-to-CFC exception to all CFCs is simple, administrable, and consistent with Congressional intent.

¹³² S. Rep. No. 108-192, at 39 (2003).

(iii) Proportional Debt Exception

It is common for a multi-national corporate group to centralize its external borrowing in a limited number of entities (often the parent). Even if the funds of any given borrowing are nominally used for a specific acquisition, given the fungibility of money, indebtedness of a group supports all of the group's operations. Given the difficulty of actually breaking external borrowing into separate borrowings by each business unit or geographic unit, we think the rules of Proposed Regulation section 1.385-3 should make allowance for an expanded group to continue to centralize its external borrowing and distribute that debt burden using intercompany debt between members of the expanded group.

Accordingly, we suggest an exception to the rules of Proposed Regulation section 1.385-3, under which a debt instrument would not be recharacterized to the extent the issuing member's net indebtedness does not exceed its proportional share of the expanded group's third-party indebtedness. A taxpayer using this exception would not also use the Current E&P Exception.

Proportionality could be determined either by earnings or asset values or some proxy therefor. We suggest that the rules for allocating interest expense between domestic and foreign sources (which generally allocate based on asset values or asset basis) be adapted for this purpose, as those rules were devised for a similar purpose and have a track record suggesting that they are workable without too much distortion. In order to make this rule administrable, taxpayers would have to be able to plan against target amounts based on historical financial data. In order to apply this rule to expanded groups parented by foreign corporations, some use may have to be made of financial statements rather than U.S. tax principles. (We note that the Documentation Rule proposes to use financial statement data to establish its thresholds.)

This proposal is consistent with proposals by the Administration, certain members of Congress, and the OECD to limit interest deductions of a corporation to its proportional share of a financial reporting group's net interest expense.

(iv) Debt Intended to Leave the Expanded Group

Sometimes debt will be established with a related party with the intention that it become third party debt, because, for example, it will be disposed of to an unrelated party or, perhaps more commonly, because the issuer and holder will become unrelated. When debt is issued pursuant to such a plan, and the plan is effectuated within a reasonable time (such as before the first relevant return is filed), there is no policy justification to impose the distortions that result from recharacterizing the instrument as stock and back to debt again. Accordingly, we recommend an exception be created for such cases.

(v) Debt Distributed to a Partner

We recommend that the distribution of a partnership's own note to one or more of its partners not be subject to Proposed Regulation section 1.385-3. The distribution of a note from a partnership to a partner is not equivalent to the distribution of a note from a corporation to its shareholder. If the distribution is pro rata, we read the General/Funding Rule to say it would be ignored. Even if the distribution is not pro rata to the partners, the transaction does not reduce the value of the stock of any of the corporate partners. The corporate partner receiving the note holds a note instead of equity in a partnership. As an economic matter, the other partners have effectively bought assets with debt, which is generally acceptable under the theory of the General/Funding Rules.

5. Transition Rule Issues

Proposed Regulation section 1.385-3 is retroactive; it applies to an EGDI issued on or after April 4, 2016, which predates the eventual date in which the regulations will be finalized (the "Finalization Date").¹³³ The regulations also contain a transition rule applicable to an EGDI issued after April 4, 2016, and before the Finalization Date (the "Gap Period"), which would have been treated as stock under Proposed Regulation section 1.385-3. Specifically, Proposed Regulation section 1.385-3(h)(3) (the "Transition Rule") provides, in part, that when Proposed Regulation section 1.385-3 "*otherwise would treat a debt instrument as stock prior to the date of publication in the Federal Register of the Treasury decision adopting this rule as a final regulation*, the debt instrument is treated as indebtedness until the date that is 90 days after the date of publication in the Federal Register of the Treasury decision adopting this rule as a final regulation" (emphasis added).

The application of the Transition Rule is unclear in a variety of common instances. Aside from the language of the Transition Rule itself, no further guidance, explanations, or examples are provided to assist taxpayers in interpreting this rule. In particular, it is not clear how an EGDI that otherwise would be stock under Proposed Regulation section 1.385-3 should be treated for purposes of applying the Transition Rule to other EGDIs issued during the Gap Period. Similarly, it is also unclear as to what effect, if any, that the repayment of an EGDI that is debt, but otherwise would be treated as equity after the 90-day period following the Finalization Date, will have on other EGDIs. As a result, taxpayers will face significant uncertainty in analyzing EGDIs issued during the Gap Period.

¹³³ Prop. Reg. § 1.385-3(h)(1), 81 Fed. Reg. 20,912, 20,941 (Apr. 8, 2016).

Example 23 (Gap Period). To illustrate this uncertainty, assume that during the Gap Period, a taxpayer engages in the same series of transactions as described in Proposed Regulation section 1.385-3(g), Example 1, which is as follows:

(i) *Facts.* On Date A in Year 1, FS lends \$100x to USS1 in exchange for USS1 Note A. On Date B in Year 2, USS1 issues USS1 Note B, which has a value of \$100x, to FP in a distribution.

(ii) *Analysis.* USS1 Note B is a debt instrument that is issued by USS1 to FP, a member of USS1's expanded group, in a distribution. Accordingly, USS1 Note B is treated as stock under [Proposed Regulation section 1.385-3(b)(2)(i)]. Under [Proposed Regulation section 1.385-3(d)(1)(i)], USS1 Note B is treated as stock when it is issued by USS1 to FP on Date B in Year 2. Accordingly, USS1 is treated as distributing USS1 stock to its shareholder FP in a distribution that is subject to section 305. Because USS1 Note B is treated as stock for federal tax purposes when it is issued by USS1, USS1 Note B is not treated as property for purposes of Proposed Regulation section 1.385-3(b)(3)(ii)(A) because it is not property within the meaning specified in section 317(a). Accordingly, USS1 Note A is not treated as funding the distribution of USS1 Note B for purposes of Proposed Regulation section 1.385-3(b)(3)(ii)(A).

Further assume that each of Date A and Date B falls within the Gap Period, and each of USS1 Note A and USS1 Note B remains outstanding as of the Finalization Date.

Under the Transition Rule, USS1 must determine whether Proposed Regulation section 1.385-3 would otherwise treat USS1 Note A and/or USS1 Note B as stock.

First, USS1 might look to Example 1 (even though not addressing the Gap Period) for the position that USS1 Note B should be treated as stock and USS1 Note A should remain as debt. If this were the case, USS1 Note B would remain debt for 90 days following the Finalization Date, and then, if still outstanding, would convert into stock of USS1. Further, under this approach, because USS1 Note B otherwise would be stock, it is treated as stock for purposes of applying the Transition Rule to Note A. Consistent with the example, USS1 Note A would remain as debt.

This approach could largely neuter the retroactive effect of Proposed Regulation section 1.385-3. For example, assume that USS1 uses the cash proceeds from issuing USS1 Note A to repay USS1 Note B within the 90 day period following the Finalization Date. USS1's repayment of USS1 Note B would not be a distribution under the Funding Rule because USS1 Note B remains debt for 90-days following the Finalization Date. In this case, following the repayment of USS1 Note B, USS1 would still have replaced \$100 of its existing equity with an EGDI (USS1 Note A), effectively through a distribution transaction, which is precisely the type of transaction the Government does not believe taxpayers should be allowed to engage in.

The conclusion in Example 1 was based, in part, on the fact that USS1 Note B was treated as equity upon its issuance, as a result of which USS1 did not make a distribution of property for purposes of the Funding Rule, and therefore USS1 Note A was not treated as stock. Where this transaction is undertaken during the Gap Period, USS1 Note A would be property when issued (because it remains as debt until 90 days after the Finalization Date). However, if the distribution of USS1 Note B is treated as a property distribution for purposes of analyzing USS1 Note A, then USS1 Note A would be treated as having funded the distribution of USS1 Note B under the Funding Rule.

A similar situation occurs if, assume instead: (i) on Date A in Year 1, FS lends \$100x to USS1 in exchange for USS1 Note A; (ii) on Date B in Year 1, FS lends \$100x to USS1 in exchange for USS1 Note B; and (iii) on Date C in Year 1, USS1 distributes \$100x of cash to FP in a distribution. Under the normal rules, each of USS1 Note A and USS1 Note B may be treated as having funded USS1's distribution of \$100x to USP. However, under Proposed Regulation section 1.385-3(b)(3)(iv)(B)(3), if "two or more debt instruments may be treated as a principal purpose debt instrument, the debt instruments are tested under [the Funding Rule] based on the order in which they were issued." Here, it seems that USS1 Note A, issued first, would be "tested" and as a result, be treated as stock, but under the Transition Rule, USS1 Note A would remain as debt until 90 days after the Finalization Debt. In addition, because USS1 Note B would not be stock (because it did not fund the \$100x distribution), it would seemingly remain as debt.

It does not appear that this result changes if USS1 repays USS1 Note A during the 90-day period following the Finalization Date because the repayment of USS1 Note A is not a transaction described in the Funding Rule, and thus should not cause USS1 Note B to become stock.

E. Additional Comments

1. Recommendations Relating to Cash Pooling Arrangements

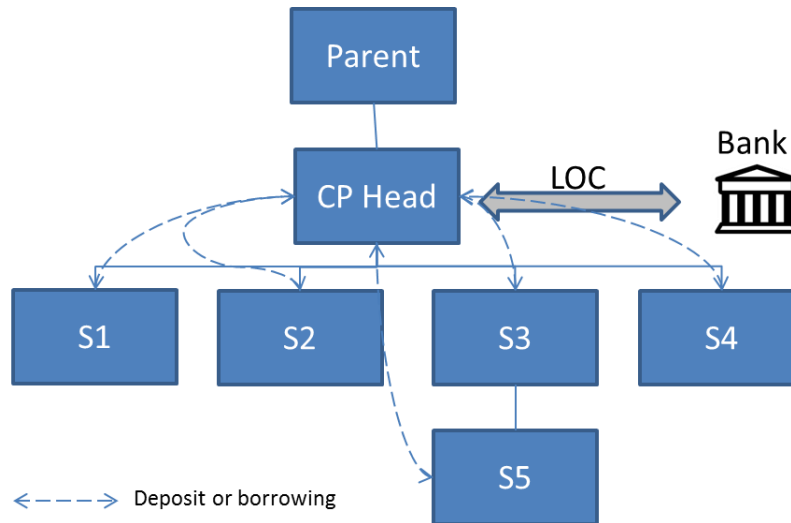
(a) The Nature of Cash Pools and Similar Arrangements

A cash pool is a structure involving several related bank accounts whose balances have been aggregated for the purposes of optimizing interest paid or received and improving liquidity management. Similar arrangements include cash sweeps, revolving credit arrangements, internal banking services, overdraft setoff facilities, operational

facilities, and other tools typically used by affiliate corporate group treasurers to manage cash.¹³⁴

A typical, simple cash pooling arrangement can be illustrated as follows:

Example 24.



In this structure, Parent owns all of the stock of Cash Pool Head (“CP Head”), which serves as the group’s treasury center and internal bank. CP Head may also serve as the group’s borrower on a line of credit or other facility with an unrelated, third-party bank. S1, S2, S3, and S4 are subsidiaries of CP Head and S5 is a subsidiary of S3.¹³⁵ All members of the group are “participants” in the cash pool and each participant has a separate account with CP Head through which it borrows cash as needed in its operations or deposits surplus cash. (In many cases, excess cash in the participants’ accounts is

¹³⁴ Cf. Reg. § 1.1471-5T(e)(5)(D)(1)(v), which defines “treasury center” for FATCA purposes as:

Managing the working capital of the expanded affiliated group (or any member thereof) such as by pooling the cash balances of affiliates (including both positive and deficit cash balances) or by investing or trading in financial assets solely for the account and risk of such entity or any members of its expanded affiliated group.

For the purpose of these Comments, we will use the term “cash pools” to refer to all of these similar arrangements unless expressly indicated otherwise.

¹³⁵ Alternatively, some or all of S1, S2, S3, or S4 may be owned directly by P rather than CP Head.

swept into, or overdrafts are funded by, CP Head on a daily basis.) CP Head and one or all of the participants (including Parent) may be either domestic or foreign entities (assuming at least one U.S. company).

Cash pools can typically serve one or more of the following corporate purposes:

- To give the group's Treasury function a complete and accurate real-time view of the group's cash position;
- To facilitate accurate financial reporting and compliance;
- To redeploy cash around the group—including across borders—quickly to meet the operational needs of the group's businesses;
- To maximize yield by reducing interest expense and obtaining the highest rates on interest earned;
- To optimize the group's liquidity;
- To reduce costs by enabling group-wide procurement and collections;
- To use cash flows to easily measure the performance of particular businesses within the group; and
- To effectively manage foreign exchange risks.

Cash pools can address these goals most efficiently through direct intercompany loans. It does this by designating CP Head as the group's internal "bank" to advance funds to companies who need cash and to take deposits from companies with surplus cash. While it is theoretically possible to move cash around a group through distributions and contributions to capital, such equity transfers are invariably more time-consuming, incur additional costs (such as withholding taxes), and may be subject to legal limitations on the nature and amounts of distributions because of local rules on distributable reserves and limits on capital transfers. In contrast, intercompany debt can be issued and repaid with less cost and restrictions.

(b) Effect of the Proposed Regulations on Cash Pools

Elsewhere in these Comments, we discuss general problems with recharacterizing EGIs as stock under Proposed Regulation section 1.385-3. All of those problems are multiplied in the context of cash pools due to the large volume and relatively short term of the advances and repayments. For example, if CP Head were to make an advance to S5 and if S5 had, at any time during the 36-month period before or after the date of the advance, made a proscribed distribution or acquisition, then the advance would be recharacterized as the issuance of stock. In addition, repayment of the debt (perhaps as

soon as the next day) would be treated as a distribution that could be viewed as restarting the 36-month time period of Proposed Regulation section 1.385-3(b)(3)(iv)(B)(1). The practical effect of these recharacterizations would be that almost all advances under a cash pool would become equity unless the taxpayer created and perfectly maintained elaborate internal controls that analyzed each of the thousands of advances from and payments to the cash pool. Even if such controls were possible to create and maintain, they would vitiate the financial efficacy of cash pools in the first place.

Moreover, once an advance from a cash pool is recharacterized as stock under either the General Rule of Proposed Regulation section 1.385-3(b)(2) or the Funding Rule of Proposed Regulation section 1.385-3(b)(3), there are a number of collateral consequences that more severely impact cash pools.

- Foreign tax credits. Assume in Example 24 that CP Head has made an advance to S5 that has been recharacterized as stock; the recharacterized stock will generally be treated as nonvoting preferred stock. Thus, if S5 were a foreign corporation, CP Head would not own at least a 10 percent voting interest in S5.¹³⁶ As a result, repayments recharacterized as deemed dividends would reduce the foreign tax credits in S5's foreign tax pools¹³⁷ but would not move the S5's foreign tax credits to CP Head's foreign tax pools. This could result in the group's foreign tax credits slowly bleeding away to the point that the group could face double taxation of its foreign earnings.
- Loss of control. In addition to causing the group to lose foreign tax credits, recharacterization of a borrowing by S5 from CP Head as nonvoting preferred stock could cause S3 to lose control of S5 within the meaning of section 368(c). As a result, a contribution of assets by S3 to S5 could become a taxable exchange under section 351(a) and any section 368(a) reorganization may fail.
- Hedging. Assuming that S5 is a foreign corporation and that its borrowing from CP Head is denominated in a nonfunctional currency of CP Head, then any hedging transaction by CP Head with respect to the advance to S5 would no

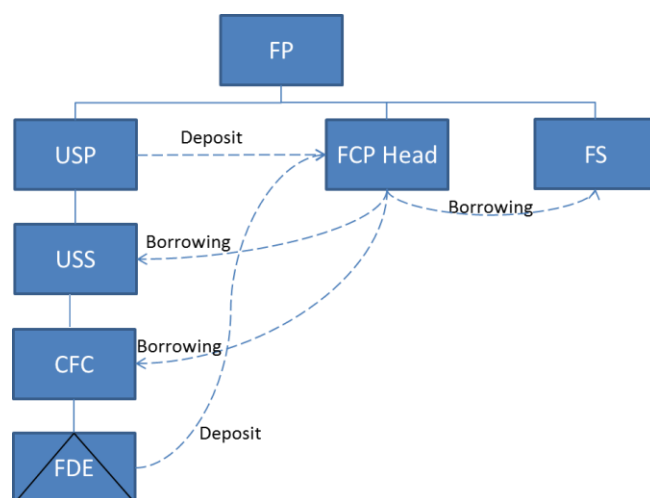
¹³⁶ See Reg. § 1.902-1(a)(1)-(4), (8)(i), (11).

¹³⁷ Reg. § 1.902-1(a)(8).

longer qualify as a hedging transaction.¹³⁸ Consequently, any foreign currency gain from the hedge will be subpart F income.¹³⁹

- Treaties. Recharacterization of borrowings can create deemed dividends that could be subject to U.S. withholding tax notwithstanding provisions of U.S. tax treaties that would require a lower withholding rate for interest (in some cases, 0%). Example 25, below, assumes that FP, a foreign parent corporation, wholly-owns (i) FCP Head, a foreign cash pool; (ii) FS, a foreign subsidiary; and (iii) USP, a U.S. corporation that is the parent of a consolidated group that includes its subsidiary, USS. USS owns CFC, which owns a foreign disregarded entity, FDE. USS, CFC, and FS have advances outstanding from FCP Head, while USP and FDE deposit excess funds with FCP Head. FS then makes a distribution in excess of its current year earnings and profits to FP.

Example 25.



FS's advance from FCP Head would be recharacterized as stock under Proposed Regulation section 1.385-3(b)(3)(ii)(B). FCP Head's deposits from

¹³⁸ See Reg. § 1.1221-2(b)(2) (transaction qualifies as hedge only if it manages risk with respect to ordinary property or obligations). See also *Hoover Co. v. Commissioner*, 72 T.C. 206 (1979), *acq.* 1984-2 C.B. 1 (foreign currency hedge entered into with respect to stock of foreign subsidiary stock did not constitute a hedging transaction for federal income tax purposes).

¹³⁹ I.R.C. § 954(c)(1)(D).

USP and FDE would also be recharacterized as stock because the deposits would be treated as funding FCP Head's acquisition of FS stock. Because FDE would be disregarded, CFC would be treated as acquiring FCP Head stock as a result of FDE's deposit with FCP Head, so its advance from FCP Head would also be recharacterized as stock. Moreover, USS is treated as acquiring FCP Head stock (because USP and USS are treated as a single taxpayer) with the result that the advance to USS would also be recharacterized as stock.¹⁴⁰

Repayments of "principal" and "interest" by USS to FCP Pool would be treated as dividends for U.S. income tax purposes and would be subject to 30 percent U.S. withholding tax notwithstanding tax treaties to the contrary.

- Deconsolidation. Example 25 could also result in the deconsolidation of USS from USP because the recharacterized stock of USS deemed held by FCP Head would not be held by an includible corporation and might not be excluded under section 1504(a)(4).
- Fast-pay stock. Example 25 also illustrates that, if CFC's borrowing from CP Head were recharacterized as stock and if the principal of the advance is repaid over the term of the advance, the stock could be "fast-pay stock" under Regulation section 1.7701(l)-3(b)(2), resulting in a listed transaction.
- Cumulative Effect. The iterative application of Proposed Regulation section 1.385-3 has been noted elsewhere in these Comments. The complexities resulting from such applications are particularly dangerous in the cash pool context. For example, once a borrowing from CP Head is recharacterized as stock, CP Head will be considered to have acquired stock in another member of the expanded group, which would result in other deposits from other members of the expanded group also being recharacterized as stock. Moreover, common transactions such as paying employees with Parent stock, experiencing a retroactive transfer pricing adjustment, or missing an estimate of Current E&P can trigger recharacterization under Proposed Regulation section 1.385-3.

¹⁴⁰ See Prop. Reg. § 1.385-3(b)(3)(ii)(A), 81 Fed. Reg. 20,912, 20,935 (Apr. 8, 2016). The exception for funding acquisition of subsidiary stock under Proposed Regulation section 1.385-3(c)(3) would not apply to any of these deemed acquisitions because FCP Head would not, directly or indirectly, control FS under section 958(a).

The cumulative effect of these recharacterizations expands as the group increases in size—especially globally. For example, it is common for many multinational groups to have a separate cash pool head in each country where it has multiple subsidiaries utilize the cost savings and efficiency benefits of cash pools within that jurisdiction. These local country cash pools may then participate in a currency-specific pool to enable the group treasury to better manage currency risks. Finally, the currency-specific cash pools may then participate in a global cash pool to centralize both banking operations and currency risks. If any one of the separate cash pools were to engage in a proscribed transaction under Proposed Regulation section 1.385-3, however minor, it could replicate itself throughout the entire group cash management system. In light of the business objective of operating cash pools, this seems to us to be an excessively harsh result.

(c) Recommendations

In the Preamble, Treasury recognized that special rules may be warranted for cash pools and similar arrangements. In particular, Treasury seems concerned that, in order to receive special treatment, cash pooling be distinguishable from the long-term creation of over-leverage.¹⁴¹ Given the critical role that cash pools play in the everyday operations of group treasuries, the limited opportunity for base erosion, and the potentially dramatic impact the Proposed Regulations would have on cash pools if adopted unchanged, we believe that it is important for Treasury to provide special rules to allow the continued viability of cash pools and that such rules can be adopted without impairing the policies of the Proposed Regulations.

First, we suggest that the regulations specifically provide that an upfront umbrella or omnibus cash pool agreement (a “Qualified Cash Pool Agreement” or “QCPA”) satisfies the general documentation requirements of Proposed Regulation section 1.385-2(b)(2) for both the CP Head and the participants who expressly join the QCPA. A QCPA should follow the general documentation requirements of Proposed Regulation section 1.385-2(b)(2) with the following modifications:

¹⁴¹ See *Debt-Equity Regs Aren't a Very Complicated Sea Change*, Comments of Robert Stack, Treasury Deputy Assistant Secretary (International Tax Affairs), TAX NOTES TODAY (May 25, 2016) (LEXIS, FEDTAX lib., TNT file, elec. cit. 2016 TNT 101-2).

1. The QCPA must provide that any advance to any participant in the QCPA (including the CP Head) is an unconditional and legally binding obligation to pay the balance due (net of any balances owed to it).
2. The QCPA must establish that each participant, to the extent that it is a net creditor, has the rights of a creditor to enforce the obligation.
3. At the time that each participant joins the QCPA, there must be contemporaneous written documentation prepared containing information establishing that such participant intends to, and would be able to, meet its obligations under the QCPA.
4. At least annually, each participant other than the CP Head would be required to document its ability to repay the balance due (net of any balances owed to it).

The regulations should further provide that, if a QCPA meets these modified documentation requirements, then it creates a Qualified Cash Pool (“QCP”).

Second, QCPs should be exempt from the application of Proposed Regulation section 1.385-3. This avoids the problems identified above while maintaining sufficient documentation for the Service to monitor the arrangement through application of common law debt-equity principles to ensure against base erosion.

We recognize that the Government may be reluctant to provide a blanket exemption from Proposed Regulation section 1.385-3. We therefore suggest that the exemption for QCPs be conditioned on certain limitations on the net balance that a participant may owe to the CP Head at the time of the periodic reassessment of its ability to repay. In our view, the most practical and administrable limitations rely on objective criteria based on the borrower’s financial statement, such as the amount of its current assets¹⁴² or an amount equal to its previous year’s operating expenses. The participant should be given one year to cure any failure to meet this limitation.

In addition, if the Government determines that a blanket exemption for cash pools is inappropriate, the Final Regulations should prevent iterative application of the rules of Proposed Regulation section 1.385-3 to QCPs by providing that (i) the acquisition of a recharacterized debt instrument in a cash pool does not constitute an acquisition under Proposed Regulation section 1.385-3(b)(3)(ii)(B), and (ii) a repayment of a

¹⁴² Current assets are all assets that can reasonably be expected to be converted into cash within one year. They include cash and cash equivalents, accounts receivable, inventory, marketable securities, prepaid expenses, and other liquid assets that can be readily converted to cash.

recharacterized debt instrument in a cash pool does not constitute a distribution under Proposed Regulation section 1.385-3(b)(3)(ii)(A).

Finally, if the Government determines that Proposed Regulation section 1.385-3(b)(3) should not apply to a QCP, then solely for purposes of that section, neither a CP Head nor an unrelated third party lending to a CP Head should be treated as a conduit under section 7701(l) and Regulation section 1.881-3. The policy of the anti-conduit regulations (to protect against avoidance of withholding taxes) is completely different than the policy underlying the Proposed Regulations (to protect the U.S. tax base by limiting earnings stripping), so it would be inappropriate to apply the anti-conduit rules to ordinary business transactions such as cash pools under the Proposed Regulations.¹⁴³

2. Recommendations Relating to Consolidated Groups

(a) Overview and Proposed Expansion of the Consolidated Group Exception

Proposed Regulation section 1.385-1(e) provides that, for purposes of the regulations under section 385, all members of a consolidated group (as defined in Regulation section 1.1502-1(h))¹⁴⁴ are treated as one corporation.¹⁴⁵ The Preamble describes the rationale for the rule as follows:

¹⁴³ Cf. e.g., T.D. 8611, 1995-2 C.B. 286 (noting that related corporations engaged in integrated businesses may enter into many financing transactions in the course of conducting those businesses, the vast majority of which have no tax avoidance purpose).

¹⁴⁴ Reg. §1.1502-1(h) defines the term “consolidated group” as a group filing (or required to file) consolidated returns for the taxable year. *See also* I.R.C. § 1504(a) (defining an “affiliated group” as 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 (A) possessing at least 80 percent of the total voting power of the stock of the relevant corporation and (B) having a value equal to at least 80 percent of the total value of the stock of such corporation (exclusive of preferred stock described in section 1504(a)(4)) in at least one other includible corporation, and one or more other includible corporations owns directly stock meeting the same requirements in each includible corporation (except the common parent)); section 1504(b) (generally limiting an “includible corporation” to a domestic corporation that is not granted special status under the Code).

¹⁴⁵ The general rule is subject to a very limited exception for purposes of determining the applicable 72-month *per se* period under the Funding Rule. *See* Prop. Reg. section 1.385-4(b)(1)(ii)(B) (discussed *infra*).

[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 federal income tax return.¹⁴⁶

Of course, "one corporation" treatment is limited to application of the Proposed Regulations. For example, Proposed Regulation 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 Regulation section 1.1502-13(g).¹⁴⁷ Similarly, the Preamble cautions 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.¹⁴⁸

The most significant effect of the "one corporation" rule is that transactions occurring between members of a consolidated group and any instrument issued by one member of the group and held by another are not subject to the Proposed Regulations, regardless of whether such transactions or instruments otherwise would have been subject to the Bifurcation, Documentation, General, or Funding Rule.¹⁴⁹ We applaud the

¹⁴⁶ Notice of Proposed Rulemaking, *supra* note 37, at 81 Fed. Reg. 20,914. 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 20,920.

¹⁴⁷ Prop. Reg. § 1.385-2(c)(4)(ii).

¹⁴⁸ Notice of Proposed Rulemaking, *supra* note 37, 81 Fed. Reg. at 20,920.

¹⁴⁹ See, e.g., Prop. Reg. § 1.385-2(c)(4)(i) (restating the general rule of Proposed Regulation section 1.385-1(e) and stating that, as a result, the applicable instrument is treated as *not outstanding* for purposes of Proposed Regulation section 1.385-2 during the time that the issuer and the holder of an applicable instrument are members of the same consolidated group); Prop. Reg. § 1.385-4(a) (restating the general rule); and Prop. Reg. § 1.385-4(b)(2) (restating the general rule and concluding "Thus, for example, the sale of a consolidated group debt instrument to an expanded group member that is not a member of the consolidated group will be treated as an issuance of the debt instrument to the transferee expanded group member in exchange for property."); Notice of Proposed Rulemaking, *supra* note 37, 81 Fed. Reg. at 20,922 ("Proposed section 1.385-3 does not apply to a consolidated group debt instrument. Thus, 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.")

Government's decision to except from the Proposed Regulations a wide range of instruments and activities that do not raise the policy concerns expressed in the Preamble. But we suggest that Treasury and the Service consider expanding the exception to apply to a group of domestic entities meeting the ownership requirements of section 1504(a)(2) and connected through common ownership by a domestic corporation.¹⁵⁰ Because such a group would be entirely domestic, transactions amongst its member would raise neither the "repatriation" nor "earnings stripping" concerns detailed in the Preamble; to wit, all or virtually all of a group's income, gain, loss, and deduction would be taken into account currently for federal income tax purposes.¹⁵¹ Moreover, an expanded domestic group rule would ameliorate the adverse consequences to, and compliance burden on, those taxpayers whose transactions do not raise the policy concerns cited by the Government, but are nonetheless affected by Proposed Regulations as currently drafted.¹⁵²

The second significant effect of "one corporation" treatment is that, for purposes of section 385, an expanded group or modified expanded group member, as applicable (other than a member of the consolidated group), is treated as interacting with a single corporation comprised of all of the consolidated group members. A corollary to this construct and to disregarding arrangements and instruments between consolidated group members is the necessity for rules addressing 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. These rules are provided in Proposed Regulation section 1.385-4 concerning the application of the General Rule and the Funding Rule.¹⁵³

¹⁵⁰ For this purpose, a "controlled partnership," within the meaning of Proposed Regulation section 1.385-1(b)(1), at least 80% of which, by vote and value, is owned members of a domestic group could be treated as an aggregate of its partners, consistent with Proposed Regulation section 1.385-3(f)(5), or as a corporation, similar to Proposed Regulation section 1.385-2(c)(6).

¹⁵¹ We recognize that the items of income and expense in such a group would not always produce the same net tax result as intercompany and corresponding items recognized by members of a consolidated group.

¹⁵² If Treasury and the Service choose not to expand the consolidated group exception in this manner, we urge the government to include more targeted relief aimed at partnerships wholly owned by members of a consolidated group, insurance companies, and S corporations, each of which is discussed elsewhere in our Comments.

¹⁵³ *See, e.g.*, Prop. Reg. §1.385-3(a) (cross-referencing Prop. Reg. §1.385-4 for rules regarding the application of Prop. Reg. §1.385-3 to members of a consolidated group); Prop. Reg. §1.385-4(a) (noting that Prop. Reg. §1.385-4 provides rules for applying Prop. Reg. §1.385-3 to consolidated

(cont'd)

For example, when a corporation ceases to be a member of the consolidated group but continues to be a member of the expanded group, the treatment of a debt instrument issued or held by the departing member as indebtedness or stock keys off of whether or not the instrument is an “exempt consolidated group debt instrument” (“ECGDI”).¹⁵⁴ An ECGDI that is issued or held by the departing member is deemed to be exchanged for stock *immediately after* the departing member leaves the group.¹⁵⁵ In contrast, a consolidated group debt instrument issued or held by a departing member that is not an ECGDI (“non-exempt consolidated group debt instrument,” or “non-ECGDI”) is treated as indebtedness unless and until it is treated as stock as a result of a subsequent distribution or acquisition that would trigger the application of the Funding Rule.¹⁵⁶

Solely for purposes of applying the 72-month *per se* period under the Funding Rule, a non-ECGDI is treated as having been issued when it was first treated as a

(cont'd from previous page)

groups when an interest ceases to be a consolidated group debt instrument or becomes a consolidated group debt instrument).

¹⁵⁴ Prop. Reg. §1.385-4(b)(1). An ECGDI is defined as any debt instrument that was not treated as stock solely by reason of the departing member’s treatment under Proposed Regulation section 1.385-1(e). Prop. Reg. §1.385-4(b)(1)(i).

¹⁵⁵ Prop. Reg. § 1.385-4(b)(1)(i). *See also* Prop. Reg. § 1.385-4(d)(3), Example 3(ii)(A). Note that Proposed Regulation 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 Proposed Regulation sections 1.385-4(b)(1), 1.385-4(b)(2), or 1.385-4(c). We recommend that Proposed Regulation section 1.385-1(c) be revised to clarify its application to these provisions.

As an ancillary consequence of the application of Proposed Regulation 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. As discussed in detail below, the deemed issuance could deconsolidate the issuer if the deemed stock is not described in section 1504(a)(4).

It appears that an instrument can be an ECGDI only if it satisfies the requirements of Proposed Regulation section 1.385-2. In addition, it appears that the instrument must not be subject to recharacterization under the Bifurcation Rule, absent application of Proposed Regulation section 1.385-1(e). A taxpayer’s ability to make this determination is unclear in light of the fact that bifurcation may only be asserted by the Commissioner.

¹⁵⁶ Prop. Reg. §1.385-4(b)(1)(ii)(A). *See also* Prop. Reg. §1.385-4(d)(3), Example 3(ii). Note that it is implicit in the definition of a non-ECGDI that the instrument otherwise satisfies the requirements of Proposed Regulation sections 1.385-1(d) and 1.385-2.

consolidated group debt instrument.¹⁵⁷ For all other purposes of applying Proposed Regulation section 1.385-3, though, a non-ECGDI is treated as issued by the issuer of the debt instrument *immediately after* the departing member leaves the group.¹⁵⁸

When a member of a consolidated group holding a consolidated group debt instrument transfers the instrument to an expanded group member that is not a member of the consolidated group,¹⁵⁹ the debt instrument is treated for purposes of Proposed Regulation section 1.385-3 as issued by the issuer of the debt instrument to the transferee expanded group member on the date of the transfer.¹⁶⁰ To the extent the debt instrument is treated as stock upon being transferred because, for example, the common parent of the group distributes the instrument to its foreign parent,¹⁶¹ the debt instrument is deemed to

¹⁵⁷ Prop. Reg. §1.385-4(b)(1)(ii)(B). *See also* Prop. Reg. §1.385-4(d)(3), Example 4. That is, the issuance of a non-ECGDI commences the running of the 72-month *per se* rule period even though Proposed Regulation section 1.385-3 otherwise disregards the existence of a non-ECGDI. This proposed rule is the only exception in the Proposed Regulations to the otherwise strong “one corporation” treatment of consolidated group members embodied in Proposed Regulation section 1.385-1(e).

¹⁵⁸ Prop. Reg. §1.385-4(b)(1)(ii)(B).

¹⁵⁹ 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 expanded group 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 expanded group member of a consolidated group member’s obligation to another consolidated group member may reflect the view that such an assumption would trigger the “significant modification” rules of Regulation 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.

¹⁶⁰ Prop. Reg. §1.385-4(b)(2) (also providing that, for purposes of Proposed Regulation 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 consolidated group debt instrument to an expanded group member that is not a member of the consolidated group will be treated as an issuance of the debt instrument to the transferee expanded group member in exchange for property). *See also* Prop. Reg. §1.385-4(a) (noting that Proposed Regulation section 1.385-4 provides rules for applying Proposed Regulation 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).

¹⁶¹ Prop. Reg. §1.385-4(d)(3), Example 1. *See also* Prop. Reg. §1.385-4(d)(3), Example 2 (reaching a similar conclusion where a consolidated group member sells a consolidated group debt instrument to an expanded group member within 36 months of the issuer making a cash distribution to the purchaser). 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.*

(cont'd)

be exchanged for stock *immediately after* the debt instrument is transferred outside of the consolidated group.¹⁶²

Finally, when a debt instrument that is treated as stock under the General Rule or the Funding Rule 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), 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 Proposed Regulation section 1.385-3(b) *immediately before* that debt instrument becomes a consolidated group debt instrument.¹⁶³

We have grouped our specific comments into three broad categories. The first addresses issues related to the appropriate scope of the "one corporation" concept reflected in Proposed Regulation 1.385-1(e) and related provisions. The second highlights situations in which the characterization of debt as stock (other than stock described in section 1504(a)(4))¹⁶⁴ might cause an issuer to "cycle" in and out of

(cont'd from previous page)

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).

¹⁶² Prop. Reg. §1.385-4(b)(2). We note that, in certain instances, Proposed Regulation sections 1.385-4(b)(1) and 1.385-4(b)(2) could potentially apply to the same transaction. For example, if (i) an applicable instrument issued by a consolidated group is transferred outside the consolidated group, (ii) such instrument is treated under Proposed Regulation section 1.385-4(b)(2) as stock other than section 1504(a)(4) stock, and (iii) the represents more than 20% of the vote or value of the issuer, the issuer would disaffiliate from the consolidated, thereby triggering the application of Proposed Regulation section 1.385-4(b)(1). Given that (a) the application of Proposed Regulation section 1.385-4(b)(2) is needed to activate Proposed Regulation section 1.385-4(b)(1) and (b) Regulation section 1.1502-76(b)(1)(ii)(A)(1) (the so-called "end of the day rule") preserves the issuer's membership in the group through the end of the day, it appears that Proposed Regulation section 1.385-4(b)(1) would apply only to other applicable instruments issued or held by the issuer because the initial note would have already been recharacterized as stock.

¹⁶³ Prop. Reg. §1.385-4(c).

¹⁶⁴ The Preamble contemplates that the federal tax treatment of debt recharacterized as equity under the Proposed Regulations (e.g., as common stock, preferred stock, section 306 stock, stock described in section 1504(a)(4), etc.) 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

(cont'd)

consolidated group membership or give rise to other issues related to membership in a consolidated group. The final category addresses a number of technical issues under the Proposed Regulations that fall outside of the broader “one corporation” and ownership concerns.¹⁶⁵

(b) “One Corporation” Issues

The Proposed Regulations generally reflect a strong “one corporation” approach to members of a consolidated group.¹⁶⁶ But it appears that such an approach need not be absolute where policy or practical considerations dictate otherwise. For example, Proposed Regulation section 1.385-4(b)(1)(ii)(B) respects the existence of an intercompany obligation for purposes of applying the 72-month *per se* period under the Funding Rule.¹⁶⁷

(cont'd from previous page)

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. Cf. Prop. Reg. §1.385-3(g)(3), Example 8 (observing that, depending on its terms and other factors, a debt instrument may be treated as stock described in section 351(g)). Presumably most applicable instruments regarded as stock under the Proposed Regulations will not have any voting power; the potential presence of the remaining three factors, though, will vary from instrument to instrument based on their respective terms. In addition, an instrument that becomes or ceases to be an intercompany obligation generally may very well undergo a deemed satisfaction and reissuance, and this could lead to a debt instrument being deemed reissued at a premium or discount, which could influence the analysis of the type of equity in which the instrument would convert if recharacterized under the Proposed Regulations.

¹⁶⁵ We note that certain of the recommendations would have to be modified in the event the government accepts our recommendation to expand the scope of the consolidation group exception.

¹⁶⁶ This “one corporation” concept is broader than the hybrid approach taken by the consolidated return regulations of Reg. §1.1502-1 et. seq. See, e.g., *Applied Research Associates, Inc. v. Comm’r*, 143 T.C. 310, 318 (“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.]

¹⁶⁷ See also Prop. Reg. §1.385-4(d)(3), Example 4 (illustrating this rule). Similarly, the Preamble states that “the 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

(cont'd)

We believe the Final Regulations should address how the “one corporation” rule applies in various contexts. We have considered several different broad approaches to this issue. A strict “one corporation” rule, while having the benefit of being conceptually straightforward, could lend itself to inequitable results, as described below. On the other hand, a set of rules addressing whether the “one corporation” rule must be applied strictly or leniently to each possible situation that might arise involving a consolidated group would be overly burdensome. Accordingly, we recommend a middle ground; that is, certain items should be clearly included or excluded from “one corporation” treatment and a principle-based rule should be used to address any item not specifically addressed. We highlight below certain situations that implicate the “one corporation” rule and recommend a specific approach for each situation.

(i) Partnership with All Consolidated Group Partners

In the case of a partnership that is wholly owned by members of a consolidated group, does the “one corporation” concept cause the partnership to be treated, for purposes of the Proposed Regulations, as though it has just a single owner and thus is a disregarded entity?¹⁶⁸ If so, when is the partnership collapsed (e.g., as of the effective date of the Final Regulations)? This may have far reaching effects, such as causing includible corporations owned by the partnership to be included in the consolidated group for purposes of the Proposed Regulations.

We recommend that the final regulations clarify that any applicable instrument issued or held by a partnership wholly owned by members of the same consolidated group (“Consolidated Group Partnership”) should be treated as issued or held by the

(cont'd from previous page)

income offset on the group’s consolidated federal income tax return.” 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.... Accordingly, the proposed regulations under section 385 do not apply to interests between members of a consolidated group.” These statements could be read to imply that the “one corporation” treatment is less than global in scope and functions only to ensure intercompany interests and transactions do not activate the application of the Proposed Regulations.

¹⁶⁸ The “conversion” of the partnership to a disregarded entity is a function of the default entity classification rules under Regulation section 301.7701-3. If partnerships can be so collapsed for purposes of the Proposed Regulations, could (or should) taxpayers have the ability to make an election under Reg. §301.7701-3 to treat the partnership as a corporation rather than as a disregarded entity for such purposes? For example, if the partnership were foreign, such an election may cause the entity to be regarded as a foreign corporation for purposes of the Proposed Regulations, thereby keeping it and any includible corporations below it out of the consolidated group.

consolidated group (i.e., a single corporation) for purposes of the Documentation Rule. Proposed Treasury Regulation 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 is owned, directly or indirectly, by one or more members of an expanded group. Proposed Regulation section 1.385-1(e) provides that, for purposes of the regulations, 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 should be treated as owned by one corporation, thus causing the Consolidated Group Partnership to become disregarded for purposes of the Documentation Rule, and any applicable instrument issued or held by the Consolidated Group Partnership to be treated as issued or held by that one corporation. We believe this result generally is appropriate given the purposes of the Proposed Regulations. Because Consolidated Group Partnerships items flow entirely within the consolidated group, their use does not erode the corporate tax base to any greater extent than the use of member subsidiaries.¹⁶⁹ Moreover, we note that debt issued between consolidated group members and Consolidated Group Partnerships would still have to meet the case law standard for bona fide debt.

(ii) Documentation and Maintenance
Requirements Under Proposed Regulation
section 1.385-2

The Documentation Rule applies to the “issuer” of the applicable instrument. When the legal issuer is a member of a consolidated group, it is unclear how the “one corporation” rule of Proposed Regulation section 1.385-1(e) alters the documentation and maintenance requirements, if at all. 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 determining the ability of the issuer to repay the instrument under Proposed Regulation section 1.385-2(b)(2)(iii). Treating the entire consolidated group as the “issuer” might suggest that the economics of the entire consolidated group, even entities that are not owned by the legal issuer, may be considered.¹⁷⁰ Another consideration if a strict “one corporation” approach applies is that

¹⁶⁹ The issue of whether a corporation owned 80% by such a partnership should be included in the consolidated group for purposes of the Proposed Regulations should turn on the same considerations underlying whether to broaden the consolidated group exception.

¹⁷⁰ Similarly, if the consolidated group is “one corporation,” might each member be required to satisfy each of the four documentation elements of Proposed Regulation section 1.385-2(b)(2)? Also, may the maintenance requirement of Proposed Regulation section 1.385-2(b)(4) be satisfied by any member of the group?

the rules currently make no provision for the impact of members joining or departing from the consolidated group.

We believe the potential application of Proposed Regulation section 1.385-2 to the entire consolidated group would result in unneeded complexity and administrative issues. Moreover, as noted in the Preamble, the requirements under the Documentation Rule are intended to be a proxy for the arrangements a borrower would enter into with an unrelated third party. A strict application of the “one corporation” approach to define the “issuer” appears inconsistent with this intent. Accordingly, we recommend that the Final Regulations clarify that the consolidated group member that actually issues a debt instrument is treated as the “issuer” for purposes of the documentation and maintenance requirements in Proposed Regulation section 1.385-2.

(iii) Application to the General Rule

We believe the “one corporation” concept and the mechanics in Proposed Regulation section 1.385-4(b)(2) should be revised to ensure that two economically equivalent transactions intended to be subject to the General Rule do not produce inconsistent results.

Example 26. Assume FP owns USS1, which owns DS1, and all of the corporation are members of an expanded group. Assume further that USS1 and DS1 are members of the same consolidated group and USS1 owns a note issued by DS1 (the “DS1 Note”). In Year 1, USS1 distributes to FP a USS1 note (the “USS1 Note”). Under the General Rule, the USS1 Note is recharacterized as equity that USS1 is treated as having distributed to FP in a transaction presumably governed by section 305.¹⁷¹ In Year 2, USS1 distributes the DS1 Note to FP. The distribution is treated as a General Rule transaction in which the DS1 Note is recharacterized as equity. Under Proposed Regulation section 1.385-4(b)(2), however, the DS1 Note is treated as exchanged for equity immediately after the distribution to FP (i.e., the note is treated as debt momentarily in the hands of 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 and the fact that the two distributions are otherwise subject to the General Rule, we see no reason to treat transactions differently.

¹⁷¹ Immediately before the DS1 Note is distributed, Regulation section 1.1502-13(g)(3) should apply to cause a deemed satisfaction and reissuance of the DS1 Note.

We recommend that the Final Regulations address this inconsistent treatment and clarify the application of section 305.

(iv) Application to the Funding Rule

(1) Treatment of Pre-Consolidation Transactions

As stated in the Preamble, “a debt instrument issued by one consolidated group member to a member of its expanded group 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.” This exceedingly broad application of the “one corporation” principle raises questions concerning the consequences of a “tainted” corporation (i.e., a corporation that has engaged in a prohibited transaction) that joins a consolidated group and to a corporation that departs from a “tainted” consolidated group.

Example 27. In Year 1, DS1, a non-consolidated member of an expanded group (“EG1”), makes a cash distribution to its sole parent corporation, FP1. In Year 2, unrelated USS1 acquires DS1, causing DS1 to join the USS1 consolidated group. The USS1 consolidated group is part of a separate expanded group (“EG2”). In Year 3, USS1 borrows cash from its sole parent corporation, FP2, thus becoming a “funded member” within the meaning of the Proposed Regulation section 1.385-3(b)(3)(ii).

We believe the better reading of the Funding Rule is that both the funding transaction and the prior or later prohibited transaction must involve the same expanded group (i.e., “the funded member’s expanded group,” as used in the Proposed Regulations). Another interpretation of Proposed Regulation section 1.385-3(b)(3), in conjunction with the “one corporation” rule of Proposed Regulation section 1.385-1(e), is that the Year 3 borrowing completes a funding transaction; that is, DS1 made a distribution to an expanded group member and the consolidated group of which DS1 is a member engaged in a borrowing from an expanded group member.¹⁷²

The same tainting concept works in reverse.

¹⁷² Cf. Prop. Reg. §1.1502-72(a)(2)(iv)(A) (treating a consolidated group as an “applicable corporation” when a pre-existing CERT member joins the group).

Example 28. In Year 1, USS1, the common parent of a consolidated group of which DS1 is a member, distributes \$100 cash to its sole corporate parent, FP1. In Year 2, unrelated USS2, the common parent of a consolidated group, acquires DS1 such that DS1 joins the USS2 consolidated group. In Year 3, USS2 borrows cash from its sole corporate parent, FP2, making USS2 a “funded member.”

Again, one possible reading of Proposed Regulation section 1.385-3(b)(3), in conjunction with the “one corporation” rule of Proposed Regulation section 1.385-1(e), is to treat the Year 3 borrowing as completing a funding transaction; that is, the consolidated group of which DS1 is a member (the USS1 Group) made a distribution to an expanded group member and the consolidated group of which DS1 is a member (the USS2 Group) engaged in a borrowing from an expanded group member.¹⁷³

We do not believe that either of these situations merits application of the Funding Rule. Specifically, the rule is designed to prevent an expanded group from achieving the same benefit as a General Rule transaction in two steps, as opposed to one. In contrast, none of the expanded groups in the above examples has achieved the economic effect of a General Rule transaction, although each clearly has engaged in one leg of a funding transaction. This, coupled with the increased diligence burden and numerous difficulties faced by consolidated groups that acquire other corporations (e.g., developing appropriate escrows, etc.), we recommend that a corporation not import a “taint” with it into an acquiring consolidated group if such consolidated group was not previously part of the same expanded group 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 expanded group as the acquiring consolidated group, and thus we believe it is not inappropriate to import the “taint” into the acquiring consolidated group in that circumstance.

If the Final Regulations require a departing consolidated group member to take with it the “taint,” the Final Regulations should provide the *amount* of the taint. Using the immediately preceding example as a point of reference, if the rules do require DS1 to

¹⁷³ Cf. Prop. 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). Another potential outcome of the “one corporation” approach is that DS1 could be purged of its own taint on departing from the USS1 consolidated group. For example, assume DS1 is owned 80% by USS1 and 20% by another member (CFC) of the expanded group that is also not in the USS1 consolidated group, and assume 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 Proposed Regulation section 1.385-1(e) arguably views the USS1 (rather than DS1 specifically) as having made the distribution.

take the taint with it upon departure from the USS1 consolidated group (e.g., if DS1 is itself treated as having made a \$100 distribution for purposes of applying Proposed Regulation section 1.385-3(b)(3) to the USS2 consolidated group), a correlative \$100 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., \$100 to the USS1 consolidated group and \$100 to the USS2 consolidated group). In order to prevent duplication, and in order to provide administrability to both the Service 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.¹⁷⁴

(2) Continuation of the “One Corporation”
Principle on Disaffiliation

The breadth of the “one corporation” principle could also affect the application of the Funding Rule in situations where Proposed Regulation section 1.385-1(e) ceases to apply.

Example 29. 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 expanded group 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 expanded group. 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 expanded group member, this funding has not been used to undertake a proscribed transaction. 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 expanded group member and this funding took place within a 72-month period of a proscribed transaction. We believe the “one corporation” principle should continue after the period of consolidation with respect to transactions arising within the

¹⁷⁴ 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).

consolidated group during the period of consolidation and, accordingly, we recommend that Proposed Regulation section 1.385-1(e) be clarified to indicate that transactions occurring within a consolidated group are disregarded for purposes of the Proposed Regulations subsequent to the period of consolidation.

(3) Disaggregating Activities of
Consolidated Group Members in
Certain Circumstances

Although we recognize that the drafters were likely concerned with the administrative difficulty of tracing the movement of cash within a consolidated group in order to determine whether there is a funding of a distribution or acquisition, we believe that the application of the Funding Rule should be more limited in the consolidated group context. We therefore recommend that the Funding Rule be modified to make it inapplicable to a debt instrument issued by a consolidated group member in appropriate circumstances. For example, we believe a taxpayer should have the ability to demonstrate that the Funding Rule should not apply in cases where a consolidated group member making an acquisition or distribution where the proceeds from the “funding” of the funded consolidated group member are adequately segregated.

(v) The Current E&P Exception

Finally, we believe the Government should provide guidance regarding how the “one corporation” principle applies in the context of the Current E&P Exception. For example, if 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 the FP expanded group of which DS1 is a member), it is not clear under the Proposed Regulations if Current E&P is limited to that of DS1 or is measured by reference to the Current E&P of the entire USS1 consolidated group. If the latter, how is Current E&P computed for a consolidated group for this purpose (e.g., based on Regulation section 1.1502-33 or without regard to that regulation because Proposed Regulation section 1.385-1(e) views the consolidated group as one corporation)?¹⁷⁵ Based on a strict “one corporation”

¹⁷⁵ A similar inquiry applies if DS1 has separate return year E&P. Would 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. Reg. §1.1502-33(b)(3)(ii), Example 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 Current E&P (or Current E&P deficit) with respect to its taxable year that closes on its joining the USS1 consolidated group is excluded from the USS1

(cont'd)

approach, one might argue that adjustments related to the consolidated group's Current E&P should be determined without regard to adjustments related to group member stock, which would, for example, (i) eliminate reductions to Current E&P for a worthless stock loss on group member stock and (ii) treat acquisitions of target stock as acquisitions of target asset, which might produce a step-up or step-down in asset basis the depreciation or amortization for purposes of computing Current E&P.¹⁷⁶ Given the interpretative difficulties associated with these issues, we recommend that the Final Regulations provide clear guidance on the how the Current E&P Exception applies in the context of a consolidated group.

(c) Applicable Instruments Recharacterized as non-Section 1504(a)(4) Equity

Where 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).¹⁷⁷ In that case, it can affect a corporation's status as a member in a consolidated group. The treatment of an applicable instrument as non-section 1504(a)(4) stock under the mechanical rules of the Proposed Regulations may affect consolidated group membership in unintended ways, as illustrated in the examples below.¹⁷⁸ These results seem inappropriate in that such rules should not allow for the existence of iterative deemed transactions affecting whether a corporation joins or disaffiliates from a consolidated group. Accordingly, we recommend the rules be modified in order to prevent this result.

(cont'd from previous page)

consolidated group's Current E&P? Cf. 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).

¹⁷⁶ The manner in which Current E&P is calculated also affects the Threshold Exception because the \$50 million limitation is applied after the Current E&P Exception.

¹⁷⁷ See note 164, *supra*, and accompanying text.

¹⁷⁸ In each of the following examples, 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.

(i) Impact of Proposed Regulation section
1.385-1(d) on Consolidated Group
Membership

The Bifurcation Rule requires an analysis of an EGI “as of the issuance of the EGI.” It is not clear whether this means that the instrument must be an EGI at the time it is issued, or that the rule applies to an instrument which is not an EGI on issuance, but later becomes an EGI. If the latter, an applicable instrument that is issued outside a modified expanded group could affect the issuer’s membership in a consolidated group.

Example 30. Assume P, the common parent of the P consolidated group, owns 80% 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 modified expanded group. In Year 4, FS, which is wholly owned by FP, acquires S1 Note A from X, causing S1 Note A to enter the FP modified expanded group. If the Commissioner determines that S1 Note A is in part stock, and if this recharacterization is retroactive to Year 1, P might not have been affiliated with S1 and therefore S1 might never have been a member of the P consolidated group.

This result seems 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 Regulation sections 1.1502-13 (concerning intercompany transactions), 1.1502-19 (concerning excess loss accounts), 1.1502-36 (concerning losses on member stock), etc.¹⁷⁹ In light of the severity, difficulty in implementation, unforeseeability, and unfairness of these results, we accordingly recommend against such retroactive recharacterizations under the Bifurcation Rule. We therefore recommend clarification that the analysis described in the Bifurcation Rule is required as of either (i) the issuance of an instrument if it is an EGI at such time, or (ii) when an instrument becomes an EGI.

¹⁷⁹ Strikingly, 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 issues arise with respect to whether the recharacterization under the Bifurcation Rule of an applicable instrument survives the departure of the instrument or issuer from a modified expanded group. This uncertainty could create unintended affiliation-disaffiliation cycles.

Example 31. USS1 owns 80% of the outstanding stock voting power and 79% 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 Proposed Regulation 1.385-1(d) is applied to treat 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 Proposed Regulation section 1.385-1(d) does not survive the consolidation of DS1 (e.g., due to the “one corporation” treatment of Proposed Regulation section 1.385-1(e)), DS1 immediately deconsolidates from the USS1 consolidated group because USS1 will continue to own only 79% of the DS1 stock value. This deconsolidation of DS1 triggers the application of Proposed Regulation 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 re-affiliate 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.¹⁸⁰

Example 32. USS1 owns 80% of the outstanding stock voting power and 79% of the outstanding stock value in DS1, and FP owns an applicable instrument issued by DS1 (“DS1 Note A”) that Proposed Regulation section 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 by reducing USS1’s ownership of DS1’s outstanding stock value to 79%. In Year 3, FP transfers DS1 Note A outside the modified expanded group to unrelated X. If the stock recharacterization under the Bifurcation Rule does not survive the departure of DS1 Note A from the modified expanded group and DS1 Note A becomes regarded as indebtedness, DS1 could then become affiliated and consolidated with the USS1 consolidated group.

¹⁸⁰ A similar issue may arise any time where (i) the issuer of an ECGDI leaves the consolidated group, thereby potentially preventing an intended deconsolidation, or (ii) 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 Proposed Regulation section 1.385-3(d)(5)(ii) results in S1 joining the consolidated group. Cf. Prop. Reg. §1.385-3(g)(3), Example 14.

(ii) Impact of Proposed Regulation section
1.385-2 on Consolidated Group Membership

Consolidated group membership status may also be affected by the interaction of the Documentation Rule and 1.385-1(e), particularly if the characterization of an instrument as stock under the Documentation Rule does not continue after the issuer joins a consolidated group.

Example 33. USS1 owns 80% of the outstanding stock voting power and 79% 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 Proposed Regulation 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. Proposed Regulation section 1.385-2(c)(2)(ii) appears to treat DS1 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% of the DS1 stock value.¹⁸¹ Because no terms have changed with respect to DS1 Note A, the Documentation Rule causes DS1 Note A to be regarded as stock, which then restarts the cyclical attempted (and prevented) consolidation.¹⁸²

(iii) Impact of Proposed Regulation sections
1.385-3 and 1.385-4 on Consolidated Group
Membership

The rules under Proposed Regulation 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

¹⁸¹ Cf. Prop. Reg. § 1.385-4(c) (requiring similar treatment where an instrument characterized as stock under Proposed Regulation section 1.385-3 becomes a consolidated group debt instrument). Similar issues arise where an applicable instrument that is issued by an expanded group member that is “almost” a consolidated group member to a member of the consolidated group, and if Proposed Regulation 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.

¹⁸² 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.

corporation. The multiple note ordering rule of Proposed Regulation section 1.385-3(b)(3)(iv)(B)(3) also may be disrupted with changes in consolidated group status.

Example 34. USS1, an includible corporation within the meaning of section 1504(b), owns 80% of the outstanding stock voting power and 79% 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 Proposed Regulation 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 the Proposed Regulation section 1.385-4(c) applies (i.e., because USS2 Note A was treated as stock under Proposed Regulation 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 Proposed Regulation section 1.385-3(b)(2)) immediately before USS1 joins the consolidated group, thereby precluding the affiliation of USS1 with the USS2 consolidated group.¹⁸³ As a consequence, the USS2 consolidated group continues and, because “new” USS2 Note A is not recharacterized under Proposed Regulation section 1.385-3(b)(2), it is respected as indebtedness.¹⁸⁴

Example 35. USS1 owns 80% of the outstanding stock voting power and stock voting rights of DS1. USS1 also owns an applicable instrument issued by DS1 (“DS1 Note A”) that is an exempt instrument under Proposed Regulation 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 Proposed Regulation 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% of the outstanding stock voting power and stock voting

¹⁸³ The fiction of Proposed Regulation section 1.385-4(c) appears to preempt temporally the application of Proposed Regulation section 1.385-4(b)(1) (dealing with the deconsolidation of an issuer or holder).

¹⁸⁴ The application of Proposed Regulation section 1.385-4(c) has essentially *purged* the stock taint that was momentarily imposed by Proposed Regulation 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 Proposed Regulation 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 Regulation section 1.1502-13(g)(3), Proposed Regulation section 1.385-4(b)(2), and Proposed Regulation section 1.385-4(c), causing transitory satisfactions and issuances of the applicable instrument.

rights 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.¹⁸⁵ However, if Proposed Regulation 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.

(iv) Recommendation

These issues could be addressed through a rule that either continues the equity characterization of a debt instrument or disregards a recharacterized debt instrument in determining whether a corporation is a member of a consolidated group. We believe the latter approach would be more administrable given that it avoids having to determine whether a debt instrument characterized as stock satisfies the requirements of section 1504(a)(4).

(d) Discrete Issues Impacting Consolidated Groups

In addition to the issues related to the “one corporation” principle and non-section 1504(a)(4) stock recharacterizations discussed above, the Proposed Regulations, and in particular Proposed Regulation sections 1.385-3 and 1.385-4, give rise to a number of discrete consolidated return issues and concerns.

(i) Interaction with Ordering Rule in Proposed Regulation section 1.385-3(b)(3)(iv)(B)(3)

As noted above, Proposed Regulation 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 Proposed Regulation section 1.385-4(b)(1)(ii)(B), by, for example, unwinding prior stock status.

Assume that DS1 is owned 80% by USS1 and is a member of the USS1 consolidated group and the FP expanded group. FP owns the remaining 20% of DS1. In Year 1, DS1 borrows \$100 cash from USS1 in exchange DS1 Note A, which is a non-ECGDI. In Year 2, DS1 makes a \$100 cash distribution to FP. In Year 3, DS1 borrows \$100 cash from CFC, a member of the FP expanded group, in exchange for DS1 Note B. The Year 2 distribution and issuance of DS1 Note B constitute a Funding Transaction and

¹⁸⁵ Note that the deemed exchange rule of Proposed Regulation section 1.385-4(c) would not apply due to the fact that DS1 Note A is treated as stock under Proposed Regulation section 1.385-4(b)(1) rather than under Proposed Regulation section 1.385-3.

DS1 Note B is recharacterized as stock under Proposed Regulation section 1.385-3(b)(3). Later in Year 3, DS1 leaves the USS1 consolidated group but remains in the FP expanded group. Under Proposed Regulation section 1.385-4(b)(1)(ii)(B), DS1 Note A is treated as issued in Year 1. Under Proposed Regulation 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 principal purpose debt instrument, it appears that DS1 Note B toggles back to indebtedness treatment and DS1 Note A becomes treated as stock because DS1 Note A was issued before DS1 Note B.

This result is inappropriate in that the mechanical rules of the Proposed Regulations should not, as a matter of administrability for both taxpayers and the Service, permit applicable instruments to switch back and forth between indebtedness and stock status. Accordingly, we recommend that, for purposes of the ordering rule of Proposed Regulation section 1.385-3(b)(3)(iv)(B)(3), debt instruments such as that described in the preceding example be regarded as issued immediately after deconsolidation.¹⁸⁶

(ii) Subgroup Exception Under Proposed
Regulation section 1.385-4(b)(1)(ii)(B)

The breadth of Proposed Regulation section 1.385-4(b)(1) 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 expanded group (e.g., when two consolidated groups with the same foreign corporation shareholder combines such groups under Regulation section 1.1502-75(d)(3)). This change in consolidated group location within the broader expanded group 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 federal income tax return – and thus we recommend the provision of a “subgroup” exception under which Proposed Regulation 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 expanded group. An analogous concept already appears generally in the consolidated

¹⁸⁶ We note that properly addressing the interaction of the deemed satisfaction and reissuance rule of the Proposed Regulations with Regulation 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* Reg. §1.1502-13(g)(3)(i)(B)(7) (excepting from deemed satisfaction and reissuances certain intercompany obligations distributed under section 361(c)).

return regulations dealing with acquisitions of an entire consolidated group,¹⁸⁷ and it also appears more specifically with respect to debtor and creditor members of an intercompany obligation.¹⁸⁸

(iii) Interaction with Fictional Transactions
Under Regulation section 1.1502-13(g)

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., Proposed Regulation 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))¹⁸⁹ is the interaction of fictional exchanges under such rules with the fictional transactions arising under Regulation sections 1.1502-13(g)(3) and 1.1502-13(g)(5). Generally, Regulation 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; Regulation 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

¹⁸⁷ See 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); 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).

¹⁸⁸ See 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).

¹⁸⁹ The potential for a deemed exchange under Proposed Regulations 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 obligation that ceases to be an intercompany obligation and thus overlaps with Proposed Regulations section 1.385-2(c)(2)(i)) should be properly addressed by the rules of Proposed Regulations sections 1.385-4(b) and 1.385-4(c) and thus do not need to be separately considered.

reissuance are treated as transactions separate and apart from the transaction giving rise to the deemed satisfaction and reissuance.¹⁹⁰

Because the fictional transactions under Regulation sections 1.1502-13(g)(3) and 1.1502-13(g)(5) will occur at approximately the same time as the deemed exchange under Proposed Regulation 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,¹⁹¹ which in turn would add material uncertainty to the proper treatment of the relevant transactions. We therefore recommend the Proposed Regulations be amended to provide that any deemed issuances, satisfactions, and/or exchanges arising under Regulation section 1.1502-13(g) and Proposed Regulation 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 Regulation sections 1.1502-13(g)(3)(ii)(B) and 1.1502-13(g)(5)(ii)(B).

Relatedly, we note that Proposed Regulation section 1.385-4(d)(3), Example 4 (discussed above) appears to ignore the application of Treasury Regulation 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 Regulation section 1.1502-13(g)(3), DS1 Note B would have undergone a deemed satisfaction and reissuance on Date C of Year 4,¹⁹² meaning that DS1 Note B would not be respected as issued in Year 2.¹⁹³ We recommend that this example be revised to reflect properly the impact of Regulation section 1.1502-13(g).

(iv) Unintended Consequences of Conversion of Debt into Equity

The above described issues highlight some peculiar mechanics within the Proposed Regulations. Other, non-mechanical issues, though, may arise when the Proposed Regulations operate – as intended – to convert a debt instrument into equity. That is, aside from the predictable consequences which seem to be within the intendment

¹⁹⁰ 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.

¹⁹¹ See, e.g., Rev. Rul. 73-427; 1973-2 C.B. 301; Rev. Rul. 68-602; 1968-2 C.B. 135.

¹⁹² The Funding Rule’s 72-month period should commence with this deemed reissuance.

¹⁹³ 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.

of the Proposed Regulations (such as member deconsolidation when its debt instruments held by non-consolidated expanded group 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 expanded group 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 that rule was directed at a very different concern not implicated by the policies behind the Proposed Regulations. 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 expanded group 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);¹⁹⁴ thus, the Proposed Regulations in their current form will significantly increase the number of required ownership measurements by the consolidated group. We recommend that the Final Regulations expressly indicate that such ancillary consequences are unintended and inapplicable.

3. Recommendations Relating to S Corporations

(a) S Corporations Generally

(i) Summary

As noted earlier in our Comments, although S corporations are in form corporations, they are not part of the corporate tax base. Their issuance of related-party indebtedness affords no opportunities for erosion of the corporate tax base and implicates none of the policy concerns cited in the Preamble. Moreover, even as holders of related-party indebtedness, S corporations should be viewed as aggregates of their shareholders. They operate as flow-through entities much like partnerships and sole proprietorships. The only material difference is that the shareholders of an S corporation cannot be foreign, and therefore S corporations cannot be used to erode the domestic tax base.

The Proposed Regulations recognize that certain related-party debtor-creditor relationships do not pose policy concerns and afford them special treatment. By treating all corporations filing a consolidated return as one corporation, the Proposed Regulations effectively exempt transactions within consolidated groups from their requirements. The logical rationale for the consolidated return exemption is that all of the interest income

¹⁹⁴ Notice 2004-37, 2004-1 C.B. 947.

and deductions from any indebtedness between members of such an affiliated group are either eliminated or reported on the United States consolidated income tax return filed by the parent, which must be a domestic corporation in order for the group to file a consolidated return in the first place.¹⁹⁵

The Proposed Regulations do not treat individuals and partnerships that own corporate stock as members of an expanded group. This does not merely exempt them from the reach of the Proposed Regulations as issuers – they cannot be issuers of stock – but also as holders.¹⁹⁶ This is presumably based on a judgment that they do not expose the tax system to much risk as holders of corporate debt, though the Preamble requests comments concerning whether the Proposed Regulations should be extended to partnership funds holding controlled corporations.

In much the same way as a subsidiary in a consolidated group can be viewed as an extension of the common parent, on whose return its results are reported, an S corporation can be viewed as an extension of the individual or individuals on whose return its results are reported. Accordingly, S corporations merit the same treatment as individuals and partnerships under the Proposed Regulations.¹⁹⁷

(ii) Recommendation

We recommend that the Final Regulations modify the definition of "expanded group" to reinstate the exception for S corporations contained in section 1504(b)(8).

Proposed Regulation section 1.385-1(e) provides that "all members of a consolidated group (as defined in §1.1502-1(h)) are treated as one corporation,"¹⁹⁸ thus effectively exempting all indebtedness between and among members of a consolidated group from application of the Proposed Regulations. Although such indebtedness may involve substantial amounts, especially for publicly held entities which file consolidated federal income tax returns, the exemption is reasonable and justified because, as the

¹⁹⁵ See I.R.C. §§ 1501, 1504(b)(3).

¹⁹⁶ Individual shareholders are not always exempt as holders from the Bifurcation Rule, which is proposed to apply to individual shareholders who control a chain of corporations. Bifurcation in this situation, as we note, can have drastic and unintended consequences for S corporations and their shareholders.

¹⁹⁷ The absence of foreign shareholders only makes S corporations more deserving than partnerships in this regard.

¹⁹⁸ 81 Fed. Reg. at 20,931.

Preamble states, “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 . . . return.”¹⁹⁹ Thus, the drafters decided to exempt consolidated return entities from the substantial new requirements imposed by the Proposed Regulations, even though the distinction between indebtedness and equity is not without tax consequences within a consolidated return, because base erosion, profit shifting and earnings stripping do not appear to be significant concerns when all of the income and deductions will be reported on a single, domestic United States income tax return.

Similarly, in the case of debt existing between S corporations, all income and deductions of S corporations must be reported on the domestic United States income tax returns of their shareholders. Clearly, the simple situation where a single shareholder owns 100% of the stock of two brother-sister S corporations should be exempted on the basis of the same rationale as are affiliated groups filing a consolidated return. In such a situation, all of the income and deductions of both S corporations are, in fact, reported on the single individual’s income tax return. The sole shareholder, who must, under the Code, be fully taxable on all the income and deductions passed through from both S corporations, is effectively in the same position as the corporate parent of an affiliated group filing a consolidated return, which, under the Code, must also be domestic and fully report all of the income and deductions of its subsidiaries. A substantial majority of S corporations, in fact, have only one shareholder. For calendar year 2013 (the latest year for which such statistics are available on the Service’s website), single shareholder S corporations make up slightly more than 63% of the total number of S corporations, and over 95% of all S corporations have no more than three shareholders.²⁰⁰

As noted above, it makes sense to exempt the indebtedness of large, publicly-held entities from the substantial new burdens imposed by the Proposed Regulations, and thus it is also reasonable and appropriate to spare S corporations from these same burdens. First, all of the income and deductions of S corporations are reported domestically within the United States. Second, the single class of stock requirement imposes significant rigor with respect to stock ownership. Any transferor of S corporation stock unavoidably relinquishes a pro rata share of all of his or her economic rights with respect to dividends

¹⁹⁹ Notice of Proposed Rulemaking, *supra* note 37, at 81 Fed. Reg. 20,914.

²⁰⁰ IRS, *SOI Tax Stats – Table 6 – Returns of Active Corporations, Form 1120S*, <https://www.irs.gov/uac/soi-tax-stats-table-6-returns-of-active-corporations-form-1120s>.

and liquidation.²⁰¹ Accordingly, it is reasonable and appropriate to treat S corporations as not part of an expanded group under the Proposed Regulations.

Moreover, Regulation sections 1.385-2, 1.385-3 and 1.385-4 do not even purport to cover indebtedness held by individuals, partnerships and other noncorporate taxpayers, because the definition of "expanded group" includes only corporations.²⁰² The distinction between debt and equity has drastically reduced significance in the context of debtors and creditors that are S corporations, partnerships and other pass-through entities whose income is taxed to their individual owners. In this regard, it would be anomalous for partnerships to be excluded from the provisions of the Proposed Regulations, but for S corporations, which, by definition, must be 100% domestically own and taxed, and cannot be subsidiaries of other corporations, to be covered.

(b) Qualification as an S Corporation and QSub

(i) Summary

The Bifurcation Rule allows the Service to recharacterize indebtedness between members of a "modified expanded group" as "in part indebtedness and in part stock" in certain circumstances. There is no de minimis exception, and so (as in the case of partnerships holding controlled subsidiaries) this rule would potentially apply to all indebtedness of all S corporations and QSubs to the extent that the holder of any portion of such indebtedness was another member of the same modified expanded group. An S corporation's modified expanded group could include related partnerships and individuals, as well as related S corporations and C corporations.²⁰³ In addition, other sections of the Proposed Regulations would recharacterize indebtedness of S corporations as equity in other circumstances, such as the failure to maintain specified records under the Documentation Rule. Any such recharacterization of an S corporation's indebtedness, unless covered by certain rules discussed below, would nearly always invalidate its S corporation election under either the single class of stock rule or the eligible shareholder

²⁰¹ See Reg. § 1.1361-1(l)(1).

²⁰² Prop. Reg. § 1.385-1(b)(3), 81 Fed. Reg. at 20,930. Proposed Regulation section 1.385-3(d)(5) does deal with so-called "controlled partnerships," but only for purposes of treating corporate members of the expanded group as acquiring, issuing and/or holding debt instruments under the aggregate theory of partnerships.

²⁰³ See Prop. Reg. § 1.385-1(b)(5), 81 Fed. Reg. 20,912, 20,930 (Apr. 8, 2016).

rule or both. Also, any such recharacterization of a QSub's indebtedness, unless covered by the rules discussed below, would, in many cases, invalidate its election to be treated as a "division" of an S corporation for tax purposes under section 1361(b)(3), because that section requires 100% of the QSub's stock to be owned by the S corporation parent.

(ii) Recommendation

We recommend that the Final Regulations clarify and confirm that they would not apply in determining the qualification of an S corporation and a QSub as such. The simplest approach would be to exclude S corporations from an expanded group, as requested above, and failing that, a provision directly to the effect that qualification would continue to be determined pursuant to section 1361 and the regulations thereunder without regard to the Final Regulations. This would be clearer and simpler than relying on the potential applicability of the special provisions preserving debt status described above.

Under section 1362, only "a small business corporation" may elect to be an S corporation. Section 1361 defines the term "small business corporation" for this purpose, and, among other things, provides that such corporations may not "have more than 1 class of stock" or have as shareholders persons other than citizen or resident individuals, estates or certain trusts and exempt organizations. Corporations, partnerships and other entities are not eligible to be shareholders of an S corporation. Thus, the recharacterization of virtually any indebtedness of an S corporation as part indebtedness and part stock, if effective for S Corporation qualification purposes and not covered by the rules discussed below, would cause that corporation to no longer qualify as a "small business corporation" and invalidate its S corporation election. This is because any such indebtedness would invariably not "confer identical rights to distribution and liquidation proceeds" that are the same as those for the corporation's common stock and would, therefore, be treated as a second class of stock under Regulation section 1.1361-1(l)(1). In addition, if the holder of such indebtedness were another corporation (whether an S corporation or a C corporation), a partnership, an ineligible trust or any other nonqualifying S corporation shareholder, such ownership would also violate the S corporation eligible shareholder requirements, thereby also terminating the S corporation's status as such.²⁰⁴

²⁰⁴ There is one scenario where such a bifurcated holding might not terminate the S corporation election. This is in the unusual situation where the indebtedness is "owned solely by the owners of, *and in the same proportion as*, the outstanding stock of the corporation." See Reg. § 1.1361-1(l)(4)(ii)(B)(2) (emphasis added). However, this constitutes only a very small percentage of the indebtedness arising in the ordinary course of S Corporation operations.

The Regulations under section 1361 already contain a comprehensive set of rules for determining whether an indebtedness will be treated as a second class of stock for purposes of S Corporation qualification. These Regulations were adopted after an extensive comment period and carefully balance the policies underpinning the S corporation qualification rules with the need to provide certainty with respect to such a fundamental question as continued eligibility for S status. In particular, they provide that, even if an "instrument, obligation, or arrangement constitutes equity or otherwise results in the holder being treated as the owner of stock under general principles of Federal tax law," the instrument, obligation, or arrangement will not be treated as a second class of stock unless "[a] principal purpose of issuing or entering into the instrument, obligation, or arrangement is to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to circumvent the limitation on eligible shareholders."²⁰⁵

In addition, section 1361(c)(5) specifically provides that indebtedness qualifying as "straight debt shall not be treated as a second class of stock." Section 1361(c)(5) defines "straight debt" as "any 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 on profits, the borrower's discretion, or similar factors, (ii) there is no convertibility (directly or indirectly) into stock, and (iii) the creditor is an individual (other than a nonresident alien), an estate, a trust described in paragraph (2), or a person which is actively and regularly engaged in the business of lending money.

Moreover, the Regulations provide that, even if such "straight debt" "is considered equity under general principles of Federal tax law," it nonetheless "is generally treated as debt and when so treated is subject to the applicable rules governing indebtedness for other purposes of the Code."²⁰⁶

Under section 1361(b)(3)(B)(i), a subsidiary of an S corporation can elect to be treated as a QSub, *i.e.*, as a "division" of the S corporation, but only if "100 percent of the stock of such corporation is held by the S corporation." Therefore, except in the case of indebtedness held exclusively by the S corporation parent, any recharacterization of any portion of a QSub's indebtedness as stock, if not covered by the rules below, would

²⁰⁵ Reg. § 1.1361-1(l)(4)(i), (ii)(A)(1)–(2).

²⁰⁶ Reg. § 1.1361-1(l)(5)(iv). A portion of the interest may be recharacterized and treated as a payment that is not interest if the rate of interest is "unreasonably high," but such recharacterization would not result in a second class of stock. Reg. § 1.1361-1(l)(5)(iv).

automatically invalidate the QSub's election as such. Moreover, Proposed Regulation section 1.385-2(c)(5) specifically provides that any debt recharacterized as stock under the Documentation Rule would be "treated as an equity interest of the disregarded entity rather than stock in the disregarded entity's owner."

Regulation section 1.1362-2(b)(2) specifically provides that "[a]ny outstanding instruments, obligations, or arrangements of the [QSub] corporation which would not be considered stock for purposes of section 1361(b)(1)(D) [the single class of stock rule] if the corporation were an S corporation are not treated as outstanding stock of the QSub." Thus, the rules described above, namely that an instrument, obligation, or arrangement is not to be treated as stock unless "[a] principal purpose of issuing or entering into the instrument, obligation, or arrangement is to circumvent" the S corporation qualification rules, are equally applicable with respect to QSubs.

The purpose of the Proposed Regulations is to prevent base erosion, profit shifting and earnings stripping. By definition, QSubs and their S corporation parents are treated as a single taxable entity, and therefore the opportunity to engage in such practices among themselves does not even exist. In this respect, S corporation/QSub "groups" are very similar to affiliated groups filing a single, consolidated return, and the Proposed Regulations specifically exempt such consolidated return affiliated groups from all of the Proposed Regulations.²⁰⁷ This is what we would be proposing for S corporation/QSub groups also.

(c) Real Estate Investment Trusts

We note that REITs raise many of the same considerations as S corporations. Although the mechanism is different, the large majority of the income of a REIT is effectively outside of the corporate tax base. Although REITs cannot file consolidated returns, analogously to QSubs, they can operate through tax-transparent subsidiaries, including QRSs or subsidiaries organized as private REITs or partnerships.

The exception to the tax-transparent treatment of REIT subsidiaries is TRSs, which are permitted to carry on business activities. However, the securities of a TRS held by a REIT may not represent more than 25% of the gross value of a REIT's assets.²⁰⁸

²⁰⁷ See Prop. Reg. § 1.385-1(e), 81 Fed. Reg. at 20,931.

²⁰⁸ I.R.C. § 856(c)(4)(B)(ii). The limitation will decrease to 20% for years after 2017.

Although it has subsequently evolved, particularly with the proliferation of private REITs, the REIT concept originated from an intention to afford retail investors the same flow-through tax treatment as was historically available to wealthy investors through real estate partnerships.

For the above reasons, we believe that consideration should be given to affording REITs relief under the Final Regulations comparable to that requested for S corporations. Absent such relief, various qualification issues could be faced. For example, mortgage debt issued by a TRS to a controlling REIT, if recast, could result in disqualification of the REIT based on the increased value of TRS securities (other than qualifying assets) held by the REIT.²⁰⁹

4. Recommendations Relating to Relatedness

(a) In General

For purposes of the Proposed Regulations, there are two sets of “relatedness” rules. First, there is the “expanded group” concept, which starts with the section 1504 affiliated group definition and makes certain modifications. A key aspect of using the “affiliated group” as a starting point is that it relies on the concept of a common parent corporation. This affiliated group definition is then modified to eliminate the eight exclusions (most importantly foreign corporations and S corporations), to change vote and value to vote or value, and to allow indirect ownership of members by the common parent by applying section 304(c)(3). One effect of the attribution rules is to include downward attribution to the common parent from shareholders, including individuals and partnerships, of corporations they own. Assuming the intent is to only include side-by-side brother corporations, this application of section 304(c)(3) is over-broad as it also pulls into the expanded group corporations that are owned by partners of a partnership that is a shareholder.²¹⁰ Further, although controlled partnerships are not expanded group members, their debt can be treated as stock of their corporate partners that are members for purposes of the General/Funding Rules, so they must be accounted for in monitoring groups as if they were expanded group members.

²⁰⁹ Mortgage debt issued by a TRS to its parent REIT counts as a qualifying asset for purposes of the REIT asset test. I.R.C. § 856(c)(5)(B). However, it will no longer be a qualifying asset if it is recharacterized as equity.

²¹⁰ Section 318(a)(3)(A) attributes ownership to a partnership stock owned by its partners without any ownership threshold, and section 318(a)(3)(C) as modified by section 304(c)(3) attributes to a corporation stock owned by any 5% shareholders.

For purposes of the Documentation Rule, the definition of expanded group is further expanded by making 80% controlled partnerships group members.²¹¹ This produces a different treatment for partnerships under the Documentation Rule than under the General/Funding Rules (which treat partnership as pure aggregates).

For purposes of the Bifurcation Rule, the expanded group is modified by substituting 50% for 80%, including 50% controlled partnerships in the group, and including in the group any person to whom is attributed 50% of the stock of a group member by section 318, which means any person (including individuals and partnerships) who owns at least 50% of a modified expanded group member (either the common parent or other member only 50% of which needs to be owned in the group). This definition, unlike the expanded group definition, can make an individual or partnership that is a large shareholder of a common parent a group member. We have already expressed concerns about the scope of the modified expanded group definition in the context of the Bifurcation Rule and focus our Comments here on the other two rules.

(b) Relatedness Recommendations

(i) Section 1504 Definition

The definition of an expanded group begins with section 1504 and makes changes to that rule. It is not clear to us that the section 1504 definition is the right starting place.

The threshold question to be addressed is whether an expanded group should be defined downwards from a corporate common parent or should also include brother-sister corporations owned by the same individual, family or partnership. Relevant considerations include the number of such corporations, the likelihood that they will finance each other, and the availability of financial information to these corporations about each other (as well as the availability of that information to the Service). Unfortunately, there is no uniform answer that clearly guides this choice. Related family-owned corporations are more likely to finance each other than are the portfolio companies of a private equity partnership. Financial accounting is commonly done by aggregating entities under a corporate common parent. It is less common to aggregate entities under a partnership, and it would be unusual to aggregate entities under an individual or family. A common parent would be expected to have access to financial information about its corporate and noncorporate subsidiaries. Portfolio companies owned in substantial part by private equity funds through a partnership or related partnership might be able to obtain information based on such common ownership, but

²¹¹ Prop. Reg. § 1.385-2(c)(6), 81 Fed. Reg. at 20,937.

would be expected to know almost nothing about each other directly. Family-owned corporations might be able to get information through the family, assuming enough overlap. Given the compliance and information burdens, one might conclude that grouping corporations under a common parent is a useful concept. The number of family-owned brother-sister groups that might be brought within the scope of the General/Funding Rules, which require \$50 million of related-party debt, might be relatively small. On the other hand, the number of family-owned brother-sister groups that would be within the scope of the Bifurcation Rule is vast.

If Treasury or the Service wishes to include brother-sister corporations that are not connected directly or indirectly under a common corporate owner, we believe that section 1504 is a poor place to start. First, it is not compatible with an effort to include parallel chains of corporations and other indirectly owned corporations. It is built on the concept of one chain with a common parent directly owning control of at least one member, which is necessary for defining the common parent. If that concept is abandoned, the utility of the section 1504 definition is undermined.

Other group definitions in the Code seem better adapted and more compatible with the purposes of these regulations. We recommend that section 1563 be used, perhaps as modified by section 267(f). This would have the advantage of employing a rule that was designed for brother-sister as well as parent-subsidiary groups. It is also designed to look through partnerships without reference to the attribution rules of section 318, and, in particular, without downward attribution, which is one of the most problematic aspects of the definition of an expanded group.

Section 267(f) applies a more than 50% control level, which is preferable to a 50% level because it precludes a corporation being drawn into two groups where there is 50:50 ownership. The section could be applied for this purpose by substituting an 80% ownership level.

Even if the common parent aspect of defining an expanded group is retained, the parent-subsidiary prong of section 1563 provides a better model than adding the section 304 and 318 overlay onto section 1504. That would avoid drawing in all of the inappropriate attribution that can arise under section 318.

Because section 1563(e) employs similar look-through rules for partnerships and corporations, the use of section 1563 would assist in defining controlled partnerships for the purpose of the Proposed Regulations.

(c) Definition of a Controlled Partnership

(i) Clarify Reference to Section 304(c)(3)

If our recommended approach above is not followed, it would nevertheless be appropriate to adjust the definition of a controlled partnership. The Proposed Regulations

provide that indirect ownership of a partnership interest is determined by applying the 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 Final Regulations clarify how section 304(c)(3) applies for purposes of determining indirect ownership of a partnership interest.

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

[I]f 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, “[i]f 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% rule provided for in section 318(a)(2)(C) and (a)(3)(C) by substituting “5 percent.” Section 318(a), however, contains rules for attributing to and from partnerships, which contain no threshold ownership requirement. Thus, the 5% threshold would not apply to partnership attribution. However, section 304(c)(3)(B) nevertheless could be relevant in determining existence of a controlled partnership. For example, if A owns 40% of a partnership directly and a corporation in which A owns 40% owns another 40% of the partnership, then A would own 56% of the partnership applying section 304(c)(3)(B), but only 40% had the unmodified section 318 rules applied.

We recommend the Final Regulations provide an example to illustrate the application of section 304(c)(3) for purposes of defining a controlled partnership.

(ii) Guidance on Proportionality

We also recommend that the final Regulations provide guidance on how “proportionately” should be determined for purposes of section 318(a)(2)(A) and (3)(A). As noted above, section 318 attribution in the corporate context is determined based on “value” of stock owned. In a partnership context, the determination of “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. We believe that the Final Regulations should provide a safe harbor for purposes of determining “proportionately” in the case of a partnership. We believe that an appropriate safe harbor for these purposes is the liquidation value of a partner’s interest.²¹²

5. Recommendations Relating to Insurance Companies

(a) Overview of Recommendations

Unique among businesses, an insurance company protects its customers – the unrelated policyholders – with a promise to pay in the future in the event of an insured loss. That promise to pay is supported by the capital of the insurance company and is subject to strict regulation at both the state and country levels.²¹³ In the case of global insurance and reinsurance groups, regulators in the group’s home country and in the local jurisdictions in which operating companies are located impose these restrictions, typically at the level of both the relevant entity and regulatory subgroup. These regulatory restrictions extend to the form in which an insurance company’s core capital can be issued, with the vast majority of that capital required to be issued in the form of equity that is loss-absorbing. Accordingly, insurance groups generally are net investors in

²¹² 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 Regulation section 1.108-8(b), the determination of economic risk of loss under Regulation section 1.752-2(b)(1), the amount of the basis adjustment under section 743(b), the presence of a capital interest under Revenue Procedure 93-27, 1993-2 C.B. 343. In addition, numerous proposed regulations make use of liquidation value. For instance, liquidation value is used to determine the fair market value of a partnership interest that is transferred in connection with the performance service. *See* Prop. Reg. § 1.704-1(b)(4)(xii), 70 Fed. Reg. 29,675, 29,681 (May 24, 2005); Prop. Reg. § 1.83-3(l)(1), 70 Fed. Reg. at 29,680; Notice 2005-43, 2005-1 C.B. 1221. In addition, liquidation value is also used to determine a partner’s share of partnership profits for purposes of allocating excess nonrecourse liabilities under Proposed Regulation section 1.752-3(a)(3), 79 Fed. Reg. 4826, 4838 (Jan. 30, 2014).

²¹³ In addition, certain insurers are subject to the capital requirements that have been, and continue to be, developed through the systemically important financial institution (“SIFI”) and global systemically important insurer (“GSII”) regimes in the United States and other G-20 member countries. In this regard, the Federal Reserve Board recently approved an advance notice of proposed rulemaking that would propose new supervisory rules for the insurance companies that it regulates (namely, insurance companies that have been designated as SIFIs, *i.e.*, systemically important insurance companies, or that own a bank or thrift). *See* Advanced Notice of Proposed Rulemaking, *Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities*, 81 Fed. Reg. 38,631 (June 14, 2016). These proposed rules would include new minimum capital requirements.

securities and other debt instruments (rather than being net borrowers) and maintain low debt-to-equity ratios.²¹⁴

In view of the well-established regulatory framework imposed upon insurance companies, which we discuss further in Part II.E.5(b) of this section, and the strict limitations that framework imposes on the ability of insurance companies to incur indebtedness, the Proposed Regulations' announced purpose of curbing the "enhanced incentives for related parties to engage in transactions that result in excessive indebtedness"²¹⁵ does not have broad applicability in the insurance company context. Rather, the Proposed Regulations would introduce an unnecessary and counterproductive layer of governmental oversight to an area that already is subject to intense regulatory scrutiny, *i.e.*, scrutiny that effectively prohibits insurance companies from incurring "excessive indebtedness." Accordingly, we respectfully recommend that Treasury make the following changes to the Proposed Regulations in order to address legitimate concerns associated with their potential application to insurance companies:

1. Broaden the consolidated group rule of Proposed Regulation section 1.385-1(e) to cover "orphan" life insurance companies, *i.e.*, life insurance companies that are members of the affiliated group (without regard to the application of section 1504(b)(2)), but that are not yet members of the consolidated group (as defined in Regulation section 1.1502-1(h));
2. Amend the Ordinary Course Exception to cover payables arising from intragroup insurance and reinsurance transactions;
3. Modify the Current E&P Exception for insurance companies, which generally are unable to make distributions without receipt of regulatory approval and are subject to other relevant constraints;

²¹⁴ A.M. Best ratings guidance shows typical insurance holding company financial leverage, which information is used by A.M. Best as part of the overall ratings process. *See Insurance Holding Company and Debt Ratings* (May 6, 2014), A.M. Best, <http://www3.ambest.com/ambv/ratingmethodology/OpenPDF.aspx?rc=208685>. This guidance indicates that the holding company parents of (i) insurance groups rated as "secure" (B+ or above) have debt-to-equity ratios of less than 45% and (ii) insurance groups rated A- or above have debt-to-equity ratios of less than 35%. These ratings effectively constitute a binding constraint on insurance holding company leverage because a minimum rating usually is required in order to write certain lines of business in the insurance marketplace in the United States and abroad.

²¹⁵ Notice of Proposed Rulemaking, *supra* note 37, at 81 Fed. Reg. 20914.

4. Revise the documentation requirements of Proposed Regulation section 1.385-2(b)(2) to incorporate the long-standing principle that an insurance company's required receipt of regulatory approval before repaying a debt instrument does not vitiate the conclusion that such debt instrument constitutes an unconditional and legally binding obligation to pay a sum certain on demand or at one or more fixed dates; and
5. Exclude payables arising from intragroup insurance and reinsurance transactions from any possible expansion of the documentation requirements of Proposed Regulation section 1.385-2(b)(2) to other than "in form" debt instruments.

We discuss each of these recommendations, and our associated concerns, in greater detail in Part II.E.5(c) of this section.

(b) Existing Regulatory Framework Severely Restricts the
Ability of Insurance Companies To Incur Indebtedness

Regulators supervise insurance and reinsurance companies through the application of a regulatory framework that is designed to ensure that all insurance liabilities to policyholders can be met.²¹⁶ Accordingly, insurers and reinsurers are required to hold capital sufficient to cover potential liabilities and to support future stability. The form of that capital is heavily governed by regulation, particularly in relation to the matching of investment assets to insurance liability exposures, asset default risk, and volatility risk.

Although the regulation of insurance groups around the world continues to evolve, there is a common theme in place: an insurance company has a very limited ability to incur indebtedness. Nevertheless, subject to the limitations discussed below, intragroup lending within insurance groups does occur. For example, insurance groups oftentimes will maintain liquid funds in order to protect against known and unknown liquidity contingencies in a manner consistent with sound enterprise risk management standards and applicable regulatory requirements. This contingency planning usually includes maintaining liquid funds that can be used at relatively short notice to provide liquidity or to inject capital into operating entities in the case of a large insurance loss.

²¹⁶ For a recent, in-depth discussion of the objectives of regulating the insurance industry, see Anne Oberstadt et. al., *State of the Life Insurance Industry: Implications of Industry Trends*, NAIC & Center for Insurance Policy Research (Aug. 2013), http://www.naic.org/documents/cipr_home_130823_implications_industry_trends_final.pdf.

As a general matter, allowing these funds to be loaned intragroup is far more cost effective than requiring each operating entity in the group to borrow (or otherwise maintain facilities to borrow) from third parties.

(i) Insurance Regulation in the United States

In the United States, insurance regulation largely is determined by state regulatory bodies and generally is applied entity by entity, rather than at a group level. U.S. insurers and reinsurers also may be subject to regulation in the non-U.S. jurisdictions in which they or their affiliates operate. Furthermore, certain insurance companies that have been designated as non-bank SIFIs, *i.e.*, systemically important insurance companies, face federal regulation as well.²¹⁷

All fifty U.S. states have adopted some version of the model Insurance Holding Company System Regulatory Act (the “Insurance Holding Company Act”),²¹⁸ which includes explicit limitations on transactions between insurance companies and their affiliates. Pursuant to the Insurance Holding Company Act, an insurance company generally is prohibited from borrowing from, or extending credit to, an affiliate in an amount that exceeds 3% of the insurance company’s “admitted assets”²¹⁹ without the receipt of approval from the insurance commissioner of the insurance company’s domicile. In reviewing any proposed affiliate loan, the insurance commissioner will determine whether the loan is reasonably collectable based on the debtor’s existing assets. Thus, the insurance commissioner usually conducts a review to ensure that the purported debt is, in fact, bona fide debt entered into at arm’s length. Because this review occurs before the loan is made, U.S. insurance companies in effect are precluded from incurring the “excessive indebtedness” described in the Preamble.

²¹⁷ As noted above, certain insurers are subject to the capital requirements that have been, and continue to be, developed through the systemically important financial institution, *i.e.*, SIFI, and global systemically important insurer, *i.e.*, GSII, regimes in the United States and other G-20 member countries.

²¹⁸ NAIC, <http://www.naic.org/store/free/MDL-440.pdf>. Although states have adopted slightly different versions of the Insurance Holding Company Act, none of the differences are material to this discussion. U.S. insurers owned by foreign parents also may be subject to foreign regulation such as Solvency II, which is discussed below.

²¹⁹ In the United States, “admitted assets” are assets that an insurance regulator permits an insurance company to include on its balance sheet. Admitted assets vary from state to state, but they must be liquid and able to be valued. Admitted assets usually include mortgages, stocks, bonds, and accounts receivable that the company reasonably expects to be paid.

Beyond the restrictions imposed by the Insurance Holding Company Act, the accounting rules applicable to insurance companies further limit the degree to which an insurance company may issue debt to, or acquire debt of, an affiliate. Specifically, U.S. insurance companies account for their assets and liabilities using statutory accounting principles (“SAP”) promulgated by the National Association of Insurance Commissioners (the “NAIC”).²²⁰ Under SAP, an insurance company is required to hold admitted assets in sufficient quantity to satisfy its insurance liabilities to policyholders. If an insurance company lends to an affiliate, it may only treat that loan as an admitted asset under SAP if the loan passes regulatory review as an “arm’s length transaction” based upon an evaluation of the borrower’s payment ability.²²¹ Conversely, in accordance with applicable SAP guidance, an insurance company typically will not borrow money from an affiliate unless that borrowing occurs (i) under the strict control of the insurance commissioner of the insurance company’s domicile and (ii) in the form (and content) approved by that insurance commissioner. Thus, SAP acts as a further restriction on the lending and borrowing practices of an insurance company.

(ii) Insurance Regulation Outside of the United States

Outside of the United States, individual countries have developed their own regulatory frameworks for local insurance companies, but standardization is now becoming the norm. For example, an evolving European framework provides that insurance companies may conduct business across the European Union on either a “freedom of establishment” (“FoE”) or “freedom of services” (“FoS”) basis and also offers broadly-applicable capital requirements, which are commonly referred to as “Solvency II.” In brief, FoE and FoS provisions mean that insurers with a head office in the European Economic Area (“EEA”) are permitted to conduct insurance and reinsurance business in other EEA member states (either directly or through branches) but are only required to be authorized in their home state. Furthermore, Solvency II not only prescribes insurance company capital requirements, but it also governs the assessment, quantification, and disclosure of all insurance, financial, and operational risks of an insurance group and generally requires that all affiliated insurance companies in the

²²⁰ SAP are detailed within the *NAIC Accounting Practices and Procedures Manual*. For further background concerning SAP, see http://www.naic.org/cipr_topics/topic_statutory_accounting_principles.htm.

²²¹ See Statement of Statutory Accounting Principles No. 25, *Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*.

EEA be held under a common EEA holding company that itself is subject to solvency regulation and corresponding limits on indebtedness.²²²

Under Solvency II, insurance company capital is referred to as “own funds” and is classified into one of three tiers—Tier 1, which generally is comprised of share capital and retained reserves; Tier 2, which generally is comprised of capital issued in the form of subordinated debt instruments; and Tier 3, which generally is comprised of subordinated debt instruments that do not qualify as Tier 1 or Tier 2 capital. Each capital requirement under Solvency II is made up of different levels of capital from each tier. Pursuant to this regime, Tier 2 capital cannot exceed Tier 1 capital without jeopardizing the insurance company’s ability to treat Tier 2 capital as surplus. In practice, this outcome means an insurance company’s Tier 2 capital generally is maintained at a level significantly below its Tier 1 capital, as any large insurance or investment loss immediately impairs the company’s Tier 1 capital. Stated differently, this regime necessarily constrains an insurance company in respect of the issuance of indebtedness that could be treated as Tier 2 capital (or, correspondingly, Tier 3 capital).

(c) Recommended Changes to the Proposed Regulations

As the preceding discussion demonstrates, the existing regulatory framework imposed upon insurance companies both in the United States and in other jurisdictions places significant limitations on their ability to incur indebtedness. Thus, the Proposed Regulations announced purpose of curbing the “enhanced incentives for related parties to engage in transactions that result in excessive indebtedness”²²³ cannot be easily reconciled with the regulation currently experienced by the insurance industry. Accordingly, we respectfully recommend that Treasury make the changes to the Proposed Regulation discussed below.

(i) Broaden the One Corporation Rule To Cover Orphan Lifecos

The rules of section 1504(c) and Regulation section 1.1502-47 provide the general parameters for determining whether a domestic life insurance company (as defined in

²²² Solvency II also has been implemented outside of the European Union as part of the regulatory regimes of major reinsurance locations such as Bermuda and Switzerland, each of which has been granted Solvency II “equivalence.” For additional background on Solvency II, see Solvency II Overview – Frequently Asked Questions, European Commission (Jan. 12, 2015), http://europa.eu/rapid/press-release_MEMO-15-3120_en.htm.

²²³ Notice of Proposed Rulemaking, *supra* note 37, at 81 Fed. Reg. 20914.

section 816(a)) may join in filing a consolidated U.S. federal income tax return with one or more domestic nonlife insurance company (or non-insurance company) affiliates (a “life-nonlife consolidated return”). Pursuant to those rules, a recently acquired domestic life insurance company is not allowed to join in a life-nonlife consolidated return filed by the acquiring group for a period of five taxable years following the acquisition. The same result generally follows where:

- A newly-organized domestic life insurance company does not meet the requirements of the tacking rule found in Regulation section 1.1502-47(d)(12)(v);
- An existing nonlife member of a life-nonlife consolidated group experiences a change in tax character (as described in Regulation section 1.1502-47(d)(12)(vii)) and, as a consequence, becomes a life insurance company; *or*
- An existing life member of a life-nonlife consolidated group undergoes a disproportionate asset acquisition (as described in Regulation section 1.1502-47(d)(12)(viii)).²²⁴

Special consideration typically is given to these “orphan” life insurance companies (each, an “Orphan Lifeco”) while they reside outside the life-nonlife consolidated return.²²⁵

²²⁴ The current restrictions on the consolidation of life insurance companies are largely, if not entirely, an anachronism of the tax law. These restrictions are based on the fact that, at the time of the passage of these rules, life insurance companies were subject to a very different scheme of taxation from other Subchapter C corporations. That regime was known as the “three-phase system.” In 1983, Treasury promulgated the life-nonlife consolidated return regulations under Regulation section 1.1502-47 and, in so doing, adopted a substance over form approach to those rules and extended their reach in accordance with the peculiarities of the three-phase system. In 1984, *i.e.*, the year after Treasury promulgated the life-nonlife consolidated return regulations, Congress overhauled the federal income tax rules applicable to life insurance companies and abolished the three-phase system. Consequently, Congress’ original purpose for adopting the restrictions on consolidation of life insurance companies, and Treasury’s impetus for promulgating Regulation section 1.1502-47 in the form that largely continues to exist today, has been substantially diminished, if not eliminated, as a result of subsequent changes in the tax law.

²²⁵ In this regard, Regulation section 1.1502-47 includes certain rules that recognize an Orphan Lifeco’s status, at least partially, as a member of the affiliated group. *See, e.g.*, Reg. § 1.1502-47(d)(11) (discussed further below).

The Proposed Regulations would treat the members of a consolidated group (as defined in Regulation section 1.1502-1(h)) as “one corporation” for purposes of those rules (the “One Corporation Rule”).²²⁶ However, because an Orphan Lifeco may not join the life-nonlife consolidated return,²²⁷ it would not be encompassed by the One Corporation Rule as applied to the life-nonlife consolidated group, although it would be a member of the same expanded group (as defined in Proposed Regulation sections 1.385-1(b)(3)(i) and 1.385-3(f)(6)) as the life-nonlife consolidated group. As a consequence, an Orphan Lifeco could engage in what otherwise would be ordinary business transactions with one or more members of the life-nonlife consolidated group that could subject either the Orphan Lifeco or the life-nonlife consolidated group to unintended adverse consequences under the Proposed Regulations. In this regard, consideration should be given to the following scenarios, which are unique to insurance companies:

- Insurance companies typically enter into reinsurance agreements with other insurers and reinsurers, including affiliates, to better manage risk and achieve other business objectives.²²⁸ Where such an arrangement involves indemnity reinsurance, the parties generally settle amounts owed to one another in cash on a quarterly basis. During the period between each quarterly close, the ceding company and the reinsurer typically establish payables to one another, which amounts could be treated as debt instruments that may not qualify for the Ordinary Course Exception.²²⁹ As a result, subject to any other available exceptions, an Orphan Lifeco could be treated as lending to, or borrowing from, the life-nonlife consolidated group in a transaction that could be caught by the Funding Rule.
- A life insurance company may offer variable life insurance contracts and/or variable annuity contracts to the public. In such an instance, the life insurance company segregates the assets supporting those variable contracts from the company’s general account assets and invests the separate account assets in

²²⁶ See Prop. Reg. § 1.385-1(e), 81 Fed. Reg. 20,912, 20,937 (Apr. 8, 2016); *see also* Prop. Reg. § 1.385-4(a), 81 Fed. Reg. at 20,942.

²²⁷ Such a life insurance company nonetheless may be able to file a consolidated return with another related domestic life insurance company (a so-called life-life consolidated return) pursuant to section 1504(c)(1).

²²⁸ See *infra* Part II.E.5(c)(ii)(1) of this section for a more detailed discussion of reinsurance transactions and their business objectives.

²²⁹ See *infra* Part II.E.5(c)(ii)(3) of this section for a more detailed discussion of this issue.

accordance with the investment objectives outlined in the variable contracts. In order to satisfy the diversification requirements of section 817(h) and Regulation section 1.817-5, which generally apply to variable contracts, the separate account(s) supporting the variable contracts may not purchase shares of publicly-available mutual funds, but may invest in separate, insurance-dedicated mutual funds that qualify as regulated investment companies (as defined in section 851(a)). The life insurance company's investments in those insurance-dedicated mutual funds constitute acquisitions of stock of such regulated investment companies.²³⁰ Taking into account the fact that many insurance-dedicated mutual funds are substantially, if not completely, owned by affiliated life insurance companies (and, correspondingly, are members of the same expanded group as those life insurance companies), an Orphan Lifeco's acquisition of the stock of such a regulated investment company could constitute an acquisition of expanded group stock (as defined in Proposed Regulation section 1.385-3(f)(8)) that triggers the application of the Funding Rule.²³¹

We believe that these transactions fall far outside the concerns addressed by the Proposed Regulations and represent serious impairments to an Orphan Lifeco's (and the related life-nonlife consolidated group's) ability to conduct business. While we understand that the Proposed Regulations are designed to apply to purported indebtedness between all non-consolidated entities in an expanded group, both domestic and foreign, we believe that there is no sound policy justification for subjecting Orphan Lifecos (and their related life-nonlife consolidated groups) to the possible adverse consequences contemplated by the Proposed Regulations, particularly in view of the regulatory

²³⁰ Significantly, regulated investment companies also would fall outside of the One Corporation Rule, as such entities are prohibited from joining a consolidated group. *See* I.R.C. § 1504(b)(6).

²³¹ For example, assume that Orphan Lifeco begins to sell variable contracts to the public and offers an insurance-dedicated mutual fund organized by a member of the life-nonlife consolidated group ("Affiliate Lifeco") as an investment option for the separate account supporting those variable contracts. Thereafter, the separate account of Orphan Lifeco invests in the insurance-dedicated mutual fund in exchange for a small (less than 50%) interest in that fund. Prior to that investment by Orphan Lifeco, the insurance-dedicated mutual fund had been wholly owned by Affiliate Lifeco. Under these facts, the investment by Orphan Lifeco would constitute an acquisition of expanded group stock described in Proposed Regulation section 1.385-3(b)(3)(i)(B). As a result, a debt instrument issued by Orphan Lifeco to a member of the expanded group during the 72-month period described in Regulation section 1.385-3(b)(3)(iv)(B)(1) could be recharacterized as stock of Orphan Lifeco for all federal tax purposes.

restrictions that already prevent insurance companies from incurring the “excessive indebtedness” that the Proposed Regulations aim to curb.

As noted above, Regulation section 1.1502-47 includes certain rules that recognize an Orphan Lifeco’s status, at least partially, as a member of the affiliated group. For example, those rules apply a special separate return limitation year (“SRLY”) restriction by defining the term “group” without regard to the application of section 1504(b)(2) (the “Life-Nonlife SRLY Rule”).²³² As a consequence, even though an Orphan Lifeco must file a separate return for the period that it is ineligible to join the life-nonlife consolidated group, any losses that the Orphan Lifeco experiences during the waiting period are not subject to the SRLY limitation once it satisfies the eligibility requirements and joins the life-nonlife consolidated group. Overall, the Life-Nonlife SRLY Rule reflects an understanding that, while an Orphan Lifeco technically is not part of the life-nonlife consolidated group, it is expected to become part of the consolidated group and, correspondingly, should be permitted to use its losses to offset income of the life-nonlife consolidated group to the same extent it could have had it been a member of that consolidated group when it experienced those losses.

Taking into account the preceding discussion, we respectfully recommend that the following sentence be added to the end of Proposed Regulation section 1.385-1(e):

For purposes of the preceding sentence, if the consolidated group is filing a consolidated return for a taxable year pursuant to an election made under section 1504(c)(2), the consolidated group shall be deemed to include any life insurance company (as defined in section 816(a)) that, with respect to such taxable year, (i) is subject to tax under section 801, (ii) would be a member of the affiliated group but for the application of section 1504(b)(2) to such life insurance company, and (iii) is required to file a separate return (or a consolidated return with another ineligible life insurance company pursuant to section 1504(c)(1)) on account of the application of Regulation section 1.1502-47(d)(13) to such life insurance company.

²³² See Reg. § 1.1502-47(d)(11).

(ii) Amend the Ordinary Course Exception to
Cover Payables Arising from Intragroup
Insurance and Reinsurance Transactions

We also believe that the Ordinary Course Exception should be amended to cover common payables arising from intragroup insurance and reinsurance transactions. As discussed below, the exclusion of such payables from the Ordinary Course Exception would create substantial operational complexity for the companies that are parties to these transactions, notwithstanding the fact that these payables arise in the ordinary course of the issuer's trade or business.

(1) Reinsurance Transactions Generally

Reinsurance is a transaction in which an insurance company (the primary insurer; also referred to as the ceding company) transfers to another insurance company (the reinsurer) all or a portion of the risk arising out of an insurance or annuity contract (or a group of insurance or annuity contracts) that the primary insurer has issued. Accordingly, reinsurance typically is referred to as insurance for insurance companies because it covers a primary insurer in the event that funds are required to be paid out under one or more of the insurance or annuity contracts that the primary insurer previously issued.

Reinsurance is used by both life and nonlife insurance companies to better align risk and to manage capital more efficiently. In the life insurance sector, reinsurance is typically of long duration and is widely used to manage the capital cost of exposure to mortality risk (*i.e.*, the risk that insured individuals will die earlier than expected) and longevity risk (*i.e.*, the risk that recipients of lifetime benefits will live longer than expected). With regard to the property and casualty insurance sector, reinsurance often is used to help companies manage the risk of catastrophic loss.²³³ In summary, reinsurance offers a means to achieve the following business objectives, among others:

- Protecting the ceding company against significant insurance losses arising from business that it has underwritten;

²³³ Significantly, one study found that, from the beginning of 2011 to mid-2013, worldwide catastrophes resulted in approximately \$190 billion of insured losses. See *Global Reinsurance - Segment Review*, The Capital Challenge, Best's Special Report (Sept. 2013), <http://www.bestweek.com/europe/promo/GlobalReinsurance.pdf>.

- Ensuring an appropriate amount of capital at specific insurance companies within an insurance group;
- Pooling risk and, correspondingly, achieving diversification, which inherently frees up capital to be used most efficiently;
- Satisfying applicable regulatory requirements, which, as in the case of Solvency II, also may reward pooling and diversifying risks;
- Allowing for the movement of capital in order to manage liquidity risk;
- Servicing smaller markets where there may not be sufficient scale or diversity to economically justify holding large amounts of capital;
- Providing insurance capacity to markets vulnerable to natural catastrophes where local insurers may not be able to meet liabilities or lack diversification within their portfolios; and
- Reducing volatility, managing capital requirements, and improving returns to investors.

A typical form of reinsurance is indemnity reinsurance. In an indemnity reinsurance transaction, (i) the reinsurer agrees to indemnify the ceding company for all or a portion of the ceding company's insurance or annuity risks or liabilities,²³⁴ (ii) the ceding company retains its liability to, and its direct contractual relationship with, the insureds, beneficiaries, or holders of the reinsured contracts and pays a reinsurance premium to the reinsurer,²³⁵ and (iii) the reinsurer sets up its share of reserves and typically pays an amount referred to as a ceding commission to the ceding company. For

²³⁴ See Reg. § 1.809-4(a)(1)(iii) (“[T]he term ‘reinsurance ceded’ means an arrangement whereby the taxpayer (the reinsured) remains solely liable to the policyholder, whether all or only a portion of the risk has been transferred to the reinsurer. Such term includes indemnity reinsurance transactions but does not include assumption reinsurance transactions.”). Indemnity reinsurance can be either proportional or non-proportional in character.

²³⁵ The ceding company does not need to obtain the consent of the holders of the reinsured contracts in order for an indemnity reinsurance agreement to be effective. To the extent that the reinsurance covers an existing book of business, the ceding company may transfer the investment assets supporting the reinsured contracts directly to the reinsurer or, alternatively, to a grantor trust that the reinsurer establishes for the protection of the ceding company.

federal tax purposes, indemnity reinsurance generally is treated as the purchase of insurance protection from a reinsurer.²³⁶

(2) Funds Withheld Transactions

In an indemnity reinsurance transaction completed on a “funds withheld” basis (a “funds withheld transaction”), (i) the ceding company does not actually remit the entire premium to the reinsurer, but retains all or a portion of the premium (the “funds withheld amount”) in order to cover any claims payments,²³⁷ (ii) some amount of investment return is credited to the reinsurer on the funds withheld amount, and (iii) any portion of the funds withheld amount remaining after all claims are settled is remitted to the reinsurer. The funds withheld amount functions as a form of security because the ceding company can use that amount to cover claims that should be covered by the reinsurer but, for whatever reason (*e.g.*, the reinsurer’s insolvency), are not.²³⁸ For this reason, funds withheld transactions are common in the context of both related-party and unrelated-party reinsurance transactions, as regulators oftentimes require some form of security in order to ensure that the ceding company has adequately mitigated the risk of the reinsurer’s breaching its obligation to reimburse the ceding company for claims made.²³⁹ Where a funds withheld transaction is employed, the funds withheld amount cannot be utilized by the ceding company for any purpose other than to cover claims with respect to which the reinsurer breaches its obligation to reinsure, and the ceding company may not terminate the arrangement early by earmarking other assets for this purpose.

²³⁶ See *Oxford Life Ins. Co. v. United States*, 790 F.2d 1370, 1376 (9th Cir. 1986) (“An assumption reinsurance transaction is treated as a sale of the policies; an indemnity reinsurance transaction is the purchase of insurance protection from the reinsured.”).

²³⁷ The reinsurer generally books (i) the full amount of the premium for the funds withheld transaction as income (whether or not actually received) and (ii) the portion of the premium withheld as “funds withheld or deposited with reinsured companies” instead of cash. Furthermore, under such an arrangement, the reinsurer generally sets up its share of reserves, pays its share of benefits paid to policyholders, and pays a ceding commission to the ceding company.

²³⁸ A funds withheld transaction does not reduce the overall exposure of the reinsurer, which is liable for reinsured losses in excess of the funds withheld amount.

²³⁹ For example, funds withheld transactions are common in international contexts because a reinsurer in another jurisdiction may not be licensed in the ceding company’s jurisdiction and, as a result, some form of collateral arrangement is required in order for the ceding company to claim reserve or capital credit on account of the reinsurance.

The characterization of the payable or other item evidencing the funds withheld amount (the “funds withheld payable”) under Proposed Regulation section 1.385-3(f)(3) has been the subject of ongoing debate. As relevant to this discussion, Proposed Regulation section 1.385-3(f)(3) defines the term “debt instrument” by way of a cross-reference to section 1275(a) and Regulation section 1.1275-1(d). Thus, pursuant to Proposed Regulation section 1.385-3(f)(3) (and, correspondingly, for purposes of Proposed Regulation sections 1.385-3 and 1.385-4), a debt instrument would be defined as “any instrument or contractual arrangement that constitutes indebtedness under general principles of Federal income tax law.”²⁴⁰ In view of this expansive definition, a funds withheld payable could constitute a debt instrument pursuant to Proposed Regulation section 1.385-3(f)(3), although the context in which a particular funds withheld payable arises may impact that determination.

Notwithstanding the fact that a funds withheld payable arises in the ordinary course of the ceding company’s trade or business, the Ordinary Course Exception does not seem to offer a reliable source of reprieve in the event that such a payable is determined to constitute a debt instrument pursuant to Proposed Regulation section 1.385-3(f)(3). In this regard, the Ordinary Course Exception is narrowly crafted to cover debt instruments arising in the ordinary course of a taxpayer’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.” Through the course of considering this language, we identified several difficulties associated with its possible application to a funds withheld payable; specifically:

- The funds withheld payable does not arise in connection with the ceding company’s purchase of property.
- Although arguments may exist for treating the funds withheld payable as arising in connection with the ceding company’s receipt of services, the funds withheld payable does not reflect an obligation to pay an amount that is currently deductible by the ceding company under section 162. Rather, the funds withheld payable reflects an obligation to pay an amount that is deducted from the ceding company’s gross income under either section 803(a)(1)(B) (if the ceding company is subject to tax as a life insurance company) or section 832(b)(4)(A) (if the ceding company is subject to tax as a nonlife insurance company).

²⁴⁰ Reg. § 1.1275-1(d).

- “Cost of goods sold” and “inventory” are not concepts that find application in the insurance company context. In this regard, it is worth noting that neither Form 1120-L (U.S. Life Insurance Company Income Tax Return) nor Form 1120-PC (U.S. Property and Casualty Insurance Company Income Tax Return) include “cost of goods sold” as a separate line item.

As discussed above, the Proposed Regulations aim to prevent “excessive indebtedness” between related parties and, in order to achieve that goal, would treat as equity purported debt instruments that are unaccompanied by a net investment in the debtor. However, the possibility of characterizing a funds withheld payable as stock of the ceding company goes far beyond the articulated purpose of the Proposed Regulations and may jeopardize the continuing viability of funds withheld transactions, notwithstanding the fact that such arrangements arise from regulatory mandates with respect to bona fide reinsurance transactions. In this regard, we would note the following points:

- Funds withheld transactions are done for legitimate business reasons and enable multinational insurance groups to optimize their capital by pooling uncorrelated risks. Thus, any difficulties associated with implementing funds withheld transactions on account of the Proposed Regulations could limit the ability of multinational insurance groups to efficiently pool risks.
- Ceasing the use of funds withheld transactions may not be an option because that form of reinsurance may be required by an insurance regulator.
- A funds withheld transaction cannot be used to fund any of the factual situations that have been identified as a concern in the context of the Funding Rule, as the funds withheld amount is subject to regulatory controls and represents funds committed to insurance reserves. Stated differently, such funds cannot be distributed by the ceding company or otherwise used by the ceding company to acquire stock in, or the assets of, an affiliate.
- It will be very difficult for an insurance company to monitor and administer the impact of the Proposed Regulations on a funds withheld payable because the “principal balance,” *i.e.*, the funds withheld amount, will continually change throughout the course of the funds withheld transaction. Specifically, the balance will increase as premiums are paid to the ceding company and will decrease as claims are paid by the reinsurer. Each decrease in the principal balance of the funds withheld payable presumably would be treated as a dividend paid by the ceding company should the *per se* rule of Proposed Regulation section 1.385-3(b)(3)(iv)(B)(1) be implicated in respect of that payable. The result could be a large volume of non-economic dividend flows between related parties that inappropriately shift earnings and profits and potentially eliminate foreign tax credits, among other adverse collateral consequences.

(3) Other Intragroup Insurance and Reinsurance Transactions

Apart from funds withheld transactions, payables also can arise in the ordinary course of an insurance company's trade or business on account of engaging in other intragroup insurance and reinsurance transactions. While these payables generally give rise to deductions from the issuer's perspective, they provide for such results pursuant to specific provisions in Subchapter L, *i.e.*, sections 801-848, rather than section 162.²⁴¹ For example, as discussed above, the parties to an indemnity reinsurance transaction generally settle amounts owed to one another in cash on a quarterly basis. During the period between each quarterly close, the ceding company and the reinsurer typically establish payables to one another, which amounts could be treated as debt instruments pursuant to Proposed Regulation section 1.385-3(f)(3) that may not qualify for the Ordinary Course Exception.

(4) Recommendation

In sum, we believe that payables arising from the provision of insurance, or the institution and maintenance of reinsurance, in the ordinary course of the issuer's trade or business – to the extent that such payables could be construed as debt instruments pursuant to Proposed Regulation section 1.385-3(f)(3)—should not be subject to the *per se* rule of Proposed Regulation section 1.385-3(b)(3)(iv)(B)(1).²⁴² Accordingly, we respectfully recommend that the Ordinary Course Exception be amended in pertinent part as follows:

Paragraph (b)(3)(iv)(B)(1) of this section does not apply to a debt instrument that arises in the ordinary course of the issuer's trade or business in connection with...the provision of insurance, or the institution and maintenance of reinsurance to the extent that it reflects an obligation to pay an amount that is currently deductible by the issuer under sections 162, 803, 805, or 832, or.....

²⁴¹ See I.R.C. §§ 803(a)(1)(B), 805(a)(1), 832(b)(4)(A), 832(b)(5)(A).

²⁴² In addition, we support the further recommendation of other commentators that an express exclusion from the definition of “debt instrument” be incorporated in the Final Regulations for bona fide insurance and reinsurance contracts.

(iii) Modify the Current E&P Exception for
Insurance Companies

The most prominent exception to the General Rule and the Funding Rule is the Current E&P Exception. At the outset, we note the more general recommendations set forth in Part II.D.4(a) of these Comments in relation to the Current E&P Exception. The discussion and recommendations in this section are intended to be specific to insurance companies.

As discussed above, insurance companies are subject to strict regulation at both the state and country levels. Under these regulatory regimes, insurance companies generally are required to seek approval before making distributions to their shareholders in excess of a small percentage of surplus.²⁴³ Such approval usually requires the preparation of extensive documentation showing the insurance company's capital position before and after the anticipated distribution and typically takes between three and six months to obtain. Even in cases where the insurance company meets any applicable capital requirements, or otherwise would be permitted to distribute funds, business practice both within and outside the United States often demands that regulatory approval be obtained before making such a distribution. In sum, close supervision by regulators means that insurance companies are not free to distribute dividends to shareholders whenever there is available cash.

Furthermore, there is an inherent difficulty associated with an insurance company's projection of Current E&P on account of the possibility of catastrophic losses occurring near year-end. For example, a hurricane could make landfall in the United States in late December and cause large losses to an insurer providing coverage to the victims of the storm. Those losses could wipe out the insurance company's earnings and profits for that year. This possibility, coupled with the need for the regulatory approval described in the preceding paragraph, make a distribution of Current E&P a tenuous, if not impossible, task for an insurance company to complete.

Lastly, it is not uncommon for an insurance company's capital levels to fluctuate because of items beyond the current year's results. Natural disasters, changes in law, and changes in loss expectations can create large reserve adjustments both positive and negative. These reserve adjustments can result in either a release of capital or a need for

²⁴³ See, e.g., Insurance Holding Company System Regulatory Act, § 5.B. (Dividends and other Distributions), NAIC, http://www.naic.org/cipr_topics/topic_statutory_accounting_principles.htm. As noted above, although states have adopted slightly different versions of the Insurance Holding Company Act, none of the differences are material to this discussion.

additional capital. The resulting cycle of capital increases and, more important to this discussion, capital releases is independent of current-year earnings and profits. Therefore, insurance companies could be handicapped in their management of capital by the Proposed Regulations on account of the Current E&P Exception. Stated differently, without an accommodation, an insurance company may be required to maintain its capital at an unnecessarily high level (and, correspondingly, may put its qualification as an insurance company for federal tax purposes at risk²⁴⁴) or potentially fall outside of the Current E&P Exception on account of making a distribution in excess of Current E&P.

We reiterate our recommendations set forth in Part II.C.4(a) of these Comments in relation to the Current E&P Exception. Moreover, in view of the preceding discussion, we also respectfully recommend that the exception be amended to include a provision applicable to insurance companies, as follows:

(A) In general. Except as provided in paragraph (c)(1)(B) of this section,

(B) Insurance companies. If an insurance company (as defined in section 816(a)) is a member of an expanded group, then, for purposes of applying paragraphs (b)(2) and (b)(3) of this section to such member with respect to a taxable year, the aggregate amount of any distributions or acquisitions that are described in paragraphs (b)(2) or (b)(3)(ii) of this section are reduced by an amount equal to the greater of either (i) 300 percent of the member's current year earnings and profits described in section 316(a)(2) or (ii) the member's accumulated earnings and profits described in section 316(a)(1), determined as of the end of the immediately preceding taxable year. This reduction is applied to the transactions described in paragraphs (b)(2) and (b)(3)(ii) of this section based on the order in which the distribution or acquisition occurs. For purposes of this paragraph (c)(1)(B), distributions described in paragraph (b)(3)(ii)(A) of this section that are made by the insurance company member within 9 months of the close of a taxable year shall, at the election of such member for such preceding taxable year, be deemed to have occurred during such preceding taxable year.

²⁴⁴ See, e.g., *Inter-Am. Life Ins. Co. v. Commissioner*, 56 T.C. 497, 507-508 (1971), *aff'd*, 469 F.2d 697 (9th Cir. 1972); *Cardinal Life Ins. Co. v. United States*, 300 F. Supp. 387, 391-392 (N.D. Tex. 1969), *rev'd on other grounds*, 425 F.2d 1328 (5th Cir. 1970); see also *Serv. Life Ins. Co. v. United States*, 189 F. Supp. 282, 285-286 (D. Neb. 1960), *aff'd*, 293 F.2d 72 (8th Cir. 1961).

(iv) Revise the Proposed Documentation
 Requirements for Debt Instruments Issued
 by Insurance Companies

As explained in the Preamble, the Documentation Rule is:

[T]ailored to arrangements that in form are traditional debt instruments and [does] not address other arrangements that may be treated as indebtedness under general federal tax principles. . . . Because there are a large number of ways to document these arrangements, rules that provide sufficient information about these arrangements will need to contain specific documentation and timing requirements depending on the type of arrangement. Accordingly, the Treasury Department and the Service request comments regarding the appropriate documentation and timing requirements for the various forms that these arrangements can take.²⁴⁵

In response to this request for comments, we believe that the Government should revise the Documentation Rule to incorporate the long-standing principle that an insurance company's required receipt of regulatory approval before repaying a debt instrument does not vitiate the conclusion that such debt instrument constitutes an unconditional and legally binding obligation to pay a sum certain on demand or at one or more fixed dates.²⁴⁶ As discussed above, an insurance company's ability to issue debt instruments—which may take the form of surplus notes, surplus debentures, contribution certificates, or capital notes, among other variations – and make payments thereon generally is subject to strict insurance regulation. In this regard, interest payments and principal repayments with respect to these types of debt instruments typically require the prior approval of the insurance commissioner of the issuing insurance company's domicile.

²⁴⁵ Notice of Proposed Rulemaking, *supra* note 37, at 81 Fed. Reg. 20920.

²⁴⁶ See, e.g., *Jones v. United States*, 659 F.2d 618 (5th Cir. 1981); *Harlan v. United States*, 409 F.2d 904 (5th Cir. 1969); *Commissioner v. Union Mut. Ins. Co. of Providence*, 386 F.2d 974 (1st Cir. 1967); *Anchor Nat'l Life Ins. Co. v. Commissioner*, 93 T.C. 382 (1989); *Property Owners Mut. Ins. Co. v. Commissioner*, 28 T.C. 1007 (1957); *Holyoke Mut. Fire Ins. Co. v. Commissioner*, 28 T.C. 112 (1957); see also TAM 199942005 (July 12, 1999) (IRS acknowledged that “in general, it is well established that surplus notes are treated as debt for tax purposes”); cf. Rev. Rul. 68-515, 1968-2 C.B. 297 (stating that the Service will follow the decision of the U.S. Court of Appeals for the First Circuit in *Commissioner v. Union Mutual Insurance Company of Providence*, 386 F.2d 974 (1st Cir. 1967)).

In light of the foregoing discussion, we respectfully recommend that the following sentence be added to the end of Proposed Regulation section 1.385-2(b)(2)(i):

For purposes of the preceding sentence, if an insurance company (as defined in section 816(a)) is the issuer of the debt instrument at issue, any requirement under applicable law that the issuer receive the approval or consent of an insurance regulatory authority (or any similar governmental authority) prior to making any payments on such debt instrument shall not prevent or otherwise preclude the documentation prepared by the time required in paragraph (b)(3) of this section from 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.

- (v) Exclude Payables Arising from Intragroup Insurance and Reinsurance Transactions from any Possible Expansion of the Documentation Rule

In the preamble to the Proposed Regulations, Treasury requested comments as to whether:

[O]ther instruments . . . should be subject to the proposed regulations, including other types of applicable instruments that are not indebtedness in form that should be subject to proposed § 1.385-2 and the documentation requirements that should apply to such applicable instruments[.]²⁴⁷

As discussed above in Part II.D.5(c)(ii) of this section, we believe that the Ordinary Course Exception should be amended to cover payables arising from intragroup insurance and reinsurance transactions. By extension of the same reasoning, we believe that payables arising from intragroup insurance and reinsurance transactions – to the extent that any such payables could be construed as debt instruments – should be excluded from any possible expansion of the Documentation Rule to other than “in form” debt instruments. In this regard, the transactions giving rise to these payables already are subject to significant regulatory scrutiny, oftentimes including regulatory review and approval of the documentation for those transactions, and it would be inapposite to assume, or otherwise suggest, that an insurance regulator would be amenable to adding another layer of documentation to these transactions, especially for items that constitute ordinary course payables in respect of these arrangements.

²⁴⁷ Notice of Proposed Rulemaking, *supra* note 37, at 81 Fed. Reg. 20929.

Taking into account the preceding discussion, we respectfully recommend that the following sentence be added to the end of Proposed Regulation section 1.385-2(a)(4)(i)(A):

Notwithstanding anything in this paragraph (a)(4)(i)(A) or paragraph (a)(4)(i)(B) to the contrary, an applicable instrument shall not include any debt instrument that arises in the ordinary course of the issuer's trade or business in connection with the provision of insurance or the institution and maintenance of reinsurance to the extent that it reflects an obligation to pay an amount that is currently deductible by the issuer under sections 803, 805, or 832.

6. Recommendations Relating to Partnerships Under the General/Funding Rules

(a) Preferred Equity

The Preamble states that the Government is considering rules that would treat preferred equity in a Controlled Partnership as equity in the expanded group partners, based on the principles of the aggregate approach in Proposed Regulation section 1.385-3(d)(5). The Preamble states that Treasury is aware that the issuance of preferred equity by a Controlled Partnership to an expanded group member may give rise to similar concerns as debt instruments of a Controlled Partnership issued to an expanded group member, and that Controlled Partnerships may, in some cases, issue preferred equity with a principal purpose of avoiding the application of Proposed Regulation 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 holders of the common equity.²⁴⁸ 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.²⁴⁹

²⁴⁸ E.g., *ASA Investorings P'ship v. Commissioner*, 76 T.C.M. (CCH) 325, 1998 T.C.M. (RIA) ¶ 98,305 (Tax Court recharacterized purported partnership interest as a debtor/creditor relationship), *aff'd*, 201 F.3d 505 (D.C. Cir. 2000).

²⁴⁹ See, e.g., Eric B. Sloan & Matthew Sullivan, *Deceptive Simplicity: Continuing and Current Issues with Guaranteed Payments*, 916 PLI/TAX 124-1 (2011); Paul Carman & Kelley Bender, *Debt, Equity, or Other: Applying a Binary Analysis in a Multidimensional World*, 107 J. Tax'n 17, 26 (2007) (“[G]uaranteed payments statutorily have (at least) one more debt characteristic than preferred stock.”)

Notwithstanding the similarities between debt and a preferred interest, we believe they are sufficiently different to warrant different treatment under section 385. Specifically, unlike debt, the issuance of preferred partnership equity is subject to the substantiality requirement of section 704(b) and the disguised sale restrictions of section 707, which limit abusive transactions. These rules should address any concerns on the use of preferred partnership equity in the expanded group context. Although we acknowledge that a foreign corporation may receive a preferred interest that may pull income away from a U.S. expanded group member, we think it is unlikely that a funded U.S. expanded group member would engage in one of the three transactions listed under Proposed Regulation section 1.385-3(b)(3)(ii) as a result of the issuance of preferred partnership equity. Accordingly, we recommend that the Final Regulations should not apply to preferred equity issued by a partnership.

Notwithstanding the foregoing recommendation, we believe that a partnership between (i) an expanded group member that is a foreign corporation that is neither a CFC nor a PFIC and (ii) an expanded group member that is either (a) a domestic corporation or (b) CFC (an “Applicable Partnership”) may issue preferred equity interests to achieve results similar to those achieved where a partnership issues debt. To that end, we recommend that, if the Government does not adopt our recommendation to limit the application of Proposed Regulation section 1.385-3 to debt issued by a partnership, we recommend that Proposed Regulation section 1.385-3 be limited to preferred equity interests issued by an Applicable Partnership.

It should be noted that the Proposed Regulations already include an anti-abuse rule that can be applied to instruments designed to circumvent the regulatory regime. Specifically, Proposed Regulation section 1.385-3(b)(4) states that “an interest that is not a debt instrument for purposes of this section and § 1.385-4...is treated as stock if issued with a principal purpose of avoiding the application of this section or § 1.385-4.” As a result, partnership interests that carry preferred returns or guaranteed payments that are issued in order to circumvent the proposed regulations might be attacked under the anti-abuse rule in the Proposed Regulations. We recommend that this rule remove the issuance of a partnership interest from its scope as the language is very broad and, as described above, we do not believe the potential for abuse exists, except as described above. If Treasury determines it is necessary to continue the application of the anti-abuse rule to partnership equity, we recommend the Final Regulations contain examples of situations that are not abusive and those that are.

We are also concerned that Treasury does not have the authority to extend the application of section 385 to partnership equity. Section 385(a) states, “[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)” (emphasis added). 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, “[t]hese proposed regulations under section 385 address whether an interest in a related *corporation* is

treated as stock or indebtedness, or as in part stock or in part indebtedness, for purposes of the Code” (emphasis added).²⁵⁰ 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*.”²⁵¹ 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 [emphasis added].²⁵²

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

²⁵⁰ Notice of Proposed Rulemaking, *supra* note 37, at 81 Fed. Reg. 20,914.

²⁵¹ S. Rep. No. 91-552, at 137 (1969) (emphasis added).

²⁵² *Id.* at 138.

Nonetheless, as currently drafted, Proposed Regulation section 1.385-3(d)(5) provides for the recharacterization of certain debt instruments issued by partnerships. The Preamble also states that “federal income tax liability can also be reduced or eliminated with excessive *indebtedness* between domestic related parties” (emphasis added). This stated purpose is consistent with the legislative history indicating Congressional concern about the use of debt instruments. 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 equity interests, even as an anti-abuse rule, may be beyond the apparent authority granted by section 385.

(b) Proportionate Share

For purposes of Proposed Regulation section 1.385-3, a Controlled Partnership is treated as an aggregate of its partners.²⁵³ Specifically, Proposed Regulation section 1.385-3(d)(5)(i) provides that an expanded group 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 expanded group partner’s proportionate share would be “determined in accordance with its share of partnership profits.”²⁵⁴

For purposes of determining a partner’s proportionate share of a 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 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 “Funding Transaction” as described under Proposed Regulation 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. However, if the borrowed funds are distributed non-pro rata to its partners, determining a partner’s proportionate share in accordance with that partner’s share of partnership profits may not be appropriate. To better account for the economics of such situations, 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 Proposed Regulation

²⁵³ Prop. Reg. § 1.385-3(d)(5)(i), 81 Fed. Reg. 20,912, 20,937 (Apr. 8, 2016).

²⁵⁴ *Id.*

section 1.385-3(b)(3). The alternative approach would be similar to the tracing rule in Regulation 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 recharacterization rules of Proposed Regulation section 1.385-3(b)(3) is the sum of (A) the amount of the debt proceeds that is allocable under Regulation section 1.163-8T to the money transferred to the partner, and (B) 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 the following example.

Example 36. FP owns 100% of CFC and FS. CFC and FS are equal partners in PRS. On Date A in Year 1, FP lends \$100x to PRS in exchange for PRS Note. On Date B in Year 1, PRS distributes \$90x to CFC and \$10x to FS. Also on Date B in Year 1, CFC and FS distribute \$90 and \$10 to FP, respectively.

Under Proposed Regulation section 1.385-3(d)(5)(i), CFC and FS are each treated as issuing \$50 of PRS Note, which represents their proportionate share of PRS Note based on their share of partnership profits. Under Proposed Regulation 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. Accordingly, under Proposed Regulation sections 1.385-3(b)(3)(ii)(A) and 1.385-3(d)(1)(i), CFC could be treated as issuing \$50 of stock (presumably limited to its share of PRS Note) to FP while FS could be treated as issuing \$10 of stock (presumably limited to the amount of FS' distribution to FP). The rules under the Proposed Regulations do not provide treatment for the \$40 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 recharacterization rules of Proposed Regulation section 1.385-3(b)(3) is \$90 and \$10, respectively. Because under Proposed Regulation 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 \$90 and \$10 of their stock to FP, respectively.

In addition to providing methods for determining a partner's share of profits, the Final Regulations should specify the time for determining the expanded group partner's proportionate share of profits. Specifically, the share of profits should be determined immediately after the Controlled Partnership issues a debt instrument to or receives a debt instrument from a member of the expanded group. To avoid manipulation of profit share, the Final Regulations should provide that a subsequent reduction in a partner's share of profits will be taken into account if, at the time of the issuance or receipt of the debt instrument, the partner's reduction in share of profits is anticipated. To this end, we would recommend that the Government 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 clearly establish that the decrease in the partner's share of profits was not anticipated. In addition, the Final Regulations should 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 that has as one of its principal purposes the avoidance of the regulations under section 385.²⁵⁵

For purposes of determining a partner's share of profits, we recommend providing a safe harbor. An appropriate safe harbor for this purpose would be the liquidation value percentage, as defined in Proposed Regulation section 1.752-3(a)(3). A partner's liquidation value percentage is the ratio (expressed as a percentage) of the "liquidation value" of the partner's interest in the partnership to the liquidation value of all of the partners' interests in the partnership. A partner's liquidation value, in turn, is the amount of cash the partner would receive with respect to the interest if, immediately after formation of the partnership or a revaluation event (as described in Regulation section 1.704-1(b)(2)(iv)(f)(5)),²⁵⁶ the partnership sold—in a fully taxable transaction—all of its assets for cash equal to the fair market value of its property (taking section 7701(g) into

²⁵⁵ These suggestions are very similar to the anticipated reduction rule under Proposed Regulation section 1.707-5(b)(2)(iii). Specifically, Proposed Regulation section 1.707-5(b)(2)(iii)(A) provides that for purposes of Regulation 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 (1) 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; (2) the anticipated reduction is not subject to the entrepreneurial risks of partnership operations; and (3) 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. Proposed Regulation 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 Regulation 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 Regulation section 1.707-8.

²⁵⁶ The regulations under section 704(b) describe five different revaluation events: (i) in connection with a contribution of money or other property (other than a *de minimis* amount) to the partnership by a new or existing partner as consideration for an interest in the partnership, or (ii) in connection with the liquidation of the partnership or a distribution of money or other property (other than a *de minimis* amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership, or (iii) in connection with the grant of an interest in the partnership (other than a *de minimis* interest), or (iv) in connection with the issuance by the partnership of a noncompensatory option (other than an option for a *de minimis* partnership interest), or (v) under generally accepted industry accounting practices, provided substantially all of the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market. Reg. § 1.704-1(b)(2)(iv)(f)(5)).

account), satisfied all of its fixed liabilities and paid an unrelated third party to assume all of its contingent liabilities, and then liquidated.²⁵⁷

(c) Debt Instruments Issued by Controlled Partnership, in
General

If a Controlled Partnership issues a debt instrument and that debt instrument is later recharacterized as equity, the Proposed Regulations seemingly require taxpayers to determine a series of deemed transactions without much in the way of explicit guidance. In particular, for purposes of Proposed Regulation section 1.385-3,²⁵⁸ a Controlled Partnership is treated as an aggregate of its partners. As a result, if a Controlled Partnership's debt instrument is recharacterized as equity, the lender will be treated as holding stock in the expanded group partners as opposed to the Controlled Partnership.²⁵⁹ In order to reflect this treatment, the Proposed Regulations further provide that both the Controlled Partnership and expanded group partners must make appropriate conforming adjustments.²⁶⁰ Although not completely clear from the text of the Proposed Regulations, these conforming adjustments are presumably the product of deemed transactions, which ultimately result in the lender acquiring stock in the expanded group partners.²⁶¹ Acknowledging the need for additional guidance, the Preamble requests comments on the collateral consequences of the recharacterization and any corresponding adjustments. Our recommendations are described below.

In Example 14, Foreign Parent ("FP") wholly owns a US subsidiary ("USS1") and foreign subsidiary ("FS"). FP, USS1, and FS are all treated as corporations. USS1 also wholly owns a CFC. Collectively, all of these corporations are members of the same expanded group, which has FP as the common parent (the "FP EG"). PRS is a partnership owned 50% by CFC and 50% by FS. Thus, PRS is a Controlled Partnership.²⁶²

²⁵⁷ This type of "hypothetical sale" is used elsewhere in subchapter K. *See, e.g.*, Reg. §§ 1.743-1(d), 1.751-1(a)(2), 1.755-1(b)(1)(ii).

²⁵⁸ Prop. Reg. § 1.385-3(d)(5)(i), 81 Fed. Reg. at 20,937.

²⁵⁹ Prop. Reg. § 1.385-3(d)(5)(ii), 81 Fed. Reg. at 20,937.

²⁶⁰ *Id.*

²⁶¹ Prop. Reg. § 1.385-3(g)(3), Exs. (14), (15), 81 Fed. Reg. at 20,940–41.

²⁶² Prop. Reg. § 1.385-1(b)(1), 81 Fed. Reg. at 20,930.

On Date A in Year 1, FP lends \$200 to PRS in exchange for PRS's own note (the "PRS Note"). Subsequently, on Date B in Year 2, (i) CFC distributes \$100 to USS1 and (ii) FS distributes \$100 to FP. Accordingly, because Controlled Partnerships are treated as an aggregate of their partners for purposes of Proposed Regulation section 1.385-3,²⁶³ CFC and FS are each deemed to issue \$100 of the PRS Note to FP on Date A. Because this deemed issuance of the PRS Note occurred within a 72-month period of CFC and FS respectively distributing \$100 to each of USS1 and FP, which are both members of the FP EG, the PRS Note is treated as funding the distributions by CFC and FS.²⁶⁴ Therefore, because the PRS Note would fall under the Funding Rule, each of CFC and FS would be treated as issuing \$100 of its own stock to FP on Date A in Year 1.²⁶⁵

After concluding that the PRS Note should be treated as stock in CFC and FS, Example 14 then turns to the issue of appropriate adjustments. Because appropriate adjustments are seemingly the result of deemed transactions, Treasury and the Service explained FP's acquisition of stock in CFC and FS through the following steps. First, FS is deemed to transfer \$100 to each of CFC and FS in exchange for stock. Second, CFC and FS are each deemed to transfer the \$100 to PRS in exchange for an additional interest.²⁶⁶

In addition, although not explicitly stated in Example 14, it is reasonable to assume that the stock FS would issue to CFC and FP, and the additional interest CFC and FS would receive in PRS, would have identical terms to the PRS Note to account for the payments made with respect to this instrument. Accordingly, it is likely that CFC and FS

²⁶³ Prop. Reg. § 1.385-3(d)(5)(i), 81 Fed. Reg. at 20,937.

²⁶⁴ Prop. Reg. § 1.385-3(b)(3)(iv)(B)(1), 81 Fed. Reg. at 20,935.

²⁶⁵ Prop. Reg. § 1.385-3(d)(1)(i), 81 Fed. Reg. at 20,936.

²⁶⁶ In addition, Example 15 sheds additional light on the deemed transactions resulting from the recharacterization of a Controlled Partnership's debt instrument as equity in its expanded group partners under Proposed Regulation section 1.385-3. Specifically, the facts of Example 15 are virtually identical to those of Example 14, except that CFC and FS each make their respective distributions of \$100 in the year following the issuance of the PRS Note on Date C of Year 2. Because the issuance of the PRS Note and distributions did not occur in the same year, the PRS Note was recharacterized as stock in CFC and FS on Date C in Year 2. Presumably, because of this difference in timing, Treasury and the Service also provided a different set of deemed transactions. First, CFC and FS would each assume \$100 of the liability with respect to the PRS Note from PRS. Because such an increase in liability is treated as a contribution of cash under section 752(a), CFC and FS each would receive an additional interest in PRS. Second, after assuming the liability from PRS, CFC and FS would each distribute \$100 of its respective stock to FP in satisfaction of the PRS Note.

would hold an additional interest in PRS characterized as either a guaranteed payment or a preferred return.

If CFC and FS were deemed to receive an additional preferred interest in PRS, and assuming that CFC and FS were deemed to contribute \$100 to PRS in exchange for such a preferred interest bearing a 10 percent coupon, the income allocations of PRS would be as reflected below.

	CFC	FS
<i>Preferred Return at 10%</i>	\$10	\$10
<i>Common Income Allocation</i>	\$40	\$40
<i>Interest Expense</i>	-	-
<i>Distributive Share</i>	\$50	\$50

Although the recast in Example 14 ensures there are no inside or outside basis disparities, the deemed contribution approach of Example 14 could cause unintended consequences under Subchapter K, *e.g.*, implicating anti-deferral rules such as those under sections 707(a)(2)(B), 721(b) and (c), 731 and 752(b). In order to avoid these issues, we recommend that Treasury and the IRS adopt a “Partner-Lender Rule,” whereby the loan from an expanded group member to the Controlled Partnership would be respected, but the expanded group member would be deemed to contribute the receivable to the expanded group partners in exchange for stock.²⁶⁷

²⁶⁷ As an alternative, we also considered a rule providing that, if a Controlled Partnership’s debt instrument was recharacterized as equity under Proposed Regulation section 1.385-3, then the holder of the debt instrument would be treated as owning a partnership interest in the Controlled Partnership. Specifically, we considered this alternative because, in our view, it would be administratively easier to reclassify an existing creditor-debtor relationship between the EG member, as the obligor, and the Controlled Partnership, as the obligee, as a partner-partnership relationship as opposed to creating a new partnership interest for each of the EG Partners. However, we understand that such a rule would be inconsistent with the government’s position as stated in the preamble to the Proposed Regulations. Specifically, Treasury and the Service provided that an EG member, as obligor, should not be

(cont'd)

For instance, if the Partner-Lender Rule was applied to Example 14, Treasury and the IRS would respect the loan from FP to PRS, but would deem FP to contribute half of the loan to each of CFC and FS in exchange for stock. Under the Partner-Lender Rule, if PRS earned \$100, CFC's and FS's income would remain \$50 each, consistent with the objectives of the Proposed Regulations.

	CFC	FS
<i>Interest Income at 10%</i>	\$10	\$10
<i>Common Income Allocation</i>	\$50	\$50
<i>Interest Expense</i>	(\$10)	(\$10)
<i>Distributive Share</i>	\$40	\$40
<i>Total Income</i>	\$50	\$50

Because CFC and FS would not be deemed to make contributions to PRS, neither expanded group partner would have to consider Subchapter K's anti-deferral rules.

In addition to the Partner-Lender Rule, Treasury and the IRS should also consider adopting a "Proportionate Partner Lending Exception." Specifically, under this exception, Proposed Regulation section 1.385-3 would not be applicable in situations where each

(cont'd from previous page)

recharacterized as having an interest in the Controlled Partnership because "the resulting equity could give rise to guaranteed payments that may be deductible or gross income allocations to partners that would reduce the taxable income of the other such partners that did not receive such allocations." Notice of Proposed Rulemaking, *supra* note 37, at 81 Fed. Reg. 20,927. To address this concern, we considered making a recommendation that such a guaranteed payment would be treated as tax-exempt income, and, as a result, would only produce a non-deductible expense for the other EG Partners. However, because non-deductible expenses can still reduce a corporation's earnings and profits, and thus create the opportunity to make tax-free distributions, we decided against such a recommendation.

expanded group partner lends cash to a Controlled Partnership in proportion to its profit sharing ratio. Specifically, because each expanded group partner's interest income would be offset by its additional allocation of interest expense, there would be no opportunity to reduce taxable income and, effectively, engage in earnings stripping as demonstrated above.

One may argue that the deemed transactions in Example 14 result in earnings stripping, under either the fiction of the Proposed Regulations or the Partner-Lender Rule. We believe that the deemed transactions appropriately address any concern.

As a threshold matter, it is relevant to look at the economics prior to the application of section 385. If PRS earned \$100, the PRS income allocations would be as below.

	CFC	FS
<i>Common Income Allocation</i>	\$50	\$50
<i>Interest Expense</i>	(\$10)	(\$10)
<i>Distributive Share</i>	\$40	\$40

As a result of the loan by FP and the distributions by CFC and FS, each of CFC's and FS's income has been reduced by \$10 and FP's income has been increased by \$20. As described above, the deemed transactions avoid such a result.

We considered whether a different result can occur where one partner makes a distribution, but the other does not. For instance, assume the same facts as Example 14 except that FS is the only partner in PRS that made a distribution. Under the deemed transactions in the Proposed Regulations, FP would first contribute \$100 to FS in exchange for stock, and FS would then transfer that same \$100 to PRS in exchange for an additional interest. In addition, although not explicitly stated in Example 14, it is reasonable to assume that the stock FS would issue to FP, and the additional interest FS would receive in PRS, would have identical terms to the PRS Note to account for the payments made with respect to this instrument. Accordingly, it is likely that FS would hold an additional interest in PRS characterized as either a guaranteed payment or a preferred return.

If FS was deemed to receive an additional preferred interest in PRS, it may, at first, appear that the Proposed Regulations would result in the shifting of income away

from CFC. For instance, assume that FS was deemed to contribute \$100 to PRS in exchange for a preferred interest bearing a 10 percent coupon. If PRS subsequently earned \$100 of income, and we further assume that the remaining \$100 PRS Note also bore a 10% interest rate, then CFC would receive a distributive share of \$40, and FS would receive a distributive share of \$50, as demonstrated by the table directly below.

	CFC	FS
<i>Preferred Return at 10%</i>	-	\$10
<i>Common Income Allocation</i>	\$45	\$45
<i>Interest Expense</i>	(\$5)	(\$5)
<i>Distributive Share</i>	\$40	\$50

However, because CFC did not make a distribution of \$100, CFC still has \$100 of assets that are earning a return. We think it is reasonable to assume that the \$100 is earning a return similar to the return that PRS is earning on the cash it borrowed. Thus, looking at all of CFC's assets, CFC would have \$50 of income in the year (assuming the \$100 of cash that is retained by CFC as opposed to being distributed to USS1 earns a \$10 return).

We note the same is true if the Partner-Lender Rule is adopted. For instance, if the Partner-Lender Rule was applied to Example 14 as modified, Treasury and the Service would respect the loan from FP to PRS, but would deem FP to contribute a portion of its receivable to FS in exchange for stock. Under the Partner-Lender Rule, if PRS earned \$100, FS's income from the partnership would be \$50 and CFC's would be \$40, but CFC would continue to earn a return on the \$100 cash it retained. These results are consistent with the objectives of the Proposed Regulations.

	CFC	FS
<i>Interest Income at 10%</i>	-	\$10
<i>Common Income Allocation</i>	\$50	\$50
<i>Interest Expense</i>	(\$10)	(\$10)
<i>Distributive Share</i>	\$40	\$50

(d) Treatment of DREs

Proposed Regulation section 1.385-3(d)(6) provides that if a debt instrument of a DRE is treated as stock under the General/Funding Rules, then such debt instrument is treated as stock in the entity's owner. We recommend that the Final Regulations clarify that if a debt instrument of a DRE is treated as stock under the General/Funding Rules, 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 Proposed Regulation section 1.385-3(d)(5) (treatment of partnerships). For example, if DRE1 is owned by DRE2, which is owned by Partnership, and Partnership is owned by Corp1 and Corp2, a debt instrument of DRE1 that is treated as stock under the General/Funding Rules should be treated as stock in Corp1 and Corp2.