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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9790]

RIN 1545-BN40

Treatment of Certain Interests in Corporations as Stock or Indebtedness.

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and temporary regulations.

SUMMARY: This document contains final and temporary regulations under section 385 of the Internal Revenue Code (Code) that establish threshold documentation requirements that ordinarily must be satisfied in order for certain related-party interests in a corporation to be treated as indebtedness for federal tax purposes, and treat as stock certain related-party interests that otherwise would be treated as indebtedness for federal tax purposes. The final and temporary regulations generally affect corporations, including those that are partners of certain partnerships, when those corporations or partnerships issue purported indebtedness to related corporations or partnerships.

DATES: Effective Date: These regulations are effective on **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Applicability Dates: For dates of applicability, see §§1.385-1(f), 1.385-2(i), 1.385-3(j), 1.385-3T(k), 1.385-4T(g), and 1.752-2T(l)(4).

FOR FURTHER INFORMATION CONTACT: Concerning the final and temporary regulations, Austin M. Diamond-Jones, (202) 317-5363, and Joshua G. Rabon, (202) 317-6938 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these regulations has been reviewed and approved by the Office of Management and Budget under control number 1545-2267. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

I. In General

On April 8, 2016, the Department of the Treasury (Treasury Department) and the IRS published proposed regulations (REG-108060-15) under section 385 of the Code (proposed regulations) in the **Federal Register** (81 FR 20912) concerning the treatment of certain interests in corporations as stock or indebtedness. A public hearing was held on July 14, 2016. The Treasury Department and the IRS also received numerous written comments in response to the proposed regulations. All comments are available at www.regulations.gov or upon request. The comments received in writing and at the

public hearing were carefully considered in developing the final and temporary regulations. In addition, certain portions of the proposed regulations that were substantially revised based on comments received are being issued as temporary regulations. The text of the temporary regulations serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject published in the Proposed Rules section of this issue of the **Federal Register**. In addition, this Treasury decision reserves on the application of certain portions of the proposed regulations pending additional study.

II. Summary of Section 385 and the Proposed Regulations

Section 385 authorizes the Secretary of the Treasury to prescribe rules to determine whether an interest in a corporation is treated for purposes of the Code as stock or indebtedness (or as in part stock and in part indebtedness) by setting forth factors to be taken into account with respect to particular factual situations. Under this authority, the proposed regulations provided specific factors that, when present in the context of purported debt instruments issued between highly-related corporations, would be dispositive.

Specifically, proposed §1.385-2 provided that the absence of timely preparation of documentation and financial analysis evidencing four essential characteristics of indebtedness would be a dispositive factor requiring a purported debt instrument to be treated as stock for federal tax purposes. Because related parties do not deal independently with each other, it can be difficult for the IRS to determine whether there was an intent to create an actual debtor-creditor relationship in this context, particularly when the parties do not document the terms governing the arrangement or analyze the

creditworthiness of the borrower contemporaneously with the loan, each as unrelated parties would do. For this reason, the proposed regulations prescribed the nature of the documentation necessary to substantiate the treatment of related-party instruments as indebtedness, including documentation to establish an expectation of repayment and a course of conduct that is generally consistent with a debtor-creditor relationship. Proposed §1.385-2 required that such documentation be timely prepared and maintained, and provided that, if the specified documentation was not provided to the Commissioner upon request, the instrument would be treated as stock for federal tax purposes.

Proposed §1.385-3 identified an additional dispositive factor that indicates the existence of a corporation-shareholder relationship, rather than a debtor-creditor relationship: the issuance of a purported debt instrument to a controlling shareholder in a distribution or in another transaction that achieves an economically similar result. These purported debt instruments do not finance any new investment in the operations of the borrower and therefore have the potential to create significant federal tax benefits, including interest deductions that erode the U.S. tax base, without having meaningful non-tax significance.

Proposed §1.385-3 also included a "funding rule" that treated as stock a purported debt instrument that is issued as part of a series of transactions that achieves a result similar to a distribution of a debt instrument. Specifically, proposed §1.385-3 treated as stock a purported debt instrument that was issued in exchange for property, including cash, with a principal purpose of using the proceeds to fund a distribution to a controlling shareholder or another transaction that achieves an economically similar

result. Furthermore, the proposed regulations included a "per se" application of the funding rule that treated a purported debt instrument as funding a distribution or other transaction with a similar economic effect if it was issued in exchange for property (other than in the ordinary course of purchasing goods or services from an affiliate) during the period beginning 36 months before and ending 36 months after the funded member made the distribution or undertook the transaction with a similar economic effect.

Proposed §1.385-3 included exceptions that were intended to limit the scope of the section to transactions undertaken outside of the ordinary course of business by large taxpayers with complex organizational structures. The proposed regulations also included an anti-abuse provision to address a purported debt instrument issued with a principal purpose of avoiding the application of the proposed regulations. Proposed §1.385-4 provided rules for applying proposed §1.385-3 in the context of consolidated groups.

Finally, proposed §1.385-1(d) provided the Commissioner with the discretion to treat certain interests in a corporation for federal tax purposes as indebtedness in part and stock in part (a "bifurcation rule").

III. Overview of Significant Modifications to Minimize Burdens

In response to the proposed regulations, the Treasury Department and the IRS received numerous detailed and thoughtful comments (including comments provided at the public hearing) suited to the highly technical nature of certain of the proposed rules. The Treasury Department and the IRS carefully considered these comments. Many of the comments expressed concern that the proposed regulations would impose compliance burdens and result in collateral consequences that were not justified by the

stated policy objectives of the proposed regulations. In response to the comments received, the final and temporary regulations substantially revise the proposed regulations to achieve a better balance between minimizing the burdens imposed on taxpayers and fulfilling the important policy objectives of the proposed regulations. The remainder of this Part III summarizes the most noteworthy modifications included in the final and temporary regulations, which are the following:

Changes to the overall scope of the regulations:

- Exclusion of foreign issuers. The final regulations reserve on all aspects of their application to foreign issuers; as a result, the final regulations do not apply to foreign issuers.
- Exclusion of S corporations and non-controlled RICs and REITs. S corporations and non-controlled regulated investment companies (RICs) and real estate investment trusts (REITs) are exempt from all aspects of the final regulations.
- Removal of general bifurcation rule. The final regulations do not include a general bifurcation rule. The Treasury Department and the IRS will continue to study this issue.

Significant changes to the documentation requirements in §1.385-2:

- Extension of period required for timely preparation. The final regulations eliminate the proposed regulations' 30-day timely preparation requirement, and instead treat documentation and financial analysis as timely prepared if it is prepared by the time that the issuer's federal income tax return is filed (taking into account all applicable extensions).

- Rebuttable presumption based on compliance with documentation requirements. The final regulations provide that, if an expanded group is otherwise generally compliant with the documentation requirements, then a rebuttable presumption, rather than per se recharacterization as stock, applies in the event of a documentation failure with respect to a purported debt instrument.
- Delayed implementation. The final regulations apply only to debt instruments issued on or after January 1, 2018.

Significant changes to the rules regarding distributions of debt instruments and similar transactions under §1.385-3:

- Exclusion of debt instruments issued by regulated financial groups and insurance entities. The final and temporary regulations do not apply to debt instruments issued by certain specified financial entities, financial groups, and insurance companies that are subject to a specified degree of regulatory oversight regarding their capital structure.
- Treatment of cash management arrangements and other short-term debt instruments. The final and temporary regulations generally exclude from the scope of §1.385-3 deposits pursuant to a cash management arrangement as well as certain advances that finance short-term liquidity needs.
- Limiting certain "cascading" recharacterizations. The final and temporary regulations narrow the application of the funding rule by preventing, in

certain circumstances, the so-called “cascading” consequence of recharacterizing a debt instrument as stock.

- Expanded earnings and profits exception. The final and temporary regulations expand the earnings and profits exception to include all the earnings and profits of a corporation that were accumulated while it was a member of the same expanded group and after the day that the proposed regulations were issued.
- Expanded access to $50 million exception. The final and temporary regulations remove the “cliff effect” of the threshold exception under the proposed regulations, so that all taxpayers can exclude the first $50 million of indebtedness that otherwise would be recharacterized.
- Credit for certain capital contributions. The final and temporary regulations provide an exception pursuant to which certain contributions of property are “netted” against distributions and transactions with similar economic effect.
- Exception for equity compensation. The final and temporary regulations provide an exception for the acquisition of stock delivered to employees, directors, and independent contractors as consideration for the provision of services.
- Expansion of 90-day delay for recharacterization. The 90-day delay provided in the proposed regulations for debt instruments issued on or after April 4, 2016, but prior to the publication of final regulations, is expanded so that any debt instrument that is subject to recharacterization

but that is issued on or before **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, will not be recharacterized until immediately after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

The foregoing changes significantly reduce the number of taxpayers and transactions affected by the final and temporary regulations. As narrowed, many issuers are entirely exempt from the application of §§1.385-2 and 1.385-3. Moreover, with respect to the large domestic issuers that are subject to §1.385-3, that section is substantially revised to better focus on extraordinary transactions that have the effect of introducing related-party debt without financing new investment in the operations of the issuer. The final and temporary regulations thus apply in particular factual situations where there are elevated concerns about related-party debt being used to create significant federal tax benefits without having meaningful non-tax effects.

Summary of Comments and Explanation of Revisions

I. In General

The Treasury Department and the IRS received numerous comments requesting that various entities be excluded from the scope of the proposed regulations. After considering the comments received, the Treasury Department and the IRS have adopted several of these recommendations. As an alternative to excluding certain entities from the scope of the regulations, many comments also suggested adopting special rules or narrower technical exceptions to provide relief for particular issues. In many cases, adopting the broader comment to exclude certain entities from the scope of the final and temporary regulations renders such alternative proposals moot. For

example, comments requested a rule providing that recharacterized debt of an S corporation will not be treated as a second class of stock for purposes of section 1361(b)(1)(D). This comment is moot because the final and temporary regulations do not contain a general bifurcation rule and provide that S corporations are not treated as members of an expanded group (as described in Part III.B.2.b of the Summary of Comments and Explanation of Revisions) and therefore are not subject to the final and temporary regulations. Although the Treasury Department and the IRS considered all comments received, this preamble generally does not discuss comments suggesting alternative approaches to the extent such comments are rendered moot by adopting a broader comment. Similarly, because the final and temporary regulations do not contain the general bifurcation rule of proposed §1.385-1(d), this preamble does not discuss that rule or the comments received with respect to it.

Many comments requested that the regulations include examples illustrating the application of specific rules of the proposed regulations to specific fact patterns. Where appropriate to illustrate the basic application of rules to common fact patterns, the final and temporary regulations provide the requested examples. In some cases, the Treasury Department and the IRS determined that a modification of a rule rendered such request moot or that a clarification of a rule was sufficient to illustrate the point the requested example would clarify. In other cases, the Treasury Department and the IRS clarified the issue through discussion in this preamble.

Numerous comments recommended that the Treasury Department and the IRS extend the deadline for receiving comments. Many of those comments recommended a 90-day extension. Other comments recommended that the Treasury Department and

the IRS continue to solicit and consider taxpayer feedback outside of the comment period.

The Treasury Department and the IRS declined to extend the standard 90-day comment period because numerous detailed and substantive comments were received before the deadline. The proposed regulations provided that written or electronic comments and requests for a public hearing had to be received by July 7, 2016, which was 90 days after the publication of the notice of proposed regulations in the Federal Register. A public hearing was held on July 14, 2016. Sixteen speakers or groups of speakers spoke at the public hearing. Over 29,600 written comments were received, of which 145 were unique and commented on specific substantive aspects of the proposed regulations. Of the written comments, 6 were received after July 7, 2016, and all were considered in drafting the final and temporary regulations.

The final and temporary regulations reserve on several issues raised in comments, and this preamble includes a new request for comments regarding the type of rules that should apply in those contexts. See Future Guidance and Request for Comments. The Treasury Department and the IRS believe that all remaining issues raised in the comments are appropriately addressed in the changes described in this preamble, and, in the time since the comment period closed, have not been made aware of any particular additional issues that would benefit from an extended comment period.

In addition, because aspects of the final and temporary regulations apply to debt instruments issued after April 4, 2016, the Treasury Department and the IRS determined that it is important for taxpayers and for tax administration to issue the final

and temporary regulations expeditiously after giving due consideration to all comments received.

II. Comments Regarding Authority to Issue Regulations Under Section 385

A. Interpretation of authority under section 385

Various comments asserted that the proposed regulations were an invalid exercise of regulatory authority under section 385, including because the regulations were motivated in part by the concern over excessive interest deductions and that such purpose is not authorized by section 385.

The Treasury Department and the IRS have determined that the final and temporary regulations are a valid exercise of authority under section 385. Section 385(a) vests the Secretary with authority to promulgate such rules as may be necessary or appropriate to determine whether, for federal tax purposes, an interest in a corporation is treated as stock or indebtedness (or as in part stock and in part indebtedness). The final and temporary regulations exercise this authority consistent with Congress's mandate by providing factors that determine whether a purported debt interest is treated as stock, indebtedness, or in part stock and in part indebtedness in particular factual situations involving transactions among highly-related corporations (relatedness itself being a factor explicitly enumerated in section 385(b)(5)). Section 385 does not limit the Treasury Department and the IRS to issuing regulations only for certain purposes.

Consistent with section 385(a), the Treasury Department and the IRS have concluded that the regulations are necessary and appropriate. With respect to the documentation rules in §1.385-2, as Congress observed when it enacted section 385,

historically there has been considerable confusion regarding whether various interests are debt or equity or some combination of the two. See S. Rep. No. 91–552, at 138 (1969). The Treasury Department and the IRS have observed that this uncertainty has been particularly acute in the context of related-party debt instruments. Section 1.385-2 of the final regulations helps to resolve this uncertainty with respect to the particular factual situation of transactions among highly-related corporations by providing guidance on the type of documentation that is required to support debt classification. Focusing on this particular factual situation is appropriate because such debt raises unique concerns. Related parties do not have the same commercial incentives as unrelated parties to properly document their interests in one another, making it difficult to determine whether there exists an actual debtor-creditor relationship. In addition, because debt, in contrast to equity, gives rise to deductible interest payments, there are often significant tax incentives to characterize interests in a corporation as debt, which may be far more important than the practical commercial consequences of such characterization. Accordingly, when a controlling shareholder (or a party related to a controlling shareholder) invests in a corporation, it is necessary and appropriate to require the shareholder to document that an analysis was undertaken to establish an expectation of repayment and that the parties' conduct throughout the term of the loan is consistent with a debtor-creditor relationship.

With respect to the rules described in §§1.385-3, 1.385-3T, and 1.385-4T, a distribution of a note or an issuance of a purported debt instrument by a corporation to a controlling shareholder (or a person related to a controlling shareholder) followed by a distribution of the proceeds to a controlling shareholder, either actually or in substance,

raises additional, unique concerns. These purported debt instruments have the potential to create significant federal tax benefits, but lack meaningful non-tax significance, including because they do not finance new investment in the operations of the borrower. In the context of highly-related corporations, it is a necessary and appropriate exercise of the Secretary's rulemaking authority to provide that when this factor and the relatedness factor are present, an interest is treated as equity rather than indebtedness.

Various comments also asserted that the regulations are inconsistent with the Treasury Department and the IRS's statutory authority under section 385 because they fail to provide a rule of general application and instead address only a particular set of instruments that raise certain policy concerns.

The Treasury Department and the IRS have concluded that these comments lack merit. Section 385 does not require the promulgation of rules of general applicability. Nothing in section 385 requires the Treasury Department and the IRS to provide a universal definition of debt and equity that would apply to all possible transactions. Instead, the statute authorizes the Secretary to prescribe factors "with respect to a particular factual situation," as opposed to all possible fact patterns. The statute's legislative history reinforces the validity of this approach by noting the difficulty of legislating "comprehensive and specific statutory rules of universal and equal applicability" and the desirability of addressing the characterization of an interest as debt or equity across "numerous [and] different situations." S. Rep. No. 91–552, at 138.

The regulations follow this approach by addressing the characterization of interests in the particular factual situation of transactions among highly-related

corporations. This is a context in which there is particular confusion regarding what is required in order to establish that a debtor-creditor relationship exists. In addition, in this context there are unique issues with respect to the ability to claim significant federal tax benefits through the creation of indebtedness that often lacks meaningful non-tax effects. The use of section 385's regulatory authority to provide guidelines for documentation is necessary and appropriate to provide greater certainty in determining the nature of interests in a context where there are often no third-party checks. Further, the use of this authority to identify determinative factors (the lack of new capital along with relatedness) is also necessary and appropriate to ensure that the significant tax advantages that accompany debt (in particular, the significant deductions that can be claimed) are limited to circumstances in which there is a financing of new investment.

Several comments asserted that regulations promulgated under section 385 must consist of a list of factors to be weighed on a case-by-case basis, and that the proposed regulations deviated from this requirement by providing dispositive factors.

The Treasury Department and the IRS have concluded that the authority under section 385 does not include such a limitation. Section 385(b) authorizes the Secretary to "set forth factors which are to be taken into account in determining with respect to a particular factual situation" whether an instrument is debt or equity. The final and temporary regulations include two factors that are specifically listed in section 385(b) (both of which are critical factors traditionally relied on by courts): the presence of a "written" promise to pay (section 385(b)(1)) and the relationship between holdings of stock in the corporation and holdings of the interest in question (section 385(b)(5)). Two other factors included in the regulations have been cited in the case law: whether debt

finances new investment in the operations of the borrower, and whether the taxpayer can demonstrate that at the time the advance was made the borrower could reasonably be expected to repay the loan. In the particular factual situation of loans between highly-related corporations, a factual situation in which the relatedness factor described in section 385(b)(5) is amplified, the final and temporary regulations appropriately elevate the importance of the other factors listed above.

Section 385(b) does not require the Secretary to set forth any particular factors (regulations "may include" certain enumerated factors), nor does it prescribe the weight to be given to any selected factors, only that they "are to be taken into account." Those decisions are left to the discretion of the Secretary. See S. Rep. No. 91–552, at 138 (1969) ("The provision also specifies certain factors which may be taken into account in these [regulatory] guidelines. It is not intended that only these factors be included in the guidelines or that, with respect to a particular situation, any of these factors must be included in the guidelines, or that any of the factors which are included by statute must necessarily be given any more weight than other factors added by regulations."). As the legislative history makes clear, the Treasury Department and the IRS have the authority also to omit factors in particular factual situations and instead emphasize certain other factors. The factors identified and taken into account in the regulations therefore fall within the authority conveyed by section 385. In addition, the fact that the final and temporary regulations provide for particular weighting of these factors (including treating certain factors as dispositive in a particular context) is consistent with the Secretary's discretion to "set forth factors which are to be taken into account."

Congress enacted section 385 to resolve the confusion created by the multi-factor tests traditionally utilized by courts, which produced inconsistent and unpredictable results. See S. Rep. No. 91–552, at 138 (1969). The congressional objective of providing clarity regarding the characterization of instruments would be undermined if the regulations authorized by section 385 were required to replicate the flawed multi-factor tests in the case law that motivated the enactment of section 385. Nothing in section 385 requires a case-by-case approach. The statute does not specify what level of generality is required in respect of a "particular factual situation," and the Treasury Department and the IRS reasonably interpret this phrase to include the subset of transactions that take place among highly-related corporations. Furthermore, as discussed throughout this Part II.A, the legislative history indicates that Congress intended to grant the Secretary broad authority to provide different rules for distinguishing debt from equity in different situations or contexts. See also S. Rep. No. 91–552, at 138 (discussing the need for debt/equity rules given "the variety of contexts in which this problem can arise").

To underscore the regulations' consistency with the reference in section 385(b) to factors that are to be taken into account in particular factual situations, the final and temporary regulations first provide in §1.385-1(b) a general rule that effectively implements the common law factors. Therefore, whether an interest is classified as debt or equity ordinarily will be determined based on common law, including the factors prescribed under common law. In the particular factual situation of a purported debt instrument issued between members of an expanded group, §1.385-2 provides a minimum standard of documentation that must be met in order for an instrument to be

treated as debt based on an application of the common law factors and adjusts the weighting of certain common law factors, while §1.385-3 elevates two particular common law factors (the lack of new investment in the operations of the issuer and relatedness) into determinative factors. The regulations' enumeration of these factors to determine the characteristics of an instrument is entirely consistent with the plain text of section 385.

Finally, several comments asserted that proposed §1.385-3 set forth an inappropriate list of factors by exclusively considering circumstances outside the four corners of the instrument, such as the transaction in which the instrument is issued and the use of the funds received in exchange therefor, without regard to the characteristics of the instrument itself.

The Treasury Department and the IRS have concluded that the authority granted by section 385 is plainly broader than interpreted by the comments. As noted above, section 385 authorizes the Secretary to determine which factors must be taken into account when determining the nature of an interest in a particular factual situation. Nothing in the statute requires the Secretary to consider specific factors or, conversely, to disregard other factors. In any event, the factors set forth in the regulations derive from common law debt-equity analyses, which have, among various considerations, often looked beyond the characteristics of the instrument. For instance, Congress identified the relatedness of the parties to the transaction as among the factors that "may" be set forth under section 385, see section 385(b)(5) ("the relationship between holdings of stock in the corporation and holdings of the interest in question"), and this factor has been relied upon by numerous courts in similar factual situations. Likewise,

the lack of new capital investment created by an issuance of debt is also a common law debt-equity factor. See, e.g., Talbot Mills v. Comm'r, 146 F.2d 809, 811 (1st Cir. 1944), aff'd sub nom, John Kelley Co. v. Comm'r, 326 U.S. 521 (1946); Kraft Foods Co. v. Comm'r, 232 F.2d 118, 126-27 (2d Cir. 1956).

B. Consideration of costs

Various comments contended that the Treasury Department and the IRS failed to consider costs in the proposed regulations, that the consideration given to the costs imposed by the regulations was insufficient, or that the proposed regulations' analysis did not accurately reflect the costs of the proposed regulations. One comment cited the Supreme Court's decision in Michigan v. EPA, 135 S. Ct. 2699 (2015), as imposing an obligation to consider costs as part of establishing the appropriateness of regulation, claiming that the Treasury Department and the IRS failed to meet this obligation in the proposed regulations. Another comment asserted that the proposed regulations failed to comply with Executive Order 12866's instruction to assess the costs of regulatory action.

The Treasury Department and the IRS disagree with these comments. The final and temporary regulations are a necessary and appropriate exercise of the Secretary's authority based on the reasons described in Section A of this Part II and the analysis of the regulations' costs and benefits. The Treasury Department and the IRS do not agree with comments that the holding of Michigan v. EPA compels consideration of costs in every instance. In any event, the Treasury Department and the IRS analyzed the costs and benefits of the proposed regulations in a regulatory impact analysis. This regulatory impact analysis was conducted consistent with the proposed regulations'

designation as a “significant regulatory action” under Executive Order 12866. See https://www.regulations.gov/document?D=IRS-2016-0014-0001.

The Treasury Department and the IRS received extensive comments regarding the costs of the proposed regulations and the regulatory impact analysis that accompanied the proposed regulations. The Treasury Department and the IRS carefully considered those comments in revising the proposed rules to significantly reduce compliance burdens and in developing the regulatory impact analysis of costs and benefits that accompanies and supports the final and temporary regulations. The regulatory impact analysis of the final and temporary regulations is consistent with Executive Order 12866.

As explained in greater detail in Part I of the Special Analyses, the Treasury Department and the IRS estimate that the aspects of the regulations that will apply most broadly (§1.385-2) will impact only 6,300 of the roughly 1.6 million C corporations in the United States (0.4 percent). The total start-up expenses for these affected taxpayers is estimated to be $224 million in 2016 dollars, with ongoing annual compliance costs estimated to be $56 million in 2016 dollars, or an average of $8,900 per firm. By comparison, the regulations will significantly reduce the tax revenue losses achieved by the avoidance strategies that these regulations address. Annualizing over the period from 2017 to 2026, the regulations are estimated to yield tax revenue of between $461 million per year (7% discount rate) or $600 million per year (3% discount rate) in 2016 dollars. The analysis concludes that the tax revenues generated from reduced tax avoidance would be at least 6 to 7 times as large as the compliance costs. The analysis also explains the additional, non-quantifiable benefits the regulations will

generate, such as increased tax compliance system-wide, efficiency and growth benefits, and lower tax administration costs for the IRS. The analysis supports the conclusion that the regulations are an appropriate and effective exercise of the Treasury Department and the IRS's authority. The Office of Management and Budget reviewed and approved the analysis. The analysis and its conclusions rebut the assertions in comments that the Treasury Department and the IRS failed to consider costs, did not adequately consider costs, or did not accurately estimate costs.

As set forth in this Part II.B, the Treasury Department and the IRS disagree with the comment that the proposed regulations failed to comply with Executive Order 12866. Moreover, section 10 of Executive Order 12866 clearly states that the Order "does not create any right or benefit, substantive or procedural, enforceable at law"; rather, the Order "is intended only to improve the internal management of the Federal Government."

III. Comments and Changes to §1.385-1 — General Provisions

A. General approach

1. Regulations Limited to U.S. Borrowers

The proposed regulations applied to certain EGIs and debt instruments issued by corporations to members of the same expanded group without regard to the residency of the issuer. Numerous comments recommended that the regulations not apply to foreign borrowers, including in particular transactions where both the borrower and the lender are foreign corporations (foreign-to-foreign transactions). These comments pointed to various concerns, including the complexity of applying the regulations to potentially hundreds of foreign entities in a multinational group and certain unique

consequences that would follow from such application, such as a loss of foreign tax credits. Some comments also questioned the purpose of applying the rules to foreign borrowers. Other comments acknowledged that the United States can have an interest in the tax treatment of indebtedness issued by foreign corporations, in particular indebtedness issued by controlled foreign corporations (CFCs), but observed that the United States' interest is less direct, and of a different nature, than in the case of indebtedness issued by U.S. borrowers.

The Treasury Department and the IRS have determined that the application of the final and temporary regulations to indebtedness issued by foreign corporations requires further study. Accordingly, the final and temporary regulations apply only to EGIs and debt instruments issued by members of an expanded group that are domestic corporations (including corporations treated as domestic corporations for federal income tax purposes, such as pursuant to section 953(d), section 1504(d), or section 7874(b)), and reserve on the application to EGIs and debt instruments issued by foreign corporations. The final and temporary regulations achieve this result by creating a new term "covered member," which is defined as a member of an expanded group that is a domestic corporation, and reserves on the inclusion of foreign corporations.

One comment questioned how the proposed regulations would apply to U.S. branches of a foreign issuer. Although it is possible to increase the debt attributable to a U.S. branch through issuances of debt by the foreign owner to a related party, the various requirements on allocating liabilities between a branch and its home office (whether under the Code or a relevant bilateral tax treaty) raise unique issues. This preamble does not address those issues because the final and temporary regulations

reserve on their application to foreign issuers, including with respect to U.S. branches of foreign issuers.

2. Treatment of Consolidated Groups as One Corporation

Proposed §1.385-1(e) treated members of a consolidated group as one corporation for purposes of the regulations under section 385.

As discussed in Part IV.B.1.b of this Summary of Comments and Explanation of Revisions, the final regulations do not apply the rule in proposed §1.385-1(e) to §1.385-2. Instead §1.385-2 provides that an interest issued by a member of a consolidated group and held by another member of the same consolidated group is not within the scope of an applicable interest as defined in §1.385-2. As a result, such an interest is not subject to the documentation rules in §1.385-2. Sections 1.385-3, 1.385-3T, and 1.385-4T continue to treat members of a consolidated group as one corporation. Because the rule described in proposed §1.385-1(e) is now only applicable for purposes of §§1.385-3 and 1.385-3T and relates to the treatment of consolidated groups, the rule is moved to §1.385-4T. See Part VI of this Summary of Comments and Explanation of Revisions for a discussion of the comments and revisions to the rules regarding the application of §§1.385-3 and 1.385-3T to consolidated groups.

B. Definitions

1. Controlled Partnership

One comment requested that the regulations clarify that non-controlled partnerships are outside the scope of the regulations. The Treasury Department and the IRS have determined that proposed §1.385-3 was sufficiently clear that the partnership-specific provisions only applied to controlled partnerships and their partners.

Therefore, the regulations do not contain clarifying language to that effect. The application of §§1.385-3 and 1.385-3T to controlled partnerships is discussed further in Parts V.H.3 and 4 of this Summary of Comments and Explanation of Revisions.

a. Determining partners' interests in partnership capital or profits

The proposed regulations defined the term controlled partnership as a partnership with respect to which at least 80 percent of the interests in partnership capital or profits are owned, directly or indirectly, by one or more members of an expanded group.

A comment recommended the adoption of rules for determining whether members of an expanded group own 80 percent of the capital or profits interests of a partnership. The determination of whether a partner's share of partnership profits or capital is above or below a threshold is necessary to apply various provisions of the Code or regulations. In most cases, neither term is defined with specificity. See, e.g., sections 163(j)(4)(B)(i) and (j)(6)(D)(ii)(II), 613A(d)(3)(B), 707(b)(1) and (2), and 708(b)(1)(B), as well as §1.731-2(e)(4)(ii). The Treasury Department and the IRS decline to provide more specific rules regarding the determination of profits or capital interests in the context of identifying a controlled partnership for purposes of the section 385 regulations.

The comment also specifically recommended that, for purposes of measuring partners' profits interests, consideration be given to the use of a reasonable estimate of the partners' aggregate profit shares over time in order to prevent a partnership from flipping in and out of controlled partnership status (for example, when profit allocations are based on distribution waterfalls, which shift over time). This recommendation, made

in the context of identifying controlled partnerships, echoed other comments regarding the determination of a partner's share of profits for purposes of applying the aggregate approach to partnerships under proposed §1.385-3. The Treasury Department and the IRS recognize that a partner's share of partnership profits may not always be knowable with certainty, regardless of the purpose for making such determination. However, such determination must always be made in a reasonable manner. In some cases, that reasonable determination will require a partner or the partnership to make estimates regarding a partnership's profitability over some period of time.

The comment also recommended that the definition of a controlled partnership should not take percentages of capital interests into account, but should instead focus solely on a metric based on cumulative shares of profits. The Treasury Department and the IRS have determined that such a limitation would be inappropriate because in certain circumstances a partner's share of capital may be a good metric for identifying control.

As an alternative, the comment recommended that a shift in capital that is small or transitory be disregarded for purposes of the controlled partnership definition. The Treasury Department and the IRS have determined that such a rule would be difficult to administer because it would result in an additional deemed fiction -- that is, a partner's share of capital for this purpose could be different from the partner's actual share. The test for control looks to shares of profits or capital, not profits and capital, and because the threshold is 80 percent, small or transitory shifts in capital that would result in a partnership becoming or ceasing to be a controlled partnership should happen infrequently.

b. Indirect ownership

A comment requested confirmation that determining the status of a partnership as a controlled partnership is a separate and independent inquiry from determining the status of a corporation as an expanded group member. The comment suggested that it was unclear whether, in applying the section 318(a) attribution rules to determine "partnership interest" ownership, such partnership interests are then treated as actually owned for purposes of then applying the section 318(a) attribution rules to determine "stock" ownership. The final regulations clarify that determining the status of a partnership as a controlled partnership is a separate and independent inquiry from determining the status of a corporation as an expanded group member.

c. Unincorporated organizations

One comment requested that the regulations not treat certain unincorporated organizations described in §1.761-2 as controlled partnerships. The final regulations clarify that an unincorporated organization described in §1.761-2 that elects to be excluded from all of subchapter K is not a controlled partnership. Thus, the Treasury Department and the IRS anticipate that such unincorporated organizations will apply the rules of section 385 in a manner consistent with their pure aggregate treatment.

d. Treatment as a publicly traded partnership

A comment expressed concern that a debt instrument issued by a securitization vehicle organized as a partnership that is treated as stock in the expanded group partner under the proposed regulations could be treated as a partnership interest within the meaning of §1.7704-1(a)(2)(i)(B) because a "partnership interest" for this purpose can include certain derivative and other indirect contract rights and interests with

respect to a partnership. The comment stated that many securitization transactions require an unqualified opinion of tax counsel that the entity is not a publicly traded partnership treated as a corporation for federal income tax purposes, and that the recharacterization rules create uncertainty in this regard.

Section 1.385-2 of the final regulations does not explicitly apply to a debt instrument issued by a controlled partnership. While such a debt instrument may be subject to the anti-avoidance rule in §1.385-2(f), the concern raised in the comment would only arise under the final regulations if the debt instrument is issued with a principal purpose of avoiding the application of §1.385-2.

Similarly, §1.385-3T(f)(4) provides that a debt instrument issued by a controlled partnership is not recharacterized as stock. Instead, as described in more detail in Part V.H.4 of this Summary of Comments and Explanation of Revisions, the holder of a debt instrument (holder-in-form) all or a portion of which otherwise would be treated as stock is deemed to transfer such debt instrument to the partner or partners in the controlled partnership in exchange for stock in the partner or partners. While the deemed partner stock that the holder-in-form of the debt instrument would receive in exchange for the deemed transfer of all or a portion of the debt instrument to the partner or partners in the controlled partnership may be a non-debt financial instrument or contract the value of which is determined in whole or in part by reference to the partnership that issued the debt instrument pursuant to §1.7704-1(a)(2), the qualified dealer debt instrument exception in the final and temporary regulations is expected to address this issue. That exception applies to make a debt instrument acquired by a dealer in securities not a

covered debt instrument, and therefore, not subject to the rules that could result in deemed partner stock.

2. Expanded Group

a. General framework

The proposed regulations defined the term expanded group by reference to the term "affiliated group" in section 1504(a), with several modifications. Section 1504(a) defines an affiliated group for various purposes under the Code, including for purposes of defining an affiliated group of corporations that are permitted to file a consolidated return. Comments expressed concern that the proposed regulations' modifications to the definition in section 1504(a) for purposes of defining an expanded group would treat certain corporations as members of the same expanded group in situations where the corporations are not "highly related," which would not be consistent with the policy concerns that the regulations are intended to address. In particular, many comments described the proposed regulations' adoption of the attribution rules of sections 304(c)(3) and 318 in the definition of an expanded group as overly broad. Comments also requested that certain corporations not be included in an expanded group because their special federal tax status made their treatment as an expanded group member less relevant to the policy concerns of the proposed regulations.

Many comments proposed changes to the definition of an expanded group to better align that definition with the regulations' policy concerns, with the majority of the comments recommending changes that would retain section 1504 as the starting point for the definition, including adjustments to the attribution rules of sections 304(c)(3) and 318. However, two comments suggested that section 1563 would be a preferable

starting point. Section 1563 defines a "controlled group of corporations" for various purposes under the Code. One comment suggested that, to the extent the regulations treat corporations that are commonly controlled by non-corporate persons (for example, individuals, family members, or partnerships) as an expanded group (brother-sister groups), section 1563, with certain modifications, would be a better starting point than section 1504. Another comment asserted that the attribution rules in section 1563 would be more effective at including in an expanded group only the most highly-related entities. Other comments recommended that brother-sister groups should not be treated as a single expanded group in any case.

As described in more detail in Sections B.2.b through B.2.g of this Part III, the final regulations continue to define the term expanded group using concepts similar to those used to define the term "affiliated group" in section 1504(a). However, changes have been made and new examples added to address concerns expressed in comments regarding both the asserted overbreadth with respect to the types of corporations included in the proposed definition of an expanded group and with respect to the indirect ownership rules under the proposed regulations. Changes also have been made in response to comments to clarify other situations in which entities inadvertently were not treated as members of an expanded group under the proposed regulations but where the policy goals of the regulations clearly are implicated.

Additionally, the modifications that were made to the section 1504-based definition of an expanded group in response to the majority of comments achieve the same results that the two comments proposing a section 1563 approach indicated would be achieved through the use of a section 1563 starting point. Accordingly, the

Treasury Department and the IRS decline to adopt the recommendation to use section 1563 concepts in defining an expanded group. The Treasury Department and the IRS have determined that the modifications discussed in Sections B.2.a through g of this Part III more precisely define an expanded group to address those situations in which highly-related corporations implicate the policy goals of the regulations.

b. Exclusion of certain entities

In defining an expanded group, the proposed regulations included several modifications to the definition of an affiliated group under section 1504(a). Unlike an affiliated group, an expanded group was defined to include corporations that, under section 1504(b), would not be included within an affiliated group, including foreign corporations, tax-exempt corporations, S corporations, and RICs and REITs. In addition, indirect stock ownership was taken into account for purposes of the stock ownership requirement of section 1504(a)(1)(B)(i). Finally, the proposed regulations also modified the definition of affiliated group to treat a corporation as a member of an expanded group if 80 percent of the vote or value is owned by expanded group members (a disjunctive test) rather than 80 percent of the vote and value (a conjunctive test), as required under section 1504(a).

Numerous comments requested exclusions from the definition of an expanded group for entities described in sections 1504(b)(6) (RICs and REITs) and 1504(b)(8) (S corporations). Comments noted that RICs, REITs, and S corporations generally are not subject to corporate level taxation either because of the flow-through treatment accorded under the Code (in the case of an S corporation generally) or because of the dividends paid deduction that can have a similar effect (in the case of a RIC or REIT).

In that respect, comments asserted that RICs, REITs, and S corporations are similar to non-controlled partnerships, which the proposed regulations would not have included in an expanded group. Comments also noted that the recharacterization of an instrument issued by an S corporation, REIT, or RIC could jeopardize the entity's federal tax status. Consequently, comments suggested that the regulations exclude S corporations, REITs, and RICs from any expanded group.

In response to these comments, the final regulations exempt S corporations from being expanded group members. The final regulations also exempt RICs or REITs from being expanded group members unless the RIC or REIT is controlled by members of the expanded group. The Treasury Department and the IRS have determined that an S corporation, RIC, or REIT that otherwise would be the parent of an expanded group is generally analogous to a non-controlled partnership. Under both the proposed and the final regulations, a non-controlled partnership that would, if it were a corporation, be the parent of an expanded group is excluded from the expanded group because, by definition, the partnership is not a corporation and only corporations can be members of an expanded group. Consistent with the partnership's status generally as an aggregate of its owners, the partnership should not be a member of the expanded group if its partners would not be members. S corporations, RICs, and REITs have similar flow-through characteristics as partnerships and therefore also should not be members of the expanded group, despite otherwise being corporations that could own stock of members of an expanded group.

However, the final regulations continue to treat a RIC or REIT that is controlled by members of the expanded group as a member of the expanded group. Similar to a

controlled partnership, a controlled RIC or REIT should not be able to break affiliation with respect to an otherwise existing expanded group. Unlike partnerships, RICs and REITs are corporations and in certain limited cases are subject to federal income tax at the entity level. Therefore, the final regulations continue to treat controlled RICs and REITs as members of an expanded group, rather than as aggregates of their owners. Because an S corporation cannot be owned by persons other than U.S. resident individuals, certain trusts, and certain exempt organizations, an S corporation cannot be controlled by members of an expanded group in a manner that implicates the policies underlying the final and temporary regulations. S corporations are therefore excluded from the definition of an expanded group member for all purposes of the final and temporary regulations.

Several comments specifically requested exceptions for corporations exempt from taxation under section 501 and insurance companies subject to taxation under section 801. The final regulations do not adopt the recommendation to exclude these corporations from the definition of an expanded group. Although generally exempt from taxation, section 501 corporations may still be subject to tax on unrelated business income and therefore still present concerns relating to related-party indebtedness. In addition, while section 501 corporations are themselves generally tax exempt, they may own taxable C corporation subsidiaries. Even though S corporations and non-controlled REITs and RICs may also own taxable C corporation subsidiaries, in those situations income of the S corporation, REIT, or RIC is generally included in the income of their owners, whereas unrelated business taxable income of a corporation that is exempt from taxation under section 501 is not includible in another taxpayer's income. With

respect to insurance companies subject to taxation under section 801, like other corporations, they may also use related-party indebtedness to reduce their taxable income. However, as discussed in Part V.G.2 of this Summary of Comments and Explanation of Revisions, the final and temporary regulations exclude from the application of §1.385-3 debt instruments issued by certain regulated insurance companies, which generally include insurance companies subject to taxation under section 801.

Finally, one comment requested "specific evidence-based findings" justifying the inclusion of any entity described in section 1504(b) in an expanded group, while another comment asserted that defining a new category of related parties as an expanded group, rather than relying on a statutory definition such as an "affiliated group," was an inappropriate use of the regulatory process. Section 385 authorizes regulations that affect the treatment of certain interests in corporations as stock or indebtedness. However, the regulations limit their application to expanded group members and are premised on a broad definition of expanded group that generally applies to all types of corporations that are closely related. In defining an expanded group, the Treasury Department and the IRS are not constrained to include only "includible corporations" for purposes of determining an affiliated group of corporations under section 1504(a) or to rely on other predefined groups. The exclusion of specific types of corporations under section 1504(b) is intended to ensure that only certain corporations are permitted to benefit from consolidation for U.S. federal income tax purposes. An exclusion of a certain type of corporation from the expanded group definition, on the other hand, results from a determination by the Treasury Department and the IRS that indebtedness

between such entity and its affiliates does not sufficiently implicate the policy concerns of section 385 to subject the corporation to the final and temporary regulations.

c. Indirect stock ownership

To determine indirect stock ownership for purposes of defining an expanded group, the proposed regulations applied the constructive ownership rules of section 304(c)(3), which in turn applies section 318(a) subject to certain modifications. This Part III.B.2.c discusses comments related to indirect ownership and the application of section 318(a).

i. Indirect ownership under section 1504(a)(1)(B)(ii)

For purposes of defining an expanded group, proposed §1.385-1(b)(3)(i)(B) modified section 1504(a)(1)(B)(i) by providing that a common parent must own 80 percent of the vote or value of at least one other includible corporation (without regard to section 1504(b)) "directly or indirectly" rather than "directly." The proposed regulations did not include a similar modification to section 1504(a)(1)(B)(ii) (relating to the required ownership in includible corporations (without regard to section 1504(b)) other than the common parent); specifically, the regulations required that 80 percent of the vote or value of each includible corporation be owned "directly" by one or more includible corporations other than the common parent. Several comments recommended that, for purposes of defining an expanded group, section 1504(b)(1)(B)(ii) also be modified by substituting "directly or indirectly" for "directly."

In response to comments, the final regulations extend the "directly or indirectly" language to both the common-parent test of section 1504(a)(1)(B)(i) and the each-includible-corporation test of section 1504(a)(1)(B)(ii). Accordingly, the indirect

ownership rules of section 318, as modified by §1.385-1(c)(4)(iii) (discussed in detail in Section B.2.c.ii of this Part III) apply for purposes of both tests in section 1504(a)(1)(B). However, to make clear that the ownership tests of section 1504(a)(1)(B) apply to all corporations that can be members of an expanded group (as opposed to only includible corporations within the meaning of section 1504(b)), the final regulations provide the modified section 1504(a)(1)(B) tests in their entirety rather than by cross-reference to section 1504(a)(1)(B). Therefore, federal tax principles that are applicable in determining whether a corporation is a member of an affiliated group under section 1504(a)(1) and (a)(2) are generally applicable in determining whether a corporation is a member of an expanded group.

ii. Definition of indirect ownership

As noted in Section B.2.c of this Part III, the proposed regulations cross referenced the rules of section 304(c)(3), which themselves cross reference section 318(a) (with certain modifications), to define indirect ownership. In order to clarify how to determine indirect ownership for purposes of determining an expanded group, the final and temporary regulations cross reference section 318 and the regulations thereunder with modifications, rather than cross reference section 304(c)(3). The regulations under section 318(a) and, with respect to certain options, the regulations under section 1504, apply when determining a shareholder's indirect ownership for purposes of the final regulations.

One comment suggested that the regulations should indicate that indirect stock ownership is determined by "applying the constructive ownership rules of section 304(c)(3)," given that section 304(c)(3) refers to constructive ownership rather than

indirect stock ownership. The final regulations do not adopt this comment and instead define indirect stock ownership by reference to the "constructive ownership rules" of section 318, with appropriate modifications.

iii. Stock owned through partnerships

Under section 318(a)(2)(A), stock owned by a partnership is considered owned "proportionately" by its partners. Comments requested guidance on how "proportionately" should be determined under section 318(a)(2)(A) for purposes of determining stock ownership under the proposed regulations. Comments noted that, in the partnership context, determining the value of a partnership interest is not always straightforward, which makes it difficult to determine partners' proportionate interests in a partnership. To address these issues, comments requested safe harbors, including a safe harbor based on the liquidation value of a partner's interest.

The final regulations do not provide guidance on how "proportionately" should be determined under section 318(a)(2)(A) for purposes of determining stock ownership. The proper interpretation of "proportionately" in the context of section 318(a)(2)(A) is relevant to many provisions. See sections 304(c)(3) (providing constructive ownership rules for purposes of determining control), 355(e)(4)(C)(ii) (providing attribution rules applicable on a distribution of stock and securities of a controlled corporation), and 958(b) (regarding constructive ownership of stock for many international provisions). Thus, the Treasury Department and the IRS have determined that providing guidance on this issue is beyond the scope of these regulations because these regulations do not require a different application of section 318(a)(2)(A).

iv. Hook equity

A comment requested guidance regarding the application of the rules of section 318 to ownership structures involving hook equity. The comment indicated that the proposed regulations would increase the circumstances under which hook equity arises, increasing the need for guidance on the treatment of hook equity under section 318 under current law.

The Treasury Department and the IRS have concluded that the constructive ownership rules of section 318 already address the effect of hook equity. In general, under section 318(a)(2), the equity in the entity owning the hook equity can be attributed, in whole or in part, to the non-hook equity holder. Under section 318(a)(5)(A), stock constructively owned by a person by reason of section 318(a)(2) is considered as actually owned by such person. Section 318(a)(5)(A) permits a recursive application of section 318(a)(2), pursuant to which a non-hook equity holder is treated as owning a percentage of the hook equity owned. See Examples 3 and 4 of §1.385-1(c)(4)(vii).

v. Downward attribution and brother-sister groups

Comments recommended that, for purposes of the expanded group definition, the "downward attribution" rule of section 318(a)(3)(A) be modified to prevent taxpayers that are not highly-related from being treated as members of the same expanded group. Under section 318(a)(3)(A), all of the stock owned by a partner is treated as owned by the partnership, regardless of the partner's ownership interest in the partnership. Thus, for example, assume that USS1 owns a 1 percent interest in PRS, a partnership. Further assume that USS1 wholly owns S1, which wholly owns S2. PRS wholly owns S3. S1, S2, and S3 are all corporations. Pursuant to section 318(a)(3)(A), PRS is

treated as wholly owning S1 and S2 (after application of section 318(a)(2)(A)). Under section 318(a)(3)(C), S3 is treated as owning S1 and S2. As a result, S1, S2, and S3 would comprise an expanded group under the proposed regulations despite minimal common ownership between S3 and the other corporations.

To address fact patterns similar to the example above, comments recommended that the section 318(a)(3)(A) downward attribution rule apply only from partners with a specific threshold ownership interest in a partnership, such as partners that own 50 percent or 80 percent of the interests in a partnership. Other comments suggested different solutions to the same problem, including limiting section 318(a)(3)(A) attribution to situations in which related parties owned 80 percent or more of the interests in a partnership, or modifying section 318(a)(3)(A) attribution for these purposes such that a partnership is treated as owning only a proportionate amount of any stock owned by a partner. As an alternative, one comment recommended that the regulations include an override rule, pursuant to which two entities will not be treated as members of the same expanded group unless one of the entities has a direct or indirect ownership interest of 80 percent or more in the other entity, while applying proportionality principles under this override rule. One comment specifically requested that the downward attribution rule of section 318(a)(3)(A) be limited for purposes of applying the threshold rule of proposed §1.385-3(c)(2).

Comments also requested similar limits on downward attribution to entities other than partnerships. Specifically, comments recommended that section 318(a)(3) in general should apply only when the interest holder owns 80 percent or more of the entity, or that section 318(a)(3)(C) be modified to provide that the corporation is

attributed only a proportionate amount of the stock owned by its shareholder. One comment asserted, without explanation, that an expanded group should be determined entirely without reference to section 318(a)(3) or similar rules.

The principal consequence of requiring downward attribution for purposes of determining indirect ownership under the proposed regulations is that an expanded group included so-called "brother-sister" groups of affiliated corporations that are commonly controlled by non-corporate owners. Similarly, the principal consequence of applying section 318(a)(1) (in connection with section 318(a)(3)), which attributes stock owned by individual members of a family, would also be the treatment of brother-sister groups with non-corporate owners as part of an expanded group. The Treasury Department and the IRS continue to study the issue of brother-sister groups, including the implications of applying the final and temporary regulations to groups with identical members but different expanded group member corporate parents. As a result, the final regulations reserve on the application of section 318(a)(1) and (a)(3) for purposes of determining indirect ownership pending further study.

vi. Option attribution

A comment requested that, for purposes of determining an expanded group, the option attribution rule of section 318(a)(4) should not apply. The comment suggested that the anti-abuse rule should instead expressly apply to the use of options to avoid the expanded group definition. The comment asserted that it would not be appropriate, for example, to treat a 50-50 joint venture between unrelated corporations as an expanded group member of one or both corporations because of the existence of buy-sell rights that are common in many joint ventures.

The final regulations limit the application of the option attribution rule of section 318(a)(4) in two respects. First, the rule only applies to options that are described in §1.1504-4(d), which can include: call or put options, warrants, convertible obligations, redemption agreements, or any instrument (other than stock) that provides for the right to issue, redeem, or transfer stock, and cash settlement options, phantom stock, stock appreciation rights, or any other similar interests. Second, the rule only applies to the extent the options are reasonably certain to be exercised based on all the facts and circumstances as described in §1.1504-4(g). By limiting the application of the option attribution rule in this manner, the Treasury Department and the IRS intend that ownership of stock will be attributed to an option holder only in the limited circumstances in which the option is analogous to actual stock ownership.

The final regulations also provide a special rule for indirect ownership through options for certain members of consolidated groups. Under this special rule, in applying section 318(a)(4) to an option issued by a member of a consolidated group (other than the common parent of the consolidated group), section 318(a)(4) only applies to the option if the option is treated as stock or as exercised under §1.1504-4(b) for purposes of determining whether a corporation is a member of an affiliated group. This rule is intended to address cases where, because of the reasonable anticipation requirement of §1.1504-4(b)(2)(i)(A), members of a consolidated group could theoretically be treated as members of different expanded groups.

vii. Knowledge of constructive ownership

A comment indicated that, under the proposed regulations' attribution rules, it would be difficult in certain cases to determine whether entities are treated as members

of the same expanded group. The comment requested that a person should be treated as owning stock by reason of attribution solely to the extent such person has actual knowledge of a relationship or should have reasonably known of such relationship after due investigation. The comment did not specify the relationship with respect to which the proposed knowledge qualifier would apply (for example, whether the entities would need to have actual knowledge of their status as members of an expanded group, or if they would only require actual knowledge of the applicable relationship described in section 318 (as modified by section 304(c)(3)).

The final regulations do not adopt a knowledge qualifier with respect to the application of the attribution rules. The attribution rules in the final regulations are similar to attribution rules that are applicable under other Code sections, which are based on objective metrics rather than a subjective determination that would be difficult for the IRS and taxpayers to administer. Furthermore, in the case of highly-related groups, the requisite information needed to determine constructive ownership should be readily available to group members. Therefore, the Treasury Department and the IRS do not expect there will be situations in which taxpayers would be unable to determine constructive ownership after reasonable investigation and legal analysis.

d. Time for determining member status

Comments requested that the regulations clarify when a corporation's status as a member of an expanded group is determined for purposes of §1.385-3. Several comments recommended that the regulations adopt a "snapshot" approach, under which a corporation's membership in an expanded group is tested immediately before a transaction that is subject to the regulations. In the alternative, one comment suggested

that, for purposes of determining whether a corporation has become a member of an expanded group at the time of a distribution or acquisition, its membership should be determined at the close of the transaction or series of related transactions that include the distribution or acquisition. For example, assume FP, a foreign corporation, owns a minority equity interest in USS1, a domestic corporation, with an unrelated party owning the remainder of USS1's stock. USS1 issues a note to FP to redeem FP's stock in USS1. Pursuant to the same plan, FP purchases 100 percent of USS1's stock from the unrelated party. If this comment were adopted, FP and USS1 would be treated as members of the same expanded group at the time of the USS1 redemption because at the close of a series of transactions, FP and USS1 are members of the same expanded group. Accordingly, the USS1 note would be subject to recharacterization under §1.385-3.

The Treasury Department and the IRS have determined that a snapshot approach to determining expanded group status is more administrable and results in more consistent outcomes than determining expanded group membership after the transaction and a series of related transactions. Accordingly, the final regulations provide that the determination of whether a corporation is a member of an expanded group at the time of a distribution or acquisition described in §1.385-3(b)(2) or (b)(3)(ii) is made immediately before such distribution or acquisition.

e. Exceptions for certain stock holdings

i. Voting rights held by investment advisors

A comment recommended that, for purposes of the expanded group definition, any vote held by an investment advisor, or an entity related to the investment advisor,

should be ignored. The comment indicated that private investment funds are typically structured so that the fund's investment adviser, or a related entity, owns the voting interests in the investment fund (which may be taxable as a corporation for federal income tax purposes), while investors own non-voting interests in the fund that represent most of the fund's value. As a result, groups of investment funds managed by the same investment manager may be part of an expanded group because a common investment adviser, or a related entity, controls all of the voting interests in the investment funds. Furthermore, the comment noted that because an investment advisor generally owes separate duties to its investment funds, it does not enter into transactions to shift tax obligations from one fund to another, in contrast to a typical corporate structure.

The final regulations do not adopt this recommendation. The Treasury Department and the IRS disagree that any fiduciary duty owed by an investment advisor to its funds places meaningful limits on the ability for such funds to transact with each other through loans. To the extent that an investment advisor and its investment funds constitute an expanded group, it does not follow that intercompany transactions among such parties that give rise to tax benefits for one or more of them would be violative of fiduciary duties. In addition, unlike certain companies subject to regulation and oversight, see Part V.G.1 and 2 of this Summary of Comments and Explanation of Revisions, these funds are not subject to capital or leverage requirements that restrict their ability to issue debt. Without such restrictions, investment advisors that control investment funds may cause the funds to engage in transactions otherwise subject to the final and temporary regulations.

ii. Interests required to be held by law

A comment requested that, for purposes of determining membership in an expanded group, stock ownership should be disregarded to the extent that the stock is required to be held by law. The comment offered as an example risk retention rules applicable to asset-backed securities, which generally require sponsors to retain either five percent of the most subordinate tranche of a securitization vehicle or to retain a portion of each tranche of the securitization vehicle's securities.

The Treasury Department and the IRS decline to adopt this recommendation for purposes of defining an expanded group because the expanded group definition is already limited to corporations with a high degree of relatedness. However, as discussed in Part V.F.5 of this Summary of Comments and Explanation of Revisions, the final and temporary regulations adopt certain recommended changes to limit the application of §1.385-3 in certain securitization transactions.

f. Investment blockers

The preamble to the proposed regulations requested comments on whether certain debt instruments used by investment partnerships, including indebtedness issued by certain "blocker" entities, implicate similar policy concerns as those motivating the proposed regulations, such that the scope of the proposed regulations should be broadened. Several comments recommended that the scope of the proposed regulations should not be broadened to apply to such transactions (by, for example, treating a partnership that owns 80 percent or greater of the stock of a blocker corporation as an expanded group member). The final and temporary regulations do not adopt special rules for debt instruments used by investment partnerships, including

indebtedness issued by certain “blocker” entities. The Treasury Department and the IRS continue to study these structures and these transactions in the context of the section 385 regulations.

g. Overlapping expanded groups

One comment requested clarification that, although a corporation may be a member of multiple expanded groups, any particular expanded group can have only one common parent, such that having a common expanded group member does not cause overlapping expanded groups to be treated as a single expanded group. For example, the comment requested clarification that if USS1, a domestic corporation, owned 80% of the value of X, a corporation, and USS2, also a corporation, owned 80% of the vote of X, USS1 and USS2 would not be treated as members of the same expanded group by virtue of being common parents with respect to X.

The Treasury Department and the IRS agree that, while a corporation can be a member of more than one expanded group (overlapping expanded groups), an expanded group can have only a single common parent (an expanded group parent). The final regulations add an example to clarify that the expanded group parents of overlapping expanded groups are not themselves members of the same expanded group. See §1.385-1(c)(4)(vii) Example 1.

C. Deemed exchange rule

Under the proposed regulations, the recharacterization of an interest that was treated as debt when issued and then later characterized under the proposed regulations as stock gave rise to a deemed exchange of that interest for stock. Comments requested further guidance to address the tax implications of the deemed

exchange of a debt instrument for stock under the proposed regulations. Comments requested clarification regarding the extent to which gain or loss would be recognized on the deemed exchange, as well as the treatment of any gain or loss recognized.

Comments also requested clarity on the treatment of the deemed exchange when an interest previously treated as stock under the regulations ceases to be between two members of an expanded group and, as a result, is recharacterized as indebtedness. A number of comments requested that the regulations minimize the collateral consequences when an interest treated as equity under the regulations leaves the group, and urged that the consequences be similar to those occurring when an interest originally treated as debt is recharacterized as stock. Of particular concern was the treatment of accrued but unpaid interest; comments asked for clarification of the treatment of such amounts as part of the redemption price, noting that such treatment should be consistent with the original issue discount rules. One comment requested confirmation that the deemed exchange that occurs when an issuer or holder leaves the expanded group should be treated as a section 302(a) redemption with sale or exchange treatment.

In addition, comments requested further guidance on the treatment of tax attributes of an interest following the deemed exchange, including clarification of the treatment of foreign exchange gain or loss on qualified stated interest (QSI) and of the continued deductibility of QSI. Comments asked that the regulations address the various consequences of repayment of indebtedness that is treated as stock, including for example the effects on the basis of the stock upon redemption.

Comments also requested that the regulations clarify that the deemed exchange rule applies notwithstanding section 108(e)(8), which treats the satisfaction of indebtedness with a payment of corporate stock as a payment of an amount of money equal to the fair market value of the stock for purposes of determining the income from discharge of indebtedness.

The final regulations address these comments by adding a sentence to clarify that the rule that excludes QSI from the computation that takes place pursuant to the exchange does not affect the rules that otherwise apply to the debt instrument or EGI before the date of the deemed exchange. Thus, for example, the regulations do not affect the issuer's deduction of unpaid QSI that accrued before the date of the deemed exchange, provided that such interest would otherwise be deductible. The final regulations also clarify that the rule that treats a holder as realizing an amount equal to the holder's adjusted basis in a debt instrument or EGI that is deemed to be exchanged for stock, as well as the rule that treats an issuer as retiring the debt instrument or EGI for an amount equal to its adjusted issue price as of the date of the deemed exchange, apply for all federal tax purposes.

A new paragraph is added to the final regulations to specifically provide that, when an issuer of a debt instrument or an EGI treated as a debt instrument is treated as retiring all of or a portion of the debt instrument or EGI in exchange for stock, the stock is treated as having a fair market value equal to the adjusted issue price of the debt instrument or EGI as of the date of the deemed exchange for purposes of section 108(e)(8). This clarification also responds to the treatment of foreign exchange gain or loss, which generally follows the realization rules on indebtedness.

The final regulations do not otherwise change the rules in the proposed regulations that address the treatment of a deemed exchange. In particular, the regulations treat a debt instrument recharacterized as equity under §1.385-3 that leaves an expanded group as the issuance of a new debt instrument rather than reinstating the original debt instrument. In the case of an EGI recharacterized as equity under §1.385-2 that subsequently leaves the expanded group, federal tax principles apply to determine whether the interest is treated as a debt instrument and, if so, a new debt instrument is deemed exchanged for the EGI before it leaves the expanded group. Treating a debt instrument as newly issued in this context matches the treatment of an intercompany obligation that leaves a consolidated group in §1.1502-13(g)(3)(ii)(A). The final and temporary regulations provide no additional rules because there are detailed rules in sections 1273 and 1274 that describe how to determine issue price when a debt instrument is issued for stock.

The final regulations include a rule that coordinates §1.385-1(d) with the modified approach in the temporary regulations for controlled partnerships in §1.385-3T(f) and the modified approach in the final and temporary regulations for disregarded entities in §§1.385-2(e)(4) and 1.385-3T(d)(4). The temporary regulations addressing partnerships in §1.385-3T(f)(4) provide that a debt instrument that is issued by a partnership that becomes a deemed transferred receivable, in whole or in part, is deemed to be exchanged by the holder for deemed partner stock. See Part V.H.4 of this Summary of Comments and Explanation of Revisions. The final and temporary regulations addressing disregarded entities in §§1.385-2(e)(4) and 1.385-3T(d)(4) provide that an EGI or debt instrument that is issued by a disregarded entity is deemed

to be exchanged for stock of the regarded owner. See Parts IV.A.4 and V.H.5 of this Summary of Comments and Explanation of Revisions.

D. Payments made on bifurcated instruments

Proposed §1.385-1(d) contained a general bifurcation rule that permitted the Commissioner to treat certain debt instruments as in part indebtedness and in part stock (that is, to "bifurcate" the interest). Bifurcation of an interest could occur if an analysis of the relevant facts and circumstances under general federal tax principles resulted in a determination that the interest should be bifurcated as of its issuance into part stock and part indebtedness for federal tax purposes.

The Treasury Department and the IRS received many comments requesting additional guidance concerning how the portion of a bifurcated interest treated as stock would be determined, and how payments on such bifurcated interest would be treated for federal tax purposes. As noted in Part III of the Background, the final regulations do not contain a general bifurcation rule. The Treasury Department and the IRS continue to study the comments received. See the discussion regarding the treatment of payments with respect to debt instruments that are bifurcated pursuant to §1.385-3 in Part V.B.3 of this Summary of Comments and Explanation of Revisions.

IV. Comments and Changes to §1.385-2 — Treatment of Certain Interests Between Members of an Expanded Group

A. In general

The Treasury Department and the IRS received a significant number of comments on the rules of proposed §1.385-2 requiring preparation and maintenance of certain documentation with respect to an expanded group interest (EGI). As noted in Part II of the Background, proposed §1.385-2 prescribed the nature of the minimum

documentation necessary to substantiate the presence of four factors that are essential to the treatment of an EGI as indebtedness for federal tax purposes. The four factors are: (1) the issuer's binding obligation to pay a sum certain; (2) the holder's rights to enforce payment; (3) a reasonable expectation of repayment; and (4) a course of conduct that is generally consistent with a debtor-creditor relationship.

Comments received with respect to proposed §1.385-2 include the following:

- Comments regarding the necessity of proposed §1.385-2;
- Requests to extend the timely preparation periods;
- Requests to reconsider per se stock treatment for an undocumented EGI; and
- Requests that certain issuers or interests be exempted from proposed §1.385-2 based on a lack of earnings-stripping potential.

While a number of the comments received were critical of proposed §1.385-2, the Treasury Department and the IRS also received a number of comments that supported the goals of the documentation rules.

As noted in Part III of the Background and discussed in the remainder of this Part IV, the final regulations address many of the concerns raised in comments by adopting the following modifications:

- First, the final regulations narrow the application of §1.385-2 by excluding an EGI issued by a foreign issuer or an S corporation, and generally excluding interests issued by REITs, RICs, and controlled partnerships.
- Second, the final regulations replace the proposed 30-day (and 120-day) timely preparation requirements with a requirement that documentation and financial analysis be prepared by the time that the issuer's federal income tax return is

filed (taking into account all applicable extensions).

- Third, the final regulations provide a rebuttable presumption to characterization as stock for EGIs that fail to satisfy the documentation rules, provided the expanded group demonstrates a high degree of compliance with §1.385-2. If an expanded group does not demonstrate a high degree of compliance with §1.385-2, an EGI for which the requirements of the documentation rules are not satisfied would be treated as stock for federal tax purposes.
- Fourth, the final regulations clarify the application of the documentation rules to certain interests issued by regulated financial services entities and insurance companies that are required by regulators to include particular terms.
- Fifth, the final regulations clarify the ability of expanded group members to satisfy the documentation rules for EGIs issued under revolving credit agreements, cash pooling arrangements, and similar arrangements by establishing overall legal arrangements (master agreements).
- Finally, §1.385-2 applies only with respect to an EGI that is issued on or after January 1, 2018. The effect of this change in combination with the final regulations' new timely preparation requirements is that taxpayers will have until the filing date of their taxable year that includes January 1, 2018, to complete the documentation requirements under §1.385-2.

This Part IV addresses these modifications and additional changes suggested by comments that the Treasury Department and the IRS have adopted or declined to adopt in the final regulations.

1. Necessity of Documentation Rules

Some of the comments perceived the proposed documentation rules as beyond what would be necessary to impose discipline on related-party transactions, and some perceived the recharacterization of indebtedness as stock as a penalty disproportionate to the concern addressed by the proposed regulations. A number of comments considered the proposed documentation rules to be duplicative of existing rules and regulations that place on taxpayers both the burden of proof and the obligation to keep appropriate books and records. As a result, many of those comments urged the complete withdrawal of proposed §1.385-2.

Some comments suggested that the regulatory approach of characterizing an EGI as stock where adequate documentation is not prepared and maintained should be abandoned in favor of seeking legislation that would provide authority to the Treasury Department and the IRS to impose a monetary fine in such cases. Some comments noted that the documentation rules are, to some extent, duplicative of documentation requirements under section 6662 (relating to the accuracy-related penalty for underpayments) and suggested the adoption of the principles of §1.6662-6(d)(2)(iii)(B) (providing documentation rules for transfer pricing analysis purposes) to give taxpayers more guidance on the requirements of the regulations. Alternatively, some comments suggested relocating the proposed documentation rules under sections 6662 or 482. A number of comments urged that, in any event, the regulations should require only that a taxpayer's position with respect to the characterization of an interest as indebtedness be reasonable based on the available facts and circumstances instead of requiring documentation of prescribed factors, regardless of whether the IRS necessarily agreed with the taxpayer's characterization. Comments also suggested that the documentation

rules would need to be revised in some manner, because the comments asserted that such rules could not override “substantial compliance” principles under common law.

However, in recognition of the policy concerns stated by the Treasury Department and the IRS, virtually all of these comments also suggested modifications to make the documentation rules of proposed §1.385-2 more reasonable and administrable for both taxpayers and the IRS. Provided certain modifications were made to relax the burden of the documentation rules, many comments stated that taxpayers could comply with such modified rules. A number of comments suggested streamlining the documentation requirements, for example, by allowing (i) master agreements to support multiple transactions, (ii) balance sheets to evidence solvency, and (iii) the advance preparation of credit analysis of issuers. While many comments recognized the value of the certainty that could come from increased specificity and objective rules, many comments were equally concerned that the regulations be flexible regarding the manner in which the documentation rules apply.

The Treasury Department and the IRS have determined that the documentation rules of proposed §1.385-2 further important tax administration purposes. Moreover, the Treasury Department and the IRS have determined that the presence or absence of documentation evidencing the four indebtedness factors is more than a ministerial issue to be policed with a fine or penalty. These factors are substantive evidence of the intent to characterize an EGI as indebtedness for federal tax purposes. In addition, characterizing purported indebtedness as stock is not a penalty for failing to meet a ministerial requirement. Such characterization results from a failure to evidence the intent of the parties when the issuer characterizes the EGI for federal tax purposes or

from a failure to act consistent with such characterization during the life of the purported indebtedness. As noted earlier in this Section A, the Treasury Department and the IRS have determined that many of the concerns raised by comments can and should be addressed by modifying the approach taken in proposed §1.385-2 and, as discussed in the remainder of this Section A, that many of the modifications suggested by comments would enhance both the reasonableness and effectiveness of the final regulations.

2. Timely Preparation Requirement

Under proposed §1.385-2, documentation of an EGI issuer's binding obligation to pay a sum certain, the holder's rights under the terms of the EGI to enforce payment, and the reasonable expectation of repayment under the terms of the EGI generally would be required to be prepared within 30 days of the "relevant date" to which the documentation relates. Documentation of actions evidencing a debtor-creditor relationship would be required to be prepared within 120 days of the "relevant date" to which the actions relate.

Many comments raised concerns with the proposed timeliness rules. Some comments noted that the documentation rules did not correspond to business practice, were not reasonable, and would be impossible to satisfy without an expense to taxpayers far in excess of any benefit to be achieved. Comments argued that there was no administrative need for the documentation to be done in the timeframes specified, as the documentation would not be required until requested by the IRS in audit.

The timely preparation requirements in proposed §1.385-2 were intended to approximate third-party practice with respect to contemporaneous documentation of relevant events demonstrating the creation of a debtor-creditor relationship. The

documentation rules relating to post-issuance actions or inaction of issuers and holders were intended to demonstrate that the issuer and holder continued such a relationship. Thus, the Treasury Department and the IRS have determined that it is not appropriate for taxpayers to prepare documentation of the four indebtedness factors only if the IRS requests such information during an audit. Documentation prepared during an audit could not reasonably be viewed as contemporaneous evidence of the intent of the taxpayers when an EGI was issued.

After consideration of the comments, however, the Treasury Department and the IRS have determined that the objectives of the proposed regulations can still be achieved while allowing taxpayers more time to satisfy the documentation requirements. Many comments suggested that a reasonable and appropriate time for requiring compliance with the documentation rules would be by the time that the issuer's federal income tax return must be filed (taking into account any extensions) for the tax year of the relevant date. This timeframe would also be consistent with the framework of section 385(c), under which an issuer and holder provide notice to the Commissioner of their characterization of an interest on their tax returns. The Treasury Department and the IRS have determined that documentation prepared within such a timeframe could provide reasonable evidence of the intent of the issuer and the holder in connection with the issuance of the EGI. Accordingly, the final regulations adopt this comment for all documentation required to be prepared with respect to a relevant date for an EGI that is subject to the documentation rules (a covered EGI).

3. Per Se Stock Treatment

Under proposed §1.385-2, if the documentation rules for an EGI were not

satisfied, the EGI would be automatically treated as stock for federal tax purposes. The overwhelming response from comments was that this aspect of the documentation rules was too harsh. As described in Part V.B of this Summary of Comments and Explanation of Revisions, comments noted numerous and potentially adverse consequences from characterizing purported indebtedness as stock, including purported indebtedness issued by foreign issuers.

Comments stated that, because of the per se aspect of the documentation rules, the penalty of recharacterization would often be substantially disproportionate to the failure to comply with the documentation rules, as arguably minor instances of noncompliance could trigger a recharacterization of an interest as stock for federal tax purposes with potentially severe consequences. Comments also raised concerns that the per se aspect of the documentation rules would automatically treat an interest as stock for federal tax purposes without allowing for an alternative characterization of a transaction, such as, in substance, a distribution or contribution of purported financing proceeds.

Comments offered various solutions to address these concerns. A number of comments urged that, before any consequences attached, taxpayers be allowed to cure any defect in their documentation. Some comments urged that, instead of characterization of purported indebtedness as stock for federal tax purposes, the penalty for a failure to satisfy the documentation rules could be a denial of any interest deduction under section 163; similarly, other comments suggested allowing taxpayers to make an election to forego interest deductions under section 163 to cure any documentation defect. Some comments suggested that the bifurcation rule in proposed

§1.385-1(d) could be used to reach a more proportionate characterization result.

Section 385(a) directs that regulations promulgated under that section be applicable for all purposes of the Code. Accordingly, the Treasury Department and the IRS do not consider it appropriate to limit the federal tax consequences of the characterization of a covered EGI under §1.385-2 to particular Code provisions, such as section 163. Instead, as discussed in Part V.B of this Summary of Comments and Explanation of Revisions with respect to §§1.385-3, 1.385-3T, and 1.385-4T, the final regulations generally retain the approach of the proposed regulations under which related-party indebtedness treated as stock by application of §1.385-2 is stock for all U.S. federal tax purposes, including for purposes of applying section 1504(a) in the context of §1.385-2.

As discussed in Sections A.3.a through c of this Part IV, the risk of per se stock characterization as a result of a documentation failure is substantially reduced under the final regulations by the addition of rebuttable presumption rules.

a. Availability of rebuttable presumption

If the expanded group demonstrates a high degree of compliance with the documentation rules, the final regulations provide a rebuttable presumption (rather than a per se characterization) that a covered EGI that is noncompliant with the requirements of §1.385-2 is treated as stock for federal tax purposes. To demonstrate a high-degree of compliance with the documentation rules, a taxpayer must demonstrate that one of two tests is met. Under the first test, a taxpayer must demonstrate that covered EGIs representing at least 90 percent of the aggregate adjusted issue price of all covered EGIs within the expanded group comply with §1.385-2. Under the second test, a

taxpayer must demonstrate either that (1) no covered EGI with an issue price in excess of $100,000,000 failed to comply with §1.385-2 and less than 5 percent of the covered EGIs outstanding failed to comply with §1.385-2 or (2) that no covered EGI with an issue price in excess of $25,000,000 failed to comply with §1.385-2 and less than 10 percent of the covered EGIs outstanding failed to comply with §1.385-2.

If eligible, an expanded group member can rebut the presumption that a covered EGI is stock with evidence that the issuer intended to create indebtedness for federal tax purposes and that there are sufficient factors present to treat the covered EGI as indebtedness for federal tax purposes.

Several comments suggested that the final regulations include a de minimis rule excepting interests under a certain amount, specified as either a fixed dollar amount or a percentage of assets. The Treasury Department and the IRS are concerned that this would provide a ready method for circumventing the rules and so decline to adopt this suggestion. However, the rebuttable presumption rule contained in the final regulations would operate to mitigate these concerns. In particular, the second test for demonstrating a high degree of compliance with the documentation rules permits a simplified calculation based only on the number of covered EGIs that failed to comply with §1.385-2. This test reflects an understanding by the Treasury Department and the IRS that simplified compliance rules are appropriate where relatively smaller EGIs fail to comply with §1.385-2.

In cases where the rebuttable presumption rule applies, the final regulations provide that in applying federal tax principles to the determination of whether an EGI is indebtedness or stock, the indebtedness factors in the documentation rules are

significant factors to be taken into account. The final regulations further provide that other factors that are relevant are taken into account in the determination as lesser factors.

b. Ministerial or non-material failure or errors

The final regulations adopt a rule intended to safeguard against characterizing a covered EGI as stock for federal tax purposes if the failure to comply with the documentation rules is attributable to a minor error of a ministerial or non-material nature, such as a clerical error. In such a case, if a taxpayer discovers and corrects the documentation failure or error before discovery by the Commissioner, the failure or error will not be taken into account in determining whether the requirements of the documentation rules have been satisfied.

c. Reasonable cause exception

Proposed §1.385-2 included an exception that would allow for "appropriate modifications" to the documentation requirements when a failure to satisfy the requirements was due to reasonable cause (the reasonable cause exception). Proposed §1.385-2 adopted the principles of §301.6724-1 for purposes of determining whether reasonable cause exists in any particular case. These principles provide that a reasonable cause exception will apply if there are significant mitigating factors with respect to the failure or if the failure arose from events beyond the control of the members of the expanded group. Moreover, these principles provide that, in order for the reasonable cause exception to apply, the members of the expanded group must act in a responsible manner, both before and after the time that the failure occurred. Thus, under proposed §1.385-2, if the reasonable cause exception did not apply, any failure to

comply with the documentation requirements would give rise to a characterization as stock.

Comments viewed the exception as unnecessarily narrow in scope and unclear in application and effect. Some comments suggested adding factors to be considered and guidance about how modifications would be made to the rules. Suggestions for a more lenient standard included exceptions for "good cause," "good faith," "reasonable behavior," "innocent error," "unintentional," "inadvertent," or "lacking willfulness."

The Treasury Department and the IRS have determined that given the rebuttable presumption rule and the ministerial error rule adopted in the final regulations, the scope of the reasonable cause exception is appropriate. Accordingly, the final regulations retain the reasonable cause exception, including its incorporation of the principles of §301.6724-1 for guidance concerning its application. In addition, the final regulations provide that once a taxpayer establishes that the reasonable cause exception applies to an EGI, the taxpayer must prepare proper documentation in respect of the EGI.

4. Treatment of EGI issued by disregarded entities

Comments raised a number of questions and concerns regarding the characterization of an interest issued by a disregarded entity under proposed §1.385-2. The concerns largely centered on the collateral consequences of treating the interest as equity in the issuing legal entity, because in such a case the entity would have at least two members and therefore would be treated as a partnership under §301.7701-2(c)(1) rather than as a disregarded entity under §301.7701-2(c)(2). This change in treatment could create the potential for gain recognition and additional significant collateral issues.

The Treasury Department and the IRS have determined that the analysis of

whether there is a reasonable expectation of repayment of an interest must be made with respect to the legal entity (whether regarded or disregarded for federal tax purposes) that issued the interest for non-tax purposes, taking into account the extent to which other entities may have legal liability for the obligations of the issuing entity. In addition, documentation in respect of the other indebtedness factors must be prepared and maintained for the legal entity (whether regarded or disregarded for federal tax purposes) that issued the interest for non-tax purposes. To avoid the effects that could occur if an interest issued by a disregarded entity is characterized as equity under the documentation rules, §1.385-2 provides, under the authority of section 7701(l), that, in such cases, the regarded corporate owner of the disregarded entity is deemed to issue stock to the formal holder of the interest in the disregarded entity (and, if the recharacterization occurs later than the issuance of the interest, in exchange for that interest). The stock deemed issued is deemed to have the same terms as the interest issued by the disregarded entity, other than the identity of the issuer, and payments on the stock are determined by reference to payments made on the interest issued by the disregarded entity.

5. Exemption Based on Lack of Earnings-Stripping Potential

Some comments requested that the final regulations exclude from the documentation rules several categories of transactions believed not to raise earnings-stripping concerns. For example, many comments requested that transactions done in the ordinary course of business be exempt from the documentation rules. These comments argued in part that the sheer volume of such transactions would render any documentation requirement overly burdensome, especially given the proposed 30-day

time period for the completion of such documentation and the proposed consequence of failing to prepare and maintain such documentation. These comments also asserted that the nature of ordinary course transactions makes them an unlikely means of accomplishing abuse and a poor candidate for ultimate recharacterization as stock.

Some comments argued that this rationale would also support an exemption from proposed §1.385-2 for all interests created under cash pooling and similar arrangements. Other comments urged that all trade payables and any debt that financed working capital needs be excluded from proposed §1.385-2. A number of these comments recognized the difficulty of determining how such transactions could be identified and suggested various formulas. For example, some comments suggested formulas based on an average balance over a specified period or the average length of time outstanding. Other suggested methods included formulas based on the relationship of the underlying transaction to the operation of the business, such as financing inventory, services, fixed assets, rent, or royalties.

In addition to comments based on the nature of particular transactions, there were requests to limit application of the proposed documentation rules to the extent that the terms of a particular arrangement do not present earnings-stripping potential. Thus, for example, some comments suggested exemptions be made for purported indebtedness that is short term, with a low rate of interest (or no interest), or that is issued and held within the expanded group for a limited period.

The Treasury Department and the IRS considered these requests for exclusions from the regulations under §1.385-2, but generally declined to adopt them, principally because the goal of the documentation rules is not solely to prevent earnings-stripping.

Rather, the documentation rules are also intended to facilitate tax administration by imposing minimum documentation standards for transactions between highly related persons to determine the federal tax treatment of covered EGIs. Such minimum documentation standards are warranted as related-party transactions have historically raised concerns as to the use of purported indebtedness and the lack of proper documentation to verify the nature of the interest purported to be indebtedness. Adopting the broad exceptions urged by comments would undermine this goal. In addition, it is unclear how to administer an exemption from requirements to document ordinary course arrangements because, if taxpayers do not otherwise adequately document such arrangements, it is unclear how to determine whether they are, in fact, ordinary course arrangements.

B. Scope of covered EGIs

Many of the modifications suggested by comments would reduce the number of persons, types of entities, or transactions that would be covered by the regulations under §1.385-2. Comments regarding the scope of proposed §1.385-2 as applied to particular categories of issuers or transactions not addressed elsewhere in this Summary of Comments and Explanation of Revisions are addressed in this Section B.

1. Scope of Issuers

Under proposed §1.385-2, an issuer of an interest included, solely for purposes of the documentation rules, a person (including a disregarded entity) that is obligated to satisfy any material obligations created under the terms of an EGI. Proposed §1.385-2 also treated a person as an issuer if such person was expected to satisfy any material obligations created under the terms of an EGI. Comments asked for clarification

regarding the circumstances under which someone other than the person that is primarily liable under the terms of an EGI (the primary obligor), including a co-obligor, would be expected to satisfy an obligation created under the terms of the EGI.

Similar to the documentation rules in proposed §1.385-2, the final regulations provide that the term issuer means any person obligated to satisfy any material obligations created under the terms of an EGI, without regard to whether the person is the primary obligor. The Treasury Department and the IRS intend that the question of whether a person other than the primary obligor under the EGI is to be treated as its issuer should be analyzed under the principles of section 357(d), which contains a similar analysis with respect to liability assumptions. One comment asked for clarification as to when an obligor could be treated as an issuer for this purpose. An issuer for this purpose could include a guarantor of a primary obligor's obligations created under the terms of an EGI if the guarantor is expected to satisfy any of the material obligations under that EGI. An issuer could also include a person that assumes (as determined under section 357(d)) any material obligation under the EGI, even if such assumption occurs after the date of the issuance of the EGI.

a. Partnerships

Comments raised a number of concerns with the application of proposed §1.385-2 to controlled partnerships. Although the four indebtedness factors at the core of the documentation rules are important factors in determining the federal tax treatment of purported indebtedness issued by any entity, after consideration of the issues raised by the comments, the Treasury Department and the IRS have determined that the documentation rules should not generally apply to partnerships under the final

regulations. However, the Treasury Department and the IRS remain concerned that expanded group members could use partnerships (or other non-corporate entities) with a principal purpose of avoiding the application of the documentation rules. Accordingly, such transactions remain subject to the final regulations' anti-abuse rule.

In addition, because controlled partnerships are not treated as expanded group members under the final regulations, §1.385-2 provides that an EGI issued by an expanded group member and held by a controlled partnership with respect to the same expanded group is a covered EGI.

b. Consolidated groups

For purposes of proposed §1.385-2, members of a consolidated group were generally treated as "one corporation" and so interests issued between members of the consolidated group were not subject to the documentation rules. However, as noted in Parts III.A.2 and VI.A of this Summary of Comments and Explanation of Revisions, the one-corporation approach gave rise to numerous questions and concerns about both the implementation of the rule and the effect of this rule on the application of other provisions of the Code.

There were two reasons for excluding indebtedness between members of a consolidated group from the application of the documentation rule. The principal reason was that the consolidated return regulations, specifically §1.1502-13(g), already provide a comprehensive regime governing substantially all obligations between members. This is not the case with respect to indebtedness between consolidated group members and nonmembers, even if highly related. The second reason was that, in the very few cases where such obligations would not be subject to §1.1502-13(g), the inapplicability of

§1.1502-13(g) would generally be of limited duration and, in the meantime, all items of income, gain, deduction, and loss attributable to the obligation would offset on the consolidated federal income tax return.

The Treasury Department and the IRS have determined that the existing regulations governing obligations between members of a consolidated group are sufficiently comprehensive to warrant the exclusion of these obligations from the documentation rules. However, the Treasury Department and the IRS have reconsidered the use of the one-corporation approach with respect to §1.385-2 and determined that a simpler, more targeted approach would be to exclude obligations between consolidated group members from the category of instruments subject to the documentation rules. This approach, as provided in §1.385-2(d)(2)(ii)(A) of the final regulations, retains the general exclusion for intercompany obligations while eliminating many of the questions and concerns raised by comments, such as the question of whether a particular member of a consolidated group (or the consolidated group as a whole) would be the issuer of an EGI.

The final regulations do not, however, adopt the suggestion to expand the exception to exclude other obligations, such as obligations between affiliated corporations that are not includible corporations under section 1504(b) (such as a REIT or RIC) or that are prohibited from joining the group under section 1504(c) (certain insurance companies) and obligations between group members and controlled partnerships. In such cases, even though the obligations may generate items that may be reflected in a consolidated federal income tax return, none of the obligations generating the items are governed by the consolidated return regulations.

The final regulations also do not adopt the request to limit the consequences of characterizing an EGI as stock under §1.385-2, for example, by disregarding such stock for purposes of determining affiliation. The Treasury Department and the IRS view the characterization of an EGI as stock under §1.385-2 as a determination that general federal tax principles would preclude a characterization of the interest as indebtedness. Thus, the Treasury Department and the IRS have determined that it is appropriate to treat an EGI characterized as stock pursuant to §1.385-2 as stock for federal tax purposes generally.

c. Regulated entities

A number of comments were received requesting exemptions from the documentation rules for various regulated entities, such as insurance companies, financial institutions, and securities brokers or dealers. Comments stated that a rationale for the proposed documentation rules, facilitating tax administration by imposing minimal documentation standards for transactions between highly-related persons, is addressed by existing non-tax regulations and oversight already imposed on these entities. The Treasury Department and the IRS recognize that the various requirements noted by comments, such as the Basel III framework and increased capitalization requirements, risk management ratios, and liquidity requirements that are applicable to certain regulated financial entities, all afford increased assurance regarding certain aspects of the documentation requirements, particularly with respect to the creditworthiness of the issuer.

Accepting the fact that non-tax regulations may constrain the terms and conditions of the obligations issued and held by entities subject to those regulations

does not, however, change the fact that a determination of whether an EGI is characterized as stock or indebtedness for federal tax purposes is made under federal tax principles. This determination necessarily involves the preparation of documentation in respect of the four indebtedness factors. In addition, a non-tax regulator may not have the same interests as the Treasury Department and the IRS. Such a non-tax regulator may not constrain (and in some cases may encourage) actions to lower federal tax costs for the entities that it regulates so that more assets may be available to the depositors in, or creditors of, such entities.

Accordingly, the Treasury Department and the IRS have determined that it is not appropriate to exclude taxpayers from the documentation rules on the grounds that some of the documentation and information required may also be required by and provided to non-tax regulators. Indeed, to the extent the final regulations require documentation that is otherwise prepared and maintained under requirements imposed by non-tax regulators, such as may be required under regulations under 12 CFR Part 223 (Regulation W) issued by the Board of Governors of the Federal Reserve System, any additional burden imposed by the final regulations is reduced.

d. Expanded groups subject to §1.385-2

Under proposed §1.385-2, an EGI would not be subject to the documentation rules unless (i) the stock of any member of the expanded group was publicly traded, (ii) all or any portion of the expanded group's financial results were reported on financial statements with total assets exceeding $100 million, or (iii) the expanded group's financial results were reported on financial statements that reflect annual total revenue exceeding $50 million.

A number of comments suggested raising the asset and revenue thresholds, particularly for regulated businesses with high asset levels relative to revenue, such as banks, or for issuers with high amounts of revenue but low profit margins, such as construction companies. However, comments did not suggest particular levels to which the asset or revenue thresholds should be raised. As a result of the modifications made to §1.385-2 in the final regulations, the Treasury Department and the IRS have determined that the application of the documentation rules will be appropriately restricted to minimize burden and therefore decline to adopt this suggestion.

Accordingly, the final regulations continue to provide that an EGI is not subject to the documentation rules unless one of the following three conditions is present. First, if the stock of any member of the expanded group is publicly traded. Second, if all or any portion of the expanded group's financial results are reported on financial statements with total assets exceeding $100 million. Or third, if the expanded group's financial results are reported on financial statements that reflect annual total revenue that exceeds $50 million.

2. Special Categories of EGIs

a. Certain interests of regulated entities

Many of the comments submitted by or on behalf of regulated entities requested that, if a broad exception were not adopted for regulated entities, certain arrangements should be excluded from the documentation rules. As an example, several comments requested an ordinary course exception to the documentation rules applicable to all payments on insurance contracts, funds-withheld arrangements in connection with reinsurance, funds-withheld reinsurance, and surplus notes. Comments noted the need

for further guidance on the documentation that would be required for many of these interests, as they are typically executed by contract, not loan documents. The Treasury Department and the IRS do not agree that there is a need for guidance with respect to reinsurance or funds-withheld reinsurance, because these arrangements are not debt in form and are typically governed by the terms of a reinsurance contract (and other ancillary contracts). As such, they are not covered EGIs under the final regulations.

Comments also suggested that the final regulations create safe harbor exceptions for instruments issued to satisfy regulatory capital requirements and regulatory instruments issued in the legal form of debt that contain required features that could impair their characterization as debt, such as instruments with loss-absorbing capacity that are required by the Federal Reserve Board. For example, if a borrower's obligation to pay interest or principal, or a holder's right to enforce such payment, is conditioned upon the issuer receiving regulatory approval, but the instrument otherwise satisfies the unconditional obligation to pay a sum certain and creditor rights factors, comments argued that the required regulatory approval should not prevent the interest from being treated as debt. Similarly, comments requested the final regulations provide that, if regulatory approval delays an action, such delay will not prevent an issuer from satisfying the timeliness requirement.

The Treasury Department and the IRS agree that certain regulated entities may be required in some cases to issue an instrument that would be indebtedness under federal tax principles but for certain terms or conditions imposed by a regulator. To address this situation, the final regulations provide an exception from the documentation requirements for certain instruments issued by an excepted regulated financial company

or a regulated insurance company, as those terms are defined in §1.385-3(g). An EGI issued by an excepted regulated financial company is considered to meet the documentation rules as long as it contains terms required by a regulator of that issuer in order for the EGI to satisfy regulatory capital or similar rules that govern resolution or orderly liquidation. An EGI issued by a regulated insurance company issuer is considered to meet the documentation rules even though the instrument requires the issuer to receive approval or consent of an insurance regulatory authority before making payments of principal or interest on the EGI. In both cases, the regulations require that the parties expect at the time of issuance that the EGI will be paid in accordance with its terms and that the parties prepare and maintain the documentation necessary to establish that the instrument in question qualifies for the exception.

The Treasury Department and the IRS are aware that certain instruments required by regulators raise common law debt-equity issues that extend beyond the scope of these regulations. The scope and the form of additional guidance to address these instruments are under consideration.

b. Certain interests characterized under the Code or other regulations

Several comments requested clarification that instruments that are specifically treated as indebtedness under the Code and the regulations thereunder, such as mineral production payments under section 636, are not treated as applicable instruments, and accordingly not treated as EGIs subject to proposed §1.385-2. The final regulations clarify that such instruments are not subject to the documentation rules.

c. Master agreements, revolving credit agreements, and cash pooling arrangements

Under proposed §1.385-2, members of an expanded group using revolving credit

agreements, cash pooling arrangements, and similar arrangements under a master agreement were generally required to prepare and maintain documentation for the master agreement as a whole (rather than for each individual transaction), but comments contained a number of questions concerning the requirements applicable to these master agreements.

Some comments requested that master agreements be excluded altogether from the documentation rules, excluded at least for specific activities, or excluded if their terms exceeded those given by third parties. These comments argued that such agreements were not likely vehicles for earnings stripping. The Treasury Department and the IRS decline to provide an exemption for these master agreements because if such an exemption were granted, such master agreements could replace all other forms of indebtedness between highly-related parties, resulting in avoidance of the documentation rules. In addition, interests issued under these master agreements must be characterized for federal tax purposes, and there is no clear justification for treating such interests as exempt from the modified documentation requirements in the final regulations based on the fact that these interests are documented under a master agreement.

Many comments focused on solutions for making the application of the documentation rules to master agreements simpler, clearer, more workable for taxpayers, and more administrable for the IRS. Comments requested that the basic operation of the rules governing master agreements be clarified to provide certainty for taxpayers that (i) a comprehensive agreement such as a revolving credit agreement could satisfy the documentation requirements and (ii) individual draws under the

revolving credit agreement would not be treated as separate loans for purposes of the documentation rules. Comments also requested additional definitions and rules, for example clarifying the interaction of the documentation rules and §1.1001-3(f)(7) and the treatment of a cash pool financing both ordinary course and capital expenditures. The Treasury Department and the IRS decline to provide special rules under §1.385-2 for the cash pool financing of ordinary course and capital expenditures. In general, the question of whether an EGI is ordinary course or is used for capital expenditures is not relevant to the question of whether the EGI is indebtedness for federal tax purposes. In particular, this question is not relevant to determine whether there is an unconditional obligation to pay a sum certain, whether there are creditor's rights under the EGI, whether the parties have a reasonable expectation of repayment, or whether the parties' actions are consistent with a debtor-creditor relationship. As a result, the final regulations provide that an EGI issued under a cash pool arrangement must meet the same documentation requirements regardless of whether the EGI funds ordinary course expenses or capital expenditures.

The policy behind §1.1001-3(f)(7) is to encourage workouts when debtors have difficulty repaying their obligations to third-party creditors. In such a case, the debtor (and any shareholders of the debtor), have different economic interests from the creditors, and any modifications to a debt instrument are likely to meaningfully maintain the rights of the creditors. In the case of highly-related entities that meet the definition of expanded group, these different economic interests are not present. As a result, the final regulations provide that the rules of §1.385-2 apply before the rules of §1.1001-3(f)(7). The final regulations therefore require documentation as of certain deemed

reissuances under §1.1001-3 (even in cases where §1.1001-3(f)(7) would not require an analysis of whether a modification resulted in an instrument being treated as an instrument that is not indebtedness for federal income tax purposes).

Many comments suggested that the number of credit analyses required for master agreements be limited. For example, several comments asserted that the time for testing the issuer's ability to repay should be limited to the time of an interest's issuance. Comments also suggested that EGIs issued under master agreements should require credit analysis only upon the execution of the master agreement and subsequently upon an increase of the credit limit under the master agreement, provided that the amount of credit and term of the master agreement is reasonable. Comments generally suggested that the credit analysis be required to be repeated on a specified schedule, ranging from three to five years. The Treasury Department and the IRS generally agree with a specified schedule approach for determining the required credit analysis with respect to master agreements but have concerns about potential changes in an issuer's creditworthiness over longer periods. Because such agreements among members of an expanded group do not generally contain covenants, financial information provision, and other protections analogous to those in similar arrangements among unrelated parties, it is necessary to require a credit analysis under these agreements more frequently than every three to five years.

The Treasury Department and the IRS have addressed these comments by clarifying in the final regulations that with respect to EGIs governed by a master agreement or similar arrangement, a single credit analysis may be prepared and used on an annual basis for all interests issued by a covered member up to an overall

amount of indebtedness (including interests that are not EGIs) set forth in the annual credit analysis. The final regulations make it clear that the first such annual credit analysis should be performed upon the execution of the documents related to the overall arrangement. The only exception to this annual credit analysis rule is when the issuer has undergone a material change within the year intended to be covered by the annual credit analysis. In this case, the final regulations require a second credit analysis to be performed with a relevant date on or after the date of the material change. This requirement is consistent with commercial practice with respect to revolving credit agreements, which typically contain covenants requiring such terms.

Some comments requested clarification of the treatment of notional cash pools, noting that such arrangements are not documented as debt in form between expanded group members. The final regulations do not adopt this comment except to clarify that a notional cash pool is generally subject to the same documentation requirements as other cash pools when the notional cash pool provider operates as an intermediary. For example, a notional cash pool in which the cash received by a non-member cash pool provider from expanded group members is required to equal or exceed the amount loaned to expanded group members will generally be treated as a loan directly between expanded group members, even though the interests may be in form documented as debt between an expanded group member and a non-member facilitator. See, Rev. Rul. 87-89 (1987-2 C.B. 195). Such arrangements present the same issues as other related-party instruments and arrangements transacted under a master agreement and should be subject to the documentation rules. Because these arrangements are administered by a non-member, it is generally expected that most of the documentation

required under the final regulations would already be prepared, limiting the incremental burden of the final regulations on these arrangements.

Several comments also suggested limiting the application of the documentation rules to amounts in excess of average balances. The final regulations do not adopt this approach because almost all provisions of the Internal Revenue Code pertaining to indebtedness and stock analyze particular interests, not average or net balances. Thus, to apply the documentation rules to average or net balances would not adequately serve the purpose of determining whether a particular interest is properly treated as indebtedness or stock for federal tax purposes.

Comments also noted that coming into compliance following finalization of the regulations would be facilitated by allowing an extended time frame to document these arrangements and by excluding balances outstanding on the effective date of the final regulations. The final regulations implement this comment. Only interests issued or deemed issued on or after January 1, 2018, including EGIs issued on or after January 1, 2018 under a master agreement in place before January 1, 2018, will be subject to §1.385-2.

C. Indebtedness factors generally

While many comments acknowledged a need for documentation rules, there were two overarching concerns with respect to the form of such rules. First, comments suggested that the requirements be made as streamlined as possible. Second, comments requested clarification of the indebtedness factors so that taxpayers could have certainty about what information is requested and what documentation will satisfy the requirements of the regulations.

Some comments suggested that the Treasury Department and the IRS publish a form that taxpayers could use to report new loans or payments, with sufficient instructions to forestall debate over whether adequate documentation is provided. Under such an approach, if the form were properly completed with respect to an interest, an audit would then proceed to the merits of the debt-equity determination for the interest. The Treasury Department and the IRS have determined that the modifications made in the final regulations address these concerns. Other comments suggested providing for a level of documentation scaled to the principal amount of the loan, or that would be reduced in the case of loan guaranteed by a solvent parent or affiliate. The Treasury Department and the IRS do not adopt this suggestion. Such an approach would allow taxpayers to use numerous smaller loans to avoid the full application of the documentation rules.

Several comments suggested using a “market standard safe harbor” that would treat the documentation requirements as satisfied by the documentation customarily used in third-party transactions. The final regulations adopt this comment and provide that such documentation may be used to satisfy the indebtedness factors related to an unconditional obligation to pay a sum certain and creditor’s rights.

A number of comments also requested guidance regarding the effect of a significant modification of an instrument under section 1001 and under §1.1001-3. The consensus among comments was that the final regulations should provide that when there is a modification of an interest, as long as such modification is not very significant, no additional documentation should be required. The Treasury Department and the IRS have decided that a deemed reissuance under §1.1001-3 represents a case where the

economic rights and obligations of the issuer and holder have changed in a meaningful way. As a result, the final regulations provide that the deemed reissuance of an EGI under §1.1001-3 generally requires a new credit analysis to be performed (unless an annual credit analysis is in place at the time of the deemed reissuance). However, the final regulations do not require new documentation in respect of the factors regarding an unconditional obligation to pay a sum certain or creditor's rights, as of such a deemed reissuance, unless such deemed reissuance relates to an alteration in the terms of the EGI reflected under an express written agreement or written amendment to the EGI.

Finally, comments noted that it was unclear who was required to prepare and maintain the documentation, and some of these comments made suggestions as to the persons that should be required to prepare and maintain the documentation. Proposed §1.385-2 did not include any requirement in this respect because the taxpayer is in the best position to determine who should prepare and maintain its documents; the IRS's interest in this respect is limited to requiring that the proper documentation be prepared and maintained and ensuring that the IRS may obtain the documentation. In addition, if the documentation rules contained specific requirements as to the person or persons required to prepare and maintain documentation, such requirements would imply that an interest does not comply with the documentation rules (even when appropriate documentation was prepared and maintained) merely because the wrong member of the expanded group prepared or maintained the documentation for the interest. Such arguments would be harmful to taxpayers and would not advance the policy goals of the documentation rules. Thus, proposed §1.385-2 was purposely silent on the question of who must prepare and maintain documentation. The final regulations continue this

same approach.

1. Unconditional Obligation to Pay a Sum Certain

Comments requested several clarifications regarding the requirement that there be an unconditional obligation to pay a sum certain. A number of comments asked for clarification that an obligation would not automatically fail because of a contingency or because it was a nonrecourse obligation. Several comments also requested a clarification that the sum need only be an amount that is reasonably determinable as opposed to a specified total amount due on a single specified date. A number of other comments also requested confirmation that, if a borrower's binding obligation to pay under an interest is subject to the condition of a regulatory approval before repayment, but otherwise satisfies the requirement that there be an unconditional obligation to pay a sum certain, the fact that regulatory approval is required before repayment should not prevent the interest from satisfying that requirement. The Treasury Department and the IRS generally agree with these comments, and the final regulations provide rules clarifying these points. The effect of a contingency that may result in the repayment of less than an instrument's issue price has not been addressed by the Treasury Department or the IRS, and the documentation rules are not the appropriate place for guidance in that area. The final regulations provide that the documentation must establish that the issuer has an unconditional and legally binding obligation to pay a fixed or determinable sum certain on demand or at one or more fixed dates, without elaborating on the amount of the sum certain.

2. Creditor's Rights

Comments requested a number of clarifications regarding the requirement that

the documents evidence the creditor's right to enforce the obligation. The most common concern raised by comments was that the requirement be modified to recognize that creditor's rights are often established by law, and, in such cases, would not necessarily be included in the loan documentation. Comments requested that the rules treat this requirement as established in such cases, without regard to whether the rights are reiterated in the loan documents. In such cases, comments requested that creditor's rights be respected without requiring additional documentation.

The final regulations adopt this comment with one modification. If creditor's rights are created under local law without being reflected in writing in a loan agreement and no creditor's rights are written as part of the documentation of an interest, the documentation must refer to the law that governs interpretation and enforcement (for example, Delaware law or bankruptcy law). This requirement verifies that the issuer and holder did intend to create creditor's rights and assists the IRS in confirming that such creditor's rights apply to the holder of the interest.

Several comments requested clarification that the fact that a note is nonrecourse does not prevent the satisfaction of the creditor's rights requirement. Further, comments requested clarification that, if a creditor only has rights to certain assets under the terms of an interest, the reference to assets of the issuer means only those assets, and such a limitation would not result in the interest failing to satisfy the creditor's rights indebtedness factor. The final regulations clarify these points.

Finally, a number of comments suggested that the final regulations remove the proposed prohibition on subordination to shareholders in the case of dissolution. The principal concern of the comments was that, if, for example, one EGI (EGI#1) issued by

an issuer were subordinate to another EGI (EGI#2) issued by the same issuer, and EGI#2 were recharacterized as stock under the proposed §1.385-3 regulations, EGI#1 would fail this requirement because it would be subordinate to EGI#2 (which is treated as stock for federal tax purposes). In such case, EGI#1, because it is subordinate to EGI#2, would be subordinate to shareholders (the holders of EGI#2) in a dissolution of the issuer and would therefore violate the proposed prohibition on subordination to shareholders in the case of dissolution. The Treasury Department and the IRS have considered this comment and determined that it would be appropriate to disregard subordination if the recharacterization occurred as a result of §1.385-3 and the final regulations reflect that decision. However, because a characterization under the documentation rules speaks to the substance of the interest itself, including whether the interest properly could be indebtedness for federal tax purposes under general federal tax principles, the Treasury Department and the IRS do not agree that it is appropriate to disregard a characterization caused by the documentation rules of §1.385-2 for this purpose.

One comment asked for clarification that equitable subordination imposed by a court would not affect this determination. The Treasury Department and the IRS are not aware of a situation in which it would be appropriate to disregard equitable subordination as a factor in determining whether an interest is properly indebtedness or stock, and so the final regulations do not adopt this comment.

Several comments noted that subordination to later issued, unrelated-party indebtedness is common and should not be a negative factor. The Treasury Department and the IRS do not expect this circumstance will cause a problem under the

regulations, as the unrelated-party indebtedness is not subject to recharacterization under the final regulations and the documentation rules only require that an interest be superior to the rights of shareholders, rather than debt holders.

3. Reasonable Expectation of Ability to Repay EGI

A number of comments requested clarifications regarding the requirement that there be a reasonable expectation of the issuer's ability to repay its obligation. Comments also requested that the final regulations clarify that the expectation is subjective and that the creditor should be given reasonable latitude based on its business judgment. In addition, comments requested that the regulations should specify how frequently credit analysis is required. For example, some comments suggested that an approach similar to that taken for master agreements be adopted to allow a single agreement and a single credit analysis (done annually or at other specified intervals) to document multiple loans by expanded group members to a particular member. Other comments requested that the regulations should clarify whether it is only necessary to retest credit worthiness as often as is typical under commercial practice, or whether an annual analysis is sufficient. In response to these comments, the final regulations assist in implementing the documentation requirements for multiple EGIs issued by the same issuer by making it clear that a single credit analysis may be prepared on an annual basis and used for all interests issued by the issuer, up to an overall amount of indebtedness set forth in the annual credit analysis.

With respect to the time for measuring an issuer's reasonable expectation of ability to repay an EGI, comments presumed that the issue date of the interest would be the appropriate date to measure. Although comments also noted that there are

questions as to when this measuring date would arise. Comments also suggested that the reasonable expectation of ability to repay could be reevaluated if there is a deemed reissuance of the interest under the rules of section 1001, unless the parties can show a third party would have agreed to a modification.

The regulations retain the requirement that documentation be prepared and maintained containing information establishing that, as of the date of issuance of the EGI, the issuer's financial position supported a reasonable expectation that the issuer intended to, and would be able to, meet its obligations pursuant to the terms of the EGI. The rules addressing the reasonable expectation of repayment factor thus retain the EGI's issuance date as the appropriate date for measuring the issuer's financial position. Issuance dates are to be determined under federal tax principles.

With respect to whether the issuer's financial position supports a reasonable expectation that the issuer intended to, and would be able to meet its obligations pursuant to the terms of the obligation, comments requested that the application of a creditworthiness test of the issuer's financial position be excluded if the indebtedness is secured by specific property of the issuer. In response to this concern, the final regulations clarify that if the EGI is nonrecourse to the issuer, then the documentation to support such indebtedness must include the value of property available to support repayment of the nonrecourse EGI.

Comments suggested that the creditworthiness of the issuer could be determined by a confirmation of the creditworthiness of the issuer by a third party or internal staff of the issuer. They further suggested that the regulations could provide safe harbors for creditworthiness using ratios such as a minimum debt-to-equity or "EBIDTA"-to-interest

ratios. Comments also requested that the regulations provide a list of documents that would satisfy the reasonable expectation requirement, which could include documents that would be sufficient (but not necessary) to show that the obligation could have been issued on the same terms with a third party. The final regulations clarify that documentation may include cash flow projections and similar economic analyses prepared by either the members of the expanded group of the issuer or third parties.

Comments also requested clarification that refinancing would be an acceptable method to repay an EGI and that a refinancing does not adversely impact and may be assumed as part of the credit analysis; in other words, if the issuer could have issued the obligation to a third party with the ability to refinance the obligation on its maturity date, then the issuer would satisfy this requirement. Moreover, comments were of the view that in fact, a borrower's ability to refinance obligations when due should be a positive factor in a credit analysis. The final regulations provide that the credit analysis may assume that the principal amount of an EGI may be satisfied with the proceeds of another borrowing by the issuer to the extent that such borrowing could occur on similar terms with a third party.

Comments requested clarity as to whose credit is being analyzed, specifically, whether it is only the "recipient" of funds or, if the issuer is a member of consolidated group, whether it is the entire consolidated group. Because the final regulations remove the one-corporation rule for purposes of the documentation rules, the member that is the issuer of an interest would be analyzed for this purpose.

One comment requested that the regulations clarify limits on privileged documents and provide specific limitations regarding the ability of the IRS to request,

review, and maintain such information. The final regulations do not adopt this comment. The IRS routinely reviews and maintains confidential taxpayer information as part of its tax administration function, and strong protections for confidential taxpayer information already exist.

4. Actions Evidencing Debtor-Creditor Relationship

Comments requested clarification that certain types of payments such as payments-in-kind, additions to principal, and payments of interest could be evidenced by journal entries in centralized cash management systems in which payables and receivables are managed. They also noted that the journal entries could be made with respect to the treasury center in such cases. The Treasury Department and the IRS agree that as long as a payment is in fact made and a written record of the payment is prepared and maintained, the documentation rules should not require that the payment be made or recorded in any particular manner. However, the Treasury Department and the IRS have determined that there is no need to expressly note that payments-in-kind or additions to principal should be included because these actions generally would take place and be recorded in as a part of journal entries reflecting a payment of interest. As a result, the final regulations adopt these comments in respect of journal entries (other than with respect to payments-in-kind or additions to principal).

Comments requested that the rules make clear that the existence of creditors' rights is more important than their exercise. They urged a flexible approach that included much deference to the judgment of the creditor, suggesting a generous period in which to act on default. Comments noted that common law recognizes that choosing not to enforce the terms of the obligation may be completely consistent with

indebtedness treatment and does not necessarily require an interest to be characterized as stock. For example, if the debtor's position deteriorates, if a default could trigger other default events, or if there are reasons to expect the debtor's situation to improve, a creditor may be well advised to choose forbearance. There may also be legal constraints or obligations arising out of the relationship between an issuer and holder that are in an expanded group that prevent or forestall enforcement action, including fraudulent conveyance laws.

Most comments, however, sought a clear affirmation that this rule relates only to the documentation required, not the substantive evaluation of the creditor's actions. The Treasury Department and the IRS agree that this rule addresses only the requirement to document actions. However, the rules also require that an explanation be documented for inaction by a creditor upon failure of the issuer to comply with the terms of purported indebtedness and that the explanation for such inaction is an indebtedness factor. In the context of highly-related parties, where economic interests of the issuer and holder are aligned, there is a greater need for scrutiny where there is nonperformance and no assertion of creditor's rights. The lack of an explanation for such inaction may give rise to a substantive determination that the parties did not intend to create indebtedness in substance or ceased to treat an interest as indebtedness. Thus, the final regulations do not provide any specific guidance that addresses the comments related to the substantive evaluation of the actions the debtor or creditor must take. The final regulations provide a cross reference to §1.1001-3(c)(4)(ii), which provides rules regarding when a forbearance may be a modification of a debt instrument and therefore may result in an exchange subject to §1.1001-1(a). As later discussed,

such an exchange could be a relevant date under the documentation rules.

5. Requests for Additional Guidance

Many comments requested more detail about the type and extent of documentation that would be necessary in order to satisfy the documentation rules, often suggesting that examples and specific guidelines should be included in the regulations. Comments expressed concern that the lack of such guidelines would cause administrative difficulties, as agents would request, and taxpayers would produce, unnecessary documentation. As a result, time would be spent unnecessarily on disputes over whether the documentation rules were satisfied instead of on the underlying substantive determination of the character of the interest at issue.

Comments suggested the issuance of audit guidelines, the use of "fast track" review by the IRS Office of Appeals, and the admission of these issues relating to the satisfaction of the documentation rules into the pre-filing agreement program as ways to facilitate administration for taxpayers and the IRS alike. The IRS agrees that these administrative procedures could assist both taxpayers and the IRS in the efficient resolution of cases. They are available under generally applicable criteria and procedures.

The Treasury Department and the IRS have considered these comments and agree that the purpose of the documentation rules is not to prepare and maintain unnecessary documentation. Rather, the purpose of the documentation rules is to provide a taxpayer with guidance regarding what broad categories of information are necessary to be documented to evidence the creation of a debtor-creditor relationship, as well as to facilitate tax administration.

D. Specific technical questions

1. Relevant Dates

Under proposed §1.385-2, the relevant date for purposes of documenting the issuer's unconditional obligation to repay and the creditor's right to repayment was generally either the date that an expanded group member issued an EGI or the date that an instrument became an EGI. The relevant date for purposes of documenting the reasonable expectation of repayment was generally either the date that an expanded group member issued an EGI, the date that an EGI was deemed reissued under §1.1001-3, or the date that an instrument became an EGI. The relevant date for purposes of documenting actions evidencing a debtor-creditor relationship was generally either the date that a payment was made or the date on which an event of default occurred. Proposed §1.385-2 provided that no date before the applicable instrument becomes an EGI is a relevant date.

Some comments suggested that the "relevant date" be the same for the documentation requirements regarding the issuer's obligations, the holder's rights, or the reasonable expectation of payment. The Treasury Department and the IRS have not adopted this suggestion because these dates will not and should not always match. For example, under a revolving credit agreement individual draws would typically be made at different times than the requisite credit analysis of the borrower. The Treasury Department and the IRS have determined that the appropriate times for retesting the reasonable expectation of repayment and for documenting other indebtedness factors may differ. For example, if there is a material event affecting the solvency or business of the issuer, an updated analysis of the reasonable expectation of repayment may be

appropriate, even where the legal documents related to an interest have not been modified.

In addition, proposed §1.385-2 provided that the relevant date with respect to cash pools, master agreements, and similar arrangements included the date of the execution of the legal documents governing the arrangement and the date of any amendment to those documents that provides for an increase in the permitted maximum amount of principal.

Comments suggested that relevant dates for such arrangements should include only the dates that the arrangement is put into place, new members are added, or the maximum loan amount is increased. The final regulations clarify that these dates are generally the relevant dates for these arrangements. However, as previously discussed, an annual credit analysis (as well as a credit analysis as of a material event of an issuer) must be performed under these arrangements and, as a result, the final regulations provide that relevant dates for that credit analysis include the anniversary of the credit analysis as well as the date of any material event of the issuer.

2. Maintenance Requirements

Proposed §1.385-2 provided that required documentation must be maintained for all taxable years that an EGI is outstanding, until the period of limitations expires for any federal tax return with respect to which the treatment of the EGI is relevant. Comments raised concerns that this rule was burdensome and requested that the final regulations include a practical way to limit the length of time that documentation must be maintained. The Treasury Department and the IRS do not adopt this request because they consider it inappropriate to permit the destruction of documentation while such

documentation is relevant for federal tax purposes because this would be inconsistent with the requirements of section 6001 (requirement to keep books and records).

3. Period When §1.385-2 Characterization is Given Effect

a. Debt instrument becomes an EGI

Proposed §1.385-2 provided that, in the case of an interest that was an EGI when issued, if the EGI is determined to be stock as a result of the documentation rules, the EGI is generally treated as stock as of its issuance. The exception to this general rule was if the failure to comply with the documentation rules related to an action evidencing a debtor-creditor relationship; in that case, the EGI would be treated as stock as of the time that the failure to comply occurs. However, if the interest was not an EGI when issued but later becomes an EGI that is determined to be stock under the documentation rules, the EGI is treated as stock from the date it becomes an EGI.

Comments urged that the documentation rules apply only once an interest becomes an EGI and that any characterization based on the application of rules be limited to the treatment of the EGI after it becomes an EGI. The Treasury Department and the IRS intended that the documentation rules would not generally apply to an interest until it becomes an EGI, and the final regulations clarify this point.

Several comments also requested that the rules not apply to any interest if, when issued, either the issuer or holder was not subject to federal tax, was a CFC, or was a controlled foreign partnership. The final regulations reserve on the treatment of foreign issuers, and, other than potentially under the anti-abuse rule, do not apply to interests issued by a partnership. Accordingly, the final regulations do not adopt this comment.

Comments suggested clarifying the treatment of an interest when its status

changes from an EGI to an intercompany obligation subject to §1.1502-13(g) and when its status changes from an intercompany obligation subject to §1.1502-13(g) to an EGI. Some comments requested that in the case of an intercompany obligation becoming an EGI, the regulations treat the issue date as the date the interest ceases to be an intercompany obligation. Conversely, another comment urged that if an interest becomes an EGI, it should nevertheless be excluded from the regulations. The final regulations address this comment by treating such an EGI as subject to the documentation rules when it becomes an EGI. This approach is consistent with the approach in §1.1502-13(g)(3)(ii), which treats such an EGI as a new obligation for all federal income tax purposes.

Many comments urged that there was no need to impose documentation requirements regarding the issuer's obligations, the holder's rights, or the reasonable expectation of payment when a non-EGI became an EGI because such documentation would be done on issuance under common commercial practices. As such, it arguably would be adequate to police these requirements with an anti-abuse rule. Similarly, some comments urged there be no such documentation requirement when an expanded group acquired an EGI from another expanded group because the documentation rules would apply at the time the EGI was issued.

Thus, under either suggestion, the only documentation requirement that would apply to such notes would be that relating to evidence of a debtor-creditor relationship. These comments also requested that, if these suggestions were not adopted, the regulations allow at least a year for taxpayers to bring incoming EGIs into compliance. The Treasury Department and the IRS have determined that the documentation

requirements are necessary for EGIs, regardless of whether they are initially issued within the expanded group or whether they become EGIs after issuance. The fact that such interests may have been initially issued among less-related parties does not change the requirement that the interests must be characterized under federal tax principles as debt or equity, and the indebtedness factors in the documentation rules are important factors for the debt-equity analysis of any interest. Moreover, once an interest becomes an EGI, meaning that the issuer and holder are highly related, the terms and conditions may no longer be followed due to this high degree of relatedness. Because of this issue, it is necessary for such EGIs to be subject to the rules in order to ensure that the policy goals of the documentation rules are achieved. Treating a loan differently once it becomes held by an entity related to the issuer is not unique to these rules. For purposes of testing for cancellation of indebtedness income, section 108(e)(4) takes a similar approach by treating a purchase of a note by a party related to the issuer as in effect a repurchase of the note by the issuer. However, the Treasury Department and the IRS have relaxed the timely preparation requirement so that the documentation of all EGIs does not have to be prepared and maintained until the time for filing the issuer's federal income tax return (taking into account all relevant extensions).

b. EGI treated as stock ceases to be an EGI

Comments requested that, if an EGI that was treated as stock under the documentation rules ceases to be treated as stock when it ceases to be an EGI, the recharacterization back to indebtedness is deemed to occur immediately after the interest ceases to be an EGI. The reason offered was to avoid creating a noneconomic

dividend when the stock is deemed exchanged for the note. The final regulations do not adopt this comment. Under the final regulations, if an EGI that was treated as stock under the documentation rules ceases to be treated as stock when it ceases to be an EGI, the recharacterization back to indebtedness is deemed to occur immediately before the interest ceases to be an EGI. This rule is intended to ensure that the treatment of a third-party purchaser of the EGI is not affected by the final regulations, which are not intended to affect issuances of notes among unrelated parties. If the rule suggested by the comment were adopted, a third-party purchaser would be treated as purchasing stock that is immediately recharacterized as indebtedness for federal tax purposes. Such a rule would result in an issue price of the new debt instrument determined under section 1274, rather than section 1273, and might result in other collateral consequences to the third party purchaser.

4. Applicable Financial Statements

Comments requested clarification on the definition of the term applicable financial statement. For example, some comments suggested that the regulations define the term to mean the most recent regularly prepared financial statements, provided that the statements were prepared annually and that the taxpayer was not aware of any material adverse decline in the issuer's financial position. Other comments asked for clarification on the applicable financial statement that should be used if more than one member of the expanded group has a separate applicable financial statement. Proposed §1.385-2 referred to a combination of applicable financial statements in such a case. The final regulations clarify that, if there are multiple separate applicable financial statements that do not duplicate the assets or income of expanded group members, the applicable

financial statements must be combined to determine whether the expanded group is under the threshold for the application of the documentation rules. The final regulations provide that in the case of applicable financial statements that reflect the total assets or annual total revenue of the same expanded group member, the applicable financial statement with the greatest amount of total assets is to be used. The final regulations also provide rules that address the potential double counting of assets or revenue when a combination of applicable financial statements is used. However, the final regulations retain the rule that the set of applicable financial statements are those prepared in the past three years. This rule eliminates the possibility that the most recent applicable statement may not be representative of the long-term asset and revenue history of the expanded group. The Treasury Department and the IRS have determined that this history is an appropriate measure of whether a group should be subject to the documentation rules. Because the expanded group definition and the consolidation rules for financial accounting rules differ, it will frequently be the case that applicable financial statements will provide information about a set of corporations that does not precisely match the set of corporations in an expanded group. Applicable financial statements therefore provide an approximation of the assets and revenue of the expanded group. Thus, even if the most recent applicable financial statement were below the threshold, it may not provide definitive information about the assets and revenue of the expanded group.

One comment noted that, unless stock and notes of expanded group members were excluded from the computation of assets and income, such amounts could be duplicated in the calculation of total assets or total annual revenue. The final

regulations exclude expanded group member stock and notes, as well as any payments with respect to such stock or notes to the extent that those expanded group members are consolidated for financial accounting purposes in the applicable financial statements used to calculate whether the asset or revenue thresholds are met.

5. Consistency Rule

Proposed §1.385-2 provided that an EGI would be respected as indebtedness only if the documentation requirements were satisfied. Further, if an issuer treated an EGI as indebtedness, the issuer and all other persons, except the Commissioner, were required to treat the EGI as indebtedness for all federal tax purposes. Comments requested clarification of this rule if a taxpayer subsequently discovered that an interest it treated as indebtedness would be treated as stock under the documentation rules. The final regulations adopt these comments with respect to the consistency rule and clarify that only the issuer and holder of an EGI are subject to the consistency rule. Comments also urged that taxpayers be permitted to treat interests inconsistently with their classification under the documentation rule once an interest ceases to be subject to the rule, provided such inconsistencies were disclosed on the taxpayers' returns. The final regulations do not adopt this comment because the final regulations, including the consistency rule, would not apply to an EGI for the period it were not an EGI.

6. No Affirmative Use Rule

Proposed §1.385-2 included a rule providing that the documentation rules would not apply if a failure to comply with the rules had as a principal purpose reducing the federal tax liability of any person. Comments urged that this rule be removed, as they felt it caused significant uncertainty that could lead to conflicts with tax authorities.

Comments also urged that the rule be limited to failures of the requirement to document actions evidencing a debtor-creditor relationship, inasmuch as taxpayers that intended an interest to be treated as stock on issuance could simply fashion the interest as stock or nonqualified preferred stock at that time.

In response to comments, including comments about the no affirmative use rule creating unnecessary uncertainty, the Treasury Department and the IRS reserve on the application of the no affirmative use rule in §1.385-2 pending continued study after the applicability date.

7. Anti-Abuse Rule

Under proposed §1.385-2, if a debt instrument not issued and held by members of an expanded group was issued with a principal purpose of avoiding the documentation rules, the interest nevertheless would be subject to the documentation rules. Comments suggested that this broad anti-abuse rule be removed, or at least narrowed, so that it would not apply to loans between unrelated parties.

The Treasury Department and the IRS decline to remove the rule as it serves an important tax administration purpose. Without such a rule, applicable instruments not constituting EGIs could be issued, for example, by a non-corporate entity or a slightly less-related corporation to circumvent the documentation rules. Further, the Treasury Department and the IRS decline to adopt the suggestion to limit the rule to loans between related parties as that would permit the use of accommodation parties to avoid the documentation rules.

V. Comments and Changes to §1.385-3 — Certain Distributions of Debt Instruments and Similar Transactions

A. General approach of §1.385-3

1. Overview

The proposed regulations provided that, to the extent a debt instrument is treated as stock by reason of proposed §1.385-3, the debt instrument would be treated as stock for all federal tax purposes.

Comments requested that proposed §1.385-3 be withdrawn or thoroughly reconsidered before being finalized. Other comments recommended that proposed §1.385-3 be withdrawn and replaced with more limited rules, such as rules applicable solely to inverted entities or foreign-parented multinationals. Comments also recommended withdrawal of portions of the proposed regulations that would have a significant impact on ordinary business transactions. In some cases these comments specified which provisions should be withdrawn, such as the per se rule described in proposed §1.385-3(b)(3)(iv)(B), while in other cases, the comments did not specify which provisions should be withdrawn. In addition, comments suggested that the treatment of certain transactions (such as foreign-to-foreign issuances or C corporation-to-C corporation issuances) be excluded or reserved in the final and temporary regulations based on the U.S. tax status of the issuer or holder of the instrument, or based on whether the interest income from the instrument is subject to federal income tax.

As explained in this Part V.A, the Treasury Department and the IRS decline to adopt the alternative approaches suggested by comments and have determined that the general approach of proposed §1.385-3, including the per se funding rule, should be retained. However, based on the comments received, the Treasury Department and the IRS have determined that it is appropriate to make significant modifications to the scope

of transactions that must be considered in applying the final and temporary regulations in order to reduce the impact on ordinary business transactions. These modifications are described throughout this Part V.

The remainder of this Part V refers to the "per se funding rule" to mean either the rule described in proposed §1.385-3(b)(3)(iv)(B) or §1.385-3(b)(3)(iii) of the final regulations, or both, as the context requires.

2. U.S. Tax Status of Issuer or Holder

The final and temporary regulations do not limit the application of §1.385-3 to inverted entities or foreign-parented multinationals. Any two highly-related domestic corporations that compute federal tax liability on a separate basis have similar incentives to use purported debt to create federal tax benefits without having meaningful non-tax effects if one of the domestic corporations has taxable income and the other does not, for example due to net operating loss carryovers. Moreover, while an impetus for the regulations is the ease with which related-party debt instruments can be used to create significant federal tax benefits, the final and temporary regulations are narrowly focused on purported debt instruments that are issued to a controlling corporate shareholder (or person related thereto) and that do not finance new investment in the operations of the issuer. In developing regulations under section 385, the Treasury Department and the IRS have determined that, when these factors are present, it is appropriate to treat the debt instrument as reflecting a corporation-shareholder relationship rather than a debtor-creditor relationship across a broad range of circumstances.

Similarly, the final and temporary regulations do not adopt comments recommending an exception from §1.385-3 for instruments for which the interest income is subject to U.S. tax because it is: (i) paid to a U.S. corporation, (ii) effectively connected income of the lender, (iii) an amount subject to withholding for U.S. tax purposes, or (iv) subpart F income (within the meaning of section 952(a)). As explained in the preceding paragraph, the Treasury Department and the IRS have determined that, in the context of highly-related corporations (where the relatedness factor is also present), whether a purported debt instrument finances new investment is an appropriate determinative factor. Whether such factors are present is not dependent on the federal income tax treatment of payments on the instrument. Moreover, in all of the situations described in the comments in which an amount of interest is "subject to" U.S. tax, tax arbitrage opportunities would nonetheless arise if in fact the interest were not subject to tax at the full U.S. corporate tax rate and thus did not completely offset the related interest deduction. Since the rules apply only to payments between highly-related parties, one would expect taxpayers to seek to utilize related-party debt in those circumstances, so that such a broad exception would be inconsistent with the underlying rationale for these rules. Further, an exception based on the U.S. tax consequences of payments with respect to the instrument would require annual testing of the effective tax rate with respect to the payment and re-testing for any post-issuance transfers of the debt instrument to assess the tax status of each transferee and the payments thereto. This requirement could result in instruments that might otherwise be treated as equity pursuant to §1.385-3 switching between debt and equity classification from year to year, depending on how the payment was taxed. This generally would be

inconsistent with the purpose of section 385, which is to characterize an instrument as debt or equity for all purposes of the Code, and would be difficult for the IRS and taxpayers to administer.

Comments also recommended that distributions that are subject to U.S. tax be excluded from the general rule and funding rule. Comments asserted that such distributions do not facilitate earnings stripping and therefore should not implicate the concerns targeted under the proposed regulations. For reasons similar to those cited above for why the rules do not include an exception when interest is subject to U.S. tax, the Treasury Department and the IRS decline to adopt these comments. The final and temporary regulations are intended to address debt instruments that do not finance new investment in the operations of the borrower. The consequences of a distribution or acquisition to the recipient, whether the transaction is taxed as a dividend (including as a result of withholding tax), return of basis, or gain, does not affect the determination whether a close-in-time borrowing financed new investment in the operations of the borrower.

Thus, in general, the application of the final and temporary regulations to a debt instrument does not depend on the status of the instrument's holder, except in the case where the holder and issuer of the instrument are both members of the same consolidated group. As discussed in the preamble to the proposed regulations, §1.385-3 does not apply to instruments held by members of a consolidated group because the concerns addressed in §1.385-3 generally are not present when the issuer's deduction for interest expense and the holder's corresponding interest income precisely offset on the consolidated group's single consolidated federal income tax return. Specifically, in

addition to being reported on a single federal income tax return, the intercompany transaction rules of §1.1502-13 operate to ensure that the timing, character, and other attributes of such items generally match for federal income tax purposes. For example, the ordinary character of a borrowing member's repurchase premium with respect to an intercompany obligation results in the lending member recognizing as ordinary income what otherwise would be treated as capital gain if the members were taxed on a separate entity basis.

However, as discussed in Part III.A.1 of this Summary of Comments and Explanation of Revisions, and in response to comments received, the final and temporary regulations reserve on their application with respect to debt issued by foreign issuers due to the potential complexity and collateral consequences of applying the regulations in this context where the U.S. tax implications are less direct and of a different nature. In addition, as discussed in Part III.B.2.b of this Summary of Comments and Explanation of Revisions, the final and temporary regulations do not generally apply to S corporations or non-controlled RICs and REITs. Even though these entities are domestic corporations that can compute federal tax liability on a separate basis from their C corporation subsidiaries, the general approach in the Code is to tax these entities at the shareholder, rather than the corporate, level. Accordingly, they do not raise the same type of concerns that underlie the final and temporary regulations.

3. Entities with Disallowed or Minimal Interest Expense

Some comments requested an exception for U.S. issuers that are already treated as paying disqualified interest under section 163(j) (noting that United States real

property holding corporations (USRPHCs) in particular are often subject to such disallowance). Comments asserted that this would mitigate the concerns of the proposed regulations and proposed that an issuer paying disqualified interest be excluded from the scope of the regulations because further base erosion through related-party debt is not possible. Other comments stated that the rules should not apply to an entity with net interest income or only a de minimis amount of net interest expense.

The final and temporary regulations do not adopt the suggestion to exclude issuers with disqualified interest or issuers with low or no net interest expense because, as explained in Section A.1 of this Part V, the regulations are concerned about debt instruments that do not finance new investment, which does not depend on whether the borrower is excessively leveraged, has net interest income or expense, or is able to deduct its interest expense. The final and temporary regulations apply to distinguish debt from equity, whereas the rules under section 163(j) apply to all interest expense without the need to attribute interest to particular debt instruments. In addition, the disallowance under section 163(j) may vary from year to year, so that even if it were possible to trace interest limited under that section to a particular instrument, whether any particular instrument was so impacted would change from year to year. As discussed in Section A.1 of this Part V, annual retesting for purposes of an instrument's characterization would be inconsistent with the purpose of section 385 and would be difficult to administer. For these reasons, the Treasury Department and the IRS have determined that it would not be practical or administrable to create an exception under

the final and temporary regulations based on whether interest has been disallowed under section 163(j).

Furthermore, in the case of issuers with low or no net interest expense, a number of other exceptions provided in the final and temporary regulations will achieve a similar result for some entities. For example, as described in Section G.1 of this Part V, the final and temporary regulations provide an exception for debt instruments issued by certain regulated financial issuers, for which interest income often offsets interest expense. In addition, the final and temporary regulations expand the $50 million threshold exception in the manner described in Section E.4 of this Part V so that all taxpayers can exclude the first $50 million of indebtedness that otherwise would be recharacterized under §1.385-3. Finally, in order to further reduce compliance costs, the final and temporary regulations provide a broad exception to the funding rule for short-term debt instruments, as described in Section D.8 of this Part V, which generally applies to all non-interest bearing debt instruments as well as many other debt instruments that are short-term in form and substance. Similar to a net interest expense limitation, these new and expanded exceptions will, in combination, have the effect of exempting a number of entities with low net interest expense and will reduce the burden of complying with the final and temporary regulations in cases where the U.S. tax interest is limited. See also Section D.9 of this Part V, which addresses a related comment requesting that the final and temporary regulations permit taxpayers to net indebtedness "receivables" and "payables" for purposes of the funding rule.

4. Limiting Interest Deductibility without Reclassifying Interests

Comments also suggested addressing the policy concerns underlying the regulations by issuing guidance that more closely conforms to concepts used in section 163(j), which limits the deduction for interest on certain indebtedness in a taxable year. Section 385 authority differs fundamentally from section 163(j) because, rather than limiting interest deductions in a particular year, section 385 addresses the treatment of certain interests in a corporation as stock or indebtedness. While rules limiting interest deductions from excessive related-party indebtedness might address the broader policy concerns described in this preamble and in the notice of proposed rulemaking, Congress did not delegate such authority under section 163(j) to the Secretary. Accordingly, the final and temporary regulations are not intended to resolve the tax preference for using related-party debt to finance investment. Instead, the final and temporary regulations are more narrowly focused on the question of whether purported debt instruments issued to a controlling corporate shareholder (or a person related thereto) that do not finance new investment in the operations of the issuer reflect a corporation-shareholder relationship or a debtor-creditor relationship for purposes of the Code. The Treasury Department and the IRS have determined that this question is appropriately addressed under section 385 and, accordingly, that it is appropriate to treat such debt instruments generally as stock for federal tax purposes.

5. Group Ratio Test

One comment suggested that the regulations under §1.385-3 include an exception to the extent the issuing member's net indebtedness does not exceed its relative share of the expanded group's third-party indebtedness. The comment noted

that such a rule would be consistent with legislative proposals made by the Treasury Department to modify the interest expense disallowance rules under section 163(j).

The Treasury Department and the IRS decline to adopt this recommendation. While reference to an expanded group's third-party indebtedness could be part of a comprehensive solution to address the tax incentives to use related-party debt to create excessive leverage, as discussed in this Section A.1 of this Part V, the final and temporary regulations are more narrowly focused on purported debt instruments that do not finance new investment. The Treasury Department and the IRS have determined that, when this factor, along with the relatedness factor, is present, the purported debt instrument should be treated as stock without regard to whether the issuer is over-leveraged, whether by reference to the expanded group's third-party indebtedness or some other ratio. Furthermore, a member's relative share of the expanded group's third-party indebtedness generally would fluctuate every year as the group's income statement or balance sheet changes. An exception that varied based on such a ratio would therefore require that instruments that otherwise might be treated as equity pursuant to §1.385-3 instead switch between debt and equity classification from year to year, depending on the group's ratio for that year. As discussed in Section A.1 of this Part V, annual retesting for purposes of an instrument's characterization would be inconsistent with the purpose of section 385, and would be difficult for the IRS and taxpayers to administer.

6. Multi-factor Analysis

Some comments suggested that the regulations adopt a multi-factor debt-equity analysis similar to that traditionally undertaken by courts. The Treasury Department

and the IRS decline to adopt a multi-factor approach to §1.385-3. As discussed in Part II.A of this Summary of Comments and Explanation of Revisions, section 385 authorizes the Secretary to prescribe dispositive factors for determining the character of an instrument with respect to particular factual situations. Further, Congress enacted section 385 to resolve the confusion created by the multi-factor tests traditionally utilized by courts, which produced inconsistent and unpredictable results. See S. Rep. No. 91-552, at 138 (1969). The Treasury Department and the IRS have determined that it is necessary and appropriate to provide a clear rule regarding the characterization of issuances of purported debt instruments that do not finance new investment in the operations of the issuer. In contrast, recommendations for a multi-factor approach to address debt instruments that do not finance new investment could result in increased uncertainty for taxpayers, administrative difficulties for the IRS, and unpredictable case law.

7. Consistency with Base Erosion and Profit Shifting Outputs

Some comments claimed that the proposed regulations were inconsistent with the "best practice" recommendations that were developed as part of the G20 and Organisation for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) project under Action Item 4 (Limiting Base Erosion Involving Interest Deductions and Other Financial Payments). The report from that project recommended that countries adopt limitations on interest deductions that incorporate general group ratio and fixed ratio rules. The Treasury Department and the IRS have concluded that the final and temporary regulations are entirely consistent with the final report for Action Item 4, which recommends in paragraph 173 that, in addition to the

group ratio and fixed ratio rules, countries consider introducing domestic rules to address when "[a]n entity makes a payment of interest on an "artificial loan," where no new funding is raised by the entity or its group." Consistent with the Action Item 4 report, the final and temporary regulations provide targeted rules to address this concern.

Some comments also noted that the recharacterization of debt instruments as equity instruments under the proposed regulations would result in a significant increase in the number of hybrid instruments, contrary to the United States' endorsement of Action Item 2 (Neutralise the effects of hybrid mismatch arrangements) of the BEPS project, which recommended rules for neutralizing the effects of hybrid mismatch arrangements. The comments also noted that foreign countries could apply the BEPS hybrid mismatch rules to deny foreign interest deductions with respect to debt instruments issued by a foreign entity to a U.S. parent that were treated as stock under the proposed regulations, which could increase the foreign tax credits claimed by the U.S. parent.

The Treasury Department and the IRS do not agree that the final and temporary regulations are inconsistent with the goal of Action Item 2, which is to neutralize the tax effects of hybrid instruments that otherwise would create income that is not subject to tax in any jurisdiction, rather than to establish an international consensus on the treatment of particular instruments as debt or equity. Furthermore, because the final and temporary regulations reserve on their application to foreign issuers, hybrid instruments arising under the final and temporary regulations should not result in other jurisdictions applying the hybrid mismatch rules described in Action Item 2, which

generally apply only to instruments giving rise to a deduction in the issuer's jurisdiction with no corresponding inclusion in the lender's jurisdiction.

B. Treatment as stock for purposes of the Code

1. In General

Comments requested clarification as to the extent to which an interest treated as stock under the proposed regulations is treated as stock for all federal tax purposes. The Treasury Department and the IRS have determined that no further clarification is needed on this point. Consistent with the proposed regulations, the final and temporary regulations generally provide that an instrument treated as stock under the final and temporary regulations is treated as stock for all federal tax purposes. However, as further discussed in Section B.2 of this Part V, the final and temporary regulations provide that a debt instrument that is treated as stock under §1.385-3 is not treated as stock for purposes of section 1504(a).

Comments requested an alternative approach under which, to the extent a debt instrument is treated as stock under the regulations, equity treatment would apply solely for purposes of disallowing interest deductions under section 163, but the debt instrument would not be treated as stock for all other purposes of the Code. Other comments recommended that the proposed rules should not recharacterize a debt instrument to the extent that a taxpayer elects not to deduct interest otherwise allowable under section 163 with respect to a particular debt instrument. The Treasury Department and the IRS have not adopted these recommended approaches because, although section 385 authorizes the Secretary to prescribe rules to determine whether an interest in a corporation is treated as stock or indebtedness, neither section 385 nor

section 163 authorizes a broad rule that disallows an interest deduction under section 163 with respect to an instrument that is otherwise treated as indebtedness.

Comments also observed the potential for uncertainty or adverse results under the proposed regulations, particularly proposed §1.385-3, with respect to the following particular Code provisions and requested additional guidance or relief. In many cases, the recommended solution was a limited exception from equity treatment for a recharacterized instrument for purposes of the particular Code provision.

- Section 246. Comments noted that payments on a hybrid instrument (equity for federal income tax purposes, but debt for non-tax purposes) that affords the holder creditor rights may not qualify for the dividends received deduction under section 243. See section 246(c); Rev. Rul. 94-28 (1994-1 C.B. 86) (concluding that the holding period of such an instrument was reduced under section 246(c)(4)(A), which reduces the holding period for periods in which the taxpayer has an option to sell, or is under a contractual obligation to sell, the stock).
- Section 305. Comments requested clarification regarding the application of section 305 to a debt instrument recharacterized as stock. For example, a comment requested clarification regarding the application of section 305(c) to amounts that would represent accrued interest but for the recharacterization, which could result in a constructive distribution to the instrument holder. A comment also recommended that the final and temporary regulations provide that an interest reclassified as preferred stock should not cause section 305(c) to apply as a result of any discount resulting from the fact that the interest was

issued with a stated interest rate that is less than a market rate for dividends on preferred stock.

- Sections 336(e) and 338. A comment requested clarification regarding the qualification for, and results stemming from, asset sales that are deemed to occur when an election is made under section 336(e) or section 338. The comment posited a buyer making a section 338(g) election with respect to its purchase of a foreign target corporation, and certain of the foreign target's foreign subsidiaries, each of which is either the holder or issuer of an instrument that would have been recharacterized under proposed §1.385-3. The comment posed a series of questions, including whether the "old" and "new" entities are respected as unrelated or treated as successors, and how the recharacterized instruments affect calculations required under section 338.
- Section 368. Comments expressed concern that a debt instrument that is recharacterized as stock would constitute a discrete class of nonvoting stock for purposes of determining control under section 368(c), which could cause a transaction to fail to satisfy the control requirement of numerous nonrecognition provisions. See Rev. Rul. 59-259 (1959-2 C.B. 115) (holding that control within the meaning of section 368(c) requires ownership of 80 percent of the total number of shares of each class of nonvoting stock). One comment observed that a debt instrument recharacterized as stock could also affect whether the continuity of interest requirement for reorganizations in §1.368-1(e) is satisfied. Because continuity of interest is determined by reference to the value of the proprietary interests of the target corporation, a debt instrument that is treated as

target stock and that is redeemed for cash as part of the reorganization would dilute the percentage of acquirer stock in relation to total consideration. See §1.368-1(e)(1)(ii).

- Section 382. Comments observed that the recharacterization of an instrument could increase an existing shareholder's ownership of a loss corporation or result in the creation of a new shareholder for purposes of section 382 testing. In addition, a corresponding decrease in ownership could occur when a recharacterized debt instrument is retired. These transactions could cause an owner shift or ownership change within the meaning of section 382(g), which could limit the ability of a loss corporation (or loss group) to utilize losses of the issuing entity.
- Section 1503. Comments observed that recharacterized debt instruments could be treated as applicable preferred stock for purposes of section 1503(f)(3)(D), which could result in a member of a consolidated group losing the ability to utilize the group's losses or credits.
- Section 7701(l). Comments expressed concern that an instrument that is treated as stock could be subject to the fast-pay stock rules of §1.7701(l)-3, and observed that transactions involving fast-pay stock are listed transactions under Notice 2000-15 (2000-1 C.B. 826), thus imposing additional reporting requirements and penalties for noncompliance.
- Section 1.861-12T(f). One comment questioned whether treating purported indebtedness as stock would have consequences under §1.861-12T(f), which provides that, for purposes of apportioning expenses under an asset method for

purposes of section 904(d), in the case of any asset in connection with which interest expense accruing at the end of the taxable year is capitalized, deferred, or disallowed, the adjustment or fair market value is reduced by the principal amount of the indebtedness the interest on which is so capitalized, deferred, or disallowed.

- Provisions relating to hedging transactions. Comments expressed concern that an interest treated as stock under the final and temporary regulations would be ineligible for purposes of applying various hedging provisions in the Code and regulations that apply to debt instruments but not stock. See, e.g., §§1.954-2(a)(4)(ii), 1.988-5, and 1.1275-6.

Some comments suggested that the final and temporary regulations exercise the authority in section 351(g)(4) in order to treat any debt instrument that is treated as stock under the section 385 regulations as not stock for purposes of the control test in section 368(c) and other tests that are based on the ownership of stock. Section 351(g)(4) provides that the Secretary may prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 351(g) and sections 354(a)(2)(C), 355(a)(3)(D), and 356(e), as well as to prescribe regulations, consistent with the treatment under those sections, for the treatment of nonqualified preferred stock under other provisions of the Code. Some comments interpreted this authority broadly to authorize the Secretary to treat instruments treated as stock under section 385 as debt for all other purposes of the Code when the context suggested that the instruments were not being used to achieve federal tax benefits.

The final and temporary regulations retain the approach of the proposed regulations under which related-party indebtedness treated as stock by application of §1.385-3 is treated as stock for all federal tax purposes, with one exception with respect to section 1504 that is discussed in Section B.2 of this Part V. As discussed in Section A of this Part V, when a purported debt instrument issued to a highly-related corporation does not finance new investment in the operations of the issuer, the Treasury Department and the IRS have determined that it is appropriate to treat the purported debt instrument as stock for all federal tax purposes. Moreover, the issues described in the comments listed in this Section B.1 of this Part V generally do not arise uniquely as a result of the application of the final and temporary regulations but, rather, arise whenever purported debt instruments are characterized as stock under applicable common law. Several of these issues relate to longstanding uncertainties within those particular provisions, which are beyond the scope of the final and temporary regulations.

In addition, the final and temporary regulations provide new and broader exceptions than the proposed regulations, including an expanded $50 million threshold exception, the expanded group earnings exception, and the new qualified short-term debt exception. These exceptions are intended to accommodate ordinary course loans and distributions with the result that the final and temporary regulations focus on non-ordinary course transactions. Taking these exceptions into account, taxpayers generally will have the ability to avoid issuing debt instruments that will be treated as stock under §1.385-3, and therefore to avoid the ancillary issues described in the comments that are associated with recharacterization as stock. Accordingly, the Treasury Department and the IRS have determined that the final and temporary

regulations do not need to provide additional guidance, or additional exceptions, with respect to the specific scenarios described above, which also arise under the common law when purported debt instruments are treated as stock.

2. Limited Exception from Treatment as Stock: Section 1504(a)

Comments recommended that debt instruments treated as stock under the final and temporary regulations be treated as stock described in section 1504(a)(4), which is not treated as stock for purposes of the ownership requirements of section 1504(a). The recommended rule would prevent the recharacterization of a covered debt instrument issued by a member of a consolidated group under §1.385-3 from causing deconsolidation of the member.

Section 1504(a)(4) provides that, for purposes of section 1504(a), the term "stock" does not include certain preferred stock commonly referred to as "plain vanilla preferred stock." Specifically, section 1504(a)(4) provides that for purposes of section 1504(a), the term "stock" does not include any stock that meets four technical requirements: (i) the stock is not entitled to vote, (ii) the stock is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (iii) the stock has redemption and liquidation rights that do not exceed the issue price of the stock (except for a reasonable redemption or liquidation premium), and (iv) the stock is not convertible into another class of stock.

Comments observed that, in many instances, a debt instrument treated as stock as a result of §1.385-3 will qualify as section 1504(a)(4) stock; in particular, because the terms of such instrument often will be legally limited and preferred as to payments and will not participate in corporate growth to any significant extent. However, comments

observed that in some circumstances a debt instrument treated as stock under §1.385-3 will not qualify as section 1504(a)(4) stock because, for example, the instrument is deemed reissued at a premium or discount or is convertible into another class of stock. Comments noted that section 1504(a)(5) provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 1504(a), including by treating stock as not stock for purposes of that subsection.

The final and temporary regulations adopt the recommendation that debt instruments treated as stock under the final and temporary regulations should be treated as not stock for purposes of section 1504(a). This treatment is consistent with the statutory policy of treating stock that has certain legal features similar to debt as not stock for purposes of section 1504(a). The legislative history of section 1504(a)(5) indicates that Congress intended for the Secretary to use that authority to carry out the purposes of section 1504(a), including by treating certain stock that otherwise could cause members of an affiliated group to disaffiliate, as not stock. See H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 831, 834 (1984). Accordingly, pursuant to the authority under section 1504(a)(5)(A), the final and temporary regulations provide that a debt instrument that is treated as stock under §1.385-3 and that would not otherwise be described in section 1504(a)(4), is not treated as stock for purposes of determining whether a corporation is a member of an affiliated group under section 1504(a).

3. Allocation of Payments with respect to Bifurcated Instruments

Comments requested guidance concerning the allocation of payments to an instrument that is partially recharacterized as stock. For example, if USS borrows $100x with, which is treated as funding a distribution of $50x, and no exception applies,

half of the debt instrument would be treated as stock. If USS makes a $5x coupon payment with respect to the purported debt instrument, the proposed regulations did not specify the manner in which the payment would be allocated between the portion of the instrument treated as stock and the portion treated as debt.

Comments suggested the issuer should be permitted to determine the allocation of payments with respect to the portions of a bifurcated instrument. Comments also stated that, if an issuer fails to specifically allocate the payment, the payment should be allocated first to the debt portion of the instrument because such an allocation comports with general rules of corporate law. Other comments noted the possibility of allocating the payments on a pro rata basis.

The final and temporary regulations provide that a payment with respect to an instrument partially recharacterized as stock that is not required to be made pursuant to the terms of the instrument, for example a prepayment of principal, may be designated by the issuer as being with respect to the portion recharacterized as stock or to the portion that remains treated as indebtedness. If no such designation is made, the payment is treated as made pro rata to the portion recharacterized as stock and to the portion that remains treated as indebtedness.

The Treasury Department and the IRS decline to accept the recommendation to provide similar optionality for payments that are required to be made pursuant to the terms of the agreement. In that situation, the Treasury Department and the IRS are of the view that, because the instrument will provide for payments with respect to the entire instrument, it is appropriate to treat those payments as made pro rata with

respect to the portion recharacterized as stock and to the portion that remains treated as indebtedness.

4. Repayments Treated as Distributions

Several comments recommended that the final and temporary regulations include rules to address "cascading" recharacterizations; that is, situations in which the recharacterization of one covered debt instrument could lead to deemed transactions that result in the recharacterization of one or more other covered debt instruments in the same expanded group. Comments generally addressed two different scenarios. The first scenario involved payments made by the issuer with respect to recharacterized instruments. Those payments would be treated as distributions on stock for purposes of the funding rule, which could result in one or more of the issuer's other covered debt instruments being treated as stock. Those transactions are addressed in this Section B.4. The second scenario involved the treatment of the lending member with respect to acquisitions of instruments treated as stock, which could also result in the recharacterization of covered debt instruments issued by the lending member. This second scenario is addressed in Section B.5 of this Part V.

Regarding the first set of transactions, comments noted that, under the proposed regulations, a repayment of a debt instrument recharacterized as stock is treated as a distribution for purposes of the funding rule, and as such may cause a recharacterization of other debt instruments under the funding rule. Comments requested that the final and temporary regulations prevent this by providing that repayments or distributions with respect to recharacterized stock be disregarded for

purposes of the funding rule. For the reasons set forth below, the final and temporary regulations do not adopt this request.

Section 1.385-3(f)(4) of the proposed regulations defined a distribution as any distribution made by a corporation with respect to its stock. Under the proposed regulations, a debt instrument treated as stock under §1.385-3 was generally treated as stock for all purposes of the Code. As a result, a payment with respect to a recharacterized debt instrument was treated as a distribution for purposes of the funding rule. Comments asserted that the interaction of these rules resulted in duplicative recasts. For example, assume that a foreign parent corporation (FP) wholly owns a U.S. subsidiary (S1). FP lends $100x to S1 in exchange for Note A (transaction 1), and within 36 months, S1 distributes $100x of cash to FP (transaction 2), resulting in Note A being recharacterized as stock under proposed §1.385-3(b)(3)(ii)(A). Then, S1 repays the entire $100x principal amount of Note A (transaction 3), which is treated as a distribution, including for purposes of the funding rule because Note A is treated as stock. Next, within 36 months after transaction 3, FP again lends $100x to S1 in exchange for Note B (transaction 4). The proposed regulations would treat Note B as funding the deemed distribution in transaction 3. Therefore, as a result of transaction 3 and transaction 4, Note B is recharacterized as stock under proposed §1.385-3(b)(3)(ii)(A).

Comments asserted that this result is duplicative because both Note A and Note B are treated as stock. The Treasury Department and the IRS do not agree with this assertion, and as a result the final and temporary regulations do not provide for a different result. In this series of four transactions, on a net basis S1 has distributed

$100x to FP and has outstanding a $100x loan from FP (Note B). If the final and temporary regulations adopted the comment and did not treat transaction 3 as resulting in a distribution for purposes of the funding rule, then Note B would not be recharacterized as stock even though the series of transactions results in a funded distribution.

The Treasury Department and the IRS decline to adopt this comment because the funding rule could be circumvented if the repayment of a note that is treated as stock were not treated as a distribution. Applying the comment's requested change to the facts above, the repayment of Note A would redeem that particular instrument, which could then be replaced with Note B in transaction 4, putting the parties in an economically similar position but avoiding the application of §1.385-3.

One comment did not dispute the successive recharacterizations of Note A and Note B for the funding rule, but argued that the successive recasts nonetheless resulted in duplicative income inclusions, since each repayment would result in a dividend to the extent of current and accumulated earnings and profits. The Treasury Department and the IRS did not revise the final and temporary regulations for this comment because the potential for multiple dividend inclusions is a consequence of the subchapter C rules that treat distributions with respect to stock (including certain redemptions) as being made first out of the corporation's current and accumulated earnings and profits to the extent thereof, rather than a result specific to the application of §1.385-3.

On the other hand, to prevent inappropriate duplication under the funding rule in fact patterns like the preceding example, §1.385-3(b)(6) of the final regulations clarifies that once a covered debt instrument is recharacterized as stock under the funding rule,

the distribution or acquisition that caused that recharacterization cannot cause a recharacterization of another covered debt instrument after the first instrument is repaid. Thus, the distribution in transaction 2 that caused the recharacterization of Note A cannot cause a recharacterization of another covered debt instrument. For a discussion of a coordination rule that supersedes this non-duplication rule during the transition period while covered debt instruments that otherwise would be recharacterized as stock are not treated as stock, see Section B.2 of Part VIII of this Summary of Comments and Explanation of Revisions.

5. Iterative Recharacterizations

The second set of cascading transactions addressed by comments involves a type of iterative recharacterization. Specifically, comments noted that when a debt instrument is recharacterized as stock under the proposed regulations, the holder of the instrument is treated as acquiring stock of an expanded group member instead of indebtedness. If that holder were itself funded, the recharacterized instrument could, in turn, cause a recharacterization of the holder's own borrowing. For example, assume that P is the parent of an expanded group, and directly owns all of the stock of S1 and S2. If P loaned $100x to S1, S1 loaned $100x to S2, and S2 distributed $100x to P, S1's loan to S2 would be recharacterized as stock under the funding rule, and S1's acquisition of the S2 instrument would be treated as an acquisition of S2 stock that would cause S1's loan from P to be treated as stock under the funding rule. Comments expressed concern that an initial recharacterization could thus lead to a multitude of recharacterized instruments throughout the expanded group.

To address this concern, comments recommended an exception to the funding rule when, during the per se period described in proposed §1.385-3(b)(3)(iv)(B), a funded member makes an advance to a second expanded group member, and that advance to the second expanded group member is characterized as stock of the second expanded group member under §1.385-3. Comments stated that this series of transactions can occur frequently when the first funded member makes and receives advances frequently, particularly in connection with cash pooling and cash pool headers (as described in Section D.8 of this Part V), and thus could spread the recharacterizations throughout the cash pooling arrangement.

The Treasury Department and the IRS expect that the changes adopted in the final and temporary regulations limiting the application of §1.385-3 to domestic issuers and providing a broad exception for short-term indebtedness, including deposits with a qualified cash pool header, should substantially address the concerns regarding iterative recharacterizations of covered debt instruments. Nonetheless, in response to comments, the final and temporary regulations include a limited exception to the funding rule for certain acquisitions of expanded group stock that result from the application of §1.385-3, which include not only covered debt instruments that are recharacterized as expanded group stock under the funding rule, but also acquisitions of stock of an expanded group partner and a regarded owner under the rules described in Sections H.4 and 5 of this Part V. If this new exception applies, in the example above, S1's loan to S2 would still be treated as stock under the funding rule, but S1's acquisition of the S2 instrument would not be treated as an acquisition of S2 stock that would cause S1's loan from P to be treated as stock under the funding rule.

The Treasury Department and the IRS intend for this exception to address the concern raised in comments about unintentional serial recharacterizations. Therefore, this exception does not apply if the acquisition of deemed stock by means of the application of the funding rule is part of a plan or arrangement to prevent the application of the funding rule to a covered debt instrument.

6. Inadvertent Recharacterization

Comments noted that, in many instances, a borrower could trigger the application of the funding rule through simple inadvertence or genuine mistake (for example, incorrectly estimating earnings and profits despite reasonable effort). In addition, a taxpayer that is unaware that a debt instrument within the expanded group is treated as stock under §1.385-3 could engage in transactions that result in unanticipated ancillary consequences.

One comment offered the following example: FP wholly owns both FS and USS1, and USS1 wholly owns both USS2 and USS3. In year 1, FS loans $10x to USS2. Later in year 1, USS2 distributes $10x to USS1 and, either through a simple mistake or a good faith but erroneous belief that an exception to recharacterization applies, the expanded group fails to take into account the treatment of the USS2 note as stock under §1.385-3. Subsequently, in a transaction intended to qualify under section 351, USS1 contributes the stock of USS3 to USS2. Because FS holds recharacterized stock in USS2, USS1 fails to satisfy the section 368(c) control requirement of section 351(a) and is thus subject to tax on any unrealized gain in the USS3 stock.

Comments also included examples in which the inadvertent failure caused a termination of a consolidated group or of a special tax status of the issuer (for example,

failure to qualify as a REIT). Comments requested that an issuer be permitted to cure the inadvertent recharacterization within a reasonable period after becoming aware of the correct treatment of the instrument under the final and temporary regulations. One proposal suggested that the issuer be permitted to eliminate the debt by cancellation or repayment within a specified time period, with such elimination presumably considered retroactive to the issuance. A similar proposal requested that an issuer be permitted to cure an instrument recharacterized by the funding rule by making an equity contribution sufficient to offset any reduction in net equity, regardless of whether the recharacterized instrument remains outstanding. As discussed in Part IV.A.3.c of this Summary of Comments and Explanation of Revisions, comments also suggested expanding the scope of the reasonable cause exception in proposed §1.385-2(c)(1) to apply to instruments recharacterized under the documentation rules by adopting a more lenient standard than those used in §301.6724-1, that is, the presence of significant mitigating factors with respect to a failure or a failure arising from events beyond the control of the members of the expanded group.

The Treasury Department and the IRS decline to adopt the recommendation to provide a general remediation rule that would allow certain taxpayers to mitigate the ancillary consequences of issuing stock beyond the specific and limited exceptions for certain iterative recharacterizations discussed in Section B.5 of this Part V and certain qualified contributions discussed in Section E.3.b of this Part V because of concerns about administering the regulations and concerns about providing taxpayers a right, but not an obligation, to retroactively change the character of a transaction. Moreover, the Treasury Department and the IRS have determined that the significant scope changes

to the final and temporary regulations, including the narrowing of the regulations to only apply to covered debt instruments, the addition of several new exceptions to §1.385-3, the expansion of existing exceptions to §1.385-3, and the explicit treatment of recharacterized stock as not stock for purposes of section 1504(a) will reduce the instances of, and mitigate the effects of, inadvertent recharacterizations under the final and temporary regulations.

7. Hook Stock

One comment observed that the proposed regulations would increase the instances in which a debt instrument issued by a corporation would be treated as stock held by a direct or indirect subsidiary, commonly referred to as hook stock. The comment recommended that the regulations provide rules to avoid the creation of hook stock. The final and temporary regulations do not generally adopt this recommendation. The Treasury Department and the IRS have determined that consideration of whether a debt issuance finances new investment, in the context of related parties, are appropriate determinative factors with respect to debt-equity characterization across a broad range of circumstances. However, as discussed in Section E.2.a of this Part V, the final and temporary regulations expand the subsidiary stock issuance exception in proposed §1.385-3(c)(3) into a new "subsidiary stock acquisition exception" that excludes from the general rule and funding rule certain acquisitions of existing stock from a majority-controlled subsidiary, which eliminates one type of transaction that otherwise would have the effect of creating hook stock. However, outside of the specific exceptions discussed in Section E of this Part V, the Treasury Department and the IRS have determined that special rules are not warranted when an issuer's direct or indirect

subsidiary holds an interest that would be treated as stock under the final and temporary regulations.

8. Income Tax Treaties

This section addresses comments received related to concerns regarding the impact of the proposed regulations on the application of the income tax treaties to which the United States is a party.

a. Limitation on benefits (LOB) article

In order to qualify for treaty benefits on U.S. source income, a resident of a treaty partner must satisfy all of the requirements set forth in the applicable treaty, including the requirement that the resident satisfy the Limitation on Benefits" (LOB) article, if any, of the applicable treaty. Among other requirements, several LOB tests require that the resident of the treaty partner meet certain vote-and-value thresholds for stock ownership by certain qualified persons or equivalent beneficiaries. Some comments noted that, by recharacterizing debt into non-voting stock, the proposed regulations could cause a foreign corporation that previously satisfied a stock ownership threshold to no longer qualify for treaty benefits because of a dilution of the value of its stock owned by certain qualified persons or equivalent beneficiaries.

The comments concerning LOB qualification arise in the context of foreign issuers claiming treaty benefits on U.S. source income. Many of the comments acknowledged that not applying the regulations to foreign issuers would alleviate these concerns. Accordingly, these comments are addressed by the decision to reserve on the application of the final and temporary regulations to foreign issuers.

b. Character of payments

Some comments noted that if the proposed regulations applied to recharacterize purported debt instruments as equity for all purposes of the Code, it would change the tax treatment of payments made by U.S. issuers to foreign persons that qualify for benefits under U.S. tax treaties. Comments expressed concern that purported payments of interest and repayments of principal would be treated as dividend payments, the taxation of which would be governed by the dividends article of U.S. tax treaties, which generally result in withholding at a higher rate (including a 15 percent rate in the case of dividends paid to a beneficial owner that does meet certain direct ownership thresholds) than withholding on interest. Comments argued that the definition of "dividends" in U.S. tax treaties should not encompass payments made under instruments that are recharacterized as equity under §1.385-3**.**

The final and temporary regulations generally treat purported debt instruments as equity for all purposes of the Code, which often will result in payments under the instrument being treated as dividends, including for purposes of applying U.S. tax treaties. Treating the recharacterized instrument as giving rise to dividends is consistent with the manner in which U.S. tax treaties generally define the term "dividends" as "[i]ncome from shares or other rights, not being debt-claims, participating in profits, as well as income that is subject to the same taxation treatment as income from shares under the laws of the Contracting State of which the company making the distribution is a resident." The 1996, 2006, and 2016 U.S. Model tax treaties, as well as the OECD Model Tax Convention, all contain similar language. Because the treaty defines the term to include any "income that is subject to the same taxation treatment as income from shares," and because, under the final and temporary regulations and other

applicable Code provisions, U.S. law generally treats a payment with respect to an instrument recharacterized as equity as a dividend from shares for all purpose of the Code, dividend treatment is consistent with the terms of U.S. tax treaties. Further, if the treaty does not define the term dividends, the domestic law of the country applying the treaty generally prevails, unless the context otherwise requires.

c. Associated enterprises

Comments suggested that the proposed regulations conflict with the arm's length principle incorporated in Article 9 (Associated Enterprises) of U.S. tax treaties because a result of recharacterizing debt into equity is a denial of deductions for interest payments even though those payments were made on arm's length terms. Comments raised similar concerns with respect to section 482 and the arm's length principle outside of the treaty context, asserting that characterizing a purported debt instrument as stock based on another transaction occurring during the per se period was inconsistent with the arm's length principle. The Treasury Department and the IRS have determined that these comments mischaracterize the operation of Article 9 as well as section 482. Although Article 9 governs the appropriate arm's length terms (that is, pricing and profit allocation) for transactions entered into between associated enterprises, the arm's length principle reflected in Article 9 and section 482 is not relevant for delineating the transaction that is subject to the arm's length principle. Thus, for example, the arm's length principle may apply to determine the appropriate rate of interest charged on a loan, but it would not apply to the classification in the first instance of whether an instrument is debt or equity, which is a determination made under the relevant domestic law of the jurisdiction that is applying the treaty. Under

federal income tax law, the characterization of transactions, including determining debt versus equity, is not determined by reference to the arm's length standard. See §1.482-2(a)(1) and (a)(3)(i). Furthermore, as discussed in Section B.8.b of this Part V, an instrument recharacterized as equity under §1.385-3 will result in payments being treated as dividends, including for purposes of U.S. tax treaties. Therefore, the arm's length principle incorporated in Article 9 does not conflict with the characterization of a purported debt instrument of a U.S. issuer as equity under §1.385-3.

d. Non-discrimination

Several comments asserted that the proposed regulations implicate the non-discrimination provisions of U.S. tax treaties. These comments assert that the non-discrimination article generally prevents the United States from denying a deduction for interest paid to a resident of a treaty partner where interest paid to a U.S. resident under the same conditions would be deductible.

The Treasury Department and the IRS disagree that the final and temporary regulations raise discrimination concerns. The regulations apply broadly to U.S. issuers and would recharacterize purported debt instruments as equity under specified conditions that apply equally regardless of the residence of the payee. Although debt issued by a member of a U.S. consolidated group to another member of the group is not subject to recharacterization under these rules, the recharacterization does not depend on whether the lender is a U.S. or foreign person, but on whether the lender files (or is required to file) a consolidated return with the issuer. For example, debt issued by a non-consolidated domestic corporation to another non-consolidated domestic corporation is subject to §1.385-3 to the same extent as debt issued to a foreign

corporation that is unable to consolidate with the domestic corporate issuer. The consolidation (or other similar) rules of both the United States and other treaty countries, which are generally limited to domestic affiliates, contain numerous special rules that are generally understood not to raise discrimination concerns. See, e.g., paragraph 77 of Commentary on Article 24 of the OECD Model Convention with Respect to Taxes on Income and on Capital. Therefore, the final and temporary regulations do not implicate the non-discrimination provisions of Article 24 (Non-discrimination) of U.S. treaties.

C. Exchange transactions that are subject to §1.385-3(b)

1. Overview

The general rule under proposed §1.385-3(b)(2) treated as stock any debt instrument issued by a member of an expanded group to another member of the same expanded group in one of three transactions: (i) in a distribution; (ii) in exchange for the stock of a member of the expanded group, other than pursuant to certain identified exempt exchanges; and (iii) in exchange for property in an internal asset reorganization, but only to the extent that, pursuant to the plan of reorganization, an expanded group shareholder receives the debt instrument with respect to its stock in the transferor corporation. The funding rule under proposed §1.385-3(b)(3) generally treated as stock any debt instrument issued by a funded member in exchange for property that was treated as funding one of the three transactions described in the general rule.

The distributions and acquisitions described in the three prongs of the general rule and funding rule are referred to in this Part V as distributions and acquisitions, unless otherwise indicated or the context otherwise requires. Separately, unless

otherwise indicated or the context otherwise requires, for purposes of this Part V, acquisitions described in the second prong of the general rule and funding rule are referred to as "internal stock acquisitions," and acquisitions described in the third prong of the general rule and funding rule are referred to as "internal asset reorganizations."

The preamble to the proposed regulations explained the policy concerns underlying the three transactions described in proposed §1.385-3(b)(2). In describing concerns involving distributions of indebtedness, the preamble first noted that courts have closely scrutinized situations in which indebtedness is owed in proportion to stock ownership to determine whether a debtor-creditor relationship exists in substance. This is consistent with the relatedness factor in section 385(b)(5). The preamble also cited case law that has given weight to the lack of new investment when a closely-held corporation issues indebtedness to a controlling shareholder but receives no new investment in exchange. In addition, the preamble stated that the distribution of indebtedness typically lacks a substantial non-tax business purpose. With respect to debt instruments issued for stock of a member of the expanded group, the preamble noted that these transactions are (i) similar in many respects to distributions of indebtedness and therefore implicate similar policy concerns, (ii) could serve as a ready substitute for distributions of notes if not addressed, and (iii) frequently have limited non-tax significance. Finally, with respect to debt instruments issued in connection with internal asset reorganizations, the preamble explained that such transactions can operate similar to internal stock acquisitions as a device to convert what otherwise would be a distribution into a sale or exchange transaction without having any meaningful non-tax effects.

Several comments requested that the second and third prongs of the general rule and funding rule be narrowed or eliminated. The comments stated that such transactions are not economically or otherwise similar to a distribution of a note and thus should not be subject to the rules. Comments distinguished a distribution of debt, which reduces the value in corporate solution, from a stock acquisition or asset reorganization, which typically incorporates an exchange of value for value. Other comments suggested replacing the second and third prongs of the general rule and funding rule with an anti-abuse rule. In contrast, one comment suggested that the general rule should be broadened to include any transaction having a similar effect to the transactions described in the proposed regulations.

As explained in the remainder of this Part V.C, after considering the comments, the Treasury Department and the IRS, with one exception described in Section C.3.c of this Part V, continue to view the transactions described in the second and third prongs of proposed §1.385-3(b)(2) and (b)(3) as sufficiently economically similar to distributions such that they should be subject to the same rules and should not be reduced to an anti-abuse rule or excluded altogether. Accordingly, the final and temporary regulations retain the second and third prongs of proposed §1.385-3(b)(2) and (3) with the modifications described in this Part V.C in response to comments received.

2. Definitions of Distribution and Property

One comment recommended that the final and temporary regulations specifically define the term distribution. The proposed regulations defined the term distribution as any distribution by a corporation with respect to the distributing corporation's stock, and the final and temporary regulations retain that definition.

A comment also recommended that the final and temporary regulations clarify the definition of the term property for purposes of the funding rule in the context of an exchange described in the second and third prongs of the funding rule. Consistent with the proposed regulations, the final and temporary regulations define the term property by reference to section 317(a). The comment asserts that it is not clear how the statement in section 317(a) that the term property does not include stock of a distributing corporation should be interpreted in the context of an exchange of property for stock or assets described in the second and third prongs of the funding rule. The Treasury Department and the IRS have determined that there is no need to clarify the term property in this context. The second prong of the funding rule applies to certain acquisitions of expanded group stock by a covered member in exchange for property other than expanded group stock (rendering moot the relevance of the reference in section 317(a) to stock of the distributing corporation). The third prong of the general rule addresses acquisitions of certain assets, and includes no specific requirement regarding property exchanged by the acquirer.

The remainder of this Part V.C responds to comments regarding the scope of the exchange transactions that are included in the second and third prongs of the general rule and funding rule.

3. Acquisitions of Expanded Group Stock

The second prongs of the general rule and funding rule apply to certain acquisitions of expanded group stock in exchange for a debt instrument or in exchange for property, respectively. These rules apply both to acquisitions of expanded group

stock other than by issuance (existing stock) and to acquisitions of expanded group stock by issuance (newly-issued stock).

a. Acquisitions of existing stock in general

The Treasury Department and the IRS continue to view a transfer of property (including through the issuance of a debt instrument) to a controlling shareholder (or a person related to a controlling shareholder) in exchange for existing expanded group stock as having an economic effect that is similar to a distribution. In general, a distribution with respect to stock occurs when there is a transfer of property from a corporation to its shareholder in the shareholder's capacity as such—that is, other than in a value-for-value exchange. Although an acquisition of existing expanded group stock from a controlling shareholder (or a person related to a controlling shareholder) may, in form, be a value-for-value exchange, it generally does not change the ultimate ownership of the corporation whose stock is acquired (target). Furthermore, although neither the corporation that acquires the stock (the acquirer) nor the target experiences a standalone reduction in its assets, the combined capital of the acquirer and the target is decreased by the value transferred to the selling shareholder (in other words, by the value of the "sale" proceeds). Thus, similar to a distribution with respect to stock, the transaction effects a distribution of value from the acquirer to the selling shareholder when the post-transaction acquirer and target are considered together. As noted in the preamble to the proposed regulations, viewing the acquirer and target on a combined basis in this context is consistent with the enactment of section 304, which reflects Congress's recognition that a purchase of affiliate stock generally has the effect of a distribution with respect to stock. See S. Rep. No. 83-1622 at 46 (1954).

For the foregoing reasons, and the reasons discussed in the preamble to the proposed regulations, the Treasury Department and the IRS have determined that acquisitions of existing expanded group stock should continue to be included in the general rule and funding rule. However, as discussed in Section C.3.c of this Part V, in response to comments, the final and temporary regulations provide a new exception for certain acquisitions of existing expanded group stock by a member from its majority-owned subsidiary.

b. Acquisitions of newly-issued stock

The proposed regulations applied to two categories of acquisitions of newly-issued stock: (i) acquisitions of newly-issued stock from a member that has direct or indirect control of the acquiring member (hook stock); and (ii) acquisitions of newly-issued stock from a member that does not have direct or indirect control of the acquiring member (non-hook stock). While comments generally acknowledged the similarity between acquisitions of newly-issued hook stock and distributions, several comments asserted that acquisitions of newly-issued non-hook stock are not economically similar to a distribution and thus should be excluded from the second prongs of the general rule and funding rule. One comment recommended an exclusion for acquisitions of affiliate stock by issuance as long as such stock was acquired pursuant to arm's length terms.

Under the proposed regulations, acquisitions of newly-issued stock, whether hook-stock or non-hook stock, were described in the second prongs of the general rule and funding rule. However, solely for purposes of the funding rule, the proposed regulations provided an exception for certain acquisitions of newly-issued stock in a majority-owned subsidiary (subsidiary stock issuance exception), whereby an

acquisition of the stock in the subsidiary was exempt from the funding rule if, for the 36-month period immediately following the issuance, the acquirer held, directly or indirectly, more than 50 percent of the total voting power and value of the stock. For this purpose, indirect ownership was determined applying the principles of section 958(a) without regard to whether an intermediate entity is foreign or domestic.

Comments requested that the subsidiary stock issuance exception be expanded to apply to any acquisition of newly-issued non-hook stock, regardless of whether the acquirer owned a majority interest in the issuer following the acquisition. Comments reasoned that an acquisition of non-hook stock, unlike an acquisition of hook stock or existing stock described in section 304, is not economically similar to a distribution because (i) the acquisition is not described in a dividend provision of the Code, (ii) the acquiring member's equity value is not reduced by reason of the acquisition, and (iii) in contrast to transactions that are described in section 304, the combined value of the acquirer and the issuer is not reduced by reason of the acquisition.

The final and temporary regulations do not adopt this comment. As a result, the second prongs of the general rule and funding rule continue to apply to acquisitions of newly-issued stock when the acquirer owns, directly or indirectly, only a minority interest in the issuer of the stock. Such acquisitions are economically similar to a distribution in that the acquirer diverts capital from its operations to an affiliate controlled, directly or indirectly, by the acquirer's ultimate shareholder in exchange for a minority interest in the affiliate. In the context of highly-related corporations, holding a minority interest in an affiliate generally lacks meaningful non-tax consequences, and such an interest could be structured for tax avoidance purposes. Accordingly, the Treasury Department

and the IRS have determined that, if such transactions were excluded from the second prong of the funding rule, they would become a ready substitute for distributions as a way to use purported debt instruments to produce significant federal tax benefits without financing new investment in the operations of the obligor. That is, if the second prong did not apply to such transactions, the purposes of the final and temporary regulations could be avoided by having the obligor divert the proceeds of the purported financing to the common parent through the transfer of those proceeds to the common parent's majority-owned subsidiary.

c. Acquisitions of existing stock from a majority-owned subsidiary

Comments requested that the subsidiary stock issuance exception be extended to apply to an expanded group member's acquisition of existing stock in another expanded group member from the acquiring expanded group member's majority-owned subsidiary. Thus, for example, comments requested that an acquisition by a first-tier wholly owned subsidiary (S1) of the stock of a third-tier wholly owned subsidiary (S3) from a second-tier wholly owned subsidiary (S2) in exchange for property be excluded from the second prong of the funding rule.

The Treasury Department and the IRS have determined that an acquisition of existing stock, like an acquisition of newly-issued non-hook stock from a majority-owned subsidiary, does not implicate the same policy concerns as other transactions described in the second prongs of the general rule and funding rule when the acquiring member owns more than 50 percent of the stock in the selling member. Specifically, an acquisition of existing stock from a majority-owned subsidiary, like an acquisition of newly-issued stock from a majority-owned subsidiary, generally is not economically

similar to a distribution because the consideration provided to the seller is indirectly controlled by the acquirer through its majority interest in the seller. In contrast, if the acquirer does not, directly or indirectly, own more than 50 percent of the seller after the acquisition, the acquisition has the same potential for making the sale proceeds available to the common parent as when funds are transferred in exchange for newly-issued stock that is a minority interest. Accordingly, the final and temporary regulations expand the subsidiary stock issuance exception to include acquisitions of existing stock from a majority-owned subsidiary under the same conditions applicable to acquisitions of newly-issued non-hook stock from a majority-owned subsidiary, and refer to the expanded exception as the subsidiary stock acquisition exception. The specific requirements of the subsidiary stock acquisition exception are discussed in Section E.2.a of this Part V.

d. Acquisitions of stock in exchange for a debt instrument

Comments recommended that the subsidiary stock issuance exception be expanded to cover acquisitions of the stock of a controlled subsidiary described in the general rule (for example, when an expanded group member contributes its note to a majority-owned subsidiary for additional stock), based on the view that a transaction described in the general rule is economically similar to a transaction described in the funding rule and thus should receive similar treatment under §1.385-3. The Treasury Department and the IRS agree with this recommendation. In general, the funding rule is designed to stop taxpayers from achieving in multiple steps what the general rule prohibits from being accomplished in one step. Accordingly, the final and temporary regulations provide that an acquisition of expanded group stock (both existing stock and

newly issued stock) from a majority-controlled subsidiary in exchange for the acquirer's note qualifies for the exception on the same terms as a funded acquisition.

4. Acquisitions of Expanded Group Assets Pursuant to a Reorganization

Comments also asserted that the transactions described in the third prongs of the general rule and funding rule are not economically similar to a distribution and therefore should not be subject to proposed §1.385-3. The preamble to the proposed regulations stated that the third prongs of the general rule and funding rule were included because the issuance of a debt instrument in an internal asset reorganization is similar in many respects to the issuance of a debt instrument to make a distribution or to acquire expanded group stock. For the same reasons described in the preamble to the proposed regulations, the Treasury Department and the IRS continue to view the transfer of "other property" in certain internal asset reorganizations as having an economic effect that is similar to a distribution or an internal stock acquisition. As discussed in Section C.3.a of this Part V, a distribution with respect to stock generally is a transfer of value from a corporation to its shareholder in its capacity as such and therefore other than in a value-for-value exchange. A corporation obtains a similar result when, as part of an acquisitive asset reorganization, the corporation (acquirer) issues a debt instrument or transfers other property in exchange for the assets of a highly-related affiliate (target), which in turn, distributes the debt instrument or other property to the common shareholder with respect to its target stock. In such a transaction, the combined pre-acquisition capital of the acquirer and the target is decreased to the extent of the value of the non-stock consideration received by the common shareholder in exchange for its target stock. Accordingly, similar to a

distribution with respect to stock, the transaction effects a distribution of value from the combined entity to the common shareholder.

Congress acknowledged that an asset reorganization between highly-related parties can have the effect of distributing value to a common shareholder when it provided in section 356(a)(2) that "other property" received by the common shareholder in exchange for its target stock generally is treated as a dividend to the extent of earnings and profits. The premise of section 356(a)(2) is that, when a shareholder exchanges its stock in one controlled corporation for property of equal value from another controlled corporation, the property represents an extraction of value from the combined entity consisting of the two controlled corporations to the common shareholder. For the same reason, the Treasury Department and the IRS have determined that an internal asset reorganization in which a member of the expanded group receives property described in section 356 has an economic effect that is similar to a distribution. Thus, the final and temporary regulations continue to include internal asset reorganizations within the third prongs of the general rule and funding rule.

Other comments recommended the withdrawal of the third prongs of the general rule and funding rule based on an asserted inconsistency with the "boot-within-gain" rule in section 356(a)(2). Under section 356(a)(1), an exchanging shareholder is required to recognize gain equal to the lesser of the gain realized in the exchange or the amount of money or other property received by the shareholder. If the exchange has the effect of a distribution of a dividend, then section 356(a)(2) provides that all or part of the gain recognized by the exchanging shareholder is treated as a dividend to the extent of the shareholder's ratable share of the corporation's earnings and profits. Under the "boot-

within-gain" rule, dividend treatment under section 356(a)(2) is limited by the gain in the shareholder's stock in the transferor corporation. Comments asserted that, by converting a debt instrument that would constitute other property into stock, the third prong of the general rule effectively achieves a result that the Treasury Department and the IRS could not otherwise accomplish under section 356(a)(2) because payments of interest and principal made on the recharacterized debt instrument generally would be characterized as dividend income to the extent of the earnings and profits of the issuing corporation, without regard to the gain in the shareholder's stock in the transferor corporation. Accordingly, comments recommended that the Treasury Department and the IRS withdraw the third prongs of the general rule and funding rule. Alternatively, comments recommended that the final and temporary regulations include a coordination rule that would effectively preserve the effect of section 356(a)(2), without specifying how this rule would operate.

The Treasury Department and the IRS decline to adopt this recommendation. Section 385 provides specific authority to treat certain interests in a corporation as stock, and this express grant of authority extends to the treatment of such interests as stock for all purposes of the Code. The Treasury Department and the IRS have exercised this grant of authority to treat a debt instrument as stock when the debt instrument does not finance new investment in the operations of the issuer. In addition, as discussed in this Part V, whether new investment has been financed does not depend on whether the amount transferred to the controlling shareholder (or person related thereto) is treated as a dividend, return of basis, or gain.

5. Acquisitions of Expanded Group Assets Not Pursuant to a Reorganization

One comment questioned why the regulations apply to an acquisition of expanded group stock or an acquisition of business assets pursuant to an internal asset reorganization, but not to an acquisition of business assets not in connection with a reorganization, including through the acquisition of a disregarded entity. The Treasury Department and the IRS have determined that an acquisition of business assets in a non-reorganization transaction is not sufficiently similar to a distribution to be covered by §1.385-3. In a non-reorganization transaction, the selling member continues as an entity separate and distinct from the acquiring member following the transaction, and the common shareholder receives no property with respect to its stock in either entity. As a result, both on a standalone and combined basis, the pre-equity value of the entities does not decrease as a result of the transaction. Moreover, the property transferred by the acquiring member to the selling member is used to acquire assets that augment the business of the acquiring member. This is in contrast to property transferred by an acquiring member to acquire newly-issued non-hook stock in exchange for a minority interest in an affiliate the ownership of which generally lacks meaningful non-tax consequences.

One comment recommended that the final and temporary regulations clarify the treatment of the use of a note to acquire stock in a disregarded LLC. Because equity in a disregarded LLC is disregarded, the final and temporary regulations are not revised to address this comment.

6. Acquisitions of Existing Expanded Group Stock or Expanded Group Assets Pursuant to a Reorganization That Do Not Result in Dividend Income

Comments recommended an exemption for an acquisition subject to section 304 or 356(a)(2) to the extent the transaction results in sale or exchange treatment (for example, due to insufficient earnings and profits).

The Treasury Department and the IRS decline to adopt this recommendation. Under §1.385-3, a purported debt instrument that does not finance new investment in the issuer is not respected as debt. An issuance of a purported debt instrument does not finance new investment of the issuer to the extent a transaction has the effect of distributing the proceeds of the debt instrument to another member of the expanded group. The amount of dividend or gain recognized by an expanded group member in the transaction in which the instrument is issued or in a transaction that has the effect of transferring the proceeds is not relevant for determining whether the debt instrument financed new investment or, instead, merely introduced debt without having meaningful non-tax effects.

D. Funding rule

1. Lack of Identity between the Lender and a Recipient of the Proceeds of a Distribution or Acquisition

The funding rule under the proposed regulations treated as stock a debt instrument that was issued by a corporation (funded member) to another member of the funded member's expanded group in exchange for property with a principal purpose of funding a distribution or acquisition described in the three prongs of the funding rule. The proposed regulations included a non-rebuttable presumption that a principal purpose to fund such an acquisition or distribution existed if the expanded group debt instrument was issued by the funded member during the period beginning 36 months

before the funded member made the distribution or acquisition and ending 36 months after the distribution or acquisition.

Comments recommended several limitations on the funding rule, including limiting the funding rule to a rule that addresses only circular transactions that are economically equivalent to transactions subject to the general rule by requiring that the lender be the recipient of the proceeds of the distribution or acquisition. Thus, for example, a comment indicated that, if FP owned USP and FS, the funding rule should apply when USP borrows $100x from FP and distributes $100x to FP, but should not apply when USP borrows $100x from FS and distributes $100x to FP, unless FP also transferred funds to FS.

In the context of commonly-controlled corporations, the Treasury Department and the IRS have determined that there is not a sufficient economic difference to justify different treatment when the proceeds of a loan from one expanded group member are used to fund a distribution to, or acquisition from, that same member versus another expanded group member. First, and most significantly, in the example described in the preceding paragraph, a borrowing from FS and a distribution to FP has the same economic effect with respect to USP as a distribution by USP of a debt instrument to FP. In both cases, debt is added to USP without a commensurate increase in the amount of capital invested in USP's operations.

Moreover, in the context of commonly-controlled corporations, there is insufficient non-tax significance to the lack of identity between the lender and the recipient of the proceeds of the distribution or acquisition to justify treating the two series of transactions differently. In this context, there can be considerable flexibility regarding the expanded

group member used to lend funds to another member, since the lending member may itself be funded by other members of the group. Furthermore, an expanded group member that receives the proceeds of a distribution or economically similar transaction can transfer those proceeds to other entities in the group, for example, through distributions to a common controlling parent, which in turn can re-transfer the funds. Because of the ability to transfer funds around a multinational group, the choice of which entity will be a counterparty to a borrowing or transaction that is economically similar to a distribution may not have meaningful non-tax significance. Comments also suggested that this flexibility could be addressed through a second set of rules that would consider the extent to which the lender was itself funded by another member of the group and the extent to which the proceeds of a distribution or other economically similar transaction were transferred to the lender.

After considering the comments, the Treasury Department and the IRS decline to adopt these recommendations. The burden that would be required to essentially replicate the per se funding rule with respect to both the lender and the recipient of the proceeds of the funded distribution or acquisition in order to prevent such transactions from being used to avoid the purposes of the final and temporary regulations would far outweigh any policy justification for treating the two types of transactions differently, which, as explained in this Section D.1 of this Part V, is not compelling.

2. Per Se Application of the Funding Rule

a. Overview

Several comments noted that the per se funding rule in the proposed regulations would be overinclusive in certain fact patterns and treat a purported debt instrument as

equity even though the taxpayer could demonstrate as a factual matter that the funding was used in the taxpayer's business rather than to make a distribution or acquisition. These comments recommended that the regulations adopt a tracing approach to connect a funding with a distribution or acquisition by the funded member, including by actual tracing or by presumptions and other factors. Multiple comments suggested eliminating the per se funding rule entirely. Other comments recommended that the per se funding rule be altered or shortened. The range of suggestions included:

- Eliminate the per se funding rule and rely solely on a principal purpose test;
- Limit the per se funding rule to abusive transactions, such as those that lack a business purpose, or to expressly enumerated transactions;
- Replace the per se funding rule with a "but-for" standard;
- Replace the per se funding rule with a rule that would trace loan proceeds;
- Replace the per se funding rule with a facts-and-circumstances test subject to a rebuttable presumption (such as that contained in the disguised sale rules in §1.707-3(c)) or series of rebuttable presumptions; and
- Retain the 36-month periods, but apply a rebuttable presumption in the first and last 12 months.

In general, these comments suggested that the final and temporary regulations adopt a more subjective rule that would take into account particular facts and circumstances and allow taxpayers to demonstrate that an alternative source of cash or other property funded the distribution or acquisition and that the borrowed funds were put to a different use, rather than an objective rule based solely on whether a related-

party borrowing and a distribution or acquisition both occur during a certain time interval.

After considering these comments, the Treasury Department and the IRS have determined that it is appropriate to retain the per se funding rule to determine whether a debt instrument has funded a distribution or acquisition that occurs during the 36-month period before and after the funding transaction (the per se period). The final and temporary regulations reorganize the funding rule as (i) a per se funding rule addressing covered debt instruments issued by a funded member during the per se period; and (ii) a second rule that addresses a covered debt instrument issued by a funded member outside of the per se period with a principal purpose of funding a distribution or acquisition, determined based on all the facts and circumstances (principal purpose test). This reorganization is intended to clarify the purpose of the per se test and is not intended to be a substantive change.

Section D.2.b of this Part V explains why the Treasury Department and the IRS have determined that retaining the per se funding rule is justified. Section D.2.c of this Part V discusses the stacking rules that are necessitated by any approach based on fungibility. Section D.2.d of this Part V responds to comments regarding the length of the per se period. Section D.2.e of this Part V describes the principal purpose test.

b. Retention of per se funding rule

The general rule in §1.385-3(b)(2) addresses a distribution or acquisition in which a purported debt instrument is issued in the distribution or acquisition itself, for example, a distribution of indebtedness. In contrast, the funding rule in §1.385-3(b)(3) addresses multi-step transactions in which a related-party debt instrument is issued for cash or

property to fund a distribution or acquisition. The proposed regulations provided a principal purpose test to determine whether the indebtedness funded the distribution or acquisition in a multi-step transaction. However, the preamble to the proposed regulations also observed that money is fungible and that it is difficult for the IRS to establish the principal purposes of internal transactions. In this regard, the preamble cited the presence of intervening events that can occur between the steps, for example, other sources of cash such as free cash flow generated from operations, which could obscure the connection between the borrowing and the distribution or acquisition. For this reason, the proposed regulations included the per se funding rule based on a 36-month forward-and-back testing period.

The Treasury Department and the IRS continue to be of the view that, because money is fungible, an objective rule is an appropriate way to attribute a distribution or acquisition, in whole or in part, to a funding. The preamble to the proposed regulations emphasized the evidentiary difficulties that the IRS would face if the regulations relied exclusively on a purpose-based rule. Some comments suggested that a rebuttable presumption (such as the one contained in §1.707-3(c)) that would require a taxpayer to overcome a presumption arising upon specified events by clearly establishing facts and circumstances to the contrary could address these difficulties.

After considering these comments, the Treasury Department and the IRS have determined that, even with the benefit of a rebuttable presumption, a purpose-based rule that required tracing sources and uses of funds would present significant administrative challenges for the IRS. In particular, taxpayers potentially could purport to rebut the presumption by creating self-serving contemporaneous documentation that

"earmarks" the proceeds of related-party borrowings for particular purposes and attributes distributions and acquisitions to other sources of funds.

More fundamentally, however, because money is fungible, a taxpayer's particular purpose for a particular borrowing is largely meaningless. This is particularly true with respect to a large, active operating company (or group of operating companies that file a consolidated return) with multiple sources and uses of funds. Because of the fungibility of money, using loan proceeds for one purpose frees up funds from another source for another use. For instance, funding a distribution or acquisition with working capital could necessitate borrowing from a related party in order to replenish depleted working capital. For this reason, the Treasury Department and the IRS view tracing as having limited economic significance in the context of transactions involving indebtedness.

The concept of using mechanical rules to account for the fungibility of money from debt is well established: several provisions of the Code and regulations relating to allocation of interest expense are premised on the idea that, with certain narrow exceptions, money is fungible and therefore debt funding cannot be directly traced to particular activities or assets. See §1.861-9T(a) ("The method of allocation and apportionment for interest . . . is based on the approach that, in general, money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid"); see also section 864(e)(2) (requiring allocation and apportionment of interest expense on the basis of assets); §1.882-5 (allocation of interest expense based on assets for purposes of determining effectively connected income); section 263A(f)(2)(A)(ii) (allocating

interest that is not directly attributable to production expenditures under avoided cost principles). These provisions are based on the assumption that, due to the fungibility of money, a taxpayer's earmarking of the proceeds of a borrowing for any particular purpose is inconsequential for U.S. tax purposes.

Accordingly, the Treasury Department and the IRS have determined that it is necessary and appropriate to treat a covered debt instrument as financing a distribution or acquisition, regardless of whether the issuer associates the proceeds with a particular distribution or acquisition or with another use. As a result, the final and temporary regulations do not adopt recommendations to rely exclusively on a purpose-based tracing rule, including one based on a rebuttable presumption in favor of the IRS, an anti-abuse rule, or other multi-factor approach. In addition to the previously discussed evidentiary and economic reasons, a tracing, burden-shifting, or multi-factor approach would create significant uncertainty for both the IRS and taxpayers in ascertaining whether a borrowing should be considered to have funded a distribution or acquisition.

In adopting a per se funding rule based on the fungibility of money, the Treasury Department and the IRS recognize that all outstanding debt, regardless of how much time has transpired between the issuance and the distribution or acquisition, could be treated as funding a distribution or acquisition. This is the case for other fungibility-based rules under the Code and regulations, which typically apply to all outstanding debt and do not depend on when the debt was issued. See, e.g., sections 263A(f)(2)(A)(ii) and 864(e)(2). Nevertheless, the Treasury Department and the IRS have determined that it is appropriate to limit the application of the per se funding rule to

testing distributions or acquisitions made within a specified period to the debt issuance. Using a fixed per se period that is linked to the date of the debt issuance should address the majority of cases where purported debt is used to create federal tax benefits without having meaningful non-tax effects, since most such transactions seek to achieve these benefits immediately upon debt issuance. Such a rule also provides certainty so that taxpayers can determine the appropriate characterization of the debt instrument within a fixed period after it is issued, and need not redetermine their liability for prior taxable years. See also §1.385-3(d)(1)(ii) (treating a covered debt instrument subject to the funding rule due to a later distribution as a deemed exchange on the date of the distribution and not the issuance). Furthermore, the retention of the principal purpose test, described in Section D.2.e of this Part V, ensures that the rules appropriately apply to transactions occurring outside the per se period that intentionally seek to circumvent the per se funding rule.

A comment also suggested that the final and temporary regulations adopt a "but-for" standard under which a distribution or acquisition would be treated as funded by a purported debt instrument only if the distribution or acquisition would not have been made "but for" a funding. This comment cited proposed §1.956-4(c)(3) (REG-155164-09), which used a similar formulation to address whether a distribution by a foreign partnership to a related U.S. partner is connected to a funding of that partnership by a related CFC for purposes of section 956. Specifically, proposed §1.956-4(c)(3) contains a special rule for determining a related partner's share of a foreign partnership's obligation when the foreign partnership distributes the proceeds of the obligation to the

related partner and the partnership would not have made the distribution "but for" a funding of the partnership through an obligation held or treated as held by a CFC.

The Treasury Department and the IRS view a "but-for" standard in this context as similar in effect to a subjective tracing approach, in that a "but-for" test would require an inquiry into what a taxpayer would have chosen to do in the absence of the funding. Therefore, a "but-for" test contains the same shortcomings as a subjective tracing rule and does not adequately account for the fungibility of money. Alternatively, a "but-for" test could, in certain circumstances, function like a taxpayer-favorable stacking rule that would attribute a distribution or acquisition to a related-party borrowing only if there were no other sources of funding for the transaction. Significantly, the "but-for" approach in the proposed section 956 regulations operates only to increase the amount that otherwise would be allocated to a U.S. partner under the general aggregate approach of the regulations. That is, in the context of the proposed regulations under section 956, the "but-for" test is an anti-abuse backstop to a general rule that otherwise takes into account the fungibility of money and allocates the liabilities of a partnership pro rata based on the partner's interests in the partnership. Because the "but-for" test in the proposed section 956 regulations functions only as a backstop to a general rule that is based on the fungibility of money, the Treasury Department and the IRS considered the taxpayer-favorable stacking assumption implicit in the "but-for" test to be acceptable in that context. In contrast, if the final and temporary regulations under section 385 were to adopt a "but-for" test as the operative rule in lieu of a per se funding rule, a taxpayer could avoid the application of §1.385-3 entirely by demonstrating the presence of other sources of cash, notwithstanding that the cash obtained through a related-party

borrowing facilitated a distribution or acquisition by allowing those other sources of cash to support other uses.

c. Stacking rules

Using a fungibility approach to attribute distributions and acquisitions to covered debt instruments necessitates stacking rules for attributing uses of funds to sources of funds. Some comments asserted that the per se funding rule under the proposed regulations represents an anti-taxpayer stacking provision. One comment suggested that, to the extent a per se funding rule is appropriate due to the fungibility of money, the per se funding rule necessarily should treat a distribution or acquisition as funded pro rata by all sources of free cash flow. For example, if an entity generated $500x of free cash flow from operating its business and borrowed $100x from another member of the entity's expanded group, and, during the per se period the entity made a subsequent distribution of $100x, the comment suggested that only one-sixth of the $100x should be treated as funded by the borrowing. Other comments noted that the proposed regulations included taxpayer-unfavorable stacking because they always treated a distribution or acquisition as funded by a related-party borrowing without regard to whether there were new contributions to capital or third-party borrowing during the per se period.

The final and temporary regulations adopt several new and expanded exceptions described in Sections E, F, and G of this Part V. These exceptions represent taxpayer-favorable stacking rules that, in the aggregate, significantly reduce the extent to which distributions and acquisitions are attributed to related-party borrowings. This exception-based approach to stacking is significantly more administrable than a pro rata approach,

which would necessitate a constant recalculation of the relative amounts of funding from various sources.

In response to comments suggesting that distributions and acquisitions should be attributed first to free cash flow, or to the cumulative earnings and profits of a member, before being attributed to related-party borrowings, the final and temporary regulations treat distributions and acquisitions as funded first from earnings and profits accumulated during a corporation's membership in an expanded group. See Section E.3.a of this Part V (which includes a discussion of why earnings and profits are the better measure for tax purposes). In response to comments suggesting that distributions and acquisitions should be attributed to new contributed capital received by a member before its related-party borrowings, the final and temporary regulations treat distributions and acquisitions as funded next from capital contributions received from other members of the expanded group within the per se period but before the end of the taxable year of the distribution or acquisition. See Section E.3.b of this Part V. In response to comments suggesting that certain borrowings should not be treated as funding distributions and acquisitions, the final and temporary regulations include a broad exception from the funding rule for short-term debt instruments, which effectively are treated as financing the short-term liquidity needs of the issuer rather than distributions and acquisitions. See Section D.8.c of this Part V. Accordingly, after taking into account the various exceptions provided, the final and temporary regulations generally (i) exclude certain short-term debt instruments from funding any distributions or acquisitions, (ii) exclude certain distributions and acquisitions from being funded by any type of debt instrument, (iii) treat any remaining distributions and acquisitions as

funded by new equity capital, and (iv) only then treat any remaining distributions and acquisitions as funded by any remaining related party borrowings.

Some comments suggested that the final and temporary regulations should treat any remaining distributions and acquisitions as funded first by unrelated-party debt, rather than funded first by covered debt instruments. The Treasury Department and the IRS decline to adopt this recommendation. The Treasury Department and the IRS have determined that it is appropriate to treat any remaining distributions and acquisitions as funded first by related-party debt, because the nature of unrelated-party lending imposes a real cost to the borrower through interest expense and other costs. This real cost from unrelated-party borrowing can be justified only if the issuer will use the borrowed funds to achieve a return that is greater than the interest expense and other costs from the unrelated-party borrowing. On the other hand, a borrowing among highly-related parties, such as between members of an expanded group, has no net cost to the borrower and the lender. Because the related-party borrower and lender have a complete (or near complete) identity of interests, the related-party borrowing imposes no similar economic cost on the borrower. Indeed, the pre-tax return with respect to a related-party borrowing can be zero, or even less than zero, and the borrowing can still achieve a positive after-tax return when the related party lender's interest income is taxed at a lower effective tax rate than the related-party borrower's effective tax benefit from interest deductions. This is true whether the related-party lender is a U.S. corporation or a foreign corporation. In addition to interest and other costs, an unrelated-party lender may impose restrictive covenants or other legal and contractual restrictions that affect the borrower's business, including restrictions on the

issuer's ability to distribute the proceeds from the unrelated-party debt that a related-party lender may not impose. For these reasons, it is appropriate to treat any remaining distributions and acquisitions as funded first by related-party debt, before treating those remaining distributions and acquisitions as funded by unrelated-party debt.

d. Retention of the 36-month testing periods

Several comments suggested that, if the regulations continue to take a per se approach, the testing period should be significantly shortened. For example, comments recommended testing periods of 24 months, 18 months, 12 months, or 6 months. After consideration of these comments, the Treasury Department and the IRS have determined that it continues to be appropriate to use 36-month testing periods.

As explained in Section D.2.b of this Part V, the Treasury Department and the IRS have determined that, because money is fungible, an objective set of rules using a fixed time period and various stacking rules is the most administrable approach to determine whether a debt instrument funded a distribution or acquisition. The Treasury Department and the IRS have considered several factors in determining that the 36-month testing periods in the proposed regulations should be retained, rather than adopting one of the recommendations for a shorter period.

Many of the comments requesting a shorter testing period were concerned primarily about compliance burdens that would be imposed if the per se funding rule applied to ordinary course transactions that occur with a high frequency. These concerns are mitigated by the addition and expansion of numerous exceptions described in Sections D.8, E, F, and G of this Part V, which substantially narrow the scope of the per se funding rule in the final and temporary regulations. In particular, as

discussed in Section D.8 of this Part V, short-term debt instruments that finance short-term liquidity needs that arise frequently in the ordinary course of business are excluded from the scope of the funding rule in the final and temporary regulations. This change substantially reduces the compliance burden of applying the per se funding rule during the 36-month testing periods. In addition, as discussed in Section E.3 of this Part V, the final and temporary regulations only take into account distributions and acquisitions that exceed increases to the issuer's equity while the issuer was a member of the same expanded group from: (i) earnings and profits accumulated after the proposed regulations were published and, (ii) certain contributions to capital that occurred during the 36-month period preceding the distribution or acquisition or during the taxable year in which the distribution or acquisition occurred. Thus, the funding rule in the final and temporary regulations is focused on non-ordinary course covered debt instruments and extraordinary distributions and acquisitions.

Taking into account the implications of the narrower scope of §1.385-3 with respect to the issues raised by comments regarding the 36-month testing periods, the Treasury Department and the IRS have determined that it is appropriate to continue to attribute distributions and acquisitions that exceed the relevant earnings and profits and capital contributions to non-ordinary course related-party borrowings that were made 36 months before or after the distribution or acquisition and that remain outstanding at the time of the distribution or acquisition. The Treasury Department and the IRS have determined that 36 months is a reasonable testing period that appropriately balances the need for an administrable rule and the fact that transactions involving indebtedness are inextricably linked due to the fungibility of money. Furthermore, the Treasury

Department and the IRS are concerned that, if a shorter testing period was used, such as a 24-month forward-and-backward testing period, taxpayers could find it worthwhile to engage in funding transactions by waiting 24 months after the issuance of debt before conducting the second transaction, and that the principal purpose test described in Section D.2.e of this Part V, which is more difficult for the IRS to administer, would not be a sufficient deterrent in this circumstance.

The use of a 36-month testing period for this purpose is consistent with, and in some cases shorter than, other testing periods that the IRS has experience administering in which facts and circumstances potentially observable by the IRS provide an inadequate basis to establish the relationship between two events or transactions. See, e.g., section 172(b)(1)(D) and (g)(2) (treating certain interest deductions from indebtedness in the year of a corporate equity reduction transaction (CERT) and the following two tax years as per se attributable to the CERT, in lieu of tracing interest to specific transactions); section 302(c)(2)(A)(ii) (10-year period for determining whether shareholder has terminated their interest for purposes of applying section 302(a) to a redemption); section 2035(a) (treating gifts made three years before the decedent's death as included in the decedent's gross estate); §1.1001-3(f)(3) (disregarding modifications occurring more than five-years apart when determining if multiple modifications are significant); see also §1.7874-8T(g)(4) (36-month look-back period for determining when to account for prior acquisitions).

Although some comments asserted that the per se funding rule should be modeled on the two-year presumption rule in §1.707-3(c), the Treasury Department and the IRS have determined that the disguised sale rules under §1.707-3(c) address a

different policy in the context of transactions between a partner and partnership (regardless of the level of ownership), whereas the final and temporary regulations address transactions between highly-related corporations. In this case, the Treasury Department and the IRS have determined that a 36-month testing period is more appropriate, taking into account in particular the tax consequences associated with corporate indebtedness and the high degree of relatedness of the parties.

For these reasons, the final and temporary regulations retain a 36-month testing period as the per se period.

e. Principal purpose test

Because of the mechanical nature of the per se funding rule, the Treasury Department and the IRS are concerned that taxpayers may seek to intentionally circumvent the rule to achieve economically similar results even though the funding occurs outside of the per se period. Therefore, the final and temporary regulations provide that a covered debt instrument that is not issued during the per se period is treated as funding a distribution or acquisition to the extent it is issued by a funded member with a principal purpose of funding the distribution or acquisition. This determination is made based on all of the relevant facts and circumstances.

3. Predecessors and Successors

Under the proposed regulations, references to a funded member included a reference to any predecessor or successor of such member. The proposed regulations defined the terms predecessor and successor to “include” certain persons, without specifically stating whether other persons could be treated as predecessors or successors in certain instances. Comments requested additional clarity concerning the

scope of the definition of predecessor and successor through an exclusive enumeration of entities that may be considered predecessors or successors.

In response to comments, the final and temporary regulations replace “include” with “means” in the definitions of predecessor and successor, thereby limiting the transactions that create predecessor or successor status to those explicitly provided.

Comments recommended that a funded member be treated as making a distribution or acquisition that is made by a predecessor or successor only to the extent that the transaction creating the predecessor-successor relationship occurs during the per se period determined with respect to the distribution or acquisition. For example, assume USS1 makes a distribution of $10x to an expanded group member in year 1. USS2, also an expanded group member that is not consolidated with USS1, borrows $10x from an expanded group member in year 2. In year 10, USS1 merges into USS2 in an asset reorganization. Comments suggested that the proposed regulations arguably would treat USS2’s year 2 note as stock because USS1 is a predecessor to USS2, and the year 2 funding occurred within the 72-month period determined with respect to the year 1 distribution. One comment suggested that the predecessor or successor rule only apply in this context if there was a principal purpose to avoid the regulations.

In response to comments, the final and temporary regulations provide that, for purposes of the per se funding rule, a covered debt instrument that is otherwise issued by a funded member within the per se period of a distribution or acquisition made by a predecessor or successor is not treated as issued during the per se period with respect to the distribution or acquisition unless both (i) the covered debt instrument is issued by

the funded member during the period beginning 36 months before the date of the transaction in which the predecessor or successor becomes a predecessor or successor and ending 36 months after the date of the transaction, and (ii) the distribution or acquisition is made by the predecessor or successor during the same 72-month period. If the funding and the distribution or acquisition do not both occur during the 72-month period with respect to the transaction that created the predecessor-successor relationship, the covered debt instrument is not treated as funding the distribution or acquisition under the per se funding rule. In that case, however, the principal purpose test may still apply to treat the covered debt instrument as funding the distribution or acquisition.

Comments questioned the application of the predecessor and successor rules when a funded member and either its predecessor or successor are members of different expanded groups. One comment recommended that a funded member be treated as making a distribution or acquisition made by a predecessor or successor only to the extent that the distribution or acquisition was to a member of the same expanded group as the funded member. Similarly, comments requested that the regulations clarify that a corporation ceases to be a predecessor or successor to a funded member when the corporation and the funded member cease to be members of the same expanded group.

In response to comments, the final and temporary regulations provide that the distributing corporation and controlled corporation in a distribution that qualifies under section 355 cease to have a predecessor and successor relationship as of the date that the corporations cease to be members of the same expanded group. Similarly, a seller

in a transaction to which the subsidiary stock acquisition exception applies ceases to be a successor of the acquirer as of the date that the corporations cease to be members of the same expanded group. See Section E.2.a of this Part V for the new terminology. However, any distribution or acquisition made by a predecessor or successor of a corporation up to the date that the predecessor or successor relationship is terminated may be treated as funded by a debt instrument issued by the corporation after that date.

Comments requested that the terms predecessor and successor not include the distributing or controlled corporation in a divisive reorganization described in section 368(a)(1)(D) undertaken pursuant to a distribution under section 355, regardless of whether distributing and controlled remain members of the same expanded group. The comments asserted that the requirements of section 355 provide sufficient safeguards to protect the concerns underlying the proposed regulations (specifically, that a taxpayer would undertake a divisive reorganization with a principal purpose of avoiding the regulations), such that it is not necessary to treat the distributing and controlled corporations as predecessors and successors. For example, the active trade or business requirement and business purpose requirement of section 355 limit the ability for taxpayers to engage in tax-motivated transactions, although comments did acknowledge that these restrictions could be overcome in some circumstances.

The final and temporary regulations do not adopt this recommendation because the Treasury Department and the IRS continue to be concerned about the ability of taxpayers to issue indebtedness that does not fund new investment in connection with a reorganization that qualifies under sections 355 and 368(a)(1)(D). As discussed in Section D.6 of this Part V, the Treasury Department and the IRS have determined that

distributions that qualify for nonrecognition under section 355, whether or not preceded by a reorganization, should not be subject to the funding rule because the requirements of that provision -- in particular, the active trade or business requirement and the device limitation -- indicate that the stock of a controlled corporation is likely not fungible property. However, these safeguards do not adequately limit the amount of liquid assets that the distributing corporation can transfer to the controlled corporation pursuant to the plan of reorganization or before the spin is contemplated in the case of straight section 355 distributions. Moreover, section 355 includes no prohibition against a post-spin distribution by the controlled corporation to its common shareholder with the distributing corporation. As a result, the proceeds of a borrowing by the distributing corporation can easily be transferred to a controlled corporation, which proceeds can then be distributed by the controlled corporation or used in a transaction with similar economic effect.

One comment suggested that the predecessor and successor rules limit the extent to which multiple corporations may be treated as successors with respect to the same debt instrument issued by a funded member. The comment proposed that, in the event that a funded member has multiple successors (for example, by reason of multiple transfers of property to which the subsidiary stock acquisition exception described in Section E.2.a of this Part V applies), the successors, collectively, should only be successors up to the aggregate amount of debt instruments of the funded member outstanding at the time of the transactions that created the successor relationships. The comment further suggested that, if the recommendation were

accepted, an ordering rule may be appropriate to treat multiple successors as successors to the funded member based on a "first in time" principle.

The final and temporary regulations do not adopt the recommendation, because the Treasury Department and the IRS have determined that limiting the extent to which one or more corporations are successors to a funded member based on the member's outstanding related-party debt is inconsistent with the funding rule outside the predecessor-successor context. As discussed in Section D.2 of this Part V, under either test of the funding rule -- the per se funding rule or the principal purpose test – a covered debt instrument can be treated as funding a distribution or acquisition notwithstanding that the instrument is issued subsequent to the distribution or acquisition. In contrast, limiting successor status to the funded member's debt outstanding at the time of the transaction that creates the successor relationship would preclude a later issued covered debt instrument from being treated as funding a distribution or acquisition that precedes it. For instance, if a funded member, at a time that it has no covered debt instrument outstanding, transfers property to a subsidiary in a transaction described in the subsidiary stock acquisition exception, under the proposed limitation the subsidiary would not be a successor to the funded member, and thus any distribution or acquisition by the subsidiary would not be treated as funding a covered debt instrument of the funded member issued thereafter but within the per se period. On the other hand, if, instead of transferring property to the subsidiary, the funded member made a distribution or acquisition itself, a subsequent issuance by the funded member of a covered debt instrument within the per se period would be treated as funding the distribution or acquisition under the per se funding rule. The Treasury

Department and the IRS have determined that a distribution or acquisition by a predecessor or successor of a funded member should not be treated more favorably than a distribution or acquisition by the funded member itself. Furthermore, because the final and temporary regulations do not adopt the recommendation, no ordering rule is necessary for purposes of determining predecessor or successor status in the context of multiple predecessors or successors.

Comments also requested clarification regarding the interaction of the predecessor and successor rules and the multiple instrument rule, which provides that when two or more covered debt instruments may be treated as stock under the per se funding rule, the covered debt instruments are tested based on the order in which they were issued, with the earliest issued covered debt instrument tested first. Specifically, comments raised the concern that, under one interpretation of the proposed regulations, a distribution or acquisition that is treated as funded by a covered debt instrument of a covered member could be re-tested and treated as funded by an earlier-in-time debt instrument of another member if and when the first covered member acquires the other member in a reorganization.

To address the foregoing concerns, the final and temporary regulations provide that, except as provided in §1.385-3(d)(2) (regarding covered debt instruments treated as stock that leave the expanded group), to the extent a distribution or acquisition is treated as funded by a covered debt instrument, the distribution or acquisition may not be treated as funded by another covered debt instrument and the covered debt instrument may not be treated as funding another distribution or acquisition. This non-duplication rule clarifies that a distribution or acquisition that is treated as funded by a

covered debt instrument that is treated as stock by reason of §1.385-3(b) is not re-tested under the multiple instrument rule because of the existence of an earlier-in-time covered debt instrument of the corporation's predecessor or successor, when the transaction that created the predecessor-successor relationship occurs after the first-mentioned covered debt instrument was already treated as stock.

4. Straddling Expanded Groups

Multiple comments recommended that the final and temporary regulations provide an exception for when a funded member is funded within the per se period with respect to a distribution or acquisition, but the funding and the distribution occur in different expanded groups. For example, P1 and S are members of the P1 expanded group. P1 owns all the stock of S, which distributes $100x to P1 in year 1. In year 2, P1 sells all the stock of S to unrelated P2, a member of the P2 expanded group. In year 3, P2 loans $100x to S. The comments asserted that the borrowing and distribution by S do not implicate the policy concerns addressed by the funding rule because of the intervening change in its expanded group. Moreover, comments asserted that it would be difficult for P2 to determine the treatment of its loan to S as debt or equity without substantial due diligence with respect to the distribution history of S.

The final and temporary regulations adopt the recommendation by providing an exception to the per se funding rule, which generally applies when (i) a covered member makes a distribution or acquisition that occurs before the covered member is funded; (ii) the distribution or acquisition occurs when the covered member's expanded group parent is different than the expanded group parent when the covered member is funded; and (iii) the covered member and the counterparty to the distribution or acquisition (the

“recipient member”) are not members of the same expanded group on the date the covered member is funded. For this purpose, a recipient member includes a predecessor or successor or one or more other entities that, in the aggregate, acquire substantially all of the property of the recipient member. If the requirements of this exception are satisfied, the covered debt instrument is not treated as issued within the per se period with respect to the earlier distribution. However, the principal purpose test may still apply so that, if the debt instrument is actually issued with a principal purpose of funding the distribution or acquisition, the debt instrument would be treated as stock under the funding rule.

Comments also addressed a similar scenario in which the covered member and the recipient member are members of one expanded group (prior expanded group) at the time of the distribution or acquisition and both parties join a different expanded group (subsequent expanded group) before the covered member is funded by either the recipient member or another member of the subsequent expanded group. Some of the comments recommended that the funding rule, or at least the per se rule, not apply in this situation because the borrowing from the subsequent expanded group cannot have funded the distribution or acquisition that occurred in the prior expanded group. Comments also recommended a similar exception to the funding rule when the steps are reversed, such that the covered member issues a covered debt instrument to another member of the prior expanded group, and the distribution or acquisition occurs in the subsequent expanded group that includes both the funding and funded members.

The final and temporary regulations do not adopt these recommendations. The Treasury Department and IRS expect that any burden on taxpayers to determine the

history of loans originated in the prior expanded group would not be as significant as any burden to determine the distribution and acquisition history in a prior expanded group (that is, when the distribution or acquisition occurs in the prior expanded group, and the funding occurs in the subsequent expanded group). The Treasury Department and the IRS have determined that, when the distribution or acquisition occurs in the same expanded group that includes the funding and funded members, it is appropriate to apply the per se funding rule to the distribution or acquisition. Finally, the Treasury Department and the IRS are concerned that an exception for this type of transaction could lead to transactions in which taxpayers transfer subsidiaries between different expanded groups to accomplish what they could not accomplish absent such transactions.

5. Transactions Described in More than One Paragraph

Proposed §1.385-3(b)(3)(iii) provided that if all or a portion of a distribution or acquisition by a funded member is described in more than one prong of the funding rule, the funded member is treated as engaging in only a single distribution or acquisition for purposes of applying the funding rule. One comment questioned the application of this rule to a payment of boot in a reorganization where both the acquiring corporation and the target corporation in the reorganization have outstanding covered debt instruments.

In response to this comment, §1.385-3(b)(3)(ii) clarifies that, in the case of an internal asset reorganization, to the extent an acquisition by the transferee corporation is described in the third prong of the funding rule, a distribution or acquisition by the transferor corporation is not also described in the funding rule. Accordingly, in the case of a reorganization in which both the transferor corporation and the transferee

corporation have outstanding covered debt instruments, the reorganization is treated as a single transaction and a payment of boot in the reorganization is treated as a single acquisition by the transferee corporation for purposes of the funding rule. See Sections E.3.a.iv (regarding the application of reductions to certain internal asset reorganizations) and E.6.b (regarding the general coordination rule applicable to internal asset reorganizations) of this Part V.

6. Certain Nontaxable Distributions

Comments recommended that the funding rule not apply to liquidating distributions described in section 332. Comments further recommended that the final and temporary regulations treat the 80-percent distributee in a section 332 liquidation as a successor to the liquidating corporation. Comments requested, in the alternative, that if a section 332 distribution is treated as a distribution for purposes of the funding rule, the final and temporary regulations should clarify whether any resulting recharacterized instruments are taken into account in determining whether the liquidation satisfies the 80-percent ownership test under section 332.

One comment recommended that, if an expanded group member distributes assets in a section 331 liquidation to a shareholder that assumes a liability of the liquidated corporation, the liquidated corporation should not be treated as making a distribution for purposes of the funding rule to the extent of the assumed liabilities. The comment reasoned that, in substance, the shareholder purchased assets from the liquidating corporation. Consequently, the comment concluded that a distribution should be treated as occurring under these circumstances only to the extent the value of the distributed assets exceeds the amount of liabilities assumed.

In response to the comments, the final and temporary regulations include an exception to the funding rule for a distribution in complete liquidation of a funded member pursuant to a plan of liquidation. This exception does not distinguish between a liquidation that qualifies under section 332 and a liquidation that occurs under section 331. In the case of a liquidation that qualifies under section 332, the acquiring corporation is treated as a successor to the liquidated corporation for purposes of the funding rule.

Comments also requested an exclusion from the funding rule for distributions of stock under section 355 not preceded by a reorganization described in section 368(a)(1)(D) (a straight 355 distribution). The comment noted that in a straight 355 distribution, in contrast to a distribution of a debt instrument or a distribution of cash, the distribution of a controlled corporation must be motivated by one or more non-U.S. tax business purposes and both the distributing and controlled corporations must own historic, illiquid business assets. Moreover, the comment noted that the distributing corporation in a straight 355 distribution cannot have contributed borrowed funds to the controlled corporation; otherwise, the distribution would also qualify as a reorganization and be subject to a different rule that generally only treated the amount of boot or other property received in a distribution that qualifies under sections 355 and 368(a)(1)(D) as a distribution or acquisition for purposes of §1.385-3(b).

In response to comments, the final and temporary regulations provide an exception to the funding rule for a straight section 355 distribution. As discussed in Section D.2.a of this Part V, the per se approach is retained by the final and temporary regulations due, in large part, to the fungibility of money and thus the difficulty of tracing

the proceeds of a borrowing to a distribution. The Treasury Department and the IRS have concluded that, due to the heightened requirements for qualification under section 355 (for example, device limitation, business purpose requirement, and active trade or business requirement), the stock of a controlled corporation should not be viewed as fungible property. Furthermore, the Treasury Department and the IRS have determined that section 355 distributions should be subject to the same treatment under the final and temporary regulations as section 355 distributions that are preceded by a reorganization under section 368(a)(1)(D), because a distribution of stock described in section 355 has the same economic effect whether or not preceded by a reorganization. In that regard, the final and temporary regulations provide that a distributing corporation and a controlled corporation in a section 355, whether or not in connection with a reorganization described in section 368(a)(1)(D), are predecessor and successor to each other for purposes of the funding rule.

One comment requested that distributions described in section 305(a) (stock distributed with respect to stock not included in gross income) be excluded from the funding rule because the shareholders do not realize income and the distributing corporation's net worth does not decrease. The final and temporary regulations do not directly address transactions to which section 305(a) applies because a distribution of the stock of a corporation made by such corporation is not a distribution of property as defined for purposes of §1.385-3, and thus is not addressed by the funding rule.

7. Secondary Purchases

One comment requested confirmation that an expanded group member's secondary purchase of a debt instrument issued by a member of its expanded group is

not an issuance of a debt instrument described in the funding rule. The comment further recommended that the deemed issuance of a debt instrument from one expanded group member to another expanded group member under §1.108-2(g) should be disregarded for purposes of the funding rule. The Treasury Department and the IRS have determined that no further clarification is necessary in this area. Consistent with the proposed regulations, §1.385-3(b)(3) of the final regulations provides that the funding rule applies to a covered debt instrument issued by a covered member to a member of an expanded group, and thus the funding rule generally does not apply to secondary market purchases. However, to the extent that any other Code section or regulation deems a debt instrument to be issued by a covered member to a member of its expanded group, that issuance could, absent an exception, be an issuance described in §1.385-3(b)(3).

8. Ordinary Course Exception, Cash Pooling, and Short-Term Instruments

a. Proposed regulations and general approach

The proposed regulations provided that an ordinary course debt instrument is not subject to the per se funding rule. Proposed §1.385-3(b)(3)(iv)(B)(2) defined an ordinary course debt instrument as 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, but only 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, and 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.

Proposed §§1.385-3 and 1.385-4 did not include special rules for debt instruments that are issued in the ordinary course of managing the cash of an expanded group. However, the preamble to the proposed regulations requested comments on the special rules that might be needed with respect to cash pools, cash sweeps, and similar arrangements for managing the cash of an expanded group.

The comments regarding the ordinary course exception and the need for an exception to address common cash-management techniques overlap considerably. Accordingly, Section D.8 of this Part V addresses both topics. In general, comments indicated that it would be burdensome to apply the per se funding rule to any frequently recurring transactions, including both ordinary course business transactions between affiliates that involve a short-term extension of credit as well as debt instruments that arise in the context of companies that participate in arrangements with other expanded group members that are intended to optimize, on a daily basis, the amount of working capital required by the group. Comments also observed that the risk that such extensions of credit would be used for tax-motivated purposes, such as funding a distribution, is very low and does not justify the burdens that would be imposed if companies had to track these transactions and deal with the complexity that would follow if such routine extensions of credit were recharacterized into equity. Far less uniform were the recommendations for how to address the concerns expressed in the comments.

As described in Section D.8.c of this Part V, the Treasury Department and the IRS have determined that the ordinary course exception should be an element of a broader exception that also covers certain other short-term loans, including debt

instruments that arise in the context of a cash-management arrangement. In many cases the types of transactions covered by the ordinary course exception are in substance similar to the transactions that are facilitated by the short-term liquidity that is extended under a cash-management arrangement. For example, an expanded group member may purchase inventory from an affiliate in exchange for a trade payable or using cash obtained by an extension of credit from a third group member. The Treasury Department and the IRS have determined that it is not appropriate to create a tax preference for either form of the transaction. Accordingly, the temporary regulations adopt a broad exception from the funding rule for qualified short-term debt instruments that is intended to address the comments' concerns regarding the ordinary course exception as well as the broader need for an exception to facilitate short-term cash management arrangements.

b. Overview of comments received

i. Expansion of exception to additional instruments

Numerous comments requested that the ordinary course exception be expanded to apply to a wider range of debt instruments. These comments ranged from narrow requests to expand the list of items that might be acquired in the ordinary course of a taxpayer's business from another group member to broad requests for an exception that covers any short-term loan, including for cash.

Some comments questioned the requirement for a debt instrument to be issued for goods and services in order to qualify for the ordinary course exception, stating that the ordinary course exception otherwise would not cover many regular business expenses, including some expenses deductible as trade or business expenses under

section 162. Comments specifically noted that the ordinary course exception would not apply to instruments issued as payment for a rent or royalty due to a related party for the use of assets (including intangible assets) used in a trade or business because such payments are not in exchange for goods or services. Other comments recommended that the ordinary course exception apply to transactions involving expenses that are currently deductible or creditable under other sections of the Code, including payments (or loans to finance payments) of expenses creditable or deductible under section 41 (allowing a credit for increasing research activities), section 164 (allowing a deduction for state and local taxes), and section 174 (allowing a deduction for certain research and development expenses). Separately, comments requested that transactions involving expenses that are deferred or disallowed under a provision of the Code (for example, section 267) should nonetheless qualify for the ordinary course exception.

Comments also recommended that the ordinary course exception apply to transactions involving expenses that are required to be capitalized or amortized. Along these lines, comments recommended that loans issued in exchange for certain business property, such as operating assets or tangible personal property used in a trade or business, be treated as ordinary course debt instruments.

ii. Facts and circumstances

Comments suggested that the ordinary course exception should apply broadly under a facts-and-circumstances test. Under one articulation of a facts-and-circumstances test proposed in a comment, the ordinary course exception would apply to any debt instrument issued for services or property in the conduct of normal business activities on appropriate terms unless the facts establish a principal purpose of funding

a general rule transaction. The comment noted several instances in which such a test would apply more broadly than the test in the proposed rule, including certain issuances by securitization vehicles and dealers and issuances and modifications of intercompany debt by a distressed corporation in connection with an agreement with third-party creditors.

iii. De minimis loans

Comments recommended that the ordinary course exception apply to all loans under a de minimis threshold. Suggestions for a de minimis threshold included $1 million per obligation or $5 million per entity.

iv. Working capital loans

Numerous comments suggested an ordinary course exception or other safe harbor that would apply based on a determinable financial metric, such as current assets, current assets less cash and cash equivalents, annual expenses, or annual cost of goods sold. Representative examples of this approach include: an exception for aggregate loans below 150 percent of the closing balance of current assets of the borrower as of its most recent financial statements; an exception for aggregate loans less than annual expenses; an exception for aggregate loans less than certain annual expenses related to ordinary course transactions, such as payroll and cost of goods sold; an exception for loans up to a certain percentage of the book value of gross assets; and an exception for any debt instrument with a principal amount less than the average principal amount of all expanded group debt instruments issued by expanded group members (including the borrower) in the prior 36 months, increased by a specific percentage to account for growth. One comment noted in particular that any safe

harbor should not apply to the extent the borrower held unrestricted cash or cash equivalents available to pay for the goods or services. A comment also noted that the measurement of any specific financial metric used as the basis of an exception (for example, current assets) could be determined over a period, such as a trailing three-year average (or other period). Another comment noted that an exception based on a financial metric that is fixed in time may not work well because (i) if the metric is based on a specific balance sheet date, that date may not be representative of the working capital requirements at other times, such as during a peak season, and (ii) if the metric is based on the time of issuance of the debt instrument and that date is not a balance sheet date, it may not be knowable.

Other comments recommended that all short-term debt instruments and all non-interest bearing debt instruments should qualify for an exception.

v. Net interest expense

A comment requested an exception for cash pooling arrangements that do not give rise to net interest expense in the United States, determined on a taxable year basis. For a discussion of comments regarding exceptions based on net interest generally, see Section A of this Part V.

vi. Cash pooling arrangements

Comments noted that the preamble to the proposed regulations explicitly stated that the ordinary course exception "is not intended to apply to intercompany financing or treasury center activities." Several comments requested reconsideration of this restriction because businesses often use a treasury center or other cash-management arrangement (such as a cash pool) to finance ordinary course transactions of group

members, as well as for intercompany netting programs, centralized payment systems, foreign currency hedging, and bridge financing. Accordingly, comments requested that financing of routine transactions qualify for the ordinary course exception, regardless of whether such financing is provided by a treasury center or other cash-management arrangement. Comments also requested that debt instruments issued in connection with netting, clearing-house, and billing center arrangements be treated as ordinary course debt instruments whether or not conducted through a treasury center.

The comments suggested defining a new entity such as a treasury center or qualified cash pool and treating loans to and from the entity as ordinary course debt instruments. Some comments suggested defining a treasury center by reference to §1.1471-5(e)(5)(i)(D), which generally applies to an entity that manages working capital solely for members of its expanded affiliated group (as defined in section 1471(e)(2) and the regulations thereunder). An alternative proposal defined a qualified cash pool as any entity with a principal purpose of managing the funding and liquidity for members of the expanded group. However, some comments recommending such an approach acknowledged that some companies provide long-term financing for non-ordinary course transactions through an internal treasury center, and thus noted that loans to and from the qualified entity could be subject to reasonable restrictions on duration.

Comments also expressed concern that recharacterization of a debt instrument in the context of a cash-management arrangement could result in a multitude of cascading recharacterizations, particularly in situations where a cash pool header makes and receives a substantial number of loans. Comments indicated that cash pools typically process many transactions in a single business day, with one comment

stating that the company's cash pool processed over a million transactions in a year. For a summary of comments concerning iterative effects (including comments raising similar concerns outside the context of cash pool) and the final and temporary regulation's approach to mitigate those effects, see Section B.5 of this Part V.

The comments suggesting relief by reference to a cash pool header, treasury center, or similar entity (including an unrelated entity, such as a third party bank facilitating a notional cash pool) also requested that the exception provide that instruments issued by and to such entity be respected and not subject to recharacterization under the anti-conduit rules of §1.881-3 or similar doctrines.

c. Short-term debt instruments

In order to facilitate non-tax motivated cash management techniques, such as cash pooling or revolving credit arrangements, as well as ordinary course short-term lending outside a formal cash-management arrangement, the temporary regulations adopt an exception from the funding rule for qualified short-term debt instruments. The temporary regulations do not adopt a general exemption for all loans issued as part of a cash-management arrangement because, as comments acknowledged, such arrangements can provide long-term financing to expanded group members.

Under the temporary regulations, a covered debt instrument is treated as a qualified short-term debt instrument, and consequently is excluded from the scope of the funding rule, if the covered debt instrument is a short-term funding arrangement that meets one of two alternative tests (the specified current assets test or the 270-day test), or is an ordinary course loan, an interest-free loan, or a deposit with a qualified cash pool header. The Treasury Department and the IRS expect that the exception for

qualified short-term debt instruments generally will prevent the treatment as stock of short-term debt instruments issued in the ordinary course of an expanded group's business, including covered debt instruments arising from financing provided by a cash pool header pursuant to a cash-management arrangement. Furthermore, these tests generally rely on mechanical rules that will provide taxpayers with more certainty, and be more administrable for the IRS, as compared to a facts-and-circumstances approach that was suggested by some comments.

i. Short-term funding arrangement

A covered debt instrument that satisfies one of two alternative tests -- the specified current assets test or the 270-day test -- constitutes a qualified short-term debt instrument. These alternative tests are intended to exclude covered debt instruments issued as part of arrangements, including cash pooling arrangements, to meet short-term funding needs that arise in the ordinary course of the issuer's business. An issuer may only claim the benefit of one of the alternative tests with respect to covered debt instruments issued by the issuer in the same taxable year.

To satisfy the specified current assets test, two requirements must be satisfied. First, the rate of interest charged with respect to the covered debt instrument must be less than or equal to an arm's length interest rate, as determined under section 482 and the regulations thereunder, that would be charged with respect to a comparable debt instrument of the issuer with a term that does not exceed the longer of 90 days and the issuer's normal operating cycle.

Second, a covered debt instrument is treated as satisfying the specified current assets test only to the extent that, immediately after the covered debt instrument is

issued, the issuer's outstanding balance under covered debt instruments issued to members of the issuer's expanded group that satisfy any of (i) the interest rate requirement of the specified current assets test, (ii) the 270-day test (in the case of a covered debt instrument that was issued in a prior taxable year in which the issuer claimed the benefit of the 270-day test), (iii) the ordinary course loan exception, or (iv) the interest-free loan exception, does not exceed the amount expected to be necessary to finance short-term financing needs during the course of the issuer's normal operating cycle. For purposes of determining an issuer's outstanding balance, in the case of an issuer that is a qualified cash pool header, the amount owed does not take into account the qualified cash pool header's deposits payables. (These debt instruments are eligible for a separate exception described in Section D.8.c.iv of this Part V.) Additionally, the amount owed by any other issuer is reduced by the issuer's deposits receivables from a qualified cash pool header, but only to the extent of amounts owed to the same qualified cash pool header that satisfy the interest rate requirement of the specified current assets test or that satisfy the requirements of the 270-day test (if the covered debt instrument was issued in a prior taxable year).

The issuer's amount of short-term financing needs is determined by reference to the maximum of the amounts of specified current assets reasonably expected to be reflected, under applicable financial accounting principles, on the issuer's balance sheet as a result of transactions in the ordinary course of business during the subsequent 90-day period or the issuer's normal operating cycle, whichever is longer. For this purpose, specified current assets means assets that are reasonably expected to be realized in cash or sold (including by being incorporated into inventory that is sold) during the

normal operating cycle of the issuer, but does not include cash, cash equivalents, or assets that are reflected on the books and records of a qualified cash pool header. Thus, for example, the specified current assets test allows a covered debt instrument that is used to finance variable operating costs and that is expected to be repaid from sales during the course of a normal operating cycle to be considered a qualified short-term debt instrument. Consistent with the exclusion of a qualified cash pool header's deposits payables from consideration under the specified current assets test, specified current assets do not include assets that are reflected on the books and records of a qualified cash pool header.

The applicable accounting principles to be applied for purposes of the specified current assets test, including for purposes of determining specified current assets reasonably expected to be reflected on the issuer's balance sheet, are financial accounting principles generally accepted in the United States (GAAP), or an international financial accounting standard, that is applicable to the issuer in preparing its financial statements, computed on a consistent basis. The reference to a normal operating cycle also is intended to be interpreted consistent with the meaning of that term under applicable accounting principles. Under GAAP, the normal operating cycle is the average period between the commitment of cash to acquire economic resources to be resold or used in production and the final realization of cash from the sale of products or services that are, or are made from, the acquired resources. For example, in the course of a normal operating cycle, a retail firm would commit cash to buy inventory, convert the inventory into accounts receivable, and convert the accounts receivable into cash. However, if the issuer has no single clearly defined normal

operating cycle, then the issuer's normal operating cycle is determined based on a reasonable analysis of the length of the operating cycles of the multiple businesses and their sizes relative to the overall size of the issuer.

The reference to a financial accounting-based concept of current assets in the specified current assets test is consistent with comments that recommended an exception or safe harbor based on a determinable financial metric. The Treasury Department and the IRS have determined that, among the many potential metrics recommended in comments, the approach in the current assets test most appropriately achieves the goal of providing an administrable exception for variable funding needs during the course of a normal operating cycle. The reference to the amounts of specified current assets that are "reasonably expected" to be reflected on the balance sheet is intended to address concerns expressed by comments that any metric based on an amount reported on a prior balance sheet should be increased, for example, to 150 percent of such reported amount, in order to account for growth and seasonal needs that may not be reflected on the balance sheet date. The reference to the maximum of these amounts is intended to refer to the day on which the issuer is reasonably expected to hold the highest level of specified current assets during the designated period. Such reference is not intended to suggest the upper bound of the range of assets that might reasonably be expected to be held on any particular day. The reference to specified current assets in the ordinary course of business is intended to exclude extraordinary transactions that could affect the short-term balance sheet.

As an alternative to the specified current assets test, a covered debt instrument may also constitute a qualified short-term debt instrument by satisfying the 270-day test.

The 270-day test generally provides taxpayers an opportunity to qualify for the short-term debt instrument exception when the specified current assets test provides limited relief due to circumstances unique to the issuer, such as when an issuer has a relatively small amount of current assets and comparatively large temporary borrowing needs. The 270-day test reflects consideration of comments that requested, for example, an exception for loans of up to 180 days or an exception based on the issuer's number of days of net indebtedness during the year.

For a covered debt instrument to satisfy the 270-day test, three conditions must be met. First, the covered debt instrument must have a term of 270 days or less or be an advance under a revolving credit agreement or similar arrangement, and must bear a rate of interest that is less than or equal to an arm's length interest rate, as determined under section 482 and the regulations thereunder, that would be charged with respect to a comparable debt instrument of the issuer with a term that does not exceed 270 days. Second, the issuer must be a net borrower from the lender for no more than 270 days during the taxable year of the issuer, and in the case of a covered debt instrument outstanding during consecutive taxable years, the issuer may be a net borrower from the lender for no more than 270 consecutive days. In determining whether the issuer is a net borrower from a particular lender for this purpose, only covered debt instruments that satisfy the term and interest rate requirement and that are not ordinary-course loans (described in Section D.8.c.ii of this Part V) or interest-free loans (described in Section D.8.c.iii of this Part V) are taken into account. A covered debt instrument with respect to which an issuer claimed the benefit of the specified current assets test in a prior year could meet these conditions and be taken into account for this purpose as a

borrowing. Third, a covered debt instrument will only satisfy the 270-day test if the issuer is a net borrower under all covered debt instruments issued to any lender that is a member of the issuer's expanded group that otherwise would satisfy the 270-day test, other than ordinary course loans and interest-free loans, for 270 or fewer days during a taxable year.

The temporary regulations provide that an issuer's failure to satisfy the 270-day test will be disregarded if the taxpayer maintains due diligence procedures to prevent such failures, as evidenced by having written policies and operational procedures in place to monitor compliance with the 270-day test and management-level employees of the expanded group having undertaken reasonable efforts to establish, follow, and enforce such policies and procedures.

ii. Ordinary course loans

The temporary regulations generally broaden the ordinary course exception in the proposed regulations to provide that a covered debt instrument constitutes a qualified short-term debt instrument because it is an ordinary course loan if it is issued as consideration for the acquisition of property other than money, in the ordinary course of the issuer's trade or business. In contrast to the proposed regulations, the temporary regulations provide that, to constitute an ordinary course loan, an obligation must be reasonably expected to be repaid within 120 days of issuance. The Treasury Department and the IRS have determined that, based on comments received, this term limitation, in conjunction with the addition of the new alternatives for satisfying the qualified short-term debt instrument exception, will accommodate common business

practice with respect to trade payables while providing both the IRS and taxpayers with increased certainty.

In response to comments received on the ordinary course exception, the ordinary course loan element of the exception for qualified short-term debt instruments is broadened so as to no longer be limited to payables with respect to expenses that are currently deductible by the issuer under section 162 or currently includible in the issuer's cost of goods sold or inventory. Although comments requested an expansion to cover debt instruments issued for rents or royalties, such debt instruments are already outside the scope of the funding rule because the funding rule applies solely to debt instruments issued in exchange for property. For this reason, the ordinary course exception in the temporary regulations also does not apply to a debt instrument issued in connection with the receipt of services.

iii. Interest-free loans

In response to comments recommending that all non-interest bearing debt instruments should qualify for an exception, the temporary regulations provide that a covered debt instrument constitutes a qualified short-term debt instrument if the instrument does not provide for stated interest or no interest is charged on the instrument, the instrument does not have original issue discount (as defined in section 1273 and the regulations thereunder), interest is not imputed under section 483 or section 7872 and the regulations thereunder, and interest is not required to be charged under section 482 and the regulations thereunder. See, e.g., §1.482-2(a)(1)(iii) (providing that interest is not required to be charged with respect to an intercompany trade receivable in certain circumstances).

iv. Deposits with a qualified cash pool header

Covered members making deposits with a qualified cash pool header pursuant to a cash-management arrangement may maintain net deposits with the qualified cash pool header under circumstances that otherwise would not allow the qualified cash pool header (which is an issuer of covered debt instruments in connection with its deposits payable) to qualify for the qualified short-term debt instrument exception with respect to the deposit, for instance due to the length of time the deposits are maintained with the cash pool. In response to comments requesting a specific exception for cash pool headers, the temporary regulations provide that a covered debt instrument is a qualified short-term debt instrument if it is a deposit payable by a qualified cash pool header and certain other conditions are met. In particular, the covered debt instrument must be a demand deposit received by a qualified cash pool header pursuant to a cash-management arrangement. Additionally, the deposit must not have a purpose of facilitating the avoidance of the purposes of §1.385-3 or §1.385-3T with respect to a qualified business unit (as defined in section 989(a) and the regulations thereunder) (QBU) that is not a qualified cash pool header.

A qualified cash pool header is defined in the temporary regulations as a member of an expanded group, controlled partnership, or QBU described in §1.989(a)-1(b)(2)(ii) that is owned by an expanded group member, that has as its principal purpose managing a cash-management arrangement for participating expanded group members, provided that an amount equal to the excess (if any) of funds on deposit with the expanded group member, controlled partnership, or QBU (header) over the outstanding balance of loans made by the header (that is, the amount of deposits it

receives from participating members minus the amounts it lends to participating members) is maintained on the books and records of the cash pool header in the form of cash or cash equivalents or invested through deposits with, or acquisition of obligations or portfolio securities of, persons who are not related to the header (or in the case of a header that is a QBU described in §1.989(a)-1(b)(2)(ii), the QBU's owner) within the meaning of section 267(b) or section 707(b). The Treasury Department and the IRS expect that the qualified cash pool header's expenses of operating the cash-management arrangement (for example, hedging costs) will be paid out of its gross earnings on its cash management activities rather than from funds on deposit.

A cash-management arrangement is defined as an arrangement the principal purpose of which is to manage cash for participating expanded group members. Based on comments received, the regulations provide that managing cash includes borrowing excess funds from participating expanded group members and lending such funds to other participating expanded group members, foreign exchange management, clearing payments, investing excess cash with an unrelated person, depositing excess cash with another qualified cash pool header, and settling intercompany accounts, for example through netting centers and pay-on-behalf-of programs.

d. Other potential exceptions

i. General rule exception

Comments recommended that the ordinary course exception apply to the funding rule generally rather than applying solely for purposes of the per se funding rule. A few comments recommended that the ordinary course exception apply to both the general rule and funding rule.

The Treasury Department and the IRS have determined that it is appropriate for the exception applicable to qualified short-term debt instruments, including debt instruments issued to acquire property in the ordinary course of a trade or business, to apply to all aspects of the funding rule because it is relatively unlikely that short-term financing would be used to fund a distribution or acquisition. Moreover, in the event that such short-term financing was issued with a principal purpose of avoiding the purposes of §1.385-3 or §1.385-3T, the anti-abuse rule at §1.385-3(b)(4) may apply.

The Treasury Department and the IRS are not persuaded, however, that the transactions described in the general rule occur in the ordinary course of business. Accordingly, the suggestion to extend the ordinary course exception to general rule transactions is not accepted. However, certain specific exceptions to the general rule are provided for particular ordinary course transactions that were identified in the comments. See, for example, the exception discussed in Section E.2.b of this Part V for purchases of affiliate stock for purposes of paying stock-based compensation to employees, directors, and independent contractors in the ordinary course of business.

ii. De minimis loans

The final and temporary regulations do not adopt the recommendation to exempt de minimis loans. The Treasury Department and the IRS have determined that the threshold exception that applies to the first $50 million of aggregate issue price of covered debt instruments held by members of the expanded group that otherwise would be treated as stock under §1.385-3 is an appropriate de minimis rule that will apply in addition to the exception for short-term debt instruments described in Section D.8.c of this Part V.

iii. Notional pooling or similar arrangements

The temporary regulations do not specifically address the treatment of loans made through a notional cash pool or a similar arrangement including, for example, whether such loans would be treated for federal tax purposes as being made between expanded group members under conduit principles or other rules or doctrines. As noted in Part IV.B.2.c of this Summary of Comments and Explanation of Revisions, however, in some circumstances a notional cash pool may be treated as a loan directly between expanded group members applying federal tax principles. To the extent that notional pooling or similar arrangements give rise to loans between expanded group members for federal tax purposes, the final and temporary regulations, including the qualified short-term debt instrument exception, would apply to such loans in the same manner that they apply to loans made in form between expanded group members.

9. Exceptions to Allow Netting Against Other Receivables

Comments recommended that the amount of a member's debt instruments subject to the funding rule be limited to the excess of its related-party loan payables over its related-party loan receivables. Comments asserted that, in particular, such a rule would mitigate the impact of the final and temporary regulations on a cash pool header that receives deposits from, and makes advances to, participants in a cash pool arrangement, in particular with respect to the potential iterative consequences, which are discussed in detail in Section B.5 of this Part V. More broadly, this recommendation equates to a request for an exception from the funding rule for an amount of loans payable up to the amount of related-party loan receivables held by a funded member.

The temporary regulations, in effect, implement this recommendation with respect to short-term intercompany receivables and payables to varying degrees in the context of the funding rule. As discussed in Section D.8 of this Part V, the temporary regulations include an exception for qualified short-term debt instruments that allows taxpayers to disregard such qualified short-term debt instruments when applying the funding rule. In addition to special rules treating ordinary course loans and interest-free loans as qualified short-term debt instruments, a debt instrument that is part of a short-term funding arrangement is considered a qualified short-term debt instrument if it satisfies one of two mutually exclusive tests: the specified current assets test or the 270-day test. Both of the alternative tests, in effect, allow some netting of short-term receivables and payables. Significantly, the specified current assets test provides an exception for short-term borrowing up to a limit determined by reference to specified current assets, effectively permitting netting of short-term borrowing against short-term assets, including accounts receivables. Additionally, that limit, applied to short-term loans from a qualified cash pool header, is increased by certain deposits the borrower has made to the qualified cash pool header, which effectively permits the borrower to net amounts on deposit with the qualified cash pool header against borrowings from the qualified cash pool header.

Additionally, with respect to a qualified cash pool header, the temporary regulations treat an amount that is on deposit with the cash pool header, which may persist for a longer term, as a qualified short-term debt instrument. A qualified cash pool header, in effect, is permitted to net its long- and short-term receivables arising

from its lending activities pursuant to a cash management arrangement against those deposit payables.

However, the Treasury Department and the IRS decline to adopt a more general netting rule. The exceptions described above for qualified short-term debt instruments operate by excluding altogether from the funding rule an amount of short-term loans based on circumstances that exist at the time the loan is issued. This approach is administrable and reaches appropriate results in the context of short-term debt instruments. Administering a rule based on netting outside of this context would be difficult because of the potential variations in loans (including different terms, currencies, or interest rates) and could result in a covered debt instrument switching between debt and equity on an ongoing basis, depending on the terms of other loans.

E. Exceptions from §1.385-3 for certain distributions and acquisitions and the threshold exception

The proposed regulations included three exceptions to the application of the general rule and funding rule -- the earnings and profits exception, the subsidiary stock issuance exception, and the $50 million threshold exception. Numerous comments were received regarding these exceptions, and many recommendations were made to further narrow the scope of the proposed regulations.

1. Overview of the Exceptions under the Final and Temporary Regulations

The final and temporary regulations include two categories of exceptions that relate to distributions and acquisitions: (i) exclusions described in §1.385-3(c)(2), which include the subsidiary stock acquisition exception (the subsidiary stock issuance exception in the proposed regulations), the compensatory stock acquisition exception, and the exception to address the potential iterative application of the funding rule; and

(ii) reductions described in §1.385-3(c)(3), which are the expanded group earnings reduction and the qualified contribution reduction. The exceptions under §1.385-3(c)(2) and (c)(3) apply to distributions and acquisitions that are otherwise described in the general rule or funding rule after applying the coordination rules in §1.385-3(b). Except as otherwise provided, the exceptions are applied by taking into account the aggregate treatment of controlled partnerships described in §1.385-3T(f).

An exception under §1.385-3(c)(2) excludes a distribution or acquisition from the application of the general rule and funding rule. The Treasury Department and the IRS have determined that, based on comments received, the policy for including the second and third prongs of the general rule and funding rule does not apply to the transactions identified in §1.385-3(c)(2).

An exception under §1.385-3(c)(3) reduces the amount of a distribution or acquisition that can be treated as funded by a covered debt instrument under the general rule and funding rule. In contrast to an exclusion, each reduction is determined by reference to an attribute of a member—expanded group earnings and qualified contributions—rather than to a particular category of transactions, and thus is available to reduce the amount of any distribution or acquisition by the member. The Treasury Department and the IRS have determined that a member's distributions and acquisitions, to the extent of its expanded group earnings and qualified contributions, should be treated as funded by its new equity capital rather than by the proceeds of a related-party borrowing for purposes of the general rule and funding rule. To the extent the amount of a distribution or acquisition is reduced, the amount by which one or more

covered debt instruments can be recharacterized as stock under the general rule or funding rule by reason of the distribution or acquisition is also reduced.

The exclusions and reductions of §1.385-3(c)(2) and (3) operate independently of any exclusion with respect to the definition of covered debt instrument described in §1.385-3(g)(3) as well as the exclusion of qualified short-term debt instruments from the funding rule. Therefore, to the extent an exception applies to a distribution or acquisition, either (i) the distribution or acquisition is treated as not described in the general rule or funding rule (in the case of an exclusion) or (ii) the amount of the distribution or acquisition subject to the general rule or funding rule is reduced (in the case of a reduction). However, the application of an exception in §1.385-3(c)(2) or (3) with respect to a distribution or acquisition does not affect whether any covered debt instrument, including one issued in the distribution or acquisition itself, can be treated as funding another distribution or acquisition under the funding rule. Thus, to the extent a covered debt instrument is not treated as stock by reason of the application of an exception to a distribution or acquisition, the covered debt instrument remains available to be treated as funding another distribution or acquisition. See Section E.6 of this Part V for the treatment under the funding rule of debt instruments that are issued in a distribution or acquisition that, absent an exclusion or reduction under §1.385-3(c)(2) or (3), would be subject to the general rule.

An exception under §1.385-3(c)(2) applies to distributions or acquisitions before an exception under §1.385-3(c)(3). A distribution or acquisition to which an exclusion applies is not treated as described in the general rule or funding rule, whereas a reduction applies to reduce the amount of a distribution or acquisition described in the

general rule or funding rule. To the extent an exclusion exempts a distribution or acquisition from the general rule or funding rule, no amount of the expanded group earnings or qualified contributions of a covered member are used.

A third type of exception, the $50 million threshold exception described in §1.385-3(c)(4), applies to covered debt instruments that otherwise would be treated as stock under §1.385-3(b) because they are treated as funding one or more distributions or acquisitions, after taking into account the exclusions and reductions. The threshold exception overrides the general consequences of §1.385-3(b) for the first $50 million of debt instruments that otherwise would be treated as stock under the general rule and funding rule. A distribution or acquisition treated as funded by a covered debt instrument under §1.385-3(b) is still treated as funded by a covered debt instrument notwithstanding the application of the threshold exception. As a result, the distribution or acquisition cannot be "matched" with another covered debt instrument to cause additional recharacterizations under the funding rule.

2. Exclusions under the Final and Temporary Regulations

a. Exclusion for certain acquisitions of subsidiary stock

i. Overview

Proposed §1.385-3(c)(3) provided an exception, the subsidiary stock issuance exception, to the second prong of the funding rule. The subsidiary stock issuance exception applied to an acquisition of stock of an expanded group member (the issuer) by a funded member (the transferor), provided that, for the 36-month period immediately following the issuance, the transferor held, directly or indirectly, more than 50 percent of the total combined voting power of all classes of stock of the issuer entitled to vote and

more than 50 percent of the total value of the stock of the issuer. For this purpose, indirect ownership was determined by applying the principles of section 958(a) without regard to whether an intermediate entity is foreign or domestic. If the transferor ceased to meet the ownership requirement at any time during the 36-month period, then on the date that the ownership requirement ceased to be met (cessation date), the exception ceased to apply and the acquisition of expanded group stock was subject to the funding rule. The proposed regulations also provided that, if the exception applied to an issuance, the transferor and the issuer would be treated as predecessor and successor but only with respect to any debt instrument issued during the per se period with respect to the issuance and only to the extent of the fair market value of the stock issued in the transaction.

ii. New terminology

As discussed in Section C.3.c of this Part V, the final and temporary regulations expand the subsidiary stock issuance exception to include acquisitions of existing stock of an expanded group member from a majority-owned subsidiary (for example, acquisitions of existing stock of a second-tier subsidiary from a majority-owned first tier subsidiary of the acquiring expanded group member) under the same conditions applicable to acquisitions of newly-issued stock. To reflect these changes, in the final and temporary regulations: the “subsidiary stock issuance exception” is renamed “subsidiary stock acquisition exception”; the “transferor” is renamed “acquirer”; and the “issuer” is renamed “seller.” For the remainder of this Part, the terminology of the proposed regulations is used to describe the rules of the proposed regulations, and comments thereon. The terminology of the final and temporary regulations is used in

responses to the comments, as well as to describe the provisions of the final and temporary regulations.

iii. Holding period requirement

Comments asserted that the 36-month holding period requirement for the subsidiary stock issuance exception would unnecessarily restrict post-issuance restructuring unrelated to, and unanticipated at the time of, the issuance. For this reason, comments recommended that the regulations adopt a control requirement that incorporates the principles of section 351, under which the holding period requirement would be satisfied if the transferor controlled the issuer immediately after the issuance and all transactions occurring pursuant to the same plan as the issuance. Comments asserted that, if this recommendation were adopted, the regulations could retain the 36-month holding period as a safe harbor.

The Treasury Department and the IRS agree that transactions motivated by business exigencies that are unforeseen at the time of the acquisition should not generally result in the inapplicability of the subsidiary stock acquisition exception with respect to the acquisition. Therefore, the final and temporary regulations provide that the exception applies if the acquirer controls the seller immediately following the acquisition and does not relinquish control of the seller pursuant to a plan that existed at the time of the acquisition. For this purpose, the acquirer is presumed to have had a plan to relinquish control of the seller at the time of the acquisition if the transferor relinquishes control of the seller within the 36-month period following the acquisition. This presumption may be rebutted by facts and circumstances that clearly establish that the loss of control was not contemplated at the time of the acquisition and that avoiding

the purposes of §1.385-3 or §1.385-3T was not a principal purpose for the subsequent loss of control.

In contrast to the proposed regulations, the final and temporary regulations do not provide that the subsidiary stock acquisition exception ceases to apply upon the cessation date. Instead, if the acquirer loses control of the seller within the 36-month period following the acquisition pursuant to a plan that existed at the time of the acquisition, the subsidiary stock acquisition exception would be treated as never having applied to the expanded group stock acquisition.

iv. Cessation of expanded group relationship

Comments requested clarification on the application of the subsidiary stock issuance exception if the transferor and issuer cease to be members of the same expanded group before the end of the 36-month holding period. Comments recommended that the subsidiary stock issuance exception continue to exempt an issuance if the transferor and issuer cease to be members of the same expanded group in the same transaction in which the transferor's ownership in the issuer is reduced to be at or below 50 percent. Comments also recommended that, if the transferor and issuer cease to be members of the same expanded group, the predecessor and successor status of the transferor and issuer should also cease for purposes of applying the per se funding rule.

As discussed in Section E.2.a.iii of this Part V, the final and temporary regulations eliminate the fixed holding period requirement of the proposed regulations. However, the issue could still arise if the loss of control and the cessation of common expanded group membership occur pursuant to a plan that existed at the time of the

acquisition. For example, assume P borrows from a member of the same expanded group, and then, within 36 months of the funding, contributes property to S in exchange for S stock with the intent of selling 100 percent of the stock of S to an unrelated person. In this example, P loses control of S pursuant to a plan that existed at the time of the acquisition of S stock, but that loss of control occurs in the same transaction that causes P and S to cease to be members of the same expanded group.

The Treasury Department and the IRS have determined that a transaction that results simultaneously in a loss of control and a disaffiliation of the seller and acquirer does not achieve a result that is economically similar to a distribution because in that situation no property is made available, directly or indirectly, to a common shareholder of the seller and the acquirer. Accordingly, the final and temporary regulations provide that a transaction that results in a loss of control is disregarded for purposes of applying the subsidiary stock acquisition exception if the transaction also results in the acquirer and the seller ceasing to be members of the same expanded group. For purposes of the preceding sentence, an acquirer and seller do not cease to be members of the same expanded group by reason of a complete liquidation described in section 331. Further, as discussed in Section D.3 of this Part V, the final and temporary regulations provide that the seller ceases to be a successor to the acquirer upon the date the seller ceases to be a member of the same expanded group as acquirer.

v. Indirect ownership

One comment requested that the indirect ownership rules used for the subsidiary stock issuance exception be conformed to the indirect ownership rules used for other purposes of the section 385 regulations, such as the modified section 318 constructive

ownership rules in §1.385-1(c)(4) used to determine the composition of an expanded group. The final and temporary regulations retain the indirect ownership rules of section 958(a) as the proper measure of ownership for purposes of the subsidiary stock acquisition exception because the Treasury Department and the IRS have determined that the constructive ownership rules found in other provisions of the Code would not properly differentiate an acquisition of expanded group stock that does not have an economic effect similar to that of a distribution from one that does. As discussed in Section C.3.c of this Part V, the subsidiary stock acquisition exception is predicated on the view that the acquisition of newly-issued stock of a controlled direct or indirect subsidiary is not economically similar to a distribution because the property transferred in exchange for the stock remains indirectly controlled by the acquirer and, likewise, the transaction does not have the effect of making the property available to the ultimate common shareholder (that is, the property is not transferred "out from under" the acquirer). In this regard, constructive ownership (for instance, under section 318) is appropriate for determining whether a common shareholder controls each of two or more corporations, but is inappropriate for the limited purpose of determining whether stock or assets are indirectly owned by one of those corporations. Therefore, to effectuate the policy of the exception, indirect ownership for purposes of the subsidiary stock acquisition exception continues to be limited to indirect ownership within the meaning of section 958(a).

vi. Tiered transfers

One comment requested that the regulations clarify the impact of certain transactions occurring after a funded member's transfer of property to a controlled

subsidiary. For instance, assume that S1 contributed property to S2, its wholly-owned subsidiary, in exchange for S2 stock, and S2 subsequently contributed property to S3, its wholly-owned subsidiary, in exchange for S3 stock. The comment requested that the regulations clarify that S2's acquisition of S3 stock is not an acquisition of expanded group stock that affects the application of the subsidiary stock issuance exception to S1's initial transfer to S2.

The Treasury Department and the IRS have determined that the proposed regulations already properly provided for this result. As a result of an issuance described in the subsidiary stock issuance exception, the issuer (S2) becomes a successor to the transferor (S1) to the extent of the value of the expanded group stock acquired from the issuer, but only with respect to a debt instrument of the issuer issued during the per se period determined with respect to the issuance. If the issuer (S2) engages in another transaction described in the subsidiary stock issuance exception as a transferor, the acquisition of the stock of the expanded group member (the second issuer) would also not constitute an acquisition of expanded group stock by reason of the exception. Therefore, under a second application of the subsidiary stock issuance exception, the acquisition of the stock of S3 by the issuer (S2), a successor to the transferor (S1), is not treated as described in the second prong of the funding rule and thus cannot be treated as funded by a covered debt instrument issued by the transferor (S1). After the second issuance, the second issuer (S3) is a successor to both the first transferor (S1) and the first issuer (S2), which remains a successor to the first transferor (S1). The final and temporary regulations change the terminology, but do not change the result of the proposed regulations in this regard.

b. Exclusion for certain other acquisitions of expanded group stock, including in connection with employee stock compensation, and other recommendations for exceptions for acquisitions described in §1.1032-3

Comments requested an exception from the funding rule for all transactions described in §1.1032-3. Section 1.1032-3 generally applies to an acquisition by a corporation (acquiring entity) of the stock of its controlling parent (issuing corporation) for use as consideration to acquire money or other property (including compensation for services). Section 1.1032-3(b) addresses the transaction in the context of an acquiring entity that either does not make actual payment for the stock of the issuing corporation (§1.1032-3(b)(1)) or makes actual payment for the stock of the issuing corporation, but that actual payment is less than the fair market value of the issuing corporation stock that is acquired (§1.1032-3(b)(2)). In either case, to the extent the fair market value of the stock of the issuing corporation exceeds the value of the consideration provided by the acquiring entity, §1.1032-3(b) deems a contribution of cash to the acquiring entity by the issuing corporation followed by a deemed purchase of stock of the issuing corporation by the acquiring entity. The majority of the comments on this issue recommended an exception from the funding rule to the extent that a purchase of expanded group stock was deemed to occur solely by reason of §1.1032-3(b).

The final and temporary regulations provide relief for purchases of expanded group stock that are deemed to occur under §1.1032-3(b) by adopting a separate recommendation to reduce the amount of distributions or acquisitions described in the general rule or funding rule by qualified contributions. As described in Section E.3.b of this Part V, qualified contributions include a deemed cash contribution under §1.1032-3(b). Accordingly, after taking into account the new exception for qualified contributions, a deemed transaction under §1.1032-3(b), regardless of how the acquiring corporation

uses the stock of the issuing corporation, should not result in a "net" acquisition of expanded group stock for purposes of the funding rule. Therefore, the request for a specific exclusion for a deemed acquisition of expanded group stock under §1.1032-3 is rendered moot by the new exception for qualified contributions.

Some comments also recommended an exception to the extent that the acquiring entity makes an actual payment for the stock of the issuing corporation that is conveyed to a person as consideration for services or an acquisition of assets. That actual payment could be in the form of cash, which could implicate the funding rule, or an issuance of a debt instrument, which could implicate the general rule. Several comments, however, specifically addressed this situation in the context of an acquisition of parent stock that will be transferred to an employee, director, or independent contractor for the performance of services. Comments asserted that the acquisition of newly-issued stock of a publicly-traded parent to compensate employees, whether in exchange for actual or deemed consideration, does not implicate the policy concerns of the proposed regulations because such transactions occur in the ordinary course of the group's business and for meaningful non-tax reasons (for example, reduced cost as compared to acquiring the shares from the public). One comment recommended an exception for the acquisition of the stock of an expanded group parent by another member of the group that is a dealer in securities (within the meaning of section 475(c)(1)) in the ordinary course of the dealer's business as a dealer in securities. A comment suggested that if the Treasury Department and the IRS are concerned about parent stock that is purchased for use in a transaction that resembles a reorganization, the exception could be limited to stock that is transferred to a person in connection with

such person's performance of services as an employee, director, or independent contractor, or to a person as consideration for the acquisition of assets that will be used by the issuer in the issuer's trade or business.

As discussed in Section C.3.a of this Part V, by itself, an acquisition of expanded group stock by issuance in exchange for cash or a debt instrument has an economic effect that is similar to a distribution of the cash or note used to acquire the stock from the controlling parent. The Treasury Department and the IRS acknowledge that these concerns could be mitigated in certain circumstances, for example, when parent stock is conveyed to an unrelated person as consideration for services provided to a subsidiary or as consideration for an acquisition of assets for use in the ordinary course of a subsidiary's business. However, the Treasury Department and the IRS also are concerned that there has been significant abuse involving purchases of parent stock for use as consideration in other transactions, particularly in the context of acquisitions of control of another corporation or of substantially all of the assets of another corporation. This is the case regardless of whether the acquisition is of the stock or assets of a corporation and whether the counter-party is a related or unrelated person. See, e.g., Notice 2006-85, 2006-2 C.B. 677; Notice 2007-48, 2007-1 C.B. 1428; §1.367(b)-10.

Accordingly, the Treasury Department and the IRS have determined that, in response to comments, it is appropriate to provide an exception from the general rule and funding rule for acquisitions of expanded group stock in the two situations where comments have pointed out that it is common business practice to acquire controlling parent stock for use as currency in another transaction. Specifically, the final and temporary regulations provide an exclusion from the second prong of the general rule

and funding rule to the extent the acquired expanded group stock is delivered to individuals in consideration for services rendered as an employee, a director, or an independent contractor. This exclusion applies to an acquisition of expanded group stock regardless of whether the acquisition is in exchange for actual property or deemed property under §1.1032-3(b). To the extent parent stock is received in exchange for no consideration, the deemed contribution of cash used to purchase the stock under §1.1032-3(b) may also constitute a qualified contribution as described in Section E.3.b of this Part V. The second situation, involving acquisitions by dealers in securities, is discussed in Section E.2.d of this Part V.

The Treasury Department and the IRS decline to adopt the recommendation for a broader exception that would apply whenever the acquiring member uses the acquired stock as currency in a subsequent acquisition because the Treasury Department and the IRS remain concerned about the potential for abuse outside of the scenarios identified in comments where the use of parent stock is common business practice. See §1.385-3(h)(3) Example 2. Furthermore, taxpayers that wish to use parent stock as currency for other purposes have the flexibility to structure the transaction in ways that do not implicate the final and temporary regulations. For instance, the parent can provide the stock to its subsidiary in exchange for no consideration or, in the alternative, the parent can acquire the asset with its own stock and transfer the asset to the subsidiary.

c. Exclusion for distributions and acquisitions resulting from the application of section 482

Comments requested that the regulations disregard distributions and contributions deemed to occur by virtue of other provisions of the Code or regulations, including distributions deemed to occur under §1.482-1(g)(3) and adjustments made pursuant to Revenue Procedure 99-32, 1999-2 C.B. 296, and debt instruments and contributions deemed to occur under section 367(d). In response to these comments, the final and temporary regulations provide an exception from the funding rule for distributions and acquisitions deemed to occur as a result of transfer pricing adjustments under section 482. The Treasury Department and the IRS decline to include an exception for transactions deemed to occur under section 367(d) in the final and temporary regulations because the regulations are limited to U.S. borrowers.

d. Exclusions for acquisitions of expanded group stock by a dealer in securities

One comment recommended that the regulations provide an exception for stock issued by a member of an expanded group and subsequently acquired by a member of the same expanded group that is a dealer in securities (within the meaning of section 475(c)(1)) in the ordinary course of the dealer's business as a dealer in securities, provided that the dealer satisfies certain criteria in acquiring and holding the stock.

In response to the comments, the final and temporary regulations provide an exception for the acquisition of expanded group stock by a dealer in securities. Under §1.385-3(c)(2)(iv), the acquisition of expanded group stock by a dealer in securities (within the meaning of section 475(c)(1)) is not treated as described in the general rule or funding rule to the extent the expanded group stock is acquired in the ordinary course of the dealer's business of dealing in securities. This exception applies solely to the extent that (i) the dealer accounts for the stock as securities held primarily for sale to

customers in the ordinary course of business, (ii) the dealer disposes of the stock within a period that is consistent with the holding of the stock for sale to customers in the ordinary course of business, taking into account the terms of the stock and the conditions and practices prevailing in the markets for similar stock during the period in which it is held, and (iii) the dealer does not sell or otherwise transfer the stock to a person in the same expanded group, other than in a sale to a dealer that in turn satisfies the requirements of §1.385-3(c)(2)(iv).

e. Exclusions for certain acquisitions of affiliate stock resulting from the application of the funding rule.

The final and temporary regulations include an exception for iterative recharacterizations discussed in Section B.5 of this Part V.

3. Reductions under the Final and Temporary Regulations

a. Reduction for expanded group earnings and profits

Proposed §1.385-3(c)(1) provided that the aggregate amount of distributions and acquisitions described in the general rule and funding rule for a taxable year was reduced to the extent of the current year earnings and profits (as described in section 316(a)(2)) (the earnings and profits exception). The reduction under the earnings and profits exception was applied to each distribution and acquisition based on the order in which the distribution or acquisition occurred. The preamble to the proposed regulations explained that the earnings and profits exception was intended to accommodate ordinary course distributions and acquisitions and to provide taxpayers significant flexibility to avoid the application of the per se funding rule.

i. Earnings period

Comments requested that the earnings and profits exception be expanded to include earnings and profits accumulated by a member in one or more taxable years preceding the current year. Comments noted that earnings and profits for the current year may be difficult or impossible to compute by the close of the year. Moreover, under certain circumstances, a member may not be permitted under local law to distribute earnings and profits for the year (for example, due to a lack of distributable reserves). Comments also asserted that, by taking into account only earnings and profits for the current year, the exception would inappropriately incentivize taxpayers to "use or lose" their earnings and profits through annual distributions. Also, comments noted that the current earnings and profits of a company do not necessarily represent a company's ability to pay ordinary course dividends, due to factors such as how earnings and profits are calculated and the amount of cash available from operations, and suggested that a longer period for the exception would mitigate the impact of these factors.

Recommendations varied regarding the period for which earnings and profits should be taken into account for purposes of the exception, ranging from the current year and the immediately preceding year to the current year and all prior years. In addition, some comments requested a grace period (for example, 75 days) after the close of the taxable year to make distributions or acquisitions that would relate back to the earning and profits with respect to the previous year. Some comments requested that the earnings and profits exception include earnings and profits accumulated before the release of the notice of proposed rulemaking on April 4, 2016. Others stated that earnings and profits for purposes of this exception should include only those

accumulated in taxable years ending after that date. One comment recommended that the earnings and profits exception include all undistributed earnings and profits of a corporation accumulated since April 4, 2016, but limited to the period in which such corporation was a member of the expanded group of which it is a member at the time of a distribution or acquisition. Comments also requested that, if a cumulative measure of earnings and profits is adopted, any years in which a member had a deficit be disregarded, or, in the alternative, a member be permitted to distribute amounts at least equal to distributions from other members that themselves qualify for the earnings and profits exception, notwithstanding that the member has an accumulated deficit. In addition, comments requested that the earnings and profits exception include previously taxed income, and that, regardless of the period adopted, all previously taxed income be permitted to be distributed without implications under §1.385-3, including previously taxed income accumulated before April 4, 2016. One comment suggested that the earnings and profits exception be eliminated, noting that only the threshold exception is needed.

The final and temporary regulations adopt the recommendation to take into account all earnings and profits accumulated by a corporation during its membership in an expanded group in computing the earnings and profits exception, provided that the earnings and profits were accumulated in taxable years ending after April 4, 2016 (the expanded group earnings reduction). The expanded group earnings reduction significantly expands the exception provided in the proposed regulations, but also appropriately limits the reduction to earnings and profits attributable to the period of a corporation's membership in a particular expanded group. The Treasury Department

and the IRS decline to adopt a cumulative or fixed period approach that is not limited upon a change-of-control because either approach would create incentives for acquisitions of earnings-rich corporations for the purposes of avoiding these regulations by having such corporations use related-party debt to finance extraordinary distributions rather than new investment. Moreover, an approach that takes into account earnings and profits over a fixed period, regardless of its duration, implicates the same "use or lose" concern identified with respect to the exception in the proposed regulations, albeit delayed until the final year of the period. The Treasury Department and the IRS have determined that the expanded group earnings reduction appropriately balances concerns regarding the usefulness and administrability of the reduction with the purpose of providing an exception only for ordinary course distributions.

To effectuate this purpose, the final and temporary regulations provide that the aggregate amount of a covered member's distributions or acquisitions described in the general rule or funding rule in a taxable year during an expanded group period are reduced by the member's expanded group earnings account for the expanded group period. The expanded group period is the period during which the covered member is a member of an expanded group with the same expanded group parent. The expanded group earnings account with respect to an expanded group period is the excess, if any, of the covered member's expanded group earnings during the period over the covered member's expanded group reductions during the period. The reduction for expanded group earnings applies to one or more distributions or acquisitions based on the order in which the distributions or acquisitions occur. The reduction occurs regardless of whether any distribution or acquisition would be treated as funded by a covered debt

instrument without regard to the exception. The expanded group earnings reduction is applied to distributions and acquisitions by a covered member described in the general rule and funding rule before the reduction for qualified contributions discussed in Section E.3.b of this Part V.

Expanded group earnings are generally the earnings and profits accumulated by the covered member during the expanded group period computed as of the close of the taxable year without regard to any distributions or acquisitions by the covered member described in §§1.385-3(b)(2) and (b)(3)(i). Thus, for example, if a covered member distributes property to a member of the member's expanded group, the covered member's expanded group earnings are not decreased by the amount of the property because the distribution is described in the funding rule, even assuming the distribution reduces the covered member's accumulated earnings and profits under section 312(a). However, if, for example, a covered member distributes property to a shareholder that is not a member of the member's expanded group, so that the transaction is not described in the funding rule, the distribution generally decreases the covered member's expanded group earnings to the extent that the accumulated earnings and profits are decreased under section 312(a).

Expanded group reductions are the amounts by which acquisitions or distributions described in the general rule or funding rule were reduced by reason of the expanded group earnings reduction during the portion of the expanded group period preceding the taxable year. As discussed in the preceding paragraph, a distribution or acquisition described in the general rule or funding rule does not reduce a covered member's expanded group earnings. However, the same distribution or acquisition, to

the extent the amount of the distribution or acquisition is reduced under the expanded group earnings reduction in the taxable year, increases the covered member's expanded group reductions for the succeeding year, and thereby decreases the covered member's expanded group earnings account on a go-forward basis.

The Treasury Department and the IRS decline to adopt the recommendation to extend the earnings and profits reduction to take into account earnings and profits accumulated before the release of the notice of proposed rulemaking. The proposed regulations included only current year earnings and profits for the earnings and profits exception. Accordingly, the earnings and profits taken into account under the proposed regulations were limited to those accumulated in a taxable year ending on or after April 4, 2016. The expanded group earnings reduction provides taxpayers with significantly more flexibility than the proposed regulations to avoid the application of §1.385-3 with respect to ordinary course distributions and acquisitions. Moreover, the Treasury Department and the IRS are concerned that allowing a corporation to distribute all of its historic earnings and profits would facilitate related-party borrowing to fund extraordinary distributions and acquisitions. Although allowing a corporation to accumulate, and later distribute, earnings and profits for taxable years ending after April 4, 2016, could also facilitate extraordinary distributions, the Treasury Department and the IRS have concluded that, on balance, it is preferable to avoid the incentives that would follow from creating a "use or lose" attribute. These incentives are not applicable with respect to taxable years ending before April 4, 2016. For similar reasons, dividends from other expanded group members are not taken into account in calculating expanded group earnings of a covered member unless attributable to earnings and

profits accumulated in a taxable year of the distributing member ending after April 4, 2016 and during its expanded group period. For this purpose, dividends include deemed inclusions with respect to stock, including inclusions under sections 951(a) and 1293.

The final and temporary regulations do not adopt the recommendation to disregard a deficit in any taxable year in calculating a member's expanded group earnings. The Treasury Department and the IRS have determined that, by expanding the reduction with respect to a corporation to include all earnings and profits accumulated while the corporation was a member of the same expanded group, the expanded group earnings account appropriately reflects the amount of a corporation's new equity capital generated from earnings that is available to fund ordinary course distributions. Moreover, incorporating a "nimble dividend" concept into the expanded group earnings reduction would convert current year earnings and profits into a "use or lose" attribute if the covered member has an overall accumulated deficit, which is contrary to the policy of expanding the exception to include all earnings accumulated during an expanded group period.

The final and temporary regulations also do not adopt the recommendation to attribute to the prior year distributions and acquisitions that occur during a grace period following the close of that taxable year. The Treasury Department and the IRS have determined that a grace period is unnecessary because the cumulative approach of the expanded group earnings reduction significantly relieves the burden of computing the earnings and profits for the particular year of a distribution or acquisition.

Because the final and temporary regulations do not apply to foreign issuers (including CFC issuers), the regulations no longer implicate the concerns regarding distributions of previously taxed income.

ii. Ordering rule

The proposed regulations provided that the earnings and profits exception applied to distributions or acquisitions in chronological order. Comments asserted that this ordering rule would place an undue premium on the sequence of distributions. For example, assume that P owns all the stock of S. In Year 1, S makes distributions to P consisting of (i) $50x cash (the funding rule distribution) and (ii) an S note with a $50x principal amount (the general rule distribution). S makes no other distributions or acquisitions during Year 1 and has not been funded by a debt instrument that is outstanding during Year 1. Under the proposed regulations, if S has $50x of earnings and profits for Year 1, whether the S note issued in the general rule distribution is recharacterized as stock would depend on the sequence of the distributions. If the funding rule distribution occurred first, the earnings and profits exception would reduce the amount of that distribution; however, because S has no debt instruments outstanding that can be treated as funding the distribution, the exception would provide no immediate benefit to S and P. Further, because the funding rule distribution would exhaust the earnings and profits of S for the taxable year, the earnings and profits exception would not reduce any amount of the general rule distribution, with the result that the S note would be immediately recharacterized as stock under the general rule. On the other hand, if the general rule distribution occurred first, the amount of the general rule distribution would be reduced by the earnings and profits exception, which

would immediately benefit S and P. In that case, because S has no debt instruments outstanding, the funding rule distribution would not cause the recharacterization of any debt instrument in the taxable year of the distribution even though no amount of the funding rule distribution would be reduced by the earnings and profits exception.

To address this concern, comments recommended that, if the aggregate amount of distributions or acquisitions by a member in a taxable year exceeds the amount of a member's earnings and profits, the earnings and profits exception should apply to reduce either a general rule transaction or a funding rule transaction that was preceded by a funding within the per se period, before being applied to reduce a funding rule transaction that is not preceded by a funding, regardless of the sequence of the transactions. In the alternative, comments recommended that the regulations provide taxpayers an election to determine the distributions or acquisitions to which the earnings and profits exception would apply.

The Treasury Department and the IRS agree that, in the absence of compelling administrability or policy reasons to the contrary, the sequencing of transactions between expanded group members within the same taxable year should not generally control the consequences of debt issuances. However, the Treasury Department and the IRS do not adopt either recommendation to address the significance of sequencing under the proposed regulations because, as discussed in Section E.6 of this Part V, the final and temporary regulations treat a covered member that issues a covered debt instrument in a distribution or acquisition as a funded member if that distribution or acquisition satisfies an exception described in §1.385-3(c)(2) and (3), including the expanded group earnings reduction (the funded member rule). The funded member

rule harmonizes the application of the expanded group earnings reduction with respect to general rule and funding rule transactions, thus substantially eliminating the importance of the sequence of the two types of transactions within a taxable year. Accordingly, the final and temporary regulations retain the "first-in-time" ordering rule of the proposed regulations for the expanded group earnings reduction. A similar ordering rule applies for purposes of the qualified contribution reduction described in Section E.3.b of this Part V.

iii. Alternate metrics

Comments recommended that metrics other than earnings and profits be used as the basis for a taxpayer-favorable stacking rule. Suggestions included free cash flow from operations, as determined under GAAP; earnings before interest, taxes, depreciation and amortization (EBITDA); adjusted taxable income described in section 163(j)(6)(A); and other financial metrics under International Financial Reporting Standards (IFRS) or foreign country statutory accounting requirements. The Treasury Department and the IRS decline to adopt an alternate metric, and the final and temporary regulations retain earnings and profits as the basis for determining the amount of a distribution or acquisition treated as not funded by a covered debt instrument. The expanded group earnings reduction is intended to permit a member to make ordinary course distributions of its business earnings. In this regard, and most significantly, Congress established earnings and profits as the appropriate measure for federal tax purposes of whether a distribution represents a payment of the corporation's earnings or is a return of a shareholder's investment. In addition, using a metric such as adjusted taxable income described in section 163(j)(6)(A) or EBITDA would, over

time, significantly overstate the ability of many members to make ordinary course distributions because such computations include no reduction for capital investment, interest, or taxes. Moreover, U.S. issuers are already familiar with, and required to compute, earnings and profits for general federal tax purposes, and establishing a requirement to use an alternate metric would add administrative complexity and compliance burden. For the foregoing reasons, the final and temporary regulations retain earnings and profits as the starting point for the expanded group earnings reduction.

Comments recommended an exception for ordinary course distributions based on the distribution history of the member. An exception for ordinary course distributions based on a distribution history would require an annual or other periodic averaging of distributions by a member. Because the Treasury Department and the IRS have determined that the cumulative approach to determining the expanded group earnings reduction is both more taxpayer-favorable and easier to administer than an approach based on distribution history, the final and temporary regulations reject this recommendation.

iv. Predecessors and successors

Comments requested clarification regarding the application of the earnings and profits exception to predecessors and successors. Specifically, comments questioned whether a funding rule distribution or acquisition by a predecessor or successor with no earnings and profits nonetheless qualifies for the earnings and profits exception when the member with respect to which it is a predecessor or successor has earnings and profits.

In response to comments, the final and temporary regulations provide that, for purposes of applying the expanded group earnings reduction, as well as the qualified contribution reduction discussed in Section E.3.b of this Part V, with respect to a distribution or acquisition, references to a covered member do not include references to any corporation to which the covered member is a predecessor or successor. Accordingly, a distribution or acquisition by a predecessor or successor that is otherwise attributed to a funded member is reduced solely to the extent of the expanded group earnings and qualified contributions of the predecessor or successor that actually made the distribution or acquisition. The as-reduced amount of the distribution or acquisition is then attributed to the funded member, whose attributes are not available to further reduce the amount of the distribution or acquisition that may be treated as funded by a debt instrument of the funded member. The Treasury Department and the IRS have determined that sourcing distributions and acquisitions solely out of the relevant attributes of the distributing or acquiring member is more administrable and more consistent with the purpose of the reductions to permit ordinary course transactions not in excess of a member's new equity capital than an alternative approach such as calculating reductions by reference to the attributes of the other corporation in the predecessor-successor relationship or aggregating the attributes of both corporations.

In lieu of incorporating predecessor-successor concepts, the final and temporary regulations provide that a member that acquires the assets of another member in a complete liquidation described in section 332 or in a reorganization described in section 368 (whether acquisitive or divisive) succeeds to some or all of the acquired member's expanded group earnings account. Similar provisions apply with respect to the qualified

contribution reduction described in Section E.3.b of this Part V. This rule appropriately takes into account the enlarged dividend-paying capacity of a member that acquires the assets of another member pursuant to certain non-recognition transactions, and ensures that the expanded group earnings of a member are preserved and available for use after a reorganization, liquidation, or spin-off. Thus, while for purposes of applying the expanded group earnings reduction a reference to a member does not include a reference to a corporation to which the member is a predecessor or successor, the expanded group earnings account of a member may be determined, in whole or in part, by reference to the expanded group earnings account of a predecessor.

As discussed in Section D.5 of this Part V, the final and temporary regulations provide that a reorganization with boot, to the extent described in more than one prong of the funding rule, is treated as a single distribution or acquisition for purposes of the funding rule. The final and temporary regulations also provide that, for purposes of applying the expanded group earnings reduction, a distribution or acquisition that occurs pursuant to an internal asset reorganization is reduced by the expanded group earnings account of the acquiring member, after taking into account the expanded group earnings account it inherits form the target member. A similar provision applies to the qualified contribution reduction described in Section E.3.b of this Part V.

v. Additional recommendations to make the exception more administrable

Comments requested various safe harbors pursuant to which a taxpayer's determination of its earnings and profits would be respected if determined in good faith. One comment requested that the earnings and profits reflected on a timely filed tax return for an applicable taxable year be conclusively treated as the earnings and profits

for such year, and any adjustments to earnings and profits for such year that arise out of an audit adjustment or amended tax return not be taken into account. A similar comment recommended that a taxpayer's determination of its earnings and profits be respected for purposes of applying the regulations, notwithstanding audit adjustments by the IRS, unless the determination was based upon a position for which accuracy-related penalties could be imposed under section 6662. Comments also requested that the exception apply with respect to distributions or acquisitions that do not exceed earnings and profits by more than a de minimis amount.

The final and temporary regulations do not adopt these suggestions. The Treasury Department and the IRS have determined that the expanded group earnings reduction in the final and temporary regulations provides taxpayers with far more latitude than under the proposed regulations to make ordinary course distributions while eliminating incentives to distribute earnings and profits in a particular year or every year. Because earnings and profits under the revised exception is not a "use or lose" attribute, taxpayers will be able to take a conservative approach to making distributions in any particular year. Accordingly, the Treasury Department and the IRS have determined that additional safeguards against taxpayer error are not warranted.

b. Reduction for qualified contributions

Numerous comments recommended that capital contributions to a member be netted against distributions or acquisitions by the member for purposes of applying proposed §1.385-3(b)(2) and (b)(3)(ii) reasoning that, to the extent of capital contributions, a distribution does not reduce a member's net equity. For this purpose, some comments recommended a broad definition of a capital contribution to include any

transfer of property in deemed or actual exchange for stock under section 1032, while other comments suggested that transfers of expanded group stock or a transfer of the assets of a member pursuant to an internal reorganization not be taken into account for purposes of the netting rule. Comments also differed on the period for which capital contributions should be taken into account. Some comments suggested that contributions for the entire per se period should be taken into account, even with respect to debt instruments that had already been recharacterized under §1.385-3. One comment suggested taking into account contributions that occur after a debt instrument otherwise would be recharacterized but only to the extent that, as of that time, there was a plan to make the subsequent contributions during the remainder of the per se period. Other comments suggested narrower approaches, such as taking into account only the contributions made until the close of the taxable year in which the recharacterization otherwise would occur, or only those made in the per se period preceding the potential recharacterization. Some comments recommended that contributions from any member of the expanded group should be permitted to net against distributions or acquisitions made by another member, while other comments suggested a member-by-member approach to netting.

As discussed in Sections D.2.c and E.3.a.i of this Part V, the Treasury Department and the IRS have determined that it is appropriate to treat distributions or acquisitions as funded by new equity before related-party borrowings. Accordingly, the final and temporary regulations provide that a distribution or acquisition is reduced by the aggregate fair market value of the stock issued by the covered member in one or more qualified contributions (the qualified contribution reduction). A qualified

contribution is a contribution of property (other than excluded property) to the covered member by any member of the covered member's expanded group in exchange for stock of the covered member during the qualified period. The qualified period generally means, with respect to a distribution or acquisition, the period beginning 36 months before the date of the distribution or acquisition, and ending 36 months after the date of the distribution or acquisition, subject to two limitations. First, the qualified period in no event ends later than the last day of the first taxable year that a covered debt instrument of the covered member would, absent the application of the qualified contribution reduction, be treated as stock or, if the covered member is an expanded group partner in a controlled partnership that is the issuer of the debt instrument, as a specified portion. Second, the qualified period is further limited to only include the covered member's expanded group period that includes the date of the distribution or acquisition.

Excluded property (that is, property the contribution of which does not give rise to a qualified contribution) includes expanded group stock and property acquired by a covered member in an internal asset reorganization. The Treasury Department and the IRS have determined that the acquisition of such assets in exchange for stock of a covered member should not be taken into account as increasing capital of the covered member that is available to make distributions for reasons similar to those discussed in Sections C.3 and C.4 of this Part V. In fact, if a covered member were given "credit" for contributions of expanded group stock, for example, the covered member could do in two steps (capital contribution of expanded group stock to the covered member followed by a distribution of a debt instrument by the covered member) what the general rule

would not permit it to do in one step (a covered member's purchase of that expanded group stock in exchange for a debt instrument).

Excluded property also includes a covered debt instrument issued by a member of the covered member's expanded group, property acquired by a covered member in exchange for a covered debt instrument issued by the covered member that is recharacterized under the funding rule, and a debt instrument issued by a controlled partnership of the expanded group of which a covered member is a member. The final and temporary regulations exclude covered debt instruments and debt instruments issued by a controlled partnership because the Treasury Department and the IRS are concerned that taxpayers could use such property to create non-economic qualified contributions before such indebtedness is treated as stock under §1.385-3 or §1.385-3T. Further, the final and temporary regulations exclude property acquired by a covered member in exchange for its own covered debt instrument that is treated as stock under the funding rule. This category of excluded property addresses the potential circularity of treating a contribution of property in exchange for a covered debt instrument that is treated as stock under the funding rule as a qualified contribution, which could reduce the amount of the distribution that caused the covered debt instrument to be treated as stock.

The final and temporary regulations also provide that qualified contributions do not include certain contributions to a covered member that do not have the effect of increasing the capital of the covered member that is available to make distributions (excluded contributions). The contributions that are entirely disregarded are contributions (i) from a member (controlled member) that the covered member controls

("upstream" transfers), and (ii) from a corporation of which the covered member is a predecessor or successor or from a corporation controlled by that corporation. For purposes of the preceding sentence, control of a corporation means the direct or indirect ownership of more than 50 percent of the total combined voting power and more than 50 percent of the total value of the stock of a corporation applying the principles of section 958(a) without regard to whether an intermediate entity is foreign or domestic. If a contribution of property occurs before the covered member acquires control of the controlled member or before the transaction in which the corporation becomes a predecessor or successor to the covered member (transaction date), the contribution of property ceases to be a qualified contribution on the transaction date. If the contribution of property occurs within 36 months before the transaction date, the covered member is treated as making a distribution described in the funding rule on the transaction date equal to the amount by which any distribution or acquisition was reduced because the contribution of property was treated as a qualified contribution.

The final and temporary regulations also provide, more generally, that a contribution of property to a covered member is not a qualified contribution to the extent that the contribution does not increase the aggregate fair market value of the outstanding stock of the covered member immediately after the transaction and taking into account all related transactions, other than distributions and acquisitions described in the general rule and funding rule. Thus, for instance, a contribution to a covered member from a member in which the covered member owns an interest that represents less than 50 percent of the total combined voting power or value does not constitute a

qualified contribution to the extent that the contribution does not increase the value of the covered member.

The final and temporary regulations generally take into account only contributions made during the per se period before the time that a debt instrument would be treated as stock. The Treasury Department and the IRS have determined that taking into account contributions after the taxable year in which a distribution or acquisition caused the recharacterization of a debt instrument would unduly increase the incidence of instruments switching between debt and equity treatment, leading to additional complexity and uncertainty for both the IRS and the taxpayer. However, in response to comments, the final and temporary regulations take into account contributions after a debt instrument would be treated as stock if the contribution occurs before the end of the taxable year in which such treatment begins. This rule allows taxpayers some ability to self-help for inadvertent distributions and acquisitions without implicating the same degree of uncertainty and administrability concerns that would occur if contributions in a subsequent taxable year were taken into account.

The Treasury Department and the IRS are concerned, however, that taxpayers could use capital contributions to frustrate the purposes of the final and temporary regulations. For example, a calendar-year taxpayer could take the position that a distribution of a note on January 1, pursuant to a plan to “undo” the recharacterization of the note that otherwise would apply by making a capital contribution on December 31, gives rise to interest deductions without funding new investment during the 364-day period preceding the contribution. Accordingly, the final and temporary regulations provide that property contributed to a covered member with a principal purpose of

avoiding the purposes of §1.385-3 or §1.385-3T is excluded property, and thus does not give rise to a qualified contribution. As a result, in the example, the contribution on December 31 would not reduce the January 1 distribution or any subsequent distribution. This express limitation (as well as other targeted anti-abuse provisions, such as the limitation to the special exception to iterative recharacterization described in Section B.5 of this Part V) should not be interpreted to create a negative inference that the anti-abuse provision in §1.385-3(b)(4) would not also have addressed such a transaction.

4. Threshold Exception

Proposed §1.385-3(c)(2) provided that an expanded group debt instrument would not be treated as stock if, when the debt instrument is issued, the aggregate issue price of all expanded group debt instruments that otherwise would be treated as stock under the proposed regulations does not exceed $50 million (the threshold exception). The proposed regulations also provided that if the expanded group's debt instruments that otherwise would be treated as stock later exceed $50 million, then all expanded group debt instruments that, but for the threshold exception, would have been treated as stock were treated as stock, rather than only the amount that exceeds $50 million. Thus, the threshold exception in the proposed regulations was not an exemption of the first $50 million of expanded group debt instruments that otherwise would be treated as stock, but rather only provided an exception from the application of proposed §1.385-3 for taxpayers that have not exceeded the $50 million threshold.

Comments suggested that the $50 million limitation should be increased, with the highest specific recommended threshold being $250 million. Comments also suggested

that the threshold be based on a percentage of the issuer's or expanded group's assets, income, or another relevant financial metric. One comment recommended that the threshold exception be determined by reference to the amount by which the issuer's interest expense exceeds interest income. Comments also suggested that the threshold exception should be applied separately with respect to each specific issuer (or a subset of an expanded group) or specific instrument, which would effectively increase the $50 million limitation.

The final and temporary regulations do not increase the amount of the threshold exception, or alter the basis for determining the exception except to include certain debt instruments issued by a controlled partnership that otherwise would be subject to the treatment described in Section H.4 of this Part V in the determination of whether the limitation has been surpassed. The scope revisions (discussed in Part III of the Background), the addition and expansion of exceptions for distributions and acquisitions otherwise described in §1.385-3(b)(2) and (3) (discussed in Section E of this Part V), and the addition and expansion of exceptions for debt instruments otherwise subject to this section (discussed in Sections D.8 and F of this Part V) substantially reduce the number of instruments subject to recharacterization. These revisions are expected to limit the application of the rules to non-ordinary course transactions so that taxpayers will have the flexibility to avoid their application. Additionally, the final and temporary regulations do not adopt the recommendation to vary the threshold based on the size of the expanded group. The regulations are intended to address the use of related-party indebtedness that does not finance new investment. The comments do not establish, and the Treasury Department and the IRS have not ascertained, a policy justification for

permitting larger expanded groups to issue more indebtedness that does not finance new investment, beyond the scaling that necessarily follows from the expanded group earnings reduction. Furthermore, the assets, income, and other financial attributes of an expanded group fluctuate, making it difficult for both taxpayers and the IRS to administer such a percentage-based threshold exception. Accordingly, the final and temporary regulations retain the $50 million threshold.

Additionally, comments suggested eliminating the so-called cliff effect by only recharacterizing instruments in excess of the threshold. Alternatively, comments suggested that the cliff effect apply at a second, higher threshold. In response to these comments, the final and temporary regulations eliminate the rule providing that the exception will not apply to any debt instruments once the $50 million threshold is exceeded. The final and temporary regulations instead provide that, to the extent that the $50 million threshold is exceeded immediately after a debt instrument would be treated as stock under §1.385-3(b), only the amount of the debt instrument in excess of $50 million is treated as stock.

Comments also suggested revisions to the operation of the threshold exception. First, comments requested that an expanded group that exceeds the $50 million threshold due to reasonable cause be given a grace period (such as 90 days) to reduce the amount of outstanding debt instruments below the $50 million threshold. Second, comments recommended the use of an average quarterly amount outstanding to compute whether the $50 million threshold is exceeded. The final and temporary regulations do not adopt either of these recommendations. In light of the elimination of the cliff effect, the Treasury Department and the IRS have determined that neither a

complex computation nor a special remediation rule is required or appropriate for the threshold exception. See Part B.6 of this Part V regarding the decision not to adopt a general remediation rule.

5. Requests for New Exceptions Not Adopted in the Final and Temporary Regulations

a. Post-acquisition and pre-divestiture restructuring

Comments requested an exception for debt instruments issued in connection with the post-merger integration of a previously unrelated target. Comments highlighted that a purchaser can generally fund an acquisition of an unrelated target company entirely with related-party indebtedness without implicating the regulations, but that the realignment of such acquisition indebtedness as part of the post-merger integration of the newly acquired entity, including its subsidiaries, implicates §1.385-3. Moreover, comments asserted that transfers of stock and assets in exchange for debt are often the most practical method of realigning the stock and assets of a newly-acquired member for non-U.S. tax business reasons. Further, while the purchaser (or its subsidiaries) could acquire each target entity separately in fully debt-funded transactions that would not implicate §1.385-3, comments asserted that such a transaction structure may be impractical due to regulatory or financing restrictions or the inability to negotiate such a transaction with an unrelated seller.

For the foregoing reasons, comments recommended that the regulations exempt debt instruments issued in exchange for expanded group stock pursuant to the integration of a newly-acquired member and its subsidiaries. Some comments suggested that an exception should apply to acquisitions from a member within one year of the member's acquisition from an unrelated person. One comment suggested

that an exception should apply to acquisitions of newly-acquired members for 36 months after the acquisition. Another comment recommended an exception that would be limited to debt instruments issued by a member in exchange for the stock or assets of the new member with a principal amount equal to the amount of cash, notes, or rights to future payments received by the unrelated seller from members of the expanded group in the earlier acquisition.

Comments also recommended an exception for related-party indebtedness issued to acquire expanded group stock in connection with a plan to divest the acquiring member to unrelated persons. One comment suggested an exception for indebtedness issued by the departing member within 36 months of its divestiture, while other comments recommended an exception for any acquisitions of expanded group stock that occur pursuant to an integrated plan to dispose of the departing member. Another comment suggested that an acquisition of expanded group stock should not be described in the general rule or funding rule if the acquisition is part of a plan in which the acquirer, seller, and target cease to be members of the same expanded group.

The final and temporary regulations do not adopt an exception for debt instruments issued in connection with post-acquisition or pre-disposition restructuring. Such an exception would facilitate the use of related-party indebtedness to create significant federal tax benefits without financing new investment in the issuer. The incentives to create new related-party debt that does not finance new investment can be just as pronounced, if not more pronounced, in connection with post-acquisition restructuring or in preparation for a planned divestiture, since the new expanded group parent may have a different tax status that will allow the newly-configured group to use

related-party debt to achieve significant federal tax benefits that were not possible before the acquisition or divestiture.

Moreover, the Treasury Department and the IRS do not view the close proximity of a third-party transaction as a basis for providing a special exception for the use of related-party debt in a transaction that does not finance new investment in the issuer. When an expanded group member acquires stock or assets from an unrelated third-party in exchange for cash or property, that acquisition is not described in the general rule or funding rule, even if the cash or property consideration is fully debt-funded by a related-party borrowing, because the acquisition from the unrelated third-party represents new investment in the issuer of the debt. The comments effectively recommend that, in the case of a recent acquisition, the final and temporary regulations extend this concept further to provide that subsequent transactions involving the recently-acquired members be provided a special exception. When those recently-acquired members issue related-party indebtedness to fund an internal stock acquisition or internal asset reorganization, the concerns set forth in Section C of this Part V about related-party debt that does not finance new investment in the issuer apply in a similar manner as in the case of transactions among old and cold expanded group members. Moreover, the Treasury Department and the IRS do not agree that because a transaction with a recently-acquired expanded group member could have been effectuated, hypothetically, with the unrelated third-party seller, the regulations should provide a special exception on the basis of this hypothetical transaction.

Similar concerns apply in the case of pre-divestiture planning. As for post-acquisition restructuring, the Treasury Department and the IRS do not view the close

proximity to a subsequent third-party transaction as a basis for providing a special exception for related-party debt that does not finance new investment in the issuer.

Comments addressing pre-divestiture planning also observed that when a debt instrument is recharacterized close-in-time to the divestiture transaction with the unrelated third-party, the recharacterized debt instrument may be repaid immediately before the divestiture, which, as described in Part B.4 of this Section V, may result in a taxable sale or exchange. The Treasury Department and the IRS do not view the short duration of these instruments as changing the analysis in the preceding paragraph; however, as discussed in Part D.8 of this Section V, the temporary regulations adopt a broad exception to the funding rule for qualified short-term debt instruments that may overlap significantly with the types of short-duration debt instruments issued in anticipation of a divestiture transaction that are addressed in comments. As a result, the final and temporary regulations provide greater flexibility for issuances of debt instruments that are short term in form and in substance.

Comments requested other exceptions for certain restructuring transactions that are not undertaken in connection with a third-party transaction. One comment requested a same-country exception, which would apply to dispositions of stock or assets between expanded group members incorporated in the same country. The same comment requested an exception for internal stock acquisitions resulting in the acquired member joining the acquiring member's consolidated group or internal asset reorganizations in which the acquired member's assets are used by the acquirer in its business. A comment also requested that an internal asset reorganization be excepted if the taxpayer can demonstrate a business purpose for the reorganization.

The Treasury Department and the IRS decline to accept a broad exception for entity restructuring, because, as discussed in Sections C.3 and C.4 of this Part V, an internal stock acquisition and an internal asset reorganization with "other property" has an effect that is economically similar to a distribution regardless of whether the transaction is also supported by a non-U.S. tax business purpose. Moreover, the regulations do not generally prohibit a taxpayer from restructuring its operations; they only deny the undue federal tax benefit from the use of indebtedness in the restructuring to the extent it does not finance new investment.

b. Distributions of non-cash assets

Comments recommended that distributions of "old-and-cold," non-financial assets be excluded from the funding rule because such assets are not fungible and thus should not be treated as funded by a related-party borrowing. A comment suggested that the anti-abuse rule could adequately police distributions of property acquired with a principal purpose to avoid the regulations or acquired within a certain period before the distribution. For similar reasons, one comment recommended that the purchase of operating assets for a note should not be treated as a funding that can be matched with a distribution or acquisition.

The Treasury Department and the IRS decline to adopt this recommendation because a distribution of old-and-cold non-financial assets presents similar policy concerns to those described in Section D.2 of this Part V concerning other distributions of cash and property by a funded member. As discussed in Section D.6 of this Part V, the final and temporary regulations exclude all distributions described in section 355, whether or not preceded by an asset reorganization, from the scope of the funding rule

because the strict requirements of section 355 indicate that the stock of a controlled corporation is not fungible. There are no such safeguards with respect to taxable distributions of operating assets, which may be acquired by the distributing member with cash the day before the distribution and converted into cash by the recipient member the day after. Moreover, an acquisition of operating assets in exchange for a debt instrument is like any other debt-financed purchase, which frees up the cash that otherwise would be used in the acquisition for other uses by the issuer. For these reasons, the Treasury Department and the IRS have determined that transfers of old-and-cold operating assets should not be excepted from the funding rule, except in the narrow circumstance that the distribution qualifies for nonrecognition under section 355.

6. Application of the Funding Rule to Instruments Issued in General Rule Transactions that Qualify for an Exception

a. Treatment of the issuer of a covered debt instrument in a general rule transaction that satisfies an exception as a funded member

Comments expressed concern that a debt instrument issued in an internal stock acquisition or an internal asset reorganization that would be recharacterized under the general rule but for the application of the earnings and profits exception may nonetheless be recharacterized under the funding rule. Comments noted that a debt instrument issued in one of these transactions is, in fact, issued in exchange for property (namely, stock or assets). Therefore, absent a special rule that prevents the debt from being re-tested, the member that engages in the transaction has been funded and the debt instrument may be recharacterized if the member has made, or does make, another distribution or acquisition described in the funding rule during the per se period. Comments suggested that testing the same debt instrument under both the general rule and funding rule amounts to “double jeopardy” and recommended that the

regulations provide that, if the earnings and profits exception applies to reduce the amount of a transaction described in the second or third prong of the general rule, the issuing member should not be treated as a funded member for purposes of retesting the instrument under the funding rule.

The final and temporary regulations do not adopt this recommendation and instead provide that a member that issues a debt instrument in a general rule transaction that satisfies an exception under §1.385-3(c)(2) or (3) is treated as a funded member with respect to the debt instrument for purposes of re-testing the instrument under the funding rule (the funded member rule). The Treasury Department and the IRS have determined that the so-called "double jeopardy" highlighted by comments, in fact, harmonizes the treatment of general rule acquisitions with funding rule acquisitions, and its elimination would create an undue preference in §1.385-3 for general rule acquisitions over funding rule acquisitions. Moreover, the distribution of a debt instrument that qualifies for an exception implicates the same policy concerns, and thus the funded member rule applies to transactions described in all three prongs of the general rule.

As discussed in the preamble to the proposed regulations, a funding rule transaction achieves an economically similar outcome as a general rule transaction. In this regard, both a general rule and a funding rule transaction effect a distribution of the proceeds of a borrowing, except that the latter does in multiple steps what the former accomplishes in one. Therefore, to achieve symmetry between the two types of economically similar transactions, an exception that would exclude or reduce a

distribution or acquisition described in the funding rule should only exclude or reduce the distributive or acquisitive element of a transaction described in the general rule.

To illustrate, if S issues a note in exchange for property from P and, during the per se period, acquires the stock of T from P, and the acquisition satisfies an exception in §1.385-3(c)(2) or (3), the S note is not treated as stock by reason of the T stock acquisition. However, because the S note is treated as not having funded the T stock acquisition, the S note may still be treated as funding another distribution or acquisition that occurs within the per se period. If, however, S acquires the T stock directly from P in exchange for its own note and the acquisition satisfies an exception in §1.385-3(c)(2) or (3), under the recommendation for eliminating "double jeopardy," the S note would not be treated as stock by reason of the T stock acquisition and, moreover, the S note would not be subject to potential recharacterization under the funding rule if there is another distribution or acquisition during the per se period. Accordingly, under the recommendation, an exception intended solely to exclude or reduce a distribution or acquisition would effectively negate both the distributive element and the funding element of the transaction. Moreover, this recommendation would create divergent consequences as between transactions with the same economic effect -- after both variations of the transaction, S has acquired the T stock and P holds an S note. To conform the application of the exceptions in §1.385-3(c)(2) and (3) as between the S funding rule acquisition and the S general rule acquisition, the exceptions should apply solely to exclude or reduce the distributive aspect of the S general rule acquisition.

For the foregoing reasons, the final and temporary regulations provide that, to the extent an exception applies to exclude or reduce the amount of a distribution or

acquisition described in the general rule, the debt instrument issued in the transaction is treated as issued by a member in exchange for property solely for purposes of applying the funding rule to the debt instrument and the member. The funded member rule addresses the sequencing concern with respect to the expanded group earnings reduction discussed in Section E.3.a.ii of this Part V. In the example provided in that section, S distributes $50x cash and a note with a $50x principal amount in a taxable year in which S has expanded group earnings of $50x. Under the funded member rule, if the general rule distribution is reduced by $50x under the expanded group earnings reduction, S is treated as having been funded by the issuance of the $50x note. As a result, the ordering of the distributions does not materially affect the consequences of the transactions under the final and temporary regulations – either (1) the funding rule distribution occurs first, the amount of the cash distribution is reduced by $50x, and the S note is recharacterized as stock under the general rule, or (2) the general rule distribution occurs first, the amount of the note distribution is reduced by $50x, S is treated as having been funded by the note, and the S note is recharacterized as stock under the funding rule by reason of the cash distribution. In either sequence of events, the S note is recharacterized as stock, whether by reason of the general rule or the funding rule.

b. Treatment under the funding rule of a covered debt instrument issued in a general rule transaction that satisfies an exception

The proposed regulations provided that, to the extent a debt instrument issued in an internal asset reorganization is treated as stock under the general rule, the distribution of the debt instrument pursuant to the same reorganization is not also treated as a distribution or acquisition described in the funding rule (the “general

coordination rule”). One comment requested that the general coordination rule be expanded to provide that any transaction described in the general rule, regardless of whether such transaction results in the debt instrument being treated as stock, is not also treated as a distribution or acquisition described in the funding rule. The comment questioned, for example, whether the distribution of a covered debt instrument could be treated as a distribution of property for purposes of the funding rule if the debt instrument were not treated as stock by reason of the threshold exception of §1.385-3(c)(4). The issue could also be implicated if the amount of a general rule acquisition in an internal asset reorganization is reduced by reason of an exception described in §1.385-3(c)(3). To the extent that the amount of the acquisition is reduced by reason of an exception (for example, the expanded group earnings reduction), the covered debt instrument issued by the transferee corporation would be respected as indebtedness, and thus the distribution of the covered debt instrument by the transferor corporation to its shareholder pursuant to the plan of reorganization would be treated as a distribution of property described in the funding rule. Accordingly, absent an expansion of the general coordination rule, a single transaction with an economic effect similar to a distribution would be treated as two transactions subject to the general rule and funding rule.

The Treasury Department and the IRS adopt the recommendation to expand the general coordination rule to apply to all general rule transactions, regardless of whether the covered debt instrument issued in the transaction is treated as stock under the general rule. Accordingly, the final and temporary regulations provide that a distribution or acquisition described in the general rule is not also described in the funding rule.

Moreover, the final and temporary regulations also provide that an acquisition in an internal asset reorganization described in the general rule by the transferee corporation is not also a distribution or acquisition described in the funding rule by the transferor corporation. For purposes of the general coordination rule, whether a distribution or acquisition is described in the general rule is determined without regard the exceptions of §1.385-3(c). Thus, in an internal asset reorganization to which an exception applies, the distribution of a respected debt instrument by the transferor corporation is not also tested as a distribution or acquisition described in the funding rule.

For a discussion of the general coordination rule applicable during the transition period, see Part VIII.B.2 of this Summary of Comments and Explanation of Revisions.

F. Exceptions from §1.385-3 for certain debt instruments

The final and temporary regulations limit the application of the general rule and funding rule by excluding certain debt instruments described in this Section F of this Part V from the definition of covered debt instruments. This Section F of this Part V also discusses other requests for exceptions that were not adopted.

1. Qualified Dealer Debt Instrument

Comments recommended that the regulations provide an exception for debt instruments acquired and held by a dealer in securities (within the meaning of section 475(c)(1)) in the ordinary course of its business as a dealer in securities. Similarly, comments recommended that the regulations provide an exception for debt instruments that would be excluded from being investments in U.S. property if entered into between a controlled foreign corporation and a United States shareholder under section

956(c)(2)(K), which covers securities acquired and held by a dealer in securities in the ordinary course of its business.

In response to these comments, the regulations provide an exception for the acquisition of debt instruments by a dealer in securities. Under §1.385-3(g)(3)(i), a "qualified dealer debt instrument" is excluded from the definition of a covered debt instrument. A qualified dealer debt instrument is defined in §1.385-3(g)(3)(ii) to mean a debt instrument issued to or acquired by an expanded group member that is a dealer in securities (within the meaning of section 475(c)(1)) in the ordinary course of the dealer's business of dealing in securities. This exception applies solely to the extent that (i) the dealer accounts for the debt instruments as securities held primarily for sale to customers in the ordinary course of business, (ii) the dealer disposes of the debt instruments (or the debt instruments mature) within a period of time that is consistent with the holding of the debt instruments for sale to customers in the ordinary course of business, taking into account the terms of the debt instruments and the conditions and practices prevailing in the markets for similar debt instruments during the period in which they are held, and (iii) the dealer does not sell or otherwise transfer the debt instruments to a person in the same expanded group, other than to a dealer that satisfies the requirements of the exception for qualified dealer debt instruments.

2. Instruments That Are Not In Form Debt

Proposed §§1.385-3 and 1.385-4 applied to any interest that would, but for those sections, be treated as a debt instrument as defined in section 1275(a) and §1.1275-1(d). Consequently, the proposed regulations applied not only to debt in form, but also to any instrument or contractual arrangement that constitutes indebtedness under

general principles of federal income tax law. One comment recommended that the funding rule apply solely to instruments that are, in form, debt instruments. The Treasury Department and the IRS decline to accept this recommendation because this would fail to take into account the substance of an arrangement that is otherwise treated as a debt instrument for federal tax purposes and create an inappropriate preference for debt instruments that are not in-form debt.

Comments also noted that, in certain cases, instruments (or deemed instruments) that are expressly treated as debt under other provisions of the Code and regulations should not be subject to recharacterization. The comments cited leases treated as loans under section 467; receivables and payables resulting from correlative adjustments under section 482; production payments under section 636; coupon stripping transactions under section 1286; and debt (or instruments treated as debt) described in section 856(m)(2), 860G(a)(1), or 1361(c)(5). Similarly, comments requested that the regulations disregard debt instruments deemed to occur under section 367(d).

The final and temporary regulations exclude from the definition of covered debt instruments: production payments under section 636; REMIC regular interests (as defined in section 860G(a)(1)); instruments described in section 1286 (relating to coupon stripping transactions) unless such an instrument is issued with a principal purpose of avoiding the purposes of §1.385-3 or §1.385-3T; and leases treated as loans under section 467. The final and temporary regulations also provide an exception for debt instruments deemed to arise as a result of transfer pricing adjustments under section 482. The Treasury Department and the IRS decline to include an exception for

payables deemed to occur under section 367(d) in the final and temporary regulations because the final and temporary regulations are limited to U.S. borrowers.

The final and temporary regulations do not provide an exception for debt described in section 1361(c)(5) because S corporations are not included in the definition of an expanded group in the final and temporary regulations. The final and temporary regulations also do not provide an exception for debt described in section 856(m)(2), which addresses certain non-contingent non-convertible debt securities held by a REIT that are not taken into account for one of the asset tests for qualified REIT status. The final and temporary regulations do not adopt this exception because the final and temporary regulations apply only to REITs that are controlled by expanded group members, and not parent-REITs. In this context, debt instruments described in section 856(m)(2) that are issued to other expanded group members may present similar policy concerns as those presented by other expanded group debt instruments.

One comment suggested that the funding rule should not apply to a deemed loan arising from a nonperiodic payment arising with respect to a notional principal contract. The comment noted that multinational enterprises frequently use intercompany swaps to allocate and manage interest rate and foreign currency risk. In some situations, one member of an expanded group may make a nonperiodic payment to another member of the expanded group that might be characterized as a loan under §1.446-3T(g)(4). The comment asserts that it is unnecessary to apply the funding rule to deemed loans such as those that arise from a nonperiodic payment on a notional principal contract to achieve the policy goals of the proposed regulations.

The Treasury Department and the IRS decline to accept this recommendation, because it would not take into account the substance of an arrangement that is otherwise treated as a debt instrument for federal tax purposes. Moreover, the regulations referred to in the comment are not currently in effect, and are not scheduled to take effect until after final and temporary regulations are issued. The regulations under §1.446-3T(g)(4) have been the subject of extensive comment and are under active consideration. The Treasury Department and the IRS will consider whether it is necessary to coordinate the nonperiodic payment rules on swaps with section 385 when finalizing the regulations on notional principal contracts.

3. Significant Modifications and Refinancing

Comments suggested that a significant modification within the meaning of §1.1001-3 should not implicate the funding rule because the debt instrument deemed issued as a result of such a modification should be treated as having been issued to retire the existing instrument instead of generating new proceeds that could fund distributions or acquisitions subject to §1.385-3. However, one comment acknowledged that such an exception may be inappropriate in cases where the significant modification extends the term of the instrument. The comment stated that, in such a case, the modified debt could be viewed as essentially financing activities of the borrower for the extended term. Other comments recommended that a similar exception apply to an actual refinancing whereby a new debt instrument is issued and the proceeds are used to repay an old debt instrument. Comments recommended that the borrowing to refinance an existing debt instrument be considered used for the same purpose as the

refinanced debt, and thereby be subject to the funding rule to the same extent as the refinanced debt instrument.

In response to comments, the final and temporary regulations provide that if a covered debt instrument is treated as exchanged for a modified covered debt instrument pursuant to §1.1001-3(b), the modified covered debt instrument is treated as issued on the original issue date of the covered debt instrument. This special rule is limited to situations in which the modification, or one of the modifications, that results in the exchange (or deemed exchange) does not include (i) the substitution of an obligor on the covered debt instrument, (ii) the addition or deletion of a co-obligor on the covered debt instrument, or (iii) the material deferral of scheduled payments due under the covered debt instrument The special rule excludes a change in obligor or addition of an obligor that results in a deemed exchange because the Treasury Department and the IRS are concerned about such modifications circumventing the funding rule generally. The special rule excludes a material deferral of scheduled payments that results in a deemed exchange because the Treasury Department and the IRS are concerned about such extensions circumventing the per se period though continued extensions of maturity.

The final and temporary regulations also clarify that if the principal amount of a covered debt instrument is increased, the portion of the covered debt instrument attributable to such increase is treated as issued on the date of such increase.

The final and temporary regulations do not extend the special rule for modifications of debt instruments to an actual refinancing outside of the context of a modification described in §1.1001-3(a). For example, the rule would not apply to a

refinancing of a debt instrument held by one expanded group member through the issuance of a new debt instrument to another expanded group member. The Treasury Department and the IRS have determined that it is appropriate to provide this special rule in the context of a deemed exchange for tax purposes that may not be treated as an exchange for legal, accounting or other relevant purposes. By contrast, in a transaction that is in form a refinancing that involves an exchange for tax purposes without regard to the application of §1.1001-3(b), the Treasury Department and the IRS decline to provide a special rule. Furthermore, the Treasury Department and the IRS are concerned that the limitations to this special rule that would be necessary to prevent abuse would be difficult to administer in the context of an actual refinancing.

4. Insurance and Reinsurance Arrangements

Comments asserted that the regulations should not apply to insurance or reinsurance transactions entered into in the ordinary course of an insurer's or reinsurer's trade or business. Several comments further noted that the regulations should not apply to reinsurance arrangements where funds otherwise due to the reinsurance company are withheld by the insurance company ceding risk to a reinsurance company.

The final and temporary regulations only apply to interests that would, but for the application of §1.385-3, be treated as debt instruments as defined in section 1275(a) and §1.1275-1(d). As a result, insurance and reinsurance contracts generally would not be subject to §1.385-3 because such contracts are not ordinarily treated as debt instruments as defined in section 1275(a) and §1.1275-1(d). To the extent that an arrangement entered into in connection with an insurance or reinsurance contract would

be treated as a debt instrument, as defined in section 1275(a) and §1.1275-1(d), that arrangement is a debt instrument for federal income tax purposes. As a result, the Treasury Department and the IRS have determined that such a debt instrument should not be treated differently than any other interest subject to §1.385-3. However, as discussed in Section G.2 of this Part V, the final and temporary regulations exclude debt instruments issued by regulated insurance companies.

5. Securitization Transactions

One comment requested an exception for instruments issued pursuant to certain securitization transactions. The comment stated that in a common securitization transaction, an operating entity transfers income producing assets, such as receivables or loans, to a special purpose vehicle (SPV). The SPV then re-transfers the assets to a bankruptcy-remote entity that is typically disregarded for federal tax purposes in exchange for tranches of instruments that the SPV sells, usually to unrelated parties and often utilizing an underwriter or broker. The SPV frequently hires a servicing agent to collect on the income producing assets and channel the payments to the appropriate class of securities. The funding rule is implicated when an expanded group member acquires securities of the SPV (or instruments of the disregarded entity treated as instruments of the SPV for federal tax purposes). This may occur in the normal course of the expanded group member's investment in portfolio securities. It may also occur when the expanded group member acquires the securities because the SPV cannot place them all with unrelated parties at the time of issuance. The comment stated that the rule is particularly problematic when the SPV is a member of a consolidated group that is itself the subsidiary of a foreign parent, and an expanded group member that is

not a member of the consolidated group acquires the securities. In this case, a distribution by the common parent could be considered funded by the SPV's issuance of debt instruments acquired by related parties. The comment requested an exemption for such transactions because they are motivated by non-tax considerations and do not present the policy concerns underlying the proposed regulations.

The proposed regulations do not adopt an exception for all securitization transactions. The Treasury Department and the IRS have determined that related party debt issued as part of a securitization transaction presents the same general policy concerns as related-party debt issued in other contexts. This is because the proceeds from the sale of debt issued as part of a securitization transaction generally may be used to fund a distribution or acquisition. However, the final and temporary regulations adopt a number of exceptions for non-tax motivated transactions that provide relief to the transaction described in the comment. First, the final and temporary regulations adopt an exception for qualified dealer debt instruments acquired in the ordinary course of the dealer's business that are subsequently disposed of outside the expanded group. See Section F.1 of this Part V. Second, the final and temporary regulations do not apply to instruments issued by a foreign SPV. See Part III.A.1 of this Summary of Comments and Explanation of Revisions. Finally, the regulations continue to treat a consolidated group as a single corporation, such that the SPV will only be considered funded to the extent the securities are acquired by an expanded group member that is not part of the issuer's consolidated group. See Part III.A.2 of this Summary of Comments and Explanation of Revisions. To the extent such a funding occurs, the elimination of the cliff effect in the threshold exception also provides relief. See Section

E.4 of this Part V. Accordingly, the final and temporary regulations do not provide special rules for the treatment of instruments issued as part of a securitization transaction, but do provide numerous new exceptions that will exclude many of these transactions.

6. Principal Motive of Tax Avoidance

One comment recommended that proposed §1.385-3 be limited to debt issuances that have a principal motivation of tax avoidance. The comment does not elaborate on what type of transaction would constitute tax "avoidance."

As discussed in Section A.1 of this Part V, the Treasury Department and the IRS have decided that consideration of whether a debt instrument issued to a member of the issuer's expanded group finances new investment is an appropriate determinative factor for whether a corporation-shareholder or debtor-creditor relationship exists. Such factor may exist regardless of whether a taxpayer is motivated principally by tax avoidance. Although the final and temporary regulations retain a principal purpose test as part of the funding rule, this test looks to whether the taxpayer intended for the debt issuance to fund a distribution or acquisition, rather than whether such transaction avoided tax. See Section D.2.e of this Part V.

G. Exceptions from §1.385-3 for debt instruments issued by certain issuers

The final and temporary regulations limit the application of the general rule and funding rule by excluding debt instruments issued by excepted regulated financial companies and regulated insurance companies from the definition of covered debt instruments.

1. Regulated Financial Groups

Several comments requested that the proposed regulations be revised to exclude debt instruments issued by certain types of regulated financial institutions. Comments reasoned that financial institutions, whose core business is financial intermediation (such as the transmission of funds between lenders and borrowers), rely on intercompany loans to efficiently transfer funds among their affiliates, and therefore would be disproportionately affected by the proposed regulations. These comments also asserted that the supervision and regulation to which regulated financial institutions are subject significantly restricts their ability to engage in the types of transactions the proposed regulations are intended to address. Furthermore, the comments noted that certain regulatory and supervisory requirements mandate the issuance of intercompany debt and that it would be particularly burdensome for such debt to be subject to the proposed regulations. Comments in particular sought exceptions from the regulations for transactions that U.S. subsidiaries of foreign banks undertake to comply with the requirement adopted by the Board of Governors of the Federal Reserve System (Federal Reserve) that certain foreign banks reorganize their U.S. subsidiaries under a U.S. intermediate holding company. Comments also referred to the rules proposed by the Federal Reserve that would require U.S. subsidiaries of certain foreign banks to issue intercompany debt that could be used to facilitate a recapitalization of such subsidiaries in the event their intermediate holding company is in default or in danger of default. Comments recommended excluding companies described in, for example, section 954(h) or 904(d)(2)(C), or by reference to other provisions of U.S. law that describe financial entities subject to certain forms of federal regulation. Comments also recommended excluding certain transactions typically used to fund financial institutions

subject to regulation, such as transactions of the type that are described in section 956(c)(2)(I) and (J).

In response to these comments, the final and temporary regulations provide an exception to the definition of covered debt instrument in §1.385-3(g)(3) for covered debt instruments that are issued by an excepted regulated financial company. An excepted regulated financial company is defined in §1.385-3(g)(3)(iv) to mean a covered member that is a regulated financial company or a member of a regulated financial group.

A regulated financial company is defined in §1.385-3(g)(3)(iv)(A) by reference to certain types of financial institutions that are subject to specific regulatory capital or leverage requirements. The definition of regulated financial company is comprised of: bank holding companies; certain savings and loan holding companies; insured depository institutions and any other national banks or state banks that are members of the Federal Reserve System; nonbank financial companies subject to a determination by the Financial Stability Oversight Council; certain U.S. intermediate holding companies formed by foreign banking organizations; Edge Act and agreement corporations; supervised securities holding companies; registered broker-dealers; futures commission merchants; swap dealers; security-based swap dealers; Federal Home Loan Banks; Farm Credit System institutions; and small business investment companies. The final and temporary regulations include exceptions for swap dealers and security-based swap dealers in anticipation of the adoption of final rules that would apply capital requirements to such entities.

The Treasury Department and the IRS recognize that other types of companies are subject to various levels of regulation and supervision, including regulation designed

to ensure the financial soundness of the company. However, the Treasury Department and the IRS have tailored the exception to regulated institutions that are subject to capital or leverage requirements because such requirements most directly constrain the ability of such institutions to engage in the transactions that are intended to be addressed by the final and temporary regulations. Although the specific requirements vary across the regulatory regimes identified in §1.385-3(g)(3)(iv)(A), in each case the regulatory regime imposes capital or leverage requirements that have the effect of limiting the extent to which a regulated company can increase the amount of its debt. In contrast, institutions that are not subject to entity-specific capital or leverage requirements, such as certain types of savings and loan holding companies, are not eligible for the exception. Furthermore, the exception is tailored to focus on financial institutions that are financial intermediaries whose business activities require the efficient transfer of money among affiliates.

In addition, certain financial institutions that are included in the definition of regulated financial company (specifically, those listed in §1.385-3(g)(3)(iv)(A)(1) through (10)) are subject to consolidated supervision with respect to the entire group, including consolidated capital or leverage requirements and supervision of all material subsidiaries. This degree of regulation and supervision generally places meaningful limits on the ability of subsidiaries to issue debt. The final and temporary regulations therefore also exclude from the definition of covered debt instrument debt instruments issued by any subsidiary of a regulated financial company that is listed in §1.385-3(g)(3)(iv)(A)(1) through (10), which includes bank holding companies and certain other types of banking organizations. With respect to these regulated financial companies,

§1.385-3(g)(3)(iv)(B) defines a regulated financial group to include the subsidiaries of the regulated financial company that would constitute members of an expanded group that had as its expanded group parent the regulated financial company. Therefore, if a regulated financial company is the expanded group parent of an expanded group, the entire expanded group constitutes a regulated financial group. On the other hand, if a regulated financial company is a non-parent member of an expanded group, then only the direct and indirect subsidiaries of such regulated financial company that are expanded group members constitute the regulated financial group.

However, the Treasury Department and the IRS also have determined that certain subsidiaries of a bank holding company or savings and loan company that engage in a non-financial business should not be treated as part of a regulated financial group. Specifically, under §1.385-3(g)(3)(iv)(B)(2), subsidiaries of a bank holding company or savings and loan holding company that are held pursuant to the complementary activities authority, merchant banking authority, or grandfathered commodities activities authority provided by sections 4(k)(1)(B), 4(k)(4)(H), and 4(o) of the Bank Holding Company Act, respectively, are not treated as part of the bank holding company's or savings and loan holding company's regulated financial group. Such subsidiaries are engaged in non-financial businesses and have the same incentives as non-financial companies that are not subsidiaries of bank holding companies or savings and loan holding companies to use related-party debt to generate significant federal tax benefits without having meaningful non-tax effects, and generally do not face significant regulatory restrictions on doing so. Therefore, it is appropriate to treat such non-

financial subsidiaries comparably to non-financial companies that are not subsidiaries of bank holding companies or savings and loan holding companies.

The final and temporary regulations do not provide a separate exception for debt issued to an excepted regulated financial company because entities included within the definition of an excepted regulated financial company generally are not subject to regulatory limits on their ability to lend. In any case, debt instruments issued by one member of a regulated financial group to another member of the group are excluded from the definition of covered debt instrument under the final and temporary regulations by virtue of being issued by an excepted regulated financial company.

2. Regulated Insurance Companies

For reasons similar to those discussed in the immediately preceding section, the Treasury Department and the IRS have determined that debt instruments issued by insurance companies that are subject to risk-based capital requirements under state law should be excluded from the definition of covered debt instrument. The Treasury Department and the IRS have determined that, similar to regulated financial companies, regulated insurance companies are subject to risk-based capital requirements and other regulation that mitigates the risk that they would engage in the types of transactions addressed by the final and temporary regulations.

Therefore, the final and temporary regulations provide that a covered debt instrument does not include a debt instrument issued by a regulated insurance company. Section 1.385-3(g)(3)(v) defines a regulated insurance company as a covered member that is: (i) subject to tax under subchapter L of chapter 1 of the Code; (ii) domiciled or organized under the laws of a state or the District of Columbia;

(iii) licensed, authorized, or regulated by one or more states or the District of Columbia to sell insurance, reinsurance, or annuity contracts to persons other than related persons (within the meaning of section 954(d)(3)); and (iv) engaged in regular issuances of (or subject to ongoing liability with respect to) insurance, reinsurance, or annuity contracts with persons that are not related persons (within the meaning of section 954(d)(3)). In order to prevent a company from inappropriately qualifying as a regulated insurance company, the final and temporary regulations also provide that in no case will a corporation satisfy the licensing, authorization, or regulation requirements if a principal purpose for obtaining such license, authorization, or regulation was to qualify as a "regulated insurance company" under the final and temporary regulations.

The last prong of the definition of "regulated insurance company" has the effect of not including within the exclusion certain captive insurance and reinsurance captive companies. Covered debt instruments issued by such companies are not excluded under the final and temporary regulations because captive insurers are not subject to risk-based capital requirements and are otherwise not subject to regulation and oversight to the same degree as other insurance and reinsurance companies.

The Treasury Department and the IRS have not extended the regulated insurance company exception to other members of an insurance company's group that are not themselves regulated insurance companies. State insurance regulators only exercise direct authority over regulated insurance companies; such direct authority does not extend to other non-insurance entities within the group. Subsidiaries of insurance companies that are not themselves insurance companies are only subject to regulation indirectly through supervision of the affiliated insurance companies. Among other

things, in contrast to a regulated financial group, such non-insurance subsidiaries and affiliates are generally not subject to consolidated capital requirements.

3. Instruments Issued In Connection with Certain Real Estate Investments and Other Capital Investment

Comments expressed concern that a debt instrument that is treated as stock would not be treated as an interest "solely as a creditor" for purposes of determining whether the holder has an interest in a United States real property holding corporation (USRPHC) for purposes of sections 897 and 1445. Generally, a foreign corporation that disposes of stock of a domestic corporation is not subject to U.S. income tax on the gain realized upon the sale. However, section 897(a) treats gains from the disposition of a United States real property interest (USRPI), which includes an interest in a USRPHC, as income that is effectively connected with a U.S. trade or business that is subject to tax under section 882(a)(1). A USRPHC is defined in section 897(c)(2) as any corporation more than 50 percent of the fair market value of the business and real estate assets of which are USRPIs. Under section 897(c)(1)(A), an interest solely as a creditor in a domestic corporation does not constitute a USRPI. Under §1.897-1(d)(3)(i)(A), stock of a corporation is not an interest solely as a creditor.

Comments requested that an instrument treated as stock under the proposed regulations nonetheless be considered to be an interest solely as a creditor for purposes of section 897(c)(1)(A). Alternatively, comments requested relief for a good faith failure to report and withhold under section 1445 with respect to a recharacterized instrument no longer considered to be an interest solely as a creditor. Comments also suggested that the proposed regulations would impact various ownership-based tests

under section 897 (including whether a corporation constitutes a USRPHC and the application of certain exceptions to section 897) and lead to unexpected tax consequences. In particular, comments asserted that the proposed regulations could affect the application of the "look-through" rule in section 897(c)(5), which could ultimately affect the treatment of unrelated persons with no control or knowledge of the recharacterized instruments.

As discussed in Section B.1 of this Part V, the Treasury Department and the IRS have determined that an interest determined to be stock under the final and temporary regulations generally should be treated as stock for all federal tax purposes. Accordingly, the final and temporary regulations do not provide a special exception for purposes of section 897. The regulations are concerned with the use of related-party indebtedness issued to an expanded group member that does not finance new investment in the operations of the issuer. These concerns are no less implicated in the case of debt issued by a domestic corporation investing in U.S. real estate that may be treated as a USRPHC as compared to any other domestic corporation.

With respect to the application of the various ownership-based tests under section 897, including the look-through rule in section 897(c)(5), to the extent any uncertainties exist, they do not arise uniquely as a result of the final and temporary regulations. Instead, such uncertainties would arise whenever purported debt instruments are characterized as stock under applicable common law. Section B.1 of this Part V illustrates other areas in which recharacterization, whether under the common law or under the final and temporary regulations, can impact the application of other Code provisions.

The final and temporary regulations also do not adopt a special rule for purposes of withholding under section 1445 because §1.1445-1(e) provides rules of general application for the failure to withhold under section 1445, and the application of the final and temporary regulations does not present unique issues in this regard. The concerns raised in comments related to transfers of USRPIs among members of an expanded group, which are, by definition, highly-related parties that should be able to determine whether a particular instrument has been recharacterized under the final and temporary regulations. Furthermore, any liability of the transferee will be potentially mitigated by §1.1445-1(e)(3), which provides that the transferee is relieved of liability to the extent the transferor satisfies its tax liability with respect to the transfer. If the instrument is sold outside the group, the disposition will not subject an unrelated person to liability under section 1445 (assuming the interest is an interest solely as a creditor in the hands of the unrelated person) because the deemed exchange described in §1.385-3(d)(2) occurs immediately before the instrument leaves the group.

A comment also requested an exception for qualified foreign pension funds described in section 897(l)(2), which generally allows such funds to invest in U.S. real estate without being subject to section 897. The comment reasoned that the effect of the regulations on interest deductibility could decrease the after-tax returns such funds receive on investments in U.S. infrastructure investments, resulting in decreased investment. Other comments cited similar concerns, with one comment recommending an exception for a newly defined infrastructure asset holding company and another comment recommending an exemption for debt tied to U.S. capital expenditure investment more broadly. The Treasury Department and the IRS decline to adopt these

recommendations because the regulations are concerned in general about the creation of indebtedness that does not finance new investment, without regard to the identity of the ultimate beneficial owners of the expanded group, and without regard to the nature of a taxpayer's business.

H. Operating rules

1. Timing Rules

The proposed regulations provided that when a debt instrument is treated as stock under the funding rule, the debt instrument is treated as stock from the time the debt instrument is issued, but only to the extent it is issued in the same or a subsequent taxable year as the distribution or acquisition that the debt instrument is treated as funding. Comments recommended that this rule be modified such that a debt instrument cannot be treated as stock before the occurrence of the transaction that the debt instrument is treated as funding. Comments noted that the collateral consequences described in Section B.1 of this Part V (including the implications under section 368(c)) would be particularly burdensome in this context. Similarly, comments requested clarification that the timing rule did not cause a debt instrument that was repaid before the occurrence of a distribution or acquisition to be treated as funding that distribution or acquisition.

The final and temporary regulations eliminate the timing rule under which a covered debt instrument that is treated as funding a distribution or acquisition that occurs later in the same year is treated as stock when the covered debt instrument is issued. As a result, when a covered debt instrument is treated as funding a distribution or acquisition that occurs later in the same year, or in a subsequent year, the covered

debt instrument is recharacterized on the date of the later distribution or acquisition. Thus, when a covered debt instrument is repaid before a distribution or acquisition that the debt instrument might otherwise be treated as funding, the covered debt instrument is not recharacterized.

2. Covered Debt Instrument Treated as Stock that Leaves the Expanded Group

In general, under proposed §1.385-3(d)(2), if a debt instrument treated as stock leaves the expanded group, either because the instrument is transferred outside the expanded group or because the holder leaves the expanded group, the issuer is deemed to issue 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 applying the general rule and funding rule. Comments recommended that, when the instrument is transferred outside the group, rules similar to the deemed exchange rules of proposed §1.385-1(c) apply to the instrument treated as stock that is converted to debt upon sale outside the expanded group. Another comment suggested that the expanded group member disposing of the instrument be treated as selling stock under section 1001 and the acquirer treated as purchasing debt at an issue price determined as if the debt were respected as debt since issuance (that is, adjusting the actual purchase price to account for any accrued interest). Finally, a comment also requested a clarification that any stated interest that had accrued between the last payment date and the date of the deemed exchange should be considered a portion of the redemption price. As discussed in Part III.C of this Summary of Comments and Explanation of Revisions, the final and temporary regulations do not adopt these recommendations because there are detailed rules in sections 1273 and 1274 that describe how to

determine issue price when a debt instrument is issued for stock. Moreover, the Treasury Department and the IRS are of the view that in the situation where a debt instrument treated as stock leaves the expanded group, treating that instrument as newly issued more appropriately reflects the characterization of the transaction in the final and temporary regulations.

A comment also suggested removing the re-testing rule in the proposed regulations that required an issuer to re-test all outstanding debt instruments after a debt instrument treated as stock leaves the expanded group. The final and temporary regulations do not adopt this recommendation. The re-testing rule addresses a concern similar to that discussed in Section B.4 of this Part V, regarding when a debt instrument that is treated as stock is repaid in a transaction that is treated as a distribution for purposes of §1.385-3. In the context of a repayment of the recharacterized debt instrument, the Treasury Department and the IRS are concerned that, unless the repayment is treated as a distribution for purposes of the funding rule, the repayment could result in an inappropriate removal of a distribution or acquisition described in the general rule or funding rule from the funding rule. In the context of a transfer of the instrument outside of the expanded group, there is no repayment of the recharacterized debt instrument that would be treated as a distribution for purposes of the funding rule (although the recharacterized debt instrument is deemed redeemed when transferred outside the expanded group, proposed §1.385-3(d)(2) disregarded that redemption for purposes of the funding rule). Nonetheless, there is a similar concern about an inappropriate removal of the underlying distribution or acquisition from the funding rule. Thus, the proposed regulations provided that, after a transfer of the instrument outside

of the expanded group, the underlying distribution or acquisition that caused the disposed debt instrument to be treated as stock is re-tested against other debt instruments not already recharacterized as stock. See proposed §1.385-3((g)(3) Example 7. The final and temporary regulations clarify that this rule also applies to recharacterize later issued covered debt instruments that are within the per se period. Thus, this final rule provides that when a covered debt instrument treated as stock is transferred outside of the expanded group, the underlying distribution or acquisition that caused the disposed debt instrument to be treated as stock can cause any other covered debt instrument issued during the per se period to be treated as stock. The final and temporary regulations also apply this operating rule when a covered debt instrument treated as stock becomes a consolidated group debt instrument under §1.385-4T(c)(2).

Another comment suggested that the re-testing rule should be limited to debt instruments issued in the 36 months before the re-testing date because the re-testing rule could apply to a debt instrument issued many years before the disposition of the debt instrument treated as stock. The final and temporary regulations adopt this recommendation because it is consistent with the per se application of the funding rule as described in Section D.2 of this Part V.

The Treasury Department and the IRS considered an alternative approach that would more closely harmonize the rules for repayments and dispositions of debt instruments treated as stock by accepting the comment to eliminate the re-testing rule in §1.385-3(d)(2) when the instrument is transferred outside of the group and making a corresponding change to the funding rule to prevent inappropriate removal of a

distribution or acquisition described in the general rule or funding rule. This alternative approach would require deeming a separate distribution that is subject to the funding rule. The Treasury Department and the IRS decline to make those changes because the net effect would extend the per se period.

3. Aggregate Treatment of Partnerships

a. Overview

The legislative history of subchapter K of chapter 1 of the Code (subchapter K) provides that, for purposes of interpreting Code provisions outside of that subchapter, a partnership may be treated as either an entity separate from its partners or an aggregate of its partners, depending on which characterization is more appropriate to carry out the purpose of the particular section under consideration. H.R. Conf. Rep. No. 2543, 83rd Cong. 2d. Sess. 59 (1954). To prevent the avoidance of the application of the regulations through the use of partnerships, the proposed regulations adopted an aggregate approach to controlled partnerships.

The proposed regulations provided that, for example, when a corporate member of an expanded group becomes a partner (an expanded group partner) in a partnership that is a controlled partnership with respect to the expanded group, the expanded group partner is treated as acquiring its proportionate share of the controlled partnership's assets and issuing its proportionate share of any debt instruments issued by the controlled partnership. For these purposes, the proposed regulations determined a partner's proportionate share in accordance with the partner's share of partnership profits.

This aggregate treatment also applied to the recharacterization under proposed §1.385-3 of a debt instrument issued by a controlled partnership. Therefore, proposed §1.385-3 provided that the holder of a recharacterized debt instrument issued by a controlled partnership would be treated as holding stock in the expanded group partners rather than as holding an interest in the controlled partnership. The proposed regulations also required the partnership and its partners to make appropriate conforming adjustments to reflect this treatment. Comments raised concerns that neither section 385 nor the legislative history to section 385 suggests that Congress authorized regulations to determine the status of debt issued by a non-corporate entity and requested that any future regulations only apply to debt issued by corporations. Additionally, as described in Section H.4 of this Part V, comments expressed concern regarding the collateral consequences of treating a partnership instrument as stock of the expanded group partners under proposed §1.385-3.

After considering the comments, the Treasury Department and the IRS have determined that it is necessary and appropriate to adopt an aggregate approach to a controlled partnership in order to prevent the avoidance of the purposes of the final and temporary regulations through the use of a partnership. Thus, consistent with the longstanding practice of the Treasury Department and the IRS to apply aggregate treatment to partnerships and their partners when appropriate, and in accordance with the legislative history of subchapter K, the final and temporary regulations generally treat a controlled partnership as an aggregate of its partners in the manner described in the temporary regulations. However, in response to comments, the final and temporary regulations do not recharacterize debt issued by a partnership as equity under section

385. Instead, pursuant to the authority granted under section 7701(l) to recharacterize certain multi-party financing transactions, the temporary regulations deem the holder of a debt instrument issued by a partnership that otherwise would be subject to recharacterization (based on an application of the factors in §1.385-3 to the expanded group partners under the aggregate approach) as having transferred the debt instrument to the expanded group partner or partners in exchange for stock in the expanded group partner or partners.

Sections H.3.b through d of this Part V, discuss the application of the aggregate approach to a controlled partnership for purposes of applying the rules in §1.385-3, both for purposes of determining when a debt instrument issued by an expanded group partner is treated as equity, as well as when a debt instrument issued by the controlled partnership that otherwise would be treated as equity under the aggregate approach should be subject to the deemed transfer. Specifically, Section H.3.b of this Part V discusses the aggregate approach to controlled partnerships generally; Section H.3.c of this Part V describes the extent to which an expanded group partner is treated as acquiring a controlled partnership's property for purposes of applying the rules in §1.385-3; and Section H.3.d of this Part V describes the rules for identifying the portion of a debt instrument issued by a controlled partnership that an expanded group partner is treated as issuing for purposes of applying the rules in §1.385-3. Section H.4 of this Part V explains that a debt instrument issued by a controlled partnership that otherwise would be treated, in whole or in part, as stock under §1.385-3 is instead deemed to be transferred, in whole or in part, by the holder to the expanded group partner or partners.

b. Determining proportionate share generally

Comments raised concerns regarding the proposed regulations' requirement to determine a partner's proportionate share based on the "partner's share of partnership profits," which applied equally to the determination of a partner's share of controlled partnership assets and the determination of a partner's share of a debt instrument issued by a controlled partnership. Comments requested clarity regarding the method for determining a partner's share of partnership profits, and asserted that the determination could be made in a number of different ways. In the context of a debt instrument issued by a controlled partnership, comments noted that determining a partner's proportionate share in accordance with its share of partnership profits may be inappropriate in certain cases, such as if a controlled partnership distributes borrowed funds on a non-pro rata basis to its partners, or if a minority partner guarantees a debt. Comments further asserted that, regardless of how a partner's "proportionate share" is determined, that share may fluctuate and rules should specify when the partner's proportionate share is determined.

The temporary regulations continue to provide that, for purposes of applying the factors in §1.385-3 (as well as the rules of §1.385-3T), an expanded group partner is treated as acquiring its share of property owned by a controlled partnership and as issuing its share of a debt instrument issued by a controlled partnership. Specifically, §1.385-3T(f)(2) provides rules for acquisitions of property by a controlled partnership, and §1.385-3T(f)(3) provides rules addressing the treatment of a debt instrument issued by a controlled partnership. Both sets of rules rely on a determination of a partner's "share" of the controlled partnership's property or indebtedness. However, and as described in more detail in Section H.3.c and d of this Part V, "share" is defined

differently for each purpose and, in response to comments, is no longer defined by reference to a partner's share of profits.

When an expanded group partner is treated as acquiring a share of property owned by a controlled partnership or as issuing a share of a debt instrument issued by a controlled partnership, except as described in Section H.4 of this Part V, all parties apply the rules of §1.385-3 as though the expanded group partner acquired the property or issued the debt instrument.

c. Partner's proportionate share of controlled partnership property

A member of an expanded group that is an expanded group partner on the date a controlled partnership acquires property (including expanded group stock, a debt instrument, or any other property) from another expanded group member is treated as acquiring its share of that property under §1.385-3T(f)(2)(i)(A). The covered member is treated as acquiring its share of the property from the transferor member in the manner (for example, in an exchange for property or an issuance), and on the date on which, the property is actually acquired by the controlled partnership from the transferor member. Thus, for example, if the controlled partnership acquires expanded group stock in exchange for property other than other expanded group stock, an expanded group partner is treated as making an acquisition described in §1.385-3(b)(3)(i)(B) (funding rule) to the extent of its share of the expanded group stock. Likewise, if a controlled partnership acquires a debt instrument issued by a covered member in a distribution by that covered member or a covered member distributes property to a controlled partnership, the covered member is treated as making a distribution

described in §1.385-3(b)(2)(i) (general rule) or 1.385-3(b)(3)(i)(A) (funding rule) to the extent of any expanded group partner's share of the distributed property.

Section 1.385-3T(f)(2)(i)(C) provides that, if an expanded group partner transfers expanded group stock to the controlled partnership, the member is not treated as reacquiring (by reason of its interest in the controlled partnership) any of the expanded group stock it transferred. Thus, an expanded group partner will not be treated as acquiring expanded group stock that it already owned by reason of transferring that expanded group stock to a controlled partnership.

Expanded group stock is the only kind of property a member of an expanded group is treated as acquiring if it becomes an expanded group partner after the controlled partnership acquired the property. Under §1.385-3T(f)(2)(ii)(A), a member of an expanded group that becomes an expanded group partner when the controlled partnership already owns expanded group stock generally is treated, on the date the member becomes an expanded group partner, as acquiring its share of the expanded group stock owned by the controlled partnership from an expanded group member in exchange for property other than expanded group stock. Thus, subject to an exception described in this paragraph, the member is treated as making an acquisition described in §1.385-3(b)(3)(i)(B) (funding rule) to the extent of its share of the expanded group stock owned by the controlled partnership, regardless of how the controlled partnership acquired that expanded group stock. This approach avoids the complexity of attempting to trace the acquisition of expanded group stock to certain transferors for certain consideration depending on whether the partnership interest was acquired by contribution or transfer. Section 1.385-3T(f)(2)(ii)(C) provides an exception to this

general rule whereby a member of an expanded group that acquires an interest in a controlled partnership, either from another partner in exchange solely for expanded group stock or upon a contribution to the controlled partnership comprised solely of expanded group stock, is not treated as acquiring expanded group stock owned by the controlled partnership, so that §1.385-3(b)(3)(i)(B) will not apply.

In response to comments regarding the use of a "partner's share of partnership profits" to identify a partner's share of property, the temporary regulations provide that a partner's share of property acquired by a controlled partnership, including expanded group stock acquired by a controlled partnership before the member of the expanded group became an expanded group partner, is determined in accordance with the partner's liquidation value percentage. Pursuant to §1.385-3T(g)(17), a partner's liquidation value percentage in a controlled partnership (which can include a partnership that is owned indirectly through one or more partnerships) is the ratio (expressed as a percentage) of the liquidation value of the expanded group partner's interest in the partnership divided by the aggregate liquidation value of all the partners' interests in the partnership. The liquidation value of an expanded group partner's interest in a partnership is the amount of cash the partner would receive with respect to the interest if the partnership sold all of its property for an amount of cash equal to the fair market value of the property (taking into account section 7701(g)), satisfied all of its liabilities (other than those described in §1.752-7), paid an unrelated third party to assume all of its §1.752-7 liabilities in a fully taxable transaction, and then the partnership (and any partnership through which the partner indirectly owns an interest in the controlled partnership) liquidated.

The Treasury Department and the IRS also agree with comments that the regulations should set forth a specific time for determining a partner's share of property owned by a controlled partnership. Therefore, if an expanded group member is an expanded group partner on the date the controlled partnership acquires property, then, under §1.385-3T(f)(2)(i)(B), the liquidation value percentage is determined on the date the controlled partnership acquires the property. Otherwise, under §1.385-3T(f)(2)(ii)(B), liquidation value percentage is determined on the date the expanded group member becomes an expanded group partner in the controlled partnership.

The Treasury Department and the IRS determined that using liquidation value percentage in this context, as opposed to the test based on capital and profits that is used for purposes of identifying a controlled partnership, is appropriate because the two tests are being used for different purposes. On the one hand, the determination of whether a partnership is a controlled partnership is a threshold-based control determination. Thus, while there may be uncertainty as to ownership percentages at the margins, that uncertainty is outweighed by the appropriateness of using a partner's share of profits as one proxy for control. On the other hand, in identifying a partner's share of a controlled partnership's property, the precision afforded by using liquidation value percentage is appropriate because the test is intended to arrive at a specific amount of the property the partner is treated as acquiring.

d. Partner's proportionate share of controlled partnership indebtedness

Comments recommended alternative approaches to determining a partner's proportionate share of a debt instrument issued by a controlled partnership, including determining the partner's proportionate share by applying principles under section 752,

by reference to the partners' capital accounts, or by reference to a partner's liquidation value percentage as defined in proposed §1.752-3(a)(3) (relating to the determination of a partner's share of nonrecourse liabilities). Alternatively, comments suggested providing such methods as safe harbors. One comment suggested that the regulations adopt a rule similar to the tracing rule in §1.707-5(b)(2)(i) (relating to debt-financed distributions) for determining a partner's share of a partnership liability.

The Treasury Department and the IRS have determined that an approach based on a partner's anticipated allocations of the partnership's interest expense is better tailored to the purposes of the temporary regulations. Like the proposed regulations, §1.385-3T(f)(3)(i) provides that, for purposes of applying §§1.385-3 and 1.385-3T, an expanded group partner is treated as the issuer with respect to its share of a debt instrument issued by a controlled partnership. Thus, for example, the determination of whether a debt instrument is a covered debt instrument is made at the partner level. Section 1.385-3T(f)(3)(ii)(A) provides that an expanded group partner's share of a covered debt instrument is determined in accordance with the partner's issuance percentage. A partner's issuance percentage is defined in §1.385-3T(g)(16) as the ratio (expressed as a percentage) of the partner's reasonably anticipated distributive share of all the partnership's interest expense over a reasonable period, divided by all of the partnership's reasonably anticipated interest expense over that same period, taking into account all the relevant facts and circumstances. This approach is premised, in part, on the fungible nature of interest expense. The Treasury Department and the IRS have determined that this rule should, in most cases over time, appropriately match the interest income that an expanded group partner will be deemed to receive under the

rules described in Section H.4 of this Part V with respect to the portion of a debt instrument issued by a partnership that otherwise would be treated as stock under an aggregate application of §1.385-3, with a partner's allocations of partnership interest expense.

The Treasury Department and the IRS also agree with comments that the temporary regulations should set forth the specific time for determining a partner's share of a debt instrument issued by a controlled partnership. Accordingly, §1.385-3T(f)(3)(ii)(A) provides that an expanded group partner's share of a debt instrument is determined on each date on which the partner makes a distribution or acquisition described in §1.385-3(b)(2) or 1.385-3(b)(3)(i). Given that a partner's issuance percentage is a forward-looking facts and circumstances determination and that it may need to be determined on different dates, a partner's issuance percentage may be different from one date to another depending on whether the facts and circumstances have changed between determinations.

The exception to the funding rule for qualified short-term debt instruments is applied at the partnership level by treating the partnership as the issuer of the relevant debt instruments. This is an exception to the general rule that, for purposes of applying §§1.385-3 and 1.385-3T, an expanded group partner is treated as issuing its share of a debt instrument issued by a controlled partnership to a member of the expanded group. Thus, for example, in applying the specified current assets test, one looks to the amount of specified current assets reasonably expected to be reflected on the partnership's balance sheet as a result of transactions in the ordinary course of the partnership's business.

4. Treatment of Recharacterized Partnership Instrument

a. Comments on recharacterization approach of proposed regulations

Comments requested clarification regarding the treatment of a partnership instrument recharacterized as stock of the expanded group partners under proposed §1.385-3. A number of comments pointed out a variety of seemingly unintended consequences of the approach taken in the proposed regulations. Those consequences arose under, among other provisions, §1.337(d)-3T; sections 707, 752, and the regulations thereunder; the fractions rule under section 514(c)(9)(E); rules regarding tax credits; and rules regarding the capitalization of interest expense into cost of goods sold.

Some comments noted that the approach in the proposed regulations could lead to collateral consequences for non-expanded group partners in a controlled partnership. Comments requested clarity regarding the "appropriate conforming adjustments" required to reflect the recharacterization of debt issued by a partnership and further noted that the relationship between the partnership and the expanded group partners deemed to issue stock to the funding member could affect allocations of partnership items of income, gain, loss, deduction, and credit among partners, which could have economic consequences. Comments also asked whether the terms of additional partnership interests issued under the proposed regulations' recharacterization rule would be identical to the terms of the recharacterized indebtedness. One comment requested that the proposed regulations be revised to permit partnerships to adjust the basis of partnership property without regard to the rules of §1.754-1(b) (relating to the time for making a section 754 election to adjust basis of partnership property) when gain

is recognized as a result of the section 385 regulations. A comment requested clarification of the tax consequences when a partnership pays interest and principal on purported debt that has been recharacterized as stock. Finally, comments asserted that the equity interest in the partnership that a partner necessarily would receive as a result of the "appropriate adjustments" upon a recharacterization of a partnership's debt instrument could be viewed as an interest that gives rise to guaranteed payments, which would result in the partnership allocating deductions to its partners.

Several similar comments suggested an alternative approach to the recharacterization of a partnership's debt instrument. Those comments all essentially suggested that the proposed regulations be revised to provide that, upon an event that otherwise would result in the partnership's debt instrument being treated as equity, in lieu of recharacterizing the debt instrument, the expanded group member that holds the debt instrument be deemed to contribute its receivable to the expanded group partner or partners that made, or were treated as making under the aggregate approach, the distribution or acquisition that gave rise to the potential recharacterization of the debt instrument (deemed conduit approach). The comments asserted that this deemed conduit approach would result in interest income from the receivable offsetting the interest deductions from the partnership's debt obligation that would be allocated to the expanded group partner or partners that made (or were treated as making) the distribution or acquisition that otherwise would give rise to the recharacterization of the debt instrument. Additionally, the comments asserted that, because this deemed conduit approach would not require the "appropriate conforming adjustments" required

by the proposed regulations, the deemed conduit approach would mitigate nearly all of the collateral consequences previously described regarding the proposed regulations.

In response to these comments, the temporary regulations adopt the deemed conduit approach. The Treasury Department and the IRS agree with comments that this approach should alleviate nearly all of the collateral consequences the comments identified. The Treasury Department and the IRS also agree with comments that this approach should effectively match interest income with interest expense where appropriate, thus addressing the policy concerns set forth in the proposed regulations and in this preamble. Moreover, section 7701(l) provides ample authority for the deemed conduit approach. The adoption of the deemed conduit approach renders many of the other comments received with respect to the application of the proposed regulations to partnerships moot.

b. General framework for deemed conduit approach

The first step in applying the deemed conduit approach is to determine the portion of a debt instrument that is treated as issued by an expanded group partner and that otherwise would be treated as stock under the aggregate approach to applying §1.385-3(b) (specified portion). Section 1.385-3T(f)(4)(i) then provides that, instead of treating the specified portion as stock, the holder-in-form of the debt instrument is deemed to transfer a portion of the debt instrument (deemed transferred receivable) with a principal amount equal to the adjusted issue price of the specified portion to the expanded group partner (deemed holder) in exchange for stock in the expanded group partner (deemed partner stock). This transaction is called a “deemed transfer.” Any portion of a debt instrument issued by a controlled partnership that is not deemed

transferred is a “retained receivable” in the hands of the holder. Because the holder-in-form of the debt instrument is deemed to transfer the deemed transferred receivable, if a specified portion is created at a time when another specified portion exists, only all or a portion of the retained receivable is deemed to be transferred to the deemed holder. This rule prevents a later distribution or acquisition described in §1.385-3(b)(2) or 1.385-3(b)(3)(i) from causing a deemed transferred receivable that was previously deemed to be transferred to an expanded group partner from being deemed to be transferred again when there is a new specified portion with respect to a covered debt instrument. The deemed transfer is treated as occurring for all federal tax purposes, although there are special rules under §1.385-3(d)(7) for purposes of section 1504(a) (determining whether a corporation is a member of an affiliated group) and under §1.385-3T(f)(4)(vi) for purposes of section 752 (allocating partnership liabilities). The special rules regarding section 752 are described in more detail in Section H.4.c of this Part V.

An expanded group partner that is treated as issuing part of a covered debt instrument issued by a controlled partnership can have a specified portion because it actually makes a distribution or acquisition described in §1.385-3(b)(2) or 1.385-3(b)(3)(i), or is treated under the aggregate approach as acquiring expanded group stock the controlled partnership owns or acquires.

Defining an expanded group partner’s specified portion by reference to the portion of the expanded group partner’s share of a covered debt instrument that would be treated as stock under §1.385-3(b) ensures that the principal amount of the deemed transferred receivable will never exceed the lesser of (i) the expanded group partner’s share of a covered debt instrument, and (ii) the amount of the distribution or acquisition

described in §1.385-3(b)(2) or 1.385-3(b)(3)(i) the expanded group partner made or was treated as making.

The Treasury Department and the IRS agree with comments that the terms of stock deemed to exist as a result of section 385 applying to a debt instrument issued by a partnership along with the consequences of payments with respect to such an instrument should be clear. Section 1.385-3T(f)(4)(iv)(A) provides that the deemed partner stock generally has the same terms as the deemed transferred receivable. Section 1.385-3T(f)(4)(iv)(B) provides that when a payment is made with respect to a debt instrument issued by a controlled partnership for which there is one or more deemed transferred receivables, then, if there is no retained receivable held by the holder of the debt instrument and a single deemed holder is deemed to hold all of the deemed transferred receivables, the entire payment is allocated to the deemed transferred receivables held by the single deemed holder. Otherwise, if there is a retained receivable held by the holder of the debt instrument or there are multiple deemed holders of deemed transferred receivables, or both, the payment is apportioned among the retained receivable, if any, and each deemed transferred receivable in proportion to the principal amount of all the receivables. The portion of a payment allocated or apportioned to a retained receivable or a deemed transferred receivable reduces the principal amount of, or accrued interest with respect to, such item as applicable under general federal tax principles depending on the payment. When a payment allocated or apportioned to a deemed transferred receivable reduces the principal amount of the receivable, the expanded group partner that is the deemed holder with respect to the deemed transferred receivable is deemed to redeem the

same amount of the deemed partner stock, and the specified portion with respect to the debt instrument is reduced by the same amount. When a payment allocated or apportioned to a deemed transferred receivable reduces accrued interest with respect to the receivable, the expanded group partner that is the deemed holder with respect to the deemed transferred receivable is deemed to make a matching distribution in the same amount with respect to the deemed partner stock. The controlled partnership is treated as the paying agent with respect to the deemed partner stock.

It would be necessary to determine an expanded group partner's share of a debt instrument after a deemed transfer if there is a retained receivable and the expanded group partner makes or is treated as making a distribution or acquisition described in §1.385-3(b)(2) or 1.385-3(b)(3)(i). In that case, under §1.385-3T(f)(3)(ii)(B)(1), the expanded group partner's share of a debt instrument (determined as of the time of the subsequent distribution or acquisition) is reduced, but not below zero, by the sum of all of the specified portions, if any, with respect to the debt instrument that correspond to one or more deemed transferred receivables that are deemed to be held by the partner. That is, the creation of a deemed transferred receivable does not change the total amount of a debt instrument for which expanded group partners must be assigned shares, but it does reduce a particular partner's share of the debt instrument that can result in a subsequent deemed transferred receivable to that partner. If an expanded group partner's issuance percentage on the later testing date is lower than it was on the original testing date, it is possible that the expanded group partner's share of the covered debt instrument cannot be reduced by the entire amount of the expanded group partner's specified portion without reducing that expanded group partner's share below

zero. In that case, under §1.385-3T(f)(3)(ii)(B)(2), the other partners' shares of the covered debt instrument are reduced proportionately. Reducing a partner's share of a debt instrument for this purpose does not affect the amount of any specified portion with respect to that partner with respect to prior deemed transfers or any deemed transferred receivable previously deemed transferred. Under these rules, it is impossible for the partners' aggregate shares of a covered debt instrument to exceed the adjusted issue price of the covered debt instrument reduced by any specified portions of that debt instrument, and therefore, the maximum principal amount of all deemed transferred receivables with respect to a covered debt instrument will never exceed the adjusted issue price of the covered debt instrument.

c. Special rules

In response to comments regarding the treatment of debt instruments actually held by an expanded group partner, §1.385-3T(f)(4)(ii) provides that, if a specified portion is with respect to an expanded group partner that is the holder-in-form of a debt instrument, then the deemed transfer described in Section H.4.b of this Part V does not occur with respect to that partner and that debt instrument is not treated as stock. Similarly, §1.385-3T(f)(6) provides more broadly that as long as no partner deducts or receives an allocation of expense with respect to the debt instrument, a debt instrument issued by an expanded group partner to a controlled partnership and a debt instrument issued by a controlled partnership to an expanded group partner are not subject to the rules in §1.385-3T(f).

Section 1.385-3T(f)(5) provides rules for events that could affect the ownership of a deemed transferred receivable. These events are called "specified events." Under

§1.385-3T(f)(5)(iii), a specified event includes the following: (A) the controlled partnership that is the issuer of the debt instrument either ceases to be a controlled partnership or ceases to have an expanded group partner that is a covered member; (B) the holder-in-form is a member of the expanded group immediately before the transaction, and the holder-in-form and the deemed holder cease to be members of the same expanded group for the reasons described in §1.385-3(d)(2); (C) the holder-in-form is a controlled partnership immediately before the transaction, and the holder-in-form ceases to be a controlled partnership; (D) the expanded group partner that is both the issuer of deemed partner stock and the deemed holder transfers (directly or indirectly through one or more partnerships) all or a portion of its interest in the controlled partnership to a person that neither is a covered member nor a controlled partnership with an expanded group partner that is a covered member; (E) the expanded group partner that is both the issuer of deemed partner stock and the deemed holder transfers (directly or indirectly through one or more partnerships) all or a portion of its interest in the controlled partnership to a covered member or a controlled partnership with an expanded group partner that is a covered member; (F) the holder-in-form transfers the debt instrument (which is disregarded for federal tax purposes) to a person that is neither a member of the expanded group nor a controlled partnership.

Under §1.385-3T(f)(5)(i), in the case of any specified event, immediately before the specified event, the expanded group partner that was deemed to issue the deemed partner stock is deemed to distribute the deemed transferred receivable to the holder of the deemed partner stock in redemption of the deemed partner stock. If the specified event is that the expanded group partner transfers all or a portion of its partnership

interest to a covered member or a controlled partnership with an expanded group partner that is a covered member, then under §1.385-3T(f)(5)(ii), the holder of the deemed partner stock is deemed to retransfer the deemed transferred receivable to the transferee expanded group partner. In all cases, the redemption of the deemed partner stock is disregarded for purposes of testing whether there has been a funded distribution or acquisition. However, under §1.385-3(d)(2), all other debt instruments of the expanded group partner that are not currently treated as stock are re-tested to determine whether those other debt instruments are treated as funding the distribution or acquisition that previously resulted in the deemed transfer.

Under §1.385-3T(f)(4)(v), a transfer of the debt instrument, which after a deemed transfer is disregarded for federal tax purposes in whole or in part, to a member of the expanded group or to a controlled partnership is not a specified event. Such transfers are excluded from the definition of specified event because all specified events result in deemed partner stock being redeemed for the deemed transferred receivable, which is unnecessary when the debt instrument (as opposed to an interest in the controlled partnership) is transferred to a member of the expanded group or a controlled partnership. It is consistent with the rules contained in §1.385-3T(f) that an expanded group partner continue to own a deemed transferred receivable after the transfer of the debt instrument to a member of the expanded group or a controlled partnership. Therefore, upon such a transfer, the deemed partner stock is not redeemed for the deemed transferred receivable and instead the holder is deemed to transfer the retained receivable and the deemed partner stock to the transferee.

Finally, §1.385-3T(f)(4)(iii) provides specificity on who is deemed to receive a receivable if one or more expanded group partners are a member of a consolidated group. That section generally provides that the holder of a debt instrument is deemed to transfer the deemed transferred receivable or receivables to the expanded group partner or partners that are members of a consolidated group that make, or are treated as making (under §1.385-3T(f)(2)) the regarded distributions or acquisitions (within the meaning of §1.385-4T(e)(5)) described in §1.385-3(b)(2) or (b)(3)(i) in exchange for deemed partner stock in such partner or partners. To the extent those distributions or acquisitions are made by a member of the consolidated group that is not an expanded group partner, the holder-in-form is treated as transferring a portion of the deemed transfer receivable to each member of the consolidated group that is an expanded group partner ratably as described in §1.385-3T(f)(4)(iii).

d. Remaining collateral consequences

Comments raised certain additional consequences that the deemed conduit approach does not mitigate.

Comments noted that the proposed regulations could have reduced the debt a partnership was treated as issuing, and therefore reduced a partner's share of partnership liabilities under section 752. This reduction would be considered a distribution of money to the partner, which could be in excess of the partner's adjusted tax basis in its partnership interest and thereby result in gain recognition under section 731(a). The deemed conduit approach does not reduce the debt a partnership is treated as issuing, but does cause one or more partners to be deemed to be the holder of the debt. Causing a partner to be the holder of partnership debt, absent a special

rule, could result in the liability being reallocated among the partners under §1.752-2(c)(1). Under §1.752-2(a), a partner's share of a recourse partnership liability equals the portion of that liability, if any, for which the partner or a related person bears the economic risk of loss. Section 1.752-2(c)(1) generally provides that a partner bears the economic risk of loss for a partnership liability to the extent that the partner makes a nonrecourse loan to the partnership. If the partner who is deemed to own a deemed transferred receivable was not previously allocated all of the partnership liability represented by the deemed transferred receivable, the creation of a deemed transferred receivable can result in a reallocation of the partnership liability. This reallocation of the partnership liability raises a concern similar to that raised regarding the proposed regulations, but it is not the result of debt being treated as equity. This consequence only results from the application of these temporary regulations. For that reason, §1.385-3T(f)(4)(vi) provides that a partnership liability that is a debt instrument with respect to which there is one or more deemed transferred receivables is allocated for purposes of section 752 without regard to any deemed transfer. Section 1.752-2(c)(3) contains a cross-reference to this rule.

Comments also noted that the proposed regulations could have resulted in partners recognizing gain under §1.337(d)-3T. Generally, the proposed regulations could cause a corporate partner to recognize gain when a transaction has the effect of the corporate partner acquiring or increasing an interest in its own stock in exchange for appreciated property. For this purpose, stock of a corporate partner includes stock of a corporation that controls the corporate partner within the meaning of section 304(c), except that section 318(a)(1) and (3) shall not apply. The final and temporary

regulations do not provide an exception to the application of §1.337(d)-3T where a debt instrument held by a partnership is recharacterized as stock because the Treasury Department and the IRS do not agree that an instrument recharacterized under the final and temporary regulations should be treated differently for purposes of section 337(d) than an instrument recharacterized under common law. Likewise, neither the final nor the temporary regulations provide an exception where debt issued by a subsidiary of a partnership results in that subsidiary controlling a corporate partner because Treasury and the IRS have determined that such an event that would result in gain recognition under §1.337(d)-3T is not likely to occur often.

Finally, comments asked about the interaction of the regulations with future partnership audit procedures under section 1101 of the Bipartisan Budget Act of 2015, Public Law 114-74. Because the regulations under this new partnership audit regime are under development, it is not possible to address this comment at this time.

5. Disregarded Entities

Comments requested that the treatment of debt instruments and EGIs issued by disregarded entities under proposed §§1.385-2 and 1.385-3 be conformed. As noted in Part IV.A.4 of this Summary of Comments and Explanation of Revisions, the final and temporary regulations modify the rules in §1.385-2 to generally conform those rules to the treatment of a debt instrument issued by a disregarded entity under the temporary §1.385-3 regulations.

Proposed §1.385-3(d)(6) provided that if a debt instrument of a disregarded entity was treated as stock under proposed §1.385-3, the debt instrument would be treated as stock in the entity's owner rather than as an equity interest in the entity. Comments

requested clarity regarding the mechanical recharacterization of an interest in a disregarded entity, particularly if the disregarded entity is owned by a partnership. Consistent with the proposed regulations, the temporary regulations generally provide that a covered debt instrument issued by a disregarded entity will not be treated as an equity interest in the entity. The final and temporary regulations also provide that, to the extent that a covered debt instrument issued by a disregarded entity would be treated as stock under the final and temporary regulations, then, rather than treat the covered debt instrument as stock, the covered member that is the regarded owner of the disregarded entity is deemed to issue its stock. For purposes of the final and temporary regulations, if the covered debt instrument otherwise would have been treated as stock under the general rule, then the covered member is deemed to issue its stock to the expanded group member to which the covered debt instrument was, in form, issued (or transferred) in the relevant general rule transaction. If the covered debt instrument otherwise would have been treated as stock under the funding rule, then the covered member is deemed to issue its stock to the holder of the covered debt instrument in exchange for the covered debt instrument. In each case, the covered member that is the regarded owner of the disregarded entity is treated as the owner of a debt instrument issued by the disregarded entity.

This rule must be applied in a manner that is consistent with the principles of §1.385-3T(f)(4). Thus, for example, stock deemed issued by the covered member that is the regarded owner of the disregarded entity is deemed to have the same terms as the covered debt instrument issued by the disregarded entity, other than the identity of the issuer, and payments on the stock are determined by reference to payments made

on the debt instrument issued by the disregarded entity. Under the rules in §1.385-3T(d)(4), if the regarded owner of a disregarded entity is a controlled partnership, then §1.385-3T(f) applies as though the controlled partnership were the issuer in form of the debt instrument. Thus, a debt instrument issued by a disregarded entity owned by a controlled partnership will generally not be, for purposes of the final and temporary regulations, treated as issued by the disregarded entity or the controlled partnership, and any recharacterization of a covered debt instrument as stock required by the final and temporary regulations will happen at the partner level.

6. Withholding under Section 1441

One comment requested that a paying agent that does not have actual knowledge that a purported debt instrument is treated as stock be exempt from liability under section 1441 for a failure to withhold on a distribution with respect to the recharacterized stock. The final and temporary regulations do not address this concern because the determination of whether a payment is subject to withholding requires a withholding agent to make a number of factual determinations. These determinations are not limited to whether an instrument is debt or equity. The uncertainties that may arise in making those determinations are generally addressed in §§1.1441-2, 1.1441-3, and 1.1441-7. Accordingly, the final and temporary regulations do not adopt additional exemptions from liability under chapter 3 for covered debt instruments.

I. Anti-abuse and affirmative use

1. Anti-Abuse Rule

a. In general

Comments recommended that the anti-abuse rule in proposed §1.385-3(b)(4) be narrowed to apply to transactions only if a principal purpose of the transaction is the avoidance of the purposes of the regulations (rather than the avoidance of the "application" of the regulations). The final and temporary regulations adopt the recommendation and provide that the anti-abuse rule in §1.385-3(b)(4) applies if a member of an expanded group enters into a transaction with a principal purpose of avoiding the purposes of §1.385-3 or §1.385-3T.

Comments recommended that the anti-abuse rule be narrowed to apply only if "the" principal purpose (rather than "a" principal purpose) is the avoidance of the purposes of the regulations. This recommendation is not adopted because the Treasury Department and the IRS have determined that the anti-abuse rule should apply when a principal purpose of a transaction is to avoid the purposes of §1.385-3 or §1.385-3T, even if a taxpayer can establish that it also had other principal purposes for the transaction. In particular, it is often difficult for the IRS to establish that any one purpose was more or less motivating than another. The requirement that the purpose be a "principal" purpose serves as a sufficient limitation such that the rule should only apply in appropriate cases. In addition, the use of "a" principal purpose as part of an anti-abuse rule is standard administrative practice and is consistent with other recent regulations. See §§1.304-4(b); 1.956-1T(b)(4).

Comments also suggested that, if the anti-abuse rule applies, it should result in the instrument being subject to the regulations, rather than in the instrument automatically being recharacterized as stock. The Treasury Department and the IRS decline to accept this recommendation because of the administrative complexity that

would be involved in applying the general rule and funding rule to transactions that are, in form, not subject to these rules due to structuring undertaken by the taxpayer to intentionally avoid their application.

Comments also requested that the anti-abuse rule be clarified in several respects to provide increased certainty, and that examples be provided of the types of transactions that are considered abusive. In addition, comments requested various specific exclusions from the anti-abuse rule. The Treasury Department and the IRS decline to provide new limitations on the anti-abuse rule. While it is intended that the anti-abuse rule will be applicable in cases of avoidance transactions, as opposed to routine transactions that happen to achieve a particular result, the anti-abuse rule must retain the flexibility to address transactions that circumvent the purposes of the final and temporary regulations in ways that were unexpected when the regulations were issued.

The proposed regulations contained a non-exhaustive list of the types of transactions that could implicate the anti-abuse rule, and the preamble to the proposed regulations described other transactions that could be relevant. The final and temporary regulations include the same transactions listed in the proposed regulations that could implicate the anti-abuse rule and add additional transactions with which the Treasury Department and the IRS are concerned. The final and temporary regulations also reorganize the anti-abuse rule to clarify that the principal purpose element is relevant both to issuances of a debt instrument as well as other transactions (including distributions or acquisitions); examples of both are provided. The examples listed in §1.385-3(b)(4)(i) and (ii) are illustrative and do not constitute a mutually exclusive list of the types of transactions that could implicate the anti-abuse rule.

b. Requested clarifications to and exclusions from the anti-abuse rule

i. Debt between unrelated parties

Comments specifically requested clarification that the anti-abuse rule would not apply to bona fide debt between unrelated parties (provided that neither party is acting as a conduit or agent for a related party) while the loan is held by the unrelated party. In addition, comments requested clarification that guaranteed loans are not subject to the anti-abuse rule. In particular, one comment suggested that the proposed regulations could apply to a decision by a subsidiary to borrow directly from an unrelated bank with a parent guarantee rather than cause the parent to borrow from the unrelated bank and on-lend to the subsidiary. The final and temporary regulations do not adopt these recommendations. The Treasury Department and the IRS have determined that, in light of the revision to apply §1.385-3(b)(4) only when a principal purpose of a transaction is to avoid the "purposes" of the regulations (rather than avoiding the "application" of the regulations), it would not be appropriate to provide a complete exception for loans with unrelated parties or related-party guarantees. There already is sufficient clarity under the regulations that, absent other facts and circumstances, borrowing funds from an unrelated lender including with a related-party guarantee would not avoid the purposes of §1.385-3 or §1.385-3T, which are intended to apply in the particular factual circumstance of loans between highly-related corporations.

In addition, the Treasury Department and the IRS remain concerned about transactions with non-expanded group members that are structured to avoid the purposes of §1.385-3 or §1.385-3T, such as a transaction where the lender is a not a member of the expanded group, but only on a temporary basis. As in the proposed

regulations, §1.385-3(b)(4) includes two examples of this situation. In one example, a covered debt instrument is issued to, and later acquired from, a person that is not a member of the issuer's expanded group with a principal purpose of avoiding the purposes of §1.385-3. In the second example, with a principal purpose of avoiding the purposes of §1.385-3, a covered debt instrument is issued to a person that is not a member of the issuer's expanded group, and such person later becomes a member of the issuer's expanded group.

ii. Transactions that meet existing exceptions

Comments requested that the anti-abuse rule not apply to a transaction that satisfies a specific exception to either the general rule or funding rule. For example, the comments questioned the application of the anti-abuse rule when a taxpayer issues multiple debt instruments in multiple years, each debt instrument would, but for the E&P exception, be treated as stock, and some of the debt instruments would not have benefitted from the E&P exception if they had been issued during the first year. The comments asserted that none of the debt instruments in that example should be treated as stock under the anti-abuse rule (for example, by being treated as being issued all at once in the first year of the period). The Treasury Department and the IRS agree that in that example, the anti-abuse rule generally would not be implicated, because no purpose of the regulations has been avoided. As discussed in Section I.1.a of this Part V, the final and temporary regulations provide that the anti-abuse rule applies to transactions with a principal purpose of avoiding the "purposes" of §§1.385-3 or 1.385-3T, rather than applying to transactions with a principal purpose of avoiding the "application" of §§1.385-3 or 1.385-3T.

However, the Treasury Department and the IRS decline to provide that the anti-abuse rule cannot apply to transactions that meet a specific exception to either the general rule or funding rule. The Treasury Department and the IRS remain concerned about structured transactions that satisfy the technical requirements for exceptions or exclusions but avoid the purposes of the final and temporary regulations. Those structured transactions may technically qualify for a specific exception, but would nonetheless be subject to the anti-abuse rule. Accordingly, the Treasury Department and the IRS decline to adopt the specific recommendation.

Because the final and temporary regulations significantly expand the exceptions and reductions in §1.385-3(c) that are discussed in Section E of this Part V, and because of other changes addressed in §1.385-4T that are discussed in Part VI of this Summary of Comments and Explanation of Revisions, the final and temporary regulations also clarify that the anti-abuse rule explicitly addresses distributions or acquisitions that occur with a principal purpose of avoiding the purposes of §1.385-3 or §1.385-3T, as well as other transactions that are undertaken with a principal purpose of avoiding the purposes of §1.385-3 or §1.385-3T.

iii. Interests that are not debt instruments

Comments requested additional guidance concerning the application of the anti-abuse rule to interests that are not debt instruments, with specific requests for clarity concerning preferred partnership interests. As discussed in Section F.2 of this Part V, the Treasury Department and the IRS decline to adopt a recommendation to limit the funding rule to instruments that are, in form, debt instruments and also decline to adopt a recommendation to exclude from the funding rule a deemed loan arising from a

nonperiodic payment with respect to a notional principal contract. The Treasury Department and the IRS similarly decline to narrow the application of the anti-abuse rule in these contexts.

The Treasury Department and the IRS continue to study whether it is appropriate to subject preferred equity in a controlled partnership to the rules that would apply to a debt instrument issued by a controlled partnership. As described in the preamble to the proposed regulations, the IRS intends to closely scrutinize, and may challenge under the anti-abuse rule, transactions in which a controlled partnership issues preferred equity to an expanded group member and the rules of §1.385-3T(f) would have applied had the preferred equity been denominated as a debt instrument issued by the partnership.

2. Affirmative Use

The proposed regulations provided that the rules of proposed §§1.385-3 and §1.385-4 do not apply to the extent a person enters into a transaction that otherwise would be subject to proposed §1.385-3 with a principal purpose of reducing the federal tax liability of any member of the expanded group that includes the issuer and the holder of the debt instrument by disregarding the treatment of the debt instrument that would occur without regard to §1.385-3.

Comments suggested eliminating the prohibition on affirmative use as contradictory to the objective factor-based analysis of the proposed regulations and creating unnecessary uncertainty for taxpayers that could lead to controversy with tax authorities. Comments expressed concern that determining whether a transaction was entered into with a principal purpose of reducing U.S. tax presented additional

administrative difficulties, particularly if the expected tax benefits are realized at a future date, accrue to a related taxpayer, or are subject to a material contingency. Furthermore, a taxpayer could often issue preferred stock (or another form of equity) in instances where such treatment is preferable rather than relying on recharacterization. One comment asked how the rule concerning affirmative use should interact with common law and for clarification as to what is meant by a reduction in U.S. federal income tax liability.

In response to comments, including comments about the no affirmative use rule creating unnecessary uncertainty, the Treasury Department and the IRS reserve on the application of the no affirmative use rule in §1.385-3 pending continued study after the applicability date.

VI. Comments and Changes to Proposed §1.385-4 — Treatment of Consolidated Groups

A. Treatment of consolidated groups as one corporation

To prevent application of the proposed regulations under section 385 to interests between members of a consolidated group, proposed §1.385-1(e) provided that a consolidated group (as defined in §1.1502-1(h)) is treated as one corporation (the one-corporation rule). Several comments were received requesting expansions, clarifications, or modifications of this rule, as described in this Part VI.

1. Expansion of the One-Corporation Rule

Several comments suggested that all domestic corporations under some degree of common control should be treated as one corporation under the regulations. For example, comments suggested that a group of domestic entities meeting the ownership

requirements of section 1504(a)(2) connected through common ownership by a domestic corporation (treating a controlled partnership as an aggregate of its partners or as a corporation for this purpose) should be treated as one corporation. Other comments suggested that all members of a "super affiliated group," as defined in proposed §1.163(j)-5(a)(3), should be treated as one corporation. Others suggested that multiple consolidated groups that are commonly controlled should be treated as one corporation, without specifying the necessary degree of common control.

Comments also suggested that certain entities that would not be treated as members of a consolidated group should be treated as consolidated group members for purposes of the one-corporation rule. For example, comments suggested that the one-corporation rule should apply to affiliated groups determined without regard to section 1504(b)(2) and (c) (preventing certain life insurance companies from joining an affiliated group) or section 1504(b)(6) (preventing RICs and REITs from joining an affiliated group).

As discussed in Part V.A.2 of this Summary of Comments and Explanation of Revisions, the proposed regulations did not apply to indebtedness issued by a corporation to members of its consolidated group while the indebtedness was held in such group because the policy concerns addressed in the proposed regulations generally are not present when the issuer's deduction for interest expense and the holder's corresponding inclusion of interest income offset on the group's consolidated federal income tax return. For the reasons described in Part V.A.2 of this this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS continue to view the filing of a single federal income tax return as the appropriate basis

for excluding transactions among consolidated group members, and decline to extend the treatment afforded to consolidated groups to expanded group members that file separate federal income tax returns. In addition, modifications made in the final and temporary regulations significantly reduce, and in certain cases eliminate, the application of the regulations to life insurance companies and non-controlled RICs and REITs.

2. Clarification of the One-Corporation Rule

a. Scope

Comments generally supported the principle-based one-corporation rule of the proposed regulations while recommending certain specific clarifications and exceptions, each of which is described in this preamble. One comment requested guidance regarding the interaction of the one-corporation rule with other provisions of the Code, recommending that the regulations provide an order of operations as follows: First, apply the provisions of the Code and the regulations thereunder, treating the members of a consolidated group as separate entities for purposes of applying the rules; second, apply the section 385 regulations to the transaction as it is characterized under other provisions of the Code and the regulations thereunder, giving effect to the one-corporation rule. For example, assume that FP owns USP1 and USP2, each of which is the common parent of a different consolidated group. USP1, which owns USS1 and several other subsidiaries, sells USS1 to USP2 for a note. The comment recommended that USP1 be treated as transferring USS1 stock, but noted that the transaction could instead be treated as the sale of a branch comprised of USS1's assets and liabilities under the one-corporation rule.

The temporary regulations adopt this recommendation. Under the order of operations rule of §1.385-4T(b)(5), a transaction involving one or more members of a consolidated group is first characterized under federal tax law without regard to the one-corporation rule, and then §§1.385-3 and 1.385-4T apply to the transaction as characterized to determine whether the debt instrument is treated as stock, treating the consolidated group as one corporation, unless otherwise provided. Applying this rule to the example above, USP2's acquisition of USS1 is respected as an acquisition of the stock of USS1 in exchange for a note of USP2. Therefore, absent an exception, the note issued by USP2 is treated as stock under §1.385-3(b).

Another comment stated that the scope of the one-corporation rule is unclear, and recommended that certain items be clearly included or excluded from the one-corporation rule and that a principle-based rule be used to address the items not expressly included or excluded. For example, the comment noted that, for purposes of determining the treatment of an interest that ceases to be a consolidated group debt instrument, proposed §1.385-4(b)(1)(ii)(B) respected the existence of the consolidated group debt instrument solely for purposes of determining the per se period under proposed §1.385-3(b)(3)(iv)(B). As discussed in more detail in Section B.2 of this Part VI, the temporary regulations address the concern raised in this comment by providing that when a departing member ceases to be a member of a consolidated group, but remains a member of the expanded group, the departing member's history of transactions with other consolidated group members remains disregarded. For this purpose, a departing member is a member of an expanded group that ceases to be a

member of its original consolidated group but continues to be a member of the same expanded group.

b. Wholly-owned partnerships

Comments requested clarification of the treatment of loans between a consolidated group member and a partnership that is wholly owned by members of the consolidated group. Specifically, comments requested clarification that any such loan would be treated as a loan from one consolidated group member to another consolidated group member, which generally would be treated as a debt instrument issued and held by members of the same consolidated group (a consolidated group debt instrument), so that the loan would not be subject to proposed §§1.385-3 and 1.385-4. By contrast, other comments recommended that the regulations not apply to such a debt instrument because the one-corporation rule suggests that a partnership wholly owned by members of a consolidated group should be disregarded as a separate entity for purposes of proposed §§1.385-3 and 1.385-4.

The temporary regulations clarify that a partnership all of the partners of which are members of the same consolidated group is treated as a partnership for purposes of §§1.385-3, 1.385-3T, and 1.385-4T. However, §1.385-3T treats a partner in a controlled partnership as issuing its share of a debt instrument issued by the controlled partnership and holding its share of a debt instrument held by the controlled partnership. Accordingly, under the one-corporation rule, a covered debt instrument between a consolidated group member and a controlled partnership that is wholly owned by members of the consolidated group is treated as a consolidated group debt instrument.

c. Identity of issuer

Comments recommended that the regulations provide that a debt instrument issued by a member of a consolidated group, if characterized as stock under the regulations, is stock in the particular member that issued the debt instrument. Comments noted that this result was demonstrated by examples in the proposed regulations, but requested that an operative rule in the regulations confirm the outcome demonstrated by the examples. Other comments questioned whether this was the appropriate outcome, and indicated that in certain cases, the common parent of a consolidated group should be treated as the issuer when a debt instrument issued by another member of its consolidated group is treated as stock under the regulations. However, one comment noted that treating a debt instrument issued by one member as having been issued by another member (such as the common parent) may be inappropriate in certain cases, including when the issuer of the instrument has a minority shareholder that is not a member of the consolidated group.

In response to these comments, the temporary regulations provide that a debt instrument issued by a member of a consolidated group, if treated as stock under the regulations, is treated as stock in the particular member that is treated as the issuer of the debt instrument under general tax principles.

d. Interaction with the funding rule

One comment requested confirmation that an effect of the one-corporation rule is that, under the funding rule, a debt instrument issued by one member of a consolidated group to a member of its expanded group that is not a member of the same consolidated group could be treated as funding a transaction described in proposed §1.385-3(b)(3) undertaken by a different member of the same consolidated group, such

that the debt instrument would be treated as stock. The temporary regulations confirm this result in §1.385-4T(b)(1).

Another comment recommended an exception from the one-corporation rule which would reverse this outcome when the issuer of the debt instrument can demonstrate that the proceeds obtained in connection with the issuance of the debt instrument can be shown to have not directly funded the other consolidated group member's transaction. The temporary regulations do not adopt this recommendation, which is essentially a tracing approach, for the reasons described in Section V.D.2 of this Summary of Comments and Explanation of Revisions.

Multiple comments were received regarding the application of the funding rule when a corporation joins a consolidated group. One comment stated that when an expanded group member engages in a transaction described in proposed §1.385-3(b)(3)(ii) and subsequently joins a consolidated group (while remaining a member of the same expanded group), it is appropriate to treat the consolidated group as having engaged in the transaction. For example, assume that FP, USS1, and USS2 are members of the same expanded group, and that USS1 is the common parent of a consolidated group that, in Year 1, does not include USS2. If USS2 makes a distribution to FP in Year 1, and joins USS1's consolidated group in Year 2, the USS1 consolidated group would be treated as having made USS2's Year 1 distribution. The temporary regulations adopt this recommendation by providing that, when a member of an expanded group becomes a member of a consolidated group and continues to be a member of the same expanded group (a joining member), the joining member and the

consolidated group that it joins are a predecessor and successor (respectively) for purposes of §1.385-3(b)(3).

e. Interaction with the reduction for expanded group earnings

Comments recommended that the regulations clarify how to apply the current year earnings and profits exception for a consolidated group treated as one corporation. Generally, comments questioned whether the one corporation's current year earnings and profits is based on §1.1502-33, or whether it should instead be recalculated as though each member of the consolidated group other than the common parent were a branch. For example, under the latter approach, current year earnings and profits would not include worthless stock loss deductions with respect to stock of a consolidated group member, and certain stock acquisitions would be treated as asset acquisitions, which could produce a step-up or step-down in the basis of depreciable or amortizable assets.

As discussed in Section V.E.3.a of this Summary of Comments and Explanation of Revisions, the earnings and profits exception has been modified in the final and temporary regulations. With respect to the expanded group earnings account, the temporary regulations provide that a consolidated group has one account and only the earnings and profits, determined in accordance with §1.1502-33 (without regard to the application of §1.1502-33(b)(2), (e), and (f)), of the common parent (within the meaning of section 1504) of the consolidated group are considered in calculating the expanded group earnings for the expanded group period of a consolidated group. The Treasury Department and the IRS have determined that a methodology based on modified §1.1502-33 principles is the simplest to administer and most accurately reflects the

treatment of all members of a consolidated group as one corporation for purposes of the final and temporary regulations.

The temporary regulations provide rules for determining when, and to what extent, a consolidated group (treated as one corporation) or a departing member succeeds to all or some of the expanded group earnings account of a joining member or a consolidated group, respectively. In this regard, a consolidated group succeeds to the expanded group earnings account of a joining member. In addition, if a departing member (including departing members that immediately after leaving a consolidated group themselves comprise another consolidated group treated as one corporation) leaves a consolidated group in a distribution under section 355, the expanded group earnings account of the consolidated group is allocated between the consolidated group and the departing member in proportion to the earnings and profits of the consolidated group and the earnings and profits of the departing member immediately after the transaction. However, no amount of the expanded group earnings account of a consolidated group is allocated to a departing member that leaves the consolidated group in a transaction other than a distribution to which section 355 applies. The temporary regulations provide similar rules with respect to the reduction for qualified contributions, discussed in Section A.2.f of this Part VI.

Comments also questioned whether the issuer's earnings and profits or the consolidated group's earnings and profits should be used when an issuer makes a distribution to a minority shareholder that is not a member of the consolidated group but is a member of the expanded group. Providing each member of a consolidated group access to the consolidated group's earnings account with respect to a distribution or

acquisition made by such member to or from another member of the expanded group is consistent with the premise of treating all members of a consolidated group as one corporation. Accordingly, the temporary regulations provide that a distribution or acquisition that a member of a consolidated group makes to or from another member of the same expanded group that is not a member of the same consolidated group is reduced to the extent of the expanded group earnings account of the consolidated group.

f. Interaction with reduction for qualified contributions

As discussed in Part V.E.3.b of this Summary of Comments and Explanation of Revisions, the final and temporary regulations provide that an expanded group member's distributions and acquisitions are reduced by qualified contributions for purposes of applying the general rule and funding rule. The temporary regulations provide that, for purposes of applying the qualified contribution reduction to distributions or acquisitions by a consolidated group, qualified contributions to any member that remains consolidated immediately after the contribution are treated as made to the consolidated group, a qualified contribution that causes a deconsolidation of a member is treated as made to the departing member and not to the consolidated group, and no contribution of property by a member of a consolidated group to any other member of the consolidated group is treated as a qualified contribution.

g. Interaction with other specific provisions in §1.385-3

The temporary regulations provide that the determination of whether a debt instrument issued by a member of a consolidated group is a covered debt instrument is made on a separate member basis without regard to the one-corporation rule. The

Treasury Department and the IRS have determined that separate-member treatment is appropriate for making this determination because the exceptions to covered debt instrument status are tailored to specific entity-level attributes of the issuer. For example, because status as an excepted regulated financial company is determined on an issuer-by-issuer basis, the Treasury Department and the IRS have determined that it would not be appropriate to extend that special status to other members of a consolidated group that do not meet the specific requirements for the exception.

Similarly, the determination of whether a member of a consolidated group has issued a qualified short-term debt instrument for purposes of §1.385-3(b)(3)(vii) is made on a separate member basis. The policy justifications for the specific tests set forth in that exception, in particular the specified current asset test, are more suited to a separate member analysis. Despite the general use of a separate member approach to applying the qualified short-term debt instrument tests, §1.385-3(b)(4)(ii)(D) specifically references situations in which a member of an expanded group enters into a transaction with a principal purpose of avoiding the purposes of §1.385-3 or §1.385-3T, including as part of a plan or a series of transactions through the use of the consolidated group rules set forth in §1.385-4T. That rule could apply, for example, to transactions in which two different members of the same consolidated group engage in "alternating" loans from a lender that is not a member of the consolidated group with a principal purpose of avoiding the purposes of the limitations in the 270-day test in §1.385-3(b)(3)(vii)(A)(2) by also engaging in other intra-consolidated group transactions that otherwise would be disregarded under the one-corporation rule.

3. State and Local Tax Comments

Comments noted that the regulations add complexity to state and local tax systems and may result in additional state tax costs and compliance burdens for taxpayers. In particular, a comment noted that, if a state applies the one-corporation rule based on the composition of the state filing group rather than the federal consolidated group, transactions could be subject to the regulations for state income tax purposes even when the transactions are not subject to the regulations for federal income tax purposes. The comment suggested that this concern could be mitigated in states that adhere to the literal language of the section 385 regulations by modifying proposed §1.385-1(e) to provide that "all members of a consolidated group (as defined in §1.1502-1(h)) that file (or that are required to file) consolidated U.S. federal income tax returns are treated as one corporation." The temporary regulations adopt this recommendation.

4. Newly-Acquired Life Insurance Subsidiaries

Several comments noted the one-corporation rule in proposed §1.385-1(e) would not apply in cases where section 1504(c)(2) prohibits inclusion of newly-acquired life insurance subsidiaries in a consolidated group. These comments asked that the regulations treat such newly-acquired life insurance companies as part of a consolidated group even when section 1504(c)(2) would not.

The one-corporation rule is intended only to treat members of a consolidated group that file a single federal income tax return as a single taxpayer because items of income and expense with respect to debt instruments between such members are included and offset each other on the consolidated group's single federal income tax return. To the extent that section 1504(c)(2) prohibits recently-acquired life insurance

companies from joining a consolidated group, the items of income and expense of the companies and the consolidated group are not included in a single federal income tax return. In this context, a consolidated group and its recently-acquired life insurance subsidiaries are not materially different from two separate consolidated groups are part of the same expanded group. Transactions between two separate consolidated groups that are part of the same expanded group are subject to §§1.385-3 and 1.385-4T. As a result, the Treasury Department and the IRS decline to include a special rule related to section 1504(c)(2) in the temporary regulations. However, as discussed in Part V.G.2 of this Summary of Comments and Explanation of Revisions, the final and temporary regulations exclude debt instruments issued by regulated insurance companies.

B. Debt instruments that cease to be among consolidated group members and remain among expanded group members

The proposed regulations provided two rules governing the treatment of a consolidated group debt instrument that ceased to be a consolidated group debt instrument, but continued to be issued and held by members of the same expanded group. One set of rules (the departing instrument rules) addressed situations in which a member of a consolidated group transfers a consolidated group debt instrument to an expanded group member that is not a member of the consolidated group. The other set of rules (the departing member rules) addressed debt held or issued by a consolidated group member that leaves a consolidated group but continues to be a member of the expanded group (such corporation, a departing member). Several comments were received regarding the operation of these rules.

1. Departing Instrument Rules

Under the departing instrument rules, when a member of a consolidated group that held a consolidated group debt instrument transferred the consolidated group debt instrument to an expanded group member that was not a member of the consolidated group, the debt instrument was treated as issued by the issuer of the debt instrument (which is treated as one corporation with the transferor of the debt instrument) to the transferee expanded group member on the date of the transfer. For purposes of proposed §1.385-3, the consequences of the transfer were determined in a manner that was consistent with treating a consolidated group as one corporation. To the extent the debt instrument was treated as stock upon being transferred, the debt instrument was deemed to be exchanged for stock immediately after the debt instrument was transferred outside of the consolidated group.

Comments recommended that when a consolidated group member distributes a debt instrument issued by another member of its consolidated group to a nonconsolidated expanded group member in a distribution, the distribution should not be taxable as an exchange, but should instead be taxable in the same manner as a distribution by a consolidated group member of its own debt instrument to a nonconsolidated member of its expanded group, which would generally be treated as a distribution subject to section 305. The temporary regulations do not adopt this comment because the comment implicitly suggests that the regulations apply the one-corporation rule for all federal tax purposes, rather than as a rule for applying §§1.385-3, 1.385-3T, and 1.385-4T in the consolidated return context.

2. Departing Member Rules

a. Harmonization with the departing instrument rule

Comments recommended harmonizing the departing member rules with the departing instrument rules. For example, one comment recommended that, when a departing member of a consolidated group is the holder or the issuer of a debt instrument issued or held by another member of the consolidated group, and the departing member remains in the same expanded group after leaving the consolidated group, then the debt instrument generally should be treated for purposes of §1.385-3 as being reissued immediately following the member's departure from the consolidated group (consistent with the departing instrument rule). This would have the effect of harmonizing the departing member rules with the departing instrument rules because the departing instrument rules provide that when a member of a consolidated group that held a consolidated group debt instrument transfers the instrument to an expanded group member that is not a member of the consolidated group, the instrument is treated as newly issued by the issuer to the transferee. The comment suggested that, if the debt instrument was issued by or to the departing member of the consolidated group as part of a plan that included the member's departure from the consolidated group, then the debt should be recast as stock when the member departs from the consolidated group if it would have previously been recast as stock absent the one-corporation rule. However, the comment also suggested that absent a plan that included the member's departure from the consolidated group and the issuance of the debt instrument, the debt instrument should be treated as reissued immediately after the member's departure from the consolidated group. As discussed in more detail in Section B.2.b of this Part VI, the temporary regulations generally adopt this approach by eliminating the classification of a departing member's debt instruments that were previously

consolidated group debt instruments as either exempt consolidated group debt instruments or non-exempt consolidated group debt instruments after departure. Instead, the temporary regulations treat those debt instruments as reissued, and thus generally do not require separate tracking of intra-consolidated group transactions, unless the anti-abuse rule in §1.385-3(b)(4) applies.

Another comment noted that, if the departing member rule and the departing instrument rule are not harmonized, there could be situations in which both rules appear to apply. For example, a consolidated group member that holds a consolidated group debt instrument and undergoes an outbound reorganization described in section 368(a)(1)(F) may be viewed as both transferring the consolidated group debt instrument and ceasing to be a member of the consolidated group. The temporary regulations add an overlap rule to provide that, if both the departing member rules and the departing instrument rules could apply to the same transaction, the departing instrument rules, rather than the departing member rules, apply.

b. Operation of departing member rules

The proposed regulations generally provided that any consolidated group debt instrument that is issued or held by the departing member and that was not treated as stock solely by reason of the one-corporation rule (an exempt consolidated group debt instrument, under the nomenclature of the proposed regulations) was deemed to be exchanged for stock immediately after the departing member leaves the consolidated group. The proposed regulations also generally provided that any consolidated group debt instrument issued or held by a departing member that is not an exempt consolidated group debt instrument (a non-exempt consolidated group debt instrument,

under the nomenclature of the proposed regulations) continued to be treated as indebtedness after the departure, unless and until the non-exempt consolidated group debt instrument was treated as stock under the funding rule as a result of a later distribution or acquisition. However, the proposed regulations also provided that, solely for purposes of applying the per se rule, the debt instrument was treated as having been issued when it was first treated as a consolidated group debt instrument, and not when the departing member departed from the consolidated group.

Several comments addressed the operation of the departing member rules. Comments requested clarification as to how the current year earnings and profits exception described in proposed §1.385-3(c)(1) applied for purposes of determining whether a consolidated group debt instrument is an exempt consolidated group debt instrument or a non-exempt consolidated group debt instrument. Specifically, the comments noted that, in order to analyze whether a consolidated group debt instrument would or would not have been recharacterized under proposed §1.385-3(b)(3) but for the one-corporation rule, the issuer would need to analyze the availability of the various exceptions in proposed §1.385-3(c), including the current year earnings and profits exception in the proposed regulations. For purposes of applying the earnings and profits exception, comments questioned whether the determination should be made by reference to the specific issuer's earnings and profits (without regard to the one-corporation rule) or whether some other measure, such as the issuer's earnings and profits plus the earnings and profits of lower-tier group members should be used. Further, one comment questioned whether adjustments to an issuer's earnings and profits should be made based on adjustments to the earnings and profits of lower-tier

consolidated group members if all exempt consolidated group debt instruments were treated as stock rather than debt.

Comments also suggested that the special timing rule for non-exempt consolidated group debt instruments be eliminated. Specifically, comments noted that, because the proposed rule for non-exempt consolidated group debt instruments did not turn off the deemed satisfaction and reissuance rules of §1.1502-13(g), the deemed reissuance rule in §1.1502-13(g) could conflict with the special timing rule, and, as a result, start a new time period for the per se rule. See proposed §1.385-4(d)(3), Example 4. Comments recommended that the example be revised to take the deemed satisfaction and reissuance rules into account, and by implication, eliminate the special timing rule for non-exempt consolidated group debt instruments. Other comments questioned whether the interaction of the special timing rule for non-exempt consolidated group debt instruments and the ordering rule in proposed §1.385-3(b)(3)(iv)(B)(3) (multiple interests) could lead to inappropriate results.

Other comments more directly recommended that the regulations disregard any history of transactions that occurred solely between consolidated group members before a departure. This approach would also render moot the concept of a non-exempt consolidated group debt instrument and an exempt consolidated group debt instrument. One comment noted that requiring tracking of consolidated group history is contrary to the notion of excluding debt instruments issued by members of a consolidated group from the scope of proposed §1.385-3, because the consolidated group would still have to monitor and analyze the history of intra-consolidated group transactions in the event there was a departing member.

Along similar lines, other comments recommended that the regulations provide that unfunded distribution and acquisition transactions that occurred solely within a consolidated group be disregarded for all purposes of proposed §§1.385-3 and 1.385-4, so that the history of such intra-consolidated group distribution and acquisition transactions would not follow a member that leaves the consolidated group. For example, assume that in Year 1, DS1 makes a $100x distribution to USS1, the common parent of a consolidated group of which DS1 is a member. In Year 2, DS1 ceases to be a member of the USS1 consolidated group, but remains a member of the same expanded group as USS1. Immediately afterwards, DS1 borrows $100x from a member of the expanded group that is not a member of the USS1 consolidated group. The comments recommended that, for purposes of applying the funding rule in this context, DS1's distribution to USS1 in Year 1 should be disregarded.

Comments also requested clarification of the application of the funding rule to a departing member in situations in which one member of a consolidated group makes a distribution or acquisition to or from another member of the same expanded group that is not a member of the same consolidated group (a regarded distribution or acquisition), and subsequently, another member of the consolidated group departs the consolidated group but remains a member of the expanded group. One comment indicated that the departing member should not be treated as having made the regarded distribution or acquisition for purposes of the funding rule, and by implication, the consolidated group should continue to be treated as having made the regarded distribution or acquisition for purposes of the funding rule. Other comments indicated that, in order to prevent

duplication, the departing member should be allocated a portion of each regarded distribution or acquisition for purposes of the funding rule.

Another comment sought clarification when a member of a consolidated group is funded through a borrowing from an expanded group member that is not a member of the same consolidated group, and therefore the entire consolidated group is treated as a funded member for purposes of proposed §1.385-3(b)(3), and a different member of the consolidated group subsequently leaves the consolidated group. The comment specifically asked whether that departing member is still treated as a funded member after departure.

The temporary regulations generally adopt the recommendations described above. Specifically, the temporary regulations provide that if a consolidated group debt instrument ceases to be treated as such because the issuer and holder are no longer members of the same consolidated group but remain members of the same expanded group, then the issuer is treated as issuing a new debt instrument to the holder in exchange for property immediately after the debt instrument ceases to be a consolidated group debt instrument. Absent application of the anti-abuse rule in §1.385-3(b)(4), the departing member's history of prior transactions with other consolidated group members, which were disregarded under the one-corporation rule for purposes of applying §1.385-3(b)(3), remain disregarded when the departing member ceases to be a member of the consolidated group. By giving greater effect to the one-corporation rule, the temporary regulations reduce the need to monitor transactions solely among consolidated group members and make the additional

exceptions set forth in §1.385-3(c) more administrable, particularly the exceptions for expanded group earnings and qualified contributions.

The temporary regulations also clarify the designation of funded status when a member leaves a consolidated group but remains in the expanded group. When a consolidated group member is funded through a borrowing from an expanded group member that is not a member of the same consolidated group, and that consolidated group member later departs the consolidated group, the departing member continues to be treated as funded by the borrowing, and the consolidated group from which the departing member departs ceases to be treated as funded by the borrowing. If instead a non-departing member had been funded by the borrowing, the temporary regulations provide that the consolidated group from which the departing member departs continues to be treated as funded by the borrowing, and the departing member ceases to be treated as funded by the borrowing when it leaves the consolidated group.

Similarly, the temporary regulations also clarify the treatment of consolidated groups in situations when a departing member has made a regarded distribution or acquisition that has not yet caused a recharacterization of a debt instrument under the general rule or funding rule. The temporary regulations provide that, in such a situation, if the departing member departs the consolidated group in a transaction other than a section 355 distribution, the departing member continues to be treated as having made the regarded distribution or acquisition, and the consolidated group from which the departing member departs ceases to be treated as having made the regarded distribution or acquisition.

For purposes of applying the funding rule when a departing member ceases to be a member of a consolidated group by reason of a section 355 distribution, the temporary regulations clarify that a departing member is a successor to the consolidated group and the consolidated group is a predecessor to the departing member. Specifically, based on the order of operations rule of §1.385-4T(b)(5), the temporary regulations provide that the determination as to whether an expanded group member that is not a member of a consolidated group is a predecessor or successor of another expanded group member that is a member of a consolidated group is made without regard to the one-corporation rule. Similarly, the determination as to whether a an expanded group member that also is a member of a consolidated group is a predecessor or successor to another expanded group member that is not a member the consolidated group is made without regard to the one-corporation rule. The temporary regulations further provide that, for purposes of the funding rule, if a consolidated group member is a predecessor or successor of a member of the expanded group that is not a member of the same consolidated group, the consolidated group is treated as a predecessor or successor of the expanded group member (or the consolidated group of which that expanded group member is a member). Thus, a departing member that is a successor to a member of the consolidated group of which it ceases to be a member is treated as a successor to the consolidated group, and the consolidated group is treated as a predecessor to the departing member. Accordingly, any regarded distribution or acquisition by the consolidated group before the departing member ceases to a be a member of the consolidated group may be treated as made by either the departing

member or the consolidated group, depending on the application of the multiple interest rule of §1.385-3(b)(3)(B).

In connection with these and other changes in §1.385-4T, the final and temporary regulations add to the anti-abuse rule in §1.385-3(b)(4) a specific reference to §1.385-4T, as well as specific examples where an expanded group member engages in a transaction with a principal purpose of avoiding the purposes of §1.385-3, 1.385-3T, or 1.385-4T through the use of a departing member. The anti-abuse rule may apply, for example, if a covered debt instrument is issued by a member of a consolidated group (USP) to an expanded group member, and pursuant to a plan with a principal purpose of avoiding the purposes of §1.385-3, 1.385-3T, or 1.385-4T, the following transactions occur: (i) the proceeds of the borrowing are contributed by USP to its subsidiary (US1), also a member of the same consolidated group, (ii) US1 deconsolidates by USP transferring all of its US1 stock to another expanded group member that is not a member of the same consolidated group, and (iii) US1 makes a distribution to its shareholder.

Finally, the temporary regulations clarify that if an interest in a consolidated group member has previously been characterized as stock under §1.385-3, that interest continues to be treated as stock in the member after the member departs the consolidated group but remains in the expanded group.

c. Subgroups leaving the consolidated group

Comments questioned whether the departing member rule should apply when an issuer and holder simultaneously depart the same consolidated group (the old consolidated group) and then simultaneously join another consolidated group (the new

consolidated group), and both the old and new consolidated groups are in the same expanded group. Comments recommended that, under these circumstances, the concerns addressed in the proposed regulations generally are not present because the issuer's deduction for interest expense and the holder's corresponding interest income continue to offset on the new consolidated group's consolidated federal income tax return. Accordingly, comments recommended the provision of a "subgroup exception" under which proposed §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. In response to these comments, the temporary regulations adopt a subgroup rule when both the issuer and the holder of a consolidated group debt instrument cease to be members of a consolidated group, but the issuer and the holder both become members of another consolidated group that is in the same expanded group immediately after the transaction. When this exception applies, the debt instrument between subgroup members remains a consolidated group debt instrument rather than a debt instrument that is treated as issued under §1.385-4T(c)(1)(ii) or deemed reissued under §1.385-4T(c)(1)(i).

3. Debt Instrument Entering a Consolidated Group

One comment noted that the deemed exchange that occurred pursuant to proposed §1.385-4(c) could be treated as a divided equivalent redemption described in section 302(d). The comment recommended that, to prevent some of the ancillary consequences of such treatment (for example, withholding tax liability), the deemed exchange should occur only after the debt instrument becomes a consolidated group debt instrument. The Treasury Department and the IRS generally adopt this

recommendation. The final and temporary regulations provide that, if a covered debt instrument that is treated as stock under §1.385-3 becomes a consolidated group debt instrument, then immediately after the covered debt instrument becomes a consolidated group debt instrument, the issuer is deemed to issue a new covered debt instrument to the holder in exchange for the covered debt instrument that was treated as stock. In addition, the final and temporary regulations provide that when the covered debt instrument that previously was treated as stock becomes a consolidated group debt instrument, the underlying distribution or acquisition that caused the covered debt instrument to be treated as stock is re-tested against other covered debt instruments issued by the consolidated group following principles set forth in §1.385-3(d)(2)(ii)(A). For further discussion of the re-testing principles in §1.385-3(d)(2)(ii)(A), see Part V.H.2 of this Summary of Comments and Explanation of Revisions.

4. Other Comments Regarding Proposed §1.385-4

a. Respecting deemed exchanges

Comments noted that §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, while §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. The consolidated return regulations explicitly provide, in each case, that the deemed satisfaction and reissuance are treated as transactions separate and apart from the transaction giving rise to the deemed satisfaction and reissuance. The comments noted that, absent similar rules to address the deemed exchanges occurring under proposed

§1.385-4 (including deemed exchanges occurring when a debt instrument becomes or ceases to be a consolidated group debt instrument, as well as deemed exchanges occurring under the transition rule described in proposed §1.385-4(e)(3)), it is possible that those exchanges could be viewed under general tax principles as transitory and thus be disregarded in certain cases. Comments recommended that the regulations expressly provide that any deemed issuances, satisfactions, or exchanges arising under §1.1502-13(g) and proposed §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 §§1.1502-13(g)(3)(ii)(B) and 1.1502-13(g)(5)(ii)(B). The temporary regulations adopt this recommendation in §1.385-4T(c)(3).

b. Terminology

The preamble to the proposed regulations described a debt instrument issued by one member of a consolidated group to another member of the same consolidated group as a "consolidated group debt instrument." The same term was used in the text of the proposed regulations, but the term was not defined. One comment recommended that the regulations define the term consolidated group debt instrument. The temporary regulations adopt this recommendation.

Another comment recommended that proposed §1.385-4 should employ terminology and concepts that are consistent with those utilized throughout the consolidated return regulations. The comment noted that, consistent with the one-corporation rule, the examples in proposed §1.385-4 refer to a consolidated group as the issuer of a debt instrument, whereas the consolidated return regulations would refer

to a particular member of the consolidated group as an issuer. Consistent with the one corporation rule in §§1.385-3 and 1.385-4T, the final and temporary regulations continue to refer to a consolidated group as the issuer of a debt instrument.

VII. Other Comments

A. Coordination with §1.368-2(m)(3)

One comment recommended that the regulations clarify their interaction with §1.368-2(m)(3)(iii), which provides that a transaction may qualify as a reorganization described in section 368(a)(1)(F) (an F reorganization) even though a holder of stock in the transferor corporation receives a distribution of money or other property from either the transferor corporation or the resulting corporation (including in exchange for shares of stock in the transferor corporation). The regulations provide that the receipt of such a distribution is treated as an unrelated, separate transaction from the reorganization, whether or not connected in a formal sense. Thus, for example, assume that FP owns USS1, USS1 forms USS2, USS1 merges into USS2, and FP receives USS2 stock and a USS2 debt instrument in exchange for its USS1 stock. Further assume that the merger would be treated as an F reorganization and that, under §1.368-2(m)(3)(iii), USS2's distribution of a debt instrument would be treated as a separate and independent transaction to which section 301 applies.

The comment stated that the proposed regulations' interaction with §1.368-2(m)(3)(iii) presented a circularity issue. Specifically, the comment stated that a distribution treated as a separate and independent transaction, such as USS2's distribution of its debt instrument, would result in the USS2 debt instrument being treated as stock, such that §1.368-2(m)(3)(iii) would no longer apply. The comment

further stated that if §1.368-2(m)(3)(iii) did not apply, no separate and independent distribution would be treated as occurring, such that the general rule of proposed §1.385-3(b)(2)(i) would not apply. To address this, the comment recommended that a coordinating rule be added to clarify the application of the section 385 regulations to the issuance of a debt instrument under this and similar circumstances.

The Treasury Department and the IRS decline to adopt the recommendation, because it is not correct that this fact pattern presents a circularity problem. Pursuant to §1.368-2(m)(3)(ii) and (iii), if a distribution of money or other property occurs at the same time as the transactions otherwise qualifying as an F reorganization, the distribution does not prevent the transactions from so qualifying. Pursuant to §1.368-2(m)(3)(iii), the distribution is treated as a separate and unrelated transaction from the F reorganization and is subject to section 301. Thus, the receipt by FP of the USS2 debt instrument in the merger would constitute a section 301 distribution of the instrument, which would be treated as stock of USS2 under the general rule.

B. Proposed section 358 regulations

One comment noted that under proposed §1.358-2, a 100-percent shareholder in a corporation may be treated as holding multiple blocks of stock with different adjusted tax bases. The comment noted that the proposed regulations, which would treat purported indebtedness as stock, would increase the number of instances in which a shareholder has multiple blocks of stock with different adjusted tax bases. The Treasury Department and the IRS decline to address comments regarding proposed regulations under section 358, which are beyond the scope of the final and temporary regulations. The final and temporary regulations do, however, retain the proposed

regulations' approach to treating an EGI or a debt instrument as stock under certain circumstances. On the date the indebtedness is recharacterized as stock, the indebtedness is deemed to be exchanged, in whole or in part, for stock with a value that is equal to the holder's adjusted basis in the portion of the indebtedness that is treated as equity under the regulations, and the issuer of the indebtedness is deemed to retire the same portion of the indebtedness for an amount equal to its adjusted issue price as of that date. Although this rule may result in indebtedness that is treated as stock having a different basis than other shares of stock held by a shareholder, many comments expressed support for this rule given that it generally will prevent both the holder and issuer from realizing gain or loss from the deemed exchange other than foreign exchange gain or loss recognized by the issuer or holder under section 988.

C. Certain additional guidance

1. Hook Equity

Ordinarily, the IRS will not issue a ruling or determination letter regarding the treatment or effects of "hook equity," including as a result of its issuance, ownership, or redemption. For this purpose, "hook equity" means an ownership interest in a business entity (such as stock in a corporation) that is held by another business entity in which at least 50 percent of the interests (by vote or value) in such latter entity are held directly or indirectly by the former entity. However, if an entity directly or indirectly owns all of the equity interests in another entity, the equity interests in the latter entity are not hook equity. See Rev. Proc. 2016-3, section 4.02(11), 2016-1 I.R.B. 126. One comment, noting that the proposed regulations could result in certain debt instruments being treated as stock that would qualify as hook equity, recommended that the IRS repeal its

policy on the issuance of rulings or determination letters regarding the treatment or effects of hook equity. The Treasury Department and the IRS decline to address this recommendation, which is beyond the scope of the final and temporary regulations. The recommendation will be considered, as appropriate, in connection with future guidance.

2. Examination Guidance

One comment recommended that the IRS should issue guidance to examiners concerning the interpretation and practical application of the regulations. The Treasury Department and the IRS decline to address this comment, which is beyond the scope of the final and temporary regulations.

VIII. Applicability Dates

A. Applicability dates of the proposed regulations

Proposed §§1.385-1 and 1.385-2 were proposed to apply to any applicable instrument issued or deemed issued on or after the date that the proposed regulations were published as final regulations and to any applicable instrument issued or deemed issued as a result of an entity classification election made under §301.7701-3 that is filed on or after that date. For purposes of applying proposed §§1.385-3 and 1.385-4, the provisions of proposed §1.385-1 were proposed to be applicable in accordance with the proposed applicability dates of proposed §§1.385-3 and 1.385-4.

Proposed §§1.385-3 and 1.385-4 were proposed to be applicable on the date of publication in the **Federal Register** of the Treasury decision adopting these rules as final regulations. Proposed §§1.385-3 and 1.385-4 were proposed to apply to any debt instrument issued on or after April 4, 2016, and to any debt instrument issued before

April 4, 2016, as a result of an entity classification election made under §301.7701-3 that is filed on or after that date. However, the proposed regulations also provided that, if a debt instrument otherwise would be treated as stock before publication of the final regulations, the debt instrument would be treated as indebtedness until the date that is 90 days after publication of the final regulations, and would only be recharacterized on that date to the extent that the debt instrument was held by expanded group members on that date (the proposed transition period). This transition rule in the proposed regulations did not apply to debt instruments issued on or after publication of the final regulations.

The proposed regulations also provided that, for purposes of determining whether a debt instrument is described in proposed §1.385-3(b)(3)(iv) (the per se funding rule), a distribution or acquisition that occurred before April 4, 2016, other than a distribution or acquisition that is treated as occurring before April 4, 2016, as a result of an entity classification election made under §301.7701-3 that is filed on or after April 4, 2016, is not taken into account.

B. Applicability dates of the final and temporary regulations

1. In General

The final and temporary regulations apply to taxable years ending on or after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. As described in Part IV.B.2.b of this Summary of Comments and Explanation of Revisions, the final regulations under §1.385-2 delay the implementation period described in proposed §1.385-2 such that §1.385-2 does not apply to interests issued or deemed issued before January 1, 2018. Sections 1.385-3 and 1.385-3T

grandfather debt instruments issued before April 5, 2016 (rather than before April 4, 2016, as was provided in the proposed regulations). The final and temporary regulations do not include the special rule in proposed §1.385-3(h)(1) relating to entity classification elections filed on or after April 4, 2016. The final and temporary regulations in §1.385-3(b)(3)(viii) also grandfather distributions and acquisitions occurring before April 5, 2016, for purposes of applying the funding rule.

2. Transition Rules

The final regulations under §1.385-3 lengthen the proposed transition period by providing that any covered debt instrument that would be treated as stock by reason of the application of the final and temporary regulations on or before **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]** (the final transition period) is not treated as stock during that 90-day period, but rather the covered debt instrument is deemed to be exchanged for stock immediately after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, but only to the extent that the covered debt instrument is held by a member of the issuer's expanded group immediately after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]** (final transition period rule). Thus, the final transition period rule addresses both covered debt instruments that would have been recharacterized before the final and temporary regulations become applicable (that is, because the recharacterization would have occurred during a taxable year ending before **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER])**, as well as other covered debt instruments that would be treated as stock on or before [**INSERT DATE 90 DAYS**

AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. The Treasury Department and the IRS extended the final transition period, as compared to the proposed regulations, in response to comments that requested additional time for taxpayers to adjust their conduct to take into account the final and temporary regulations.

Generally, under the final transition period rule, any issuance of a covered debt instrument during the final transition period that would be treated as stock under §1.385-3(b)(2) upon issuance but for the final transition period rule is treated as an issuance of indebtedness, and not an issuance of stock. The final transition period rule also clarifies that §§1.385-1, 1.385-3T, and 1.385-4T are taken into account in applying §1.385-3 during the final transition period.

The Treasury Department and the IRS are concerned that, under the final transition period rule, a taxpayer could avoid the purposes of the final and temporary regulations by, during the transition period, distributing a covered debt instrument that otherwise would be treated as stock under the general rule, and then issuing a second debt instrument to retire the first instrument (either in a direct refinancing or indirectly by using the proceeds from the second debt instrument) before the end of the transition period. If this were permitted to occur, a taxpayer could issue substantial related-party debt that does not finance new investment after having received notice of these final and temporary regulations, contrary to the purposes of the applicability dates and limited grandfather rules provided in the proposed regulations and in these final and temporary regulations. Accordingly, the final and temporary regulations also add a transition funding rule. This transition funding rule provides that on or after the date on

which a covered debt instrument would be treated as stock but for the applicability date of §1.385-3 or the final transition period rule, any payment made with respect to such covered debt instrument (other than stated interest), including pursuant to a refinancing, is treated as a distribution for purposes of the funding rule. This transition funding rule is intended to provide for the orderly operation of the funding rule, taking into account the combination of the applicability date of §1.385-3, the final transition period rule, and §1.385-3(b)(6).

Section 1.385-3(b)(6) is a non-duplication rule that provides that, once a covered debt instrument is recharacterized as stock, the distribution or acquisition that caused that recharacterization cannot cause a recharacterization of another covered debt instrument even after the first instrument is repaid. The non-duplication rule in §1.385-3(b)(6) is premised on the fact that the funding rule already treats the repayment of an instrument that is treated as stock as its own distribution for purposes of the funding rule. The rule in §1.385-3(b)(6) prevents the funding rule from applying on a duplicative basis -- to the repayment of the recharacterized instrument, and to the actual distribution or acquisition that caused the recharacterization. See Part V.B.4 of this Summary of Comments and Explanation of Revisions. The transition funding rule supersedes that non-duplication rule during the final transition period while the covered debt instrument that otherwise would be treated as stock continues to be treated as indebtedness. The transition funding rule treats payments with respect to the instrument as distributions for purposes of the funding rule, which is necessary because repayments during the final transition period are not otherwise treated as distributions.

Consistent with this transition funding rule, the final and temporary regulations also provide that a covered debt instrument that is issued in a general rule transaction during the transition period is not treated as a transaction described in §1.385-3(b)(3)(i) if, and to the extent that, the covered debt instrument is held by a member of the issuer's expanded group immediately after the transition period. In such a case, the covered debt instrument would be deemed to be exchanged for stock immediately after the transition period, and no other covered debt instrument would be treated as funding the issuance during the transition period. This change addresses a comment concerning the interaction of the general rule and funding rule during the transition period.

Covered debt instruments that otherwise would not be recharacterized for federal income tax purposes during the final transition period (due, for example, to the fact that the covered debt instrument was not treated as funding a distribution or acquisition that also occurred during the final transition period) remain subject to the funding rule after the final transition period. Finally, the final regulations clarify in §1.385-3(b)(4) that the anti-abuse rule in §1.385-3(b)(4) may apply if a covered debt instrument is issued as part of a plan or series of transactions with a principal purpose to expand the applicability of the transition rules described in §1.385-3(j)(2) or §1.385-3T(k)(2).

The following example illustrates these transition rules: Assume FP, a foreign corporation, wholly owns USS, a domestic corporation. Both FP and USS use a calendar year as their taxable year. No exceptions described in §1.385-3(c) apply. Assume that on June 1, 2016, USS distributes a $100x covered debt instrument (Note

1) to FP. On January 1, 2017, USS distributes a $200x covered debt instrument (Note 2) to FP. On January 2, 2017, USS makes a $100x repayment to retire Note 1.

For USS and FP, the first taxable year to which the final and temporary regulations apply is the taxable year ending December 31, 2017. Section 1.385-3 does not apply to the issuance of Note 1 because Note 1 is not issued in a taxable year ending on or after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. Section 1.385-3 does apply to the issuance of Note 2, because Note 2 is issued in a taxable year ending on or after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

However, the final transition period rule applies to Note 2 because Note 2 otherwise would be treated as stock on or before **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. Accordingly, Note 2 is not treated as stock until immediately after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**; and to the extent that Note 2 is held by a member of USS's expanded group immediately after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, Note 2 is deemed to be exchanged for stock immediately after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

The final transition period rule also applies to Note 1 because §1.385-3(b) and (d)(1) would have treated Note 1 as stock in a taxable year ending before **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]** but for the fact that USS's taxable year ending December 31, 2016, is not a taxable year described in §1.385-3(j)(1). However, because Note 1 was repaid on January 2, 2017,

Note 1 is not held by a member of USS's expanded group immediately after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]** and, as a result, Note 1 will not be recharacterized as stock. Because Note 1 would be recharacterized as stock during the final transition period, but Note 1 was not recharacterized as stock because it was not outstanding immediately after the final transition period, the transition funding rule applies to treat the payment with respect to Note 1 on January 2, 2017, as a distribution for purposes of applying §1.385-3(b)(3) to USS's taxable year ending on December 31, 2017, and onward.

The temporary regulations provide similar transition rules for transactions covered by §§1.385-3T(f)(3) through (5).

C. Retroactivity

The Treasury Department and the IRS received various comments regarding the applicability date of the rules in proposed §§1.385-3 and 1.385-4. Comments asserted that applying proposed §§1.385-3 and 1.385-4 to instruments issued on or after the date of the notice of proposed rulemaking but before the adoption of final or temporary regulations would be impermissibly retroactive under the relevant statutory authorities.

While the Treasury Department and the IRS disagree with these comments, the applicability dates of the final and temporary regulations have been revised. The comments regarding retroactivity continue to be inapposite. The final and temporary regulations under §§1.385-3, 1.385-3T, and 1.385-4T apply only to taxable years ending on or after 90 days after the publication of the final and temporary regulations (that is, **[INSERT DATE 90 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER]**). Accordingly, the final and temporary regulations do not require taxpayers to redetermine

their federal income tax liability for any taxable year ending before **[INSERT DATE 90 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER]**.

Furthermore, as described in Section B of this Part VIII, debt instruments issued on or before April 4, 2016, are never subject to §§1.385-3 or 1.385-3T, even if they remain outstanding during taxable years to which the final and temporary regulations apply. Further, any covered debt instrument issued after April 4, 2016, and on or before **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, will not be recharacterized until immediately after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. Any recharacterization under the final and temporary regulations will change an instrument's federal tax characterization only prospectively.

The applicability dates governing these regulations are not retroactive. Regulations are retroactive if they "impair rights a party possessed when [that party] acted, increase a party's liability for past conduct, or impose new duties with respect to transactions already completed." Landgraf v. USI Film Prods., 511 U.S. 244, 280 (1994) (explaining retroactivity). The regulations do not impair rights or increase a party's tax liability with respect to a purported debt instrument until at least 90 days after the date of publication of the final and temporary regulations. Regardless of when an instrument is issued, beginning on the publication date of the final and temporary regulations, affected parties are on notice that such instrument could be subject to the rules described in the final and temporary regulations, and those instruments will only be prospectively recast as equity (that is, beginning 90 days after publication of the final and temporary regulations).

Additionally, even if the final and temporary regulations were retroactive, the Treasury Department and the IRS have statutory authority to issue retroactive rules. Regulations which relate to statutory provisions enacted before July 30, 1996—such as section 385—are subject to the pre-1996 version of section 7805(b). That provision provides express retroactive rulemaking authority by stating that the Secretary may prescribe the extent, if any, to which any ruling or regulation shall be applied without retroactive effect. Section 7805(b) (1995). Therefore, although the final and temporary regulations are not retroactive, section 7805(b) in any event provides the necessary statutory authority to issue regulations with retroactive effect.

Comments also stated that the Treasury Department and the IRS failed to comply with the Administrative Procedure Act (APA) notice-and-comment and delayed-applicability-date provisions by purportedly making proposed §§1.385-3 and 1.385-4 effective as of April 4, 2016. One comment stated that the APA's requirement of a delayed-applicability date in 5 U.S.C. 553(d) overrides the authority provided by section 7805(b). This comment pointed to the provision in the APA that a subsequent statute may not be held to supersede or modify the APA's rulemaking requirements except to the extent that it does so expressly. 5 U.S.C. 559.

These comments are inapposite because the final and temporary regulations comply with the requirement of a 30-day delayed-applicability date in 5 U.S.C. 553(d). The final and temporary regulations apply only to taxable years that end on or after 90 days after publication of the final and temporary regulations, and only begin to recharacterize instruments as equity immediately after 90 days after publication of the final and temporary regulations. Furthermore, section 7805(b), which permits

regulations to have retroactive effect, controls in these circumstances because the more specific statute has precedence over the general notice statute in section 553(d) of the APA. See, e.g., Redhouse v. Commissioner, 728 F.2d 1249, 1253 (9th Cir. 1984); Wing v. Commissioner, 81 T.C. 17, 28-30 & n.17 (1983). Finally, the statutory authority contained in section 7805(b) predates the APA, so it is not a subsequent statute that is governed by section 559 of the APA.

Comments also identified a restriction on Congress's authorization in section 385(a) to promulgate regulations determining whether an instrument is "in part stock and in part indebtedness." See Omnibus Budget Reconciliation Act, Pub.L. 101-239, §7208(a)(2) (requiring that such authority "shall only apply with respect to instruments issued after the date on which" the Secretary "provides public guidance as to the characterization of such instruments whether by regulation, ruling, or otherwise"). As explained in Part III.D of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS have decided at this time not to adopt a general bifurcation rule pending further study. Furthermore, to the extent that §1.385-3 results in a partial recharacterization of a purported debt instrument after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, the final and temporary regulations only apply to instruments issued after April 4, 2016, which is the date on which the proposed regulations were filed for public inspection with the **Federal Register**. Accordingly, the final and temporary regulations do not apply to debt instruments issued on or before the date (April 4, 2016) that the Treasury Department and the IRS provided public guidance regarding recharacterization. Therefore, the final

and temporary regulations comply with the restriction regarding section 385(a) in the Omnibus Budget Reconciliation Act.

Some comments questioned the fairness of applying the proposed regulations to instruments issued before the publication date of final or temporary regulations, in light of the broad scope of the proposed rules and the complex subject matter at issue. The Treasury Department and the IRS have concluded that the final and temporary regulations adequately address these concerns. As is explained throughout this preamble, the scope of the final and temporary regulations is significantly narrower than the proposed regulations. For instance, the final and temporary regulations reserve on their application to foreign issuers and include many new exceptions, including a broad exception for short-term debt instruments, among others. Moreover, the final and temporary regulations provide that covered debt instruments (which excludes instruments issued on or before April 4, 2016) issued on or before 90 days after publication of the final and temporary regulations will continue to be treated for federal tax purposes as debt instruments until immediately after 90 days after the date of publication of the final and temporary regulations. To the extent such instruments are retired on or before 90 days after the date of publication of the final and temporary regulations, they will not be affected by the regulations.

Finally, a comment observed that if the future regulations made significant changes to the proposed regulations, such that debt instruments that were not subject to the proposed rules would become subject to recharacterization under the final rules, this would create an impermissible retroactive effect that is not addressed by the proposed transition rule.

In general, the final and temporary regulations do not adopt rules that would recharacterize debt instruments that would not have been recharacterized under the proposed regulations. However, to the extent a taxpayer prefers applying the proposed regulations to debt instruments issued after April 4, 2016, but before the filing date of the final and temporary regulations, the final and temporary regulations allow the taxpayer to apply §§1.385-1, 1.385-3, and 1.385-4 of the proposed regulations subject to certain consistency requirements. In particular, §1.385-3(j)(2)(v) provides that an issuer and all members of the issuer's expanded group that are covered members may choose to consistently apply those sections of the proposed regulations to all debt instruments issued after April 4, 2016, and before **October 13, 2016**, solely for purposes of determining whether a debt instrument will be treated as stock. Taxpayers choosing to apply the proposed regulations must apply them consistently (including applying the partnership provision in proposed §1.385-3(d)(5) in lieu of the temporary regulations) and cannot selectively choose which particular provisions to apply.

Furthermore, because no instrument issued before the publication date of the final and temporary regulations will be treated as equity until 90 days after the publication date, taxpayers have ample notice as to the effect the final regulations will have on such instruments.

D. Delayed applicability date and transition rules

Numerous comments requested that the final and temporary regulations' applicability date be delayed, with some comments requesting a delay of several years after the proposed regulations are finalized. Comments also requested that the final and temporary regulations apply solely to debt instruments issued on or after such

delayed applicability date. Other comments suggested different applicability dates based on certain characteristics of the issuer (for example, earlier applicability dates for inverted corporations) or the situation in which an instrument is issued (for example, cash pooling arrangements, refinancings, and certain deemed issuances of debt instruments). Other comments discussed each section of the proposed regulations and suggested applicability dates appropriate for each section. For example, many comments were concerned that taxpayers would need time to design and implement systems necessary to comply with proposed §1.385-2 and requested the applicability date of the documentation rules be delayed from a few months to two years, with the vast majority asking for a one year delay after finalization. Comments also requested that the documentation rules not apply to interests outstanding on, or to interests negotiated before, the applicability date of the final and temporary regulations. A comment questioned whether, for purposes of applying the proposed regulations before the date on which the final and temporary regulations are issued, the issuance of a debt instrument that would be treated as stock under the proposed regulations should be treated as an issuance of a debt instrument or an issuance of stock. Similarly, a comment recommended clarification of the treatment of a repayment of such a debt instrument before the date on which the interest would be treated as stock under the proposed regulations.

After considering the comments, the final and temporary regulations adopt the changes to applicability dates, grandfather rules, and expanded transition rules described in Section B of this Part VIII. However, the Treasury Department and the IRS do not adopt the recommendations to exempt covered debt instruments issued on or

after April 5, 2016, and before **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]** for purposes of the regulations, or to exempt from those rules covered debt instruments issued for some period thereafter. The Treasury Department and the IRS have determined that the significant modifications made to scope of the proposed regulations, coupled with the expansion and addition of numerous exceptions, adequately address the compliance burdens raised by the comments with respect to the regulations. For example, many of the comments that requested a delayed applicability date cited compliance difficulties faced by CFC issuers and issues associated with cash pooling arrangements. The final and temporary regulations reserve on the application to debt instruments issued by CFCs, and include broad exceptions to mitigate the compliance burden for taxpayers that participate in cash pooling arrangements.

Moreover, in developing the applicability dates and grandfathering rules for the proposed regulations, the Treasury Department and the IRS balanced compliance burdens with the need to prevent taxpayers from using any delay in implementation to maximize their related-party debt. If the proposed transition rules had simply exempted covered debt instruments issued after April 4, 2016, taxpayers would have had significant incentivizes to issue related-party debt that did not finance new investment in advance of the regulations' finalization. Accordingly, the Treasury Department and the IRS have determined that the applicability dates and transition rules provided in §§1.385-3, 1.385-3T, and 1.385-4T are necessary and appropriate.

Future Guidance and Request for Comments

As described in this Summary of Comments and Explanation of Revisions, several aspects of the final and temporary regulations are reserved pending further

study. The Treasury Department and the IRS request comments on all of the reserved issues, including in particular: (i) the application of the final and temporary regulations to foreign issuers; (ii) the application of §§1.385-3 and 1.385-3T to U.S. branches of foreign issuers, in the absence of more comprehensive guidance regarding the application of §§1.385-3 and 1.385-3T with respect to foreign issuers; (iii) the expanded group treatment of brother-sister groups with common non-corporate owners, including how to apply the exceptions in §1.385-3(c) to such groups; (iv) the application of §1.385-2 to debt not in form, and (v) rules prohibiting the affirmative use of §§1.385-2 and 1.385-3. The Treasury Department and the IRS also request comments on the general bifurcation rule of proposed §1.385-1(d). Any subsequently issued guidance addressing these issues will not apply to interests issued before the date of such guidance.

The Treasury Department and the IRS also request comments on all aspects of the temporary regulations. In addition, regarding the exception for qualified short-term debt instruments, the Treasury Department and the IRS request comments on the specified current assets test and whether the maximum outstanding balance described in §1.385-3T(b)(3)(vii)(A)(1)(iii) should be limited by reference to variances in expected working capital needs over some period of time, rather than by reference to the total amount of specified current assets reasonably expected to be reflected on the issuer's balance sheet during the specified period of time.

The Treasury Department and the IRS also are concerned that under certain circumstances, such as a high-interest rate environment, an interest rate that falls within the safe haven interest rate range under §1.482-2(a)(2)(iii)(B), and thus is deemed to be

an arm's length interest rate, may allow deduction of interest expense substantially in excess of the amount that would be determined to be an arm's length interest rate in the absence of §1.482-2(a)(2)(iii)(B). Specifically, the Treasury Department and the IRS are considering whether there is a more appropriate way to allow for a risk premium in the safe haven rate than by using a fixed percentage of the applicable federal rate. The Treasury Department and the IRS are considering a separate project to address this issue and request comments on how the safe haven rate of §1.482-2(a)(2)(iii)(B) might be modified to address these concerns.

Finally, the Treasury Department and the IRS request comments on possible future guidance to address debt instruments issued by a member of an expanded group to an unrelated third party when the obligation is guaranteed by another member of the expanded group.

Statement of Availability of IRS Documents

IRS Revenue Procedures, Revenue Rulings, notices, and other guidance cited in this document are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS Web site at http://www.irs.gov.

Special Analyses

I. Regulatory Planning and Review

Executive Orders 13563 and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order

13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility. This rule has been designated a "significant regulatory action" under section 3(f) of Executive Order 12866 and designated as economically significant. Accordingly, the rule has been reviewed by the Office of Management and Budget. A regulatory assessment for this final rule is provided below.

A. The need for the regulatory action

1. In General

Corporations can raise money using a wide variety of financial instruments. But for income tax purposes, what matters is whether the firms borrow (issue debt) or sell ownership interests in the corporation (issue equity). Under U.S. tax rules, interest (the return paid on debt) is deductible in determining taxable income while dividends (the return paid on equity) are not. This implies that corporations can reduce their U.S. federal income tax liability by financing their activities with debt instruments rather than with equity. And this provides a strong incentive to characterize financial instruments issued as "debt" even when they have some of the properties of equity instruments. In most circumstances, however, the ability to employ debt instead of equity, and thereby reduce income taxes paid, is limited by economic forces and legal constraints. In the marketplace, the cost of debt (that is, the interest rate charged) and the willingness of lenders to supply credit are generally dependent on a borrower's creditworthiness and the terms of repayment to which the parties agree. It is also generally accepted that independent parties to a lending transaction will act in their own best interests in terms of honoring the terms of a debt and in enforcing creditor's rights. Therefore, in these

circumstances where unrelated parties engage in the financial transactions, an individual corporation's choice to employ either debt or equity, and its assessment of the amount of debt it can take on, are decisions that are determined, and limited, by market forces. In this context, the ability of individual corporations to reduce U.S. federal income tax liability by financing their operations with debt issued to unrelated parties rather than equity is to a degree naturally limited.

When the checks and balances of the market are removed, as they are when related corporations transact, there are often few practical economic or legal forces that constrain the choice between employing debt or equity. Related corporations can essentially act as a unit that, in effect, borrows and lends to itself without being subject to the forces that otherwise place limits on the cost and amount of indebtedness. In the context of highly-related parties, for example a parent corporation and its wholly-owned subsidiary, factors such as creditworthiness, ability to repay, and sufficiency of collateral may not be relevant if a decision to finance has otherwise been made. In these circumstances, the financing choice thus can be determined solely on the basis of income tax considerations, which often favor debt.

The absence of market forces operating among related corporations can, in addition to influencing internal financing decisions, create incentives for corporations that do not require financing to incur debt solely for tax-related reasons. Related corporations can engage in tax arbitrage, among other ways, by causing profitable corporations (facing a relatively high marginal tax rate) to incur debt (and pay interest) to corporations with losses (facing a relatively low or zero marginal tax rate), or by causing corporations in high tax rate jurisdictions to incur debt and pay interest to

corporations in low tax rate jurisdictions. In addition, because intra-group debt will often have no legal or economic consequences outside of the related-party group of corporations, related corporations can use intra-group debt to increase the total amount of their obligations labeled as debt well beyond the amount of the external, third-party indebtedness of the group. While such tax arbitrage opportunities have been a longstanding problem, their associated economic and revenue costs appear to have increased in recent years.

From a U.S. tax perspective, subject to general tax principles and certain limited statutory constraints, corporations are generally free to structure their financial arrangements, even intra-group instruments, as debt or equity. However, the unique nature of related-party debt presents a number of issues that the section 385 regulations are intended to address. At a basic level, the section 385 regulations require highly-related parties (meaning generally those that meet an 80 percent common ownership test) to demonstrate that purported debt issued among them is properly characterized as debt for U.S. federal tax purposes, and thus that they are entitled to the interest deductions associated with such debt. An 80 percent common ownership threshold is often used under the tax Code and tax regulations to identify highly-related corporations, for example, to determine eligibility to file a consolidated federal income tax return or claim a deduction offsetting dividends received from subsidiaries. As noted, there are generally no external forces that constrain related-party debt and, as a consequence, the parties to a financing may attempt to characterize a transaction as tax-favored debt when it is more properly viewed in substance as equity. The section 385 regulations provide factors that are required to be

used in evaluating the nature of an instrument among highly-related parties as debt or equity.

The section 385 regulations require related parties to document their intention to create debt and that their continuing behavior is consistent with such characterization. With respect to unrelated parties, the establishment of a creditor-debtor relationship generally involves such documentation. In the context of related parties, that is not always the case, even though it is a factor indicative of debt under existing common law tax principles. The absence of such documentation can be particularly problematic, for example, when the IRS attempts to assess the appropriateness of tax deductions for interest attributable to related-party debt. The section 385 regulations provide minimum standards, in line with what would be expected of unrelated parties, that related parties must observe in order for their debtor-creditor relationships to be respected as such for income tax purposes.

In addition, the section 385 regulations recharacterize purported debt as equity when certain prescribed factors demonstrate that the interest reflects a corporation-shareholder relationship rather than a debtor-creditor relationship. An unrelated party would not agree to owe a "creditor" a principal amount without receiving loan proceeds or some other property of value in return. However, as discussed, related parties are not so constrained, and an unfunded promise among such parties to pay some amount in the future may have little economic effect or legal implication. Nonetheless, that promise to pay, if respected, could have significant consequences for income tax purposes. If the interest paid on an unfunded note (a debt instrument) to a parent corporation from a U.S. subsidiary was taxed at a lower rate than the marginal tax rate

faced by the subsidiary or was untaxed at the parent corporation level, then the parent-subsidiary group would have achieved a reduction of its overall tax burden without meaningfully changing its overall legal or economic profile. In characterizing an instrument as debt or equity, the section 385 regulations consider as factors the relatedness of corporations and whether or not the instrument funded new investment in the issuer. If an instrument among highly-related parties does not finance new investment, the section 385 regulations treat the instrument as representing a corporation-shareholder relationship.

The section 385 regulations are intended to apply to related-party transactions undertaken by large corporate taxpayers that are responsible for a majority of corporate business activity and that have organizational structures that include subsidiaries or affiliated groups. These businesses represent about 0.1 percent of all corporations (tax filings for consolidated groups are counted as one return) but are responsible for about 65 percent of all corporate interest deductions and 54 percent of corporate net income. It is for this group of corporations that the opportunity to engage in intercompany transactions, the scale of the business activity, and the potential gains from tax arbitrage create the most potential for mischaracterization of equity as debt.

2. Application

Information and tax data on intercompany transactions within a single multinational firm is generally not reported to the IRS, making it harder to compile than similar information for unrelated parties. Nonetheless, examples of how the mischaracterization of equity as debt can facilitate tax arbitrage are readily available. One clear example can be found in the case of foreign-parented corporations that

create debt to use interest deductions to shift income out of the U.S. tax base (so-called "interest stripping"). These corporations are referred to in this discussion as foreign controlled domestic corporations (or FCDCs) because they are owned/controlled by non-U.S. companies and they operate in the United States. When these companies pay interest to affiliated companies outside the United States, the payments reduce taxes on income generated in the United States. This is an advantage to the group as a whole if it lowers the total amount of tax paid worldwide, which will happen to the extent that the U.S. tax rate exceeds the foreign tax rate that applies to the interest income. In a purely domestic context (a U.S. owned domestic corporation lending to another affiliated U.S. owned domestic corporation), such arbitrage possibilities also exist, for example, if the borrower has net positive income but the lender has a net operating loss.

One common strategy for creating intercompany debt between related entities is distributing debt instruments. In a prototypical transaction of this type, a U.S. business distributes to its foreign parent a note. The U.S. subsidiary receives nothing in exchange for the note (in particular, it receives no cash from the parent). The parent can then keep the note, or transfer it to an affiliate in a low tax jurisdiction. The U.S. subsidiary then deducts interest on the note, which reduces U.S. income tax liability.

Such a transaction has little, if any, real economic or financial consequence aside from the tax benefit. There are no loan proceeds for the U.S. subsidiary to invest, so there is no new U.S. income generated that could offset the tax deduction for interest paid to the foreign parent. In addition, the companies can set a high interest rate on the loan (as long as they can defend the rate under tax rules as an arm's length rate; the

more leveraged the firm, the higher the rate that can be justified), in order to maximize the amount of income that is stripped out of the U.S. tax system. Because the income and deduction offset each other on the multinational company's financial statements, there are no practical impediments to charging a high rate (apart from tax audit risk related to the appropriateness of the interest deduction). Importantly, the note does not lead to an increase in investment in the United States.

Other transactions can produce a similar tax result. For instance, the parent company could lend a sum to the subsidiary, but have the subsidiary return the amount borrowed to the parent through another transaction, such as a dividend of the sum lent or a purchase of the parent's own stock. When the borrowing and the related transaction to return funds to the lender are considered in their totality, this transaction has the same practical tax and economic effect as distributing a note.

The ability of related parties to create intercompany debt generates undesirable tax incentives in certain contexts. For example, the ability of a foreign parent corporation to reduce U.S. tax liability by causing a U.S. business to distribute notes to the foreign parent gives an advantage to foreign-owned U.S. businesses over U.S.-owned multinational businesses. U.S. multinational corporations (MNCs) generally cannot use related-party debt to strip earnings out of the United States, because interest paid from the U.S. parent and U.S. subsidiaries to their foreign subsidiaries is taxed when received under the subpart F rules, the U.S. controlled foreign corporation (CFC) regime that taxes currently passive and other mobile income earned outside the United States. (Interest paid from one U.S. subsidiary to another in a consolidated

group would do nothing to reduce federal income taxes, because the recipient's tax inclusion would offset the payer's tax deduction in the same federal income tax return.)

Moreover, the advantage FCDCs gain over U.S. MNCs from mischaracterizing equity as debt is economically significant, because existing limits on tax deductions from interest stripping, which generally impact FCDCs, are ineffective in limiting tax arbitrage opportunities. Under current law, the two potential limits on the amount of FCDC debt are a statutory limit on related-party interest deductions (under section 163(j) of the Code) and a general limit based on case law distinguishing debt from equity. The statutory limit (section 163(j)) restricts deductions for interest paid to related parties or guaranteed by related parties to the extent that net interest deductions (interest paid less interest received) exceed 50 percent of adjusted taxable income (which is an expanded measure of income: income measured without regard to deductions such as net interest, depreciation, amortization, depletion, net operating losses). This deduction limit applies whenever the firm's debt-equity ratio exceeds 1.5:1. Data from IRS Form 8926 "Disqualified Corporate Interest Expense Disallowed Under Section 163(j) and Related Information" shows that 50 percent of adjusted taxable income is roughly 100 percent of taxable income before net interest, which means that firms can on average strip all of their income out of the United States using interest deductions before the limit is reached. Case law, moreover, supports a wide variety of debt-equity ratios as acceptable for purposes of supporting debt characterization. Even when debt-equity ratios are considered in the case law, they are considered on a facts-and-circumstances basis and as one of many factors used to distinguish debt from equity by the courts. Finally, as discussed previously, because intercompany debt does not affect the

multinational firm's external capital structure, the amount of intercompany debt and the interest rate applied are not subject to the constraints that the market would impose on third-party loans. Because these limitations are not binding, the tax advantages from mischaracterizing equity as debt are large and unchecked.

While interest stripping has been a longstanding problem for the U.S. tax system, the associated economic and revenue costs appear to have increased over the past several years. For example, data gathered by Bloomberg (http://www.bloomberg.com/graphics/infographics/tax-runaways-tracking-inversions.html) shows the pace of corporate inversions, which are reorganizations whereby U.S. MNCs become FCDCs, has increased over the past several years. One of the principal tax advantages obtained in an inversion is the ability to use interest deductions to reduce U.S. taxes by stripping income out of the United States. While inversions are a particularly visible example of how related-party debt can be used for tax avoidance purposes, other FCDCs have similar incentives and opportunities to use related-party debt to engage in interest stripping.

The evidence suggests that FCDCs engage in substantial interest stripping. The best evidence for interest stripping by FCDCs is presented in Jim Seida and William Wempe, "Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion," National Tax Journal, December 2004. In this paper, the authors found that the worldwide effective tax rates of inverted companies fell drastically after the inversion and that the reduction in tax was due to interest stripping. For a subsample of firms where additional information was available, the authors concluded that the mechanism for interest stripping was intercompany debt. In particular, Seida and Wempe estimate

that the inverted companies selected in their subsample for detailed analysis increased U.S. interest deductions by about $1 billion per year on average in 2002 and 2003, or about $350 million in tax savings at 35 percent. Seida and Wempe did not report tax savings from their broader group of companies (of which there were 12), only reductions in tax rates.

More recently, Zachary Mider, "'Unpatriotic Tax Loophole' Targeted by Obama to Cost U.S. $2 billion in 2015," Bloomberg BNA Daily Tax Report, December 2, 2014, reports a Bloomberg update of Seida and Wempe's broader analysis, which expands the number of inverted companies from 12 to 15 and finds tax savings of between $2.8 billion and $5.7 billion in 2015, depending on whether cash taxes paid or accounting tax expense is used.

These analyses looked at only a small subset of the companies that have inverted. There have been at least 60 inversions by public corporations since 1982. In addition there have been many takeovers of U.S. companies by previously-inverted companies, which are equivalent in result. From companies associated with inversions, it is therefore likely that the U.S. Treasury loses tens of billions of dollars per year in corporate tax revenue due to interest stripping.

Additional revenue losses come from FCDCs that have operated in the United States for many years or were not otherwise involved in transactions classified as inversions. Studies of interest stripping by FCDCs more generally have not been as conclusive as the studies of inversions. In part, this is because the level of detail in financial reports that is available for FCDCs generally is lower than for inverted companies. Nonetheless, it is likely that, given the advantage FCDCs have over U.S.

MNCs in their ability to strip earnings using interest deductions, considerable additional interest stripping is attributable to FCDCs not associated with inversions. As one indication of this possibility, the most recent (2012) available data from corporate tax Form 1120 shows that FCDCs have a nearly 50 percent higher ratio of net interest deductions relative to earnings before net interest and taxes (EBIT) than do U.S. MNCs.

While most of the concern about interest stripping is focused on interest payments made to parties outside the United States, similar transactions sometimes occur between U.S. companies. The scope for a tax advantage from such intercompany lending is limited because, in many cases, one company's deduction of an interest payment would be offset by the other company's inclusion of interest income. However, when the companies do not file a consolidated tax return, but nonetheless are members of an affiliated group, there can be tax benefits to intercompany lending. For example, if an affiliated group includes two U.S. corporations that do not file a consolidated return, and one corporation has $100 of taxable income and the other has $100 of net operating losses carried over from prior years, the corporation with taxable income pays federal income tax and the one with losses does not, nor does it get a tax refund. Collectively, the $100 of income is taxed. However, the overall federal income tax liability of the affiliated group can be reduced using an intercompany loan that results in a deductible interest payment of $100 by the entity with taxable income to the affiliate with a $100 net operating loss. As a result, both corporate entities will have zero taxable income for the year.

B. Affected population

This analysis begins by describing some basic facts about the size of the U.S. corporate business sector. These tax facts help to frame the discussion and suggest the magnitude of the section 385 regulations' estimated effects. This analysis uses an expansive definition of the estimated affected population in order to minimize the risk that the analysis will not capture the effects on collateral groups.

1. Application to C Corporations

The regulations are intended to apply primarily to large U.S. corporations taxable under subchapter C of chapter 1 of subtitle A of the Code ("C corporations") that engage in substantial debt transactions, or purported debt transactions, between highly-related businesses. C corporations are businesses that are subject to the separate U.S. corporate income tax. In 2012, approximately 1.6 million C corporation tax returns were filed in the United States (tax filings for consolidated groups are counted as one return). The regulations specifically exempt other corporations which, while having the corporate form of organization, generally do not pay the separate corporate income tax. They are a form of "pass-through" organization, so called because the income generally is passed-through the business (without tax) to the businesses' owners, who pay tax on the income. These other corporations are much more numerous than are C corporations: they number roughly 4.2 million corporations and consist mainly of "small business corporations" taxable under subchapter S of chapter 1 of subtitle A of the Code ("S corporations"), regulated investment companies (RICs, commonly known as mutual funds), and real estate investment trusts (REITs). Because the income of pass-through businesses is aggregated on their owners' returns, there is little tax incentive to mischaracterize equity as debt for purposes of shifting income between

pass-through entities and their owners -- deductions for interest paid would generally be offset by inclusions for interest received. Moreover, these pass-through entities typically are not members of large multinational or domestic affiliated groups, and so typically are not heavily engaged in the types of intra-group lending transactions with highly-related C corporations addressed by the regulations.

In 2012, C corporations reported $63 trillion (74 percent of the total reported by all corporations) of total assets, $738 billion (91 percent of the total) of interest deductions, $9.7 trillion (75 percent of the total) of total income, and $1 trillion (59 percent of the total) of net income, according to Treasury tabulations of tax return data. Given that only 27 percent of all corporate filings are for C corporations, these figures suggest that C corporations are larger than average for all corporations and account for a disproportionate fraction of business activity, relative to their number compared to all corporations. In 2012, C corporations paid $265 billion in income taxes after credits. Most C corporation activity is concentrated in a small fraction of very large firms. For instance, only about 1 percent of C corporation returns have assets in excess of $100 million and only about 0.6 percent have total income (a proxy for revenue) in excess of $50 million. However, returns of firms of this size account for about 95 percent of total interest deductions and 85 percent of total income.

The section 385 regulations do not apply to all C corporations. The concerns addressed by the regulations are not present in certain categories of related-party corporate transactions, for example among related corporations (whether ultimately U.S-parented or foreign-parented) that file a consolidated U.S. income tax return. In addition, the Treasury Department and the IRS have determined that, with respect to

certain smaller corporations, the benefits of applying the rules are outweighed by the compliance cost of applying the rules to such entities. Hence, the regulations narrow the number of firms affected substantially. As described in this description of the affected population, of 1.6 million C corporations, the Treasury Department estimates that only about 6,300 large C corporations will potentially be affected by the documentation requirements of the regulations. This is because only about 6,300 C corporations are part of expanded groups (which are defined by the regulations as section 1504(a) "affiliated groups," but also include foreign corporations, tax-exempt corporations, and indirectly held corporations) that have sufficient assets (more than $100 million), revenue (more than $50 million), or are publicly traded. An even smaller number of corporations, about 1,200, appear to report transactions consistent with those that are potentially subject to the general recharacterization rules of the regulation (§1.385-3), although limited data exists on the number of corporations that are covered by the regulations and engaged in transactions that are economically similar to the general rule transactions. Treasury estimates that even though these 1,200 corporations comprise less than 0.1 percent of C corporations, they report approximately 11 percent of corporate interest deductions and 6 percent of corporate net income on tax returns.

2. Documentation of Intercompany Loans and Compliance

While there is variation across businesses, longer-term intercompany debt would typically be documented, in some form of agreement containing terms and rights, by corporations following good business practices. However, some information required by the regulations, such as a debt capacity analysis, may not typically be prepared in some

cases. The regulations do not require a specific type of credit analysis or documentation be prepared in order to establish a debtor's creditworthiness and ability to repay, but merely impose a standard closer to commercial practice. To the extent that information supporting such analysis is already prepared in accordance with a company's normal business practice, complying with the regulations would have a relatively low compliance cost. However, where a business has not typically prepared and maintained written debt instruments, term sheets, cash flow, or debt capacity analyses for intercompany debt, compliance costs related to the regulations will be higher. While the level of documentation required is clearly evident in third-party lending, there is little available information on the extent to which related parties document their intercompany loans. Anecdotal evidence and comments received indicate that businesses vary in the extent to which related-party indebtedness is documented. Nevertheless, the Treasury Department does not have detailed and quantitative assessment of current documentation practices.

C. Description of the regulations

1. In General

The section 385 regulations have multiple parts. In general, the regulations describe factors to be used in assessing the nature of interests issued between highly-related corporations, how such factors may be demonstrated, and when the presence of certain factors will be dispositive. As proposed, the first part (proposed §1.385-1) allowed the IRS to bifurcate a single financial instrument between related parties into components of debt and equity, where appropriate. The final and temporary regulations, however, do not include the bifurcation rule as the Treasury Department

and the IRS are continuing to study the potential issues raised by such a rule. Thus, the revenue and compliance-cost effects associated with the bifurcation rule of the proposed regulations are now excluded from this analysis.

The second part of the regulations, §1.385-2, prescribes the nature of the documentation necessary to substantiate the tax treatment of related-party instruments as indebtedness, including documentation of factors analogous to those found in third-party loans. This generally means that taxpayers must be able to provide such things as: evidence of an unconditional and binding obligation to make interest and principal payments on certain fixed dates; that the holder of the loan has the rights of a creditor, including superior rights to shareholders in the case of dissolution; a reasonable expectation of the borrower's ability to repay the loan; and evidence of conduct consistent with a debtor-creditor relationship. These documentation rules would apply to relevant intercompany debt issued by U.S. borrowers beginning in 2018 and would require that the taxpayer's documentation for a given tax year be prepared by the time the borrower's federal income tax return is filed.

The third part of the regulations, §§1.385-3 and 1.385-3T, provides rules that can recharacterize purported debt of U.S. issuers as equity if the interest is among highly-related parties and does not finance new investment. These rules are intended to address transactions that create significant U.S. federal tax benefits while lacking meaningful legal or economic significance. Subject to a variety of exceptions for more ordinary course transactions, the rules recharacterize a note that is distributed from a U.S. issuer to a parent corporation, or other highly-related entity, as equity. The rules also apply to the use of notes to fund acquisitions of related-party stock and internal

asset reorganizations, as well as multi-step transactions that have an economically similar result. Any intra-group debt recharacterized as equity by the regulations eliminates the ability of the purported borrower to deduct interest from its taxable income.

The fourth part of the regulations, §1.385-4T, includes special rules for applying §1.385-3 to consolidated groups, consistent with the general purpose of §1.385-3. References in the following discussion to "§1.385-3" include §§1.385-3T and 1.385-4T. Section 1.385-3 applies only to debt issued after April 4, 2016, the date the proposed regulations were published, and so grandfather intragroup debt issued before that date.

2. Limitations of Final and Temporary Regulations and Significant Modifications

Taking into consideration the comments received on the proposed regulations, the Treasury Department and the IRS are modifying the regulations to address certain unintended impacts of the proposal. The final and temporary regulations also better target the entities and activities that lead to inappropriate interest deductions by limiting the type of businesses affected. In doing so, the final and temporary regulations significantly reduce compliance and administrative burden, while still placing effective limits on the transactions most responsible for inappropriately reducing U.S. tax revenue.

Because tax-motived incentives to mischaracterize equity as debt depend on a taxpayer's situation, in certain circumstances the likelihood of mischaracterization or the consequences thereof are small. In these circumstances, exceptions to the general rules may reduce the compliance or administrative burden of the rules, increase the compliance benefit relative to associated costs, or avoid unintended costs. To this end,

the final and temporary regulations limit the type and size of businesses affected and the types of transactions and activities to which they apply. In particular, §1.385-2 only applies to related groups of corporations where the stock of at least one member is publicly traded or the group's financial results report assets exceeding $100 million or annual revenue exceeding $50 million. Because there is no general definition of a small business in tax law, these asset and revenue limits are designed to exceed the maximum receipts threshold used by the Small Business Administration in defining small businesses (U.S. Small Business Administration, Table of Small Business Size Standards, 2016). In addition, these thresholds exclude about 99 percent of C corporation taxpayers while retaining 85 percent of economic activity as measured by total income. Approximately 1.5 million out of 1.6 million C corporation tax filers are single entities and therefore have no affiliates with which to engage in tax arbitrage. The intent is to limit the regulations to large businesses with highly-related affiliates, which are responsible for most corporate activity.

Furthermore, in response to public comments and analysis of the data related to the proposed regulations, the rules of §§1.385-2 and 1.385-3 have been significantly modified. In developing these modifications, the Treasury Department and the IRS considered a number of alternative approaches suggested by comments, as discussed previously in this preamble. The intended cumulative effect of these modifications is to focus the application of the regulations on large, complex corporate groups where the most opportunity for non-commercial, tax-motivated transactions of the type targeted by the regulations exists, while reducing, or eliminating, the burdens on other taxpayers. For example, large FCDCs (assets over $100 million and total income over $50 million)

make up 3 percent of FCDCs but report 90 percent of FCDC interest deductions and 93 percent of FCDC total income. Similarly, the modifications are intended to exempt most ordinary course transactions from the application of the regulations. The most significant modifications include the following:

- S corporations, RICs, and REITs that are not controlled by corporate members of an expanded group are excluded from all aspects of the final and temporary regulations. See Part III.B.2.b of the Summary of Comments and Explanation of Revisions. The Treasury Department and the IRS have determined that an S corporation, RIC, or REIT that would otherwise be the parent of an expanded group is generally analogous to a non-controlled partnership. Under both the proposed and the final and temporary regulations, a non-controlled partnership that would, if it were a corporation, be the parent of an expanded group is excluded from the expanded group. S corporations, RICs, and REITs have similar flow-through characteristics in that business income from these types of aggregate entities generally flows to and is aggregated on the business owners' returns. Moreover, S corporations and non-controlled RICs and REITs are generally not part of multinational groups and are unlikely to engage in the types of transactions targeted by the regulations because these types of entities have fewer incentives to mischaracterize equity as debt under the U.S. tax system, so their exclusion generally does not affect tax compliance benefits and eliminates compliance costs.
- The regulations reserve on the application to non-U.S. issuers (that is, foreign corporations that issue debt). See Part III.A.1 of the Summary of Comments and Explanation of Revisions. Non-U.S. issuers have limited incentives to

mischaracterize equity as debt under the U.S. tax system because non-U.S. debt does not generally affect U.S. corporate liability directly either because (i) the issuer is entirely foreign owned (and thus generally outside of the U.S. tax system if it lacks a U.S. presence) or, (ii) in the case of an issuer that is a CFC, its income is eligible for deferral. Applying the regulations to non-U.S. issuers would impact the operations of large, complex MNCs which may involve foreign-to-foreign lending or non-U.S. issuance, which would be burdensome to document and monitor for compliance, but there would be minimal revenue gains because the use of related party debt in these contexts generally does not result in U.S. tax benefits. In general, there is negligible tax revenue lost by this exclusion, while compliance costs are significantly reduced. Nevertheless, in certain cases there may be U.S. tax effects from mischaracterizing interests of non-U.S. issuers, although these effects are less direct and of a different nature. The regulations reserve on the application to foreign issuers as the Treasury Department and the IRS continue to consider how the burdens of complying in this context compare to the advantages of limiting potential abuses and how a better balance might be achieved.

- The final and temporary regulations generally exclude from the rules of §1.385-3 regulated financial services entities that are subject to certain levels of federal regulation and supervision, including insurance companies (other than captive insurers). See Parts IV.B.2.a and b, and V.G.1 and 2 of the Summary of Comments and Explanation of Revisions. Regulated financial service entities are subject to capital or leverage requirements which constrain the ability of such institutions to engage in the transactions that are addressed by the regulations. For example,

such entities could be precluded from or required to issue related-party debt in certain cases. Such an exception is also generally consistent with international accepted approaches on addressing interest stripping, which acknowledge the special circumstances presented by banks and insurance companies. See OECD BEPS Action Item 4 (Limiting Base Erosion Involving Interest Deductions and Other Financial Payments), ch. 10. Furthermore, compliance costs of including these entities in the regulations would likely have been significant compared to potential tax revenue gains from their inclusion. The documentation rules under §1.385-2 exempt from some of the documentation requirements debt instruments issued by regulated financial service entities to the extent the debt instruments contain terms required by a regulator to satisfy regulatory requirements or require a regulator's approval before principal or interest is paid.

- The regulations under §1.385-3 provide various exceptions and exclusions that are intended to exempt certain transactions and certain common commercial lending practices from being subject to the rules in cases where compliance burdens or efficiency costs are likely to be elevated and potential improvements in tax compliance modest.
    - Section 1.385-3 excludes cash pool borrowing and other short-term debt, by excluding loans that are short term in form and substance. See Part V.D.8 of the Summary of Comments and Explanation of Revisions. The exception for short-term debt allows companies to efficiently transfer cash around an affiliated group in order to meet the day-to-day global cash needs of the business without resorting to third-party borrowing in order to avoid §1.385-3.

These transactions tend to have low interest rates such that for a fixed amount of debt, the interest expense is limited. On the other hand, the costs of tracking these loans, which could occur with high frequency, for purposes of determining whether §1.385-3 applies may be significant. Therefore, tax compliance gains from their inclusion are likely to be small relative to the costs of compliance.

- When applying the §1.385-3 rules, an expanded earnings and profits (E&P) exception takes into account a corporation's E&P accumulated after April 4, 2016, as opposed to limiting distributions to the amount of E&P generated each year. See Part V.E.3.a of the Summary of Comments and Explanation of Revisions. The change ensures that companies are not incentivized to make distributions that use up their current E&P before it becomes unusable in the next taxable year. However, the accumulated E&P available to offset distributions or acquisitions resets to zero when there is a change in control of the issuer, due, for example, to the issuer being acquired by an unrelated party. The accumulated E&P available to offset distributions or acquisitions also resets to zero when there is a change of expanded group parent (including in an inversion). These limitations avoid creating incentives for companies (including inverted companies) to acquire or undertake transactions with companies rich in accumulated earnings to circumvent the regulations by relying on previously accumulated E&P. Therefore, this exception is of limited benefit to inverted corporations seeking to acquire new U.S. targets or to U.S. corporations themselves that undertake an inversion

that results in a new foreign parent, which could otherwise represent a major source of tax revenue loss.

- The final and temporary regulations allow a taxpayer to reduce the amount of its distributions and acquisitions that otherwise could cause an equal amount of the taxpayer's debt to be recharacterized as equity by the amount of the contributions to the taxpayer's capital. This has the effect of treating distributions and acquisitions as funded by new equity contributions before related-party borrowings and ensuring that companies that have not seen a reduction in net equity are not subject to the rules. See Part V.E.3.b of the Summary of Comments and Explanation of Revisions.
- The final and temporary regulations expand access to the $50 million indebtedness exception by removing the "cliff effect" of the threshold exception under the proposed regulations, so that all taxpayers can exclude the first $50 million of indebtedness that otherwise would be recharacterized. See Part V.E.4 of the Summary of Comments and Explanation of Revisions. Eliminating the $50 million cliff has little tax revenue effect but eliminates a potential economic distortion to the financing choices of corporations near the threshold.

- The regulations reduce and relax the documentation rules in various ways that reduce compliance burdens without compromising tax compliance.
  - The documentation requirements in §1.385-2 do not apply until January 1, 2018. Delaying the documentation requirements marginally lowers the start-

up costs related to complying with the regulations. The effect on revenue is expected to be negligible and the compliance costs slightly lower.

- The compliance period for documenting a loan has been extended from 30 days after issuance (or other relevant date) to instead be the date when the borrower's tax return is filed. Providing additional time for the recurring documentation requirements may lower the compliance burden while still providing documentation necessary for tax administration.
- The documentation rules have been eased so that a failure with respect to documentation of a particular instrument does not automatically result in recharacterization as equity where a group is otherwise substantially compliant with the rules. See Parts IV.A.2 and 3 of the Summary of Comments and Explanation of Revisions. This relief is expected to have negligible tax revenue cost while potentially lowering compliance costs for companies and increasing costs for the IRS.

- The final and temporary regulations do not include a general rule that bifurcates (for tax purposes) a single financial instrument into debt and equity components. See Part III.D of the Summary of Comments and Explanation of Revisions. The general bifurcation rule in the proposed regulations was broadly applicable and not subject to the same threshold rules as most of the regulations' other provisions. The proposed rule is not being finalized due to concerns about a lack of specificity in application and corresponding unintended collateral consequences. For example, one concern was that this provision could have unintended and disqualifying effects on an entity's

tax status, such as for an S Corporation or a REIT. The regulatory revenue effect was reduced by approximately 10 percent as a result of this change.

The exceptions and exclusions summarized in this Regulatory Impact Assessment limit the compliance burden imposed by the final and temporary regulations at limited revenue cost. Hence, the final and temporary regulations narrowly target the transactions of greatest concern while still being administrable.

D. Assessment of the regulations' effects

The documentation requirements for purported debt (§1.385-2) are likely to affect the largest number of corporations. As mentioned previously, in 2012 there were roughly 1.6 million U.S. C corporation tax returns filed (tax filings for consolidated groups are counted as one return). The Treasury Department and the IRS estimate that only 6,300 (0.4 percent) of these taxpayers would be affected by the documentation rules, mainly because 95 percent of taxpayers do not have affiliated corporations, and the regulations only affect transactions between affiliates.

While only a small fraction of corporate taxpayers will be affected by §1.385-2, these 6,300 taxpayers tend to be the largest, with 65 percent of total interest deductions, 53 percent of total income, 81 percent of total income subject to tax, and 75 percent of total income tax after credits. Of these corporations, approximately one-third are FCDCs that report about 20 percent of the affected total income and 20 percent of the affected interest deductions.

A subset of these corporate taxpayers, including both domestic and foreign-controlled domestic corporations, are likely to be affected by §1.385-3. While it is difficult to measure the exact number of firms that are likely to be affected due to tax

data limitations, Treasury estimates that of the 6,300 firms affected by §1.385-2, about 1,200 will be affected by §1.385-3. The number of firms affected is smaller because only transactions that exceed $50 million plus relevant E&P and capital contributions are affected, and because other exemptions in the final and temporary regulations limit the number of firms affected. The largest revenue effects are anticipated to arise from foreign-controlled domestic corporations.

The regulations are intended to address scenarios that present the most potential for the creation of significant U.S. federal tax benefits without having meaningful non-tax significance because the obligations are between commonly-owned corporations and because the obligations do not finance new investment in the issuer. These situations most affect revenues due to tax arbitrage. That is, the regulations are tailored to reach only transactions between related parties (where the risk of such tax arbitrage is greatest), tax situations and transactions where incentives for mischaracterization of equity as debt are strongest, and only then when there is no new investment in the borrowing entity. In developing the regulations, care was taken to balance the goals of addressing the areas where mischaracterization of equity was likely to result in tax avoidance and to introduce economic distortions against the higher compliance costs placed on business.

The likely effects of the rules in terms of their economic benefits and costs are discussed in the subsequent sections. The Treasury Department and the IRS used the best available studies, models, and data to estimate the effects of this rule. However, with regard to certain issues, relatively little relevant data and few rigorous studies are available.

1. Monetized Estimates of the Benefits and Costs

The primary benefit of the regulations is an improvement in tax compliance, which is expected to increase tax revenue. In addition, there are likely to be modest efficiency benefits because differences in the tax treatment of competing corporations are reduced. The primary cost of the regulations is the change in compliance costs of businesses, particularly from the §1.385-2 documentation rules.

a. Revenue effects associated with improved compliance

Because the regulations cover only new debt issuances occurring after April 4, 2016, and because the primary effect of the regulations is to limit the extent to which the transactions subject to the regulations can be used to achieve interest stripping, the revenue estimate is calculated primarily as a percentage reduction in the estimated growth in interest stripping relative to the baseline of current law absent these regulations. While the regulations are also likely to reduce tax avoidance by affiliated domestic corporations that do not file a consolidated return, those revenue effects are likely to be smaller and data limitations preclude an exact estimate of their magnitude. The estimated growth in interest stripping is the sum of estimates of the growth of interest stripping by existing FCDCs plus interest stripping by new FCDCs. Growth in interest stripping by existing FCDCs was calculated from the estimate of interest stripping by inverted corporations based on the Seida and Wempe and Bloomberg studies, inflated to 2016 dollars, and doubled to incorporate the amount of interest stripping by all other FCDCs, which are more numerous but where interest stripping is likely to be less intensive. The level of interest stripping is assumed to grow at a 5 percent rate annually.

Interest stripping by new FCDCs was derived from the average interest stripping by firms in the Seida and Wempe (2004) subsample, discussed above, inflated to 2016 dollars. Based on inversion rates for the past 20 years, growth by three inversions of this average size per year was assumed. This assumed growth was doubled to account for interest stripping by new FCDCs not created by inversion.

The assumed percentage reductions in interest stripping by existing FCDCs and by the creation of new FCDCs were in the mid-single digits, with the latter somewhat smaller than the former because interest stripping is not the sole reason for FCDC creation. The limitations and exclusions detailed above restrict the affected amounts of debt to a small fraction of total debt outstanding. The most important of these limitations and exclusions are the exception for short-term debt, the application of the regulations solely to related-party debt, the exclusion for most distributions separated by at least 36 months from debt issuance, and the E&P exception. Further, the grandfathering of existing interest stripping arrangements suggests that very little additional tax revenue will be paid in the short term, but that the growth rate of revenue will be high.

While the regulations also apply to affiliated domestic corporations that do not file a consolidated return, there is no good information on the extent of interest stripping by such groups. The tax benefits of such interest stripping are likely of a smaller magnitude, because in the purely domestic context, both the interest deductions and the interest income are subject to the same U.S. tax system and hence interest stripping to reduce total U.S. tax liability in this context relies on asymmetric tax positions across the

affiliated groups. As a result, the revenue estimate excludes tax revenue from purely domestic groups.

Both §§1.385-2 and 1.385-3 contribute to the revenue gain.

The §1.385-2 rules requiring documentation of instruments to support debt characterization are consistent with best documentation practices under case law, but many taxpayers do not currently follow best documentation practices. Specifically, the existence of a written loan agreement and an evaluation of the creditworthiness of a borrower are factors used by courts in deciding whether an intercompany advance should be treated as debt or equity; however, under current law taxpayers are able to sustain debt treatment even in the absence of documentation. Elevating the importance of documentation will both aid in IRS audits (by requiring a taxpayer to show contemporaneous relevant documentation as to the parties' intent and their analysis of the borrower's ability to pay) and prevent taxpayers from characterizing intercompany debt with the aid of hindsight. Both effects will improve compliance and thus raise tax revenue.

The revenue gain is also due to the §1.385-3 rules, which should limit the ability to mischaracterize equity as debt to facilitate interest stripping behaviors to the extent not covered by the exclusions and limitations previously discussed. For example, under the regulations those taxpayers choosing to interest strip by borrowing from unrelated parties will have an incentive to minimize interest rates relative to what they pay to highly-related parties. Alternatively, taxpayers may choose to separate borrowings from distributions by more than 3 years, but there will be incentives to earn as much as possible on the funds in the interim, and such earnings offset interest deductions.

Other significant limits on revenue gain from these rules include the availability of other means of earnings stripping, such as royalties and management fees, that can substitute for interest.

Preliminary estimates of the regulatory revenue effect are $7.4 billion over 10 years (or $600 million per year on an annualized 3 percent discounted basis). There is not a single answer to the question of how much revenue is generated by each piece of the regulations. This is because interactions between the pieces make the allocated subtotals depend on the order in which the allocation is made. If one assumes that §1.385-2 is "stacked first," then §1.385-2 accounts for approximately $1.5 billion of the total, and §1.385-3 accounts for the rest.

Annual discounted total revenue effects ($ millions in 2016 dollars) are shown below.

Annualized Monetized Transfer	Fiscal Years 2017 to 2026 (3% Discount Rate, 2016)	Fiscal Years 2017 to 2026 (7% Discount Rate. 2016)
Estimated change in annual tax revenue – from firms to the Federal Government	$600	$461

The regulations as originally proposed would have raised $10.1 billion over 10 years (or $843 million on an annualized 3 percent discounted basis). Since then, modifications of the rules have lowered the revenue estimate by approximately 25

percent. The modifications that lowered the revenue estimate include: the short-term debt exception and the exclusion of the §1.385-1 rules allowing the bifurcation of instruments into debt and equity components from this analysis.

b. Compliance burden

Most of the compliance burden will stem from the rules requiring documentation of intra-group loans. Our analysis thus focuses on the compliance effects of the §1.385-2 documentation requirements.

The Treasury Department and the IRS use the IRS business taxpayer burden model to estimate the additional compliance burden imposed on businesses by the regulations. These compliance costs are borne by businesses and are the primary costs imposed by this rule.

The IRS business taxpayer burden model used to calculate this compliance cost estimate is a micro-simulation model created by the IRS to provide monetized estimates of compliance costs for the business income tax return population. The model is based on an econometric specification developed using linked compliance cost survey data and tax return data. This model accounts for time as well as out-of-pocket costs of businesses and controls for the substitution of time and money by monetizing time and reporting total compliance costs in dollars. Costs are differentiated based on the characteristics and size of the business. For more detailed information on this methodology, see "Taxpayer Compliance Costs for Corporations and Partnerships: A New Look"; Contos, Guyton, Langetieg, Lerman, Nelson; SOI Tax Stats - 2012 IRS-TPC Research Conference. https://www.irs.gov/pub/irs-soi/12rescontaxpaycompliance.pdf.

Estimates of the change in compliance costs as a result of the regulations are produced using a process that compares results from a baseline scenario simulation (representing current law and practice) with an alternative scenario simulation (representing the effects of the regulations). The difference between the baseline and alternative simulation serves as the estimated compliance cost effect of the regulations.

The estimates are likely to be somewhat overstated for two practical reasons. First, they do not allow for a decline in compliance costs over time as firms become more accustomed to documenting loans. Second, the analysis assumes that the documentation requirements apply immediately to all existing loans when the §1.385-2 apply prospectively to loans originated on or after January 1, 2018. While this is intended to provide an accurate estimate of the ongoing costs of documentation in the future, it will take several years for all of a company's intra-group loans to be covered by the regulations. Hence, the actual volume of loans requiring documentation and associated costs will initially be smaller. Thus, the compliance cost for any one of the first several years in which the regulations are in effect will be lower.

Tax data were used to identify the (approximately) 6,300 businesses likely to be affected by §1.385-2 because they are estimated to have intercompany loans subject to the regulations. About 5,200 of these businesses have foreign affiliates, while the remaining firms have intercompany loans between U.S. affiliates.

Compliance costs are unlikely to be the same on a per firm basis, since some firms are likely to engage in more transactions requiring documentation, and, conditional on current practice, some firms are going to have greater compliance costs per transaction. The tax data are used to estimate for each firm the number of transactions

likely to require documentation (based on interest payments) and to place firms in categories that reflect differences in compliance cost per dollar of transaction.

Estimates using the IRS model show a compliance cost increase of approximately $56 million or an average of $8,900 per firm in 2016 dollars. In 2012, net income for these taxpayers was about $960 billion, so the documentation requirements would reduce profits for these taxpayers by, on average, roughly 0.006 percent. Of course, the experience of each affected firm will vary.

These estimates are higher than the $13 million estimate for the proposed regulations because of modifications in the regulations and adjustments to the methodology used to estimate the costs. The proposed regulations would have affected more businesses (21,000), but the modifications in response to comments significantly reduced the number affected (to 6,300). In and of itself, this would have significantly lowered the compliance cost. However, the initial estimate projected an average cost per business of $600, while the revised estimate projects an average cost per business of about $8,900. This change in the cost per business resulted in a higher overall compliance cost, all else being constant. The initial estimate was based on assumptions and modeling approaches, including a lower-than-appropriate wage rate for accountants and attorneys working on the compliance issues, that were subsequently revised in light of comments received. The revised estimate is based on a more complete analysis by the IRS burden model.

The burden estimate is lower than those suggested in some of the comments received on the proposed regulations. In part, this is because some comments assumed that none of the affected businesses have any documentation of affected

loans, when other businesses, reported that they already maintain some or all of the information required. In addition, however, our estimate is lower because the final and temporary regulations have been modified in many ways in order to reduce the burden, in response to the comments received. For example, the final rules apply just to U.S. borrowers, while the proposed regulations also applied to borrowing between foreign affiliates. These foreign-to-foreign transactions are now outside the scope of the regulations, so that the numbers of businesses and transactions subject to the rule are reduced. This change reduces the compliance costs compared to those originally proposed.

The $56 million estimate only reflects ongoing compliance costs. It does not reflect the initial startup costs and infrastructure investment. Initial startup costs and infrastructure investment are expected to result in additional costs in the first years that the section 385 regulations are in effect. IRS-supported research by Forrester in 2013 indicates these one-time start-up expenses are approximately four times the annual costs, or approximately $224 million in 2016 dollars primarily over the initial years when the section 385 regulations go into effect. Most of these start-up costs are in 2017 even though the §1.385-2 regulations require documentation starting in 2018. The ongoing and start-up costs are reported on an annual average basis in the table on these costs. In addition, the analysis includes a sensitivity analysis in which the compliance costs are estimated for a 90 percent interval around our best estimate. First the distributional characteristics of critical parameters used to produce the estimate are evaluated. Then Monte Carlo simulations are used to vary the parameter values. Finally, alternative high and low estimates are computed based on parameter values at either end of the 90

percent range. These ongoing compliance cost estimates range from $29 million per year on an annualized basis in 2016 dollars to $60 million. Using the same factor of four to estimate one-time start-up expenses, these range from $15 million per year on an annualized basis in 2016 dollars to $27 million. These combined ongoing and start-up costs on an annual average basis for both the high and low estimates appear in the table summarizing these costs. Our sensitivity analysis indicates that even using the high compliance cost estimates, that tax revenues generated by the regulations would be 6 to 7 times as large as these costs.

Annual discounted ongoing and start-up compliance costs ($ millions in 2016 dollars) are shown below.

Compliance costs associated with addressing	Fiscal Years 2017 to 2026 (3% Discount Rate, 2016)	Fiscal Years 2017 to 2026 (7% Discount Rate, 2016)
Central estimate	$70	$59
High estimate	$87	$73
Low estimate	$52	$44

2. Non-Monetized Effects

a. Increased Tax Compliance System Wide

The U.S. tax system relies for its effectiveness on voluntary tax compliance. Voluntary compliance is eroded when there is a perception that some taxpayers are able to avoid paying their fair share of the tax burden. Tax strategies of large multinational corporations, such as interest stripping, have been widely reported in the

press as inappropriate ways for these companies to avoid paying their fair share of taxes. By reducing the ability of such firms to strip earnings out of the U.S. through transactions with no meaningful economic or non-tax effect, and so raising their tax payments, the regulations are likely to increase the overall perceived legitimacy of the U.S. tax system, and hence promote voluntary compliance. This effect is not quantified.

b. Efficiency and growth effects

By changing the treatment of certain transactions and activities, the regulations potentially affect economic efficiency and growth (output). While these changes may have multiple and, to some extent, offsetting effects, on net, they are likely to improve economic efficiency. For example, the regulations reduce the tax advantage foreign owners have over domestic owners of U.S. assets, and consequently reduce the propensity for foreign purchases and ownership of U.S. assets that are motivated by tax considerations rather than economic substance. While these effects are likely to be small, they are likely to enhance efficiency and growth. By reducing tax-motivated acquisitions or ownership structures, the regulations may encourage assets to be owned or managed by those most capable of putting the assets to their highest-valued use. In addition, the regulations reduce the tax benefit of inversions, which can have economic costs to the United States even if the actual management of a firm is not changed when the firm's ownership changes. And, it may help to put purely domestic U.S. firms on more even tax footing with their foreign-owned competitors operating in the United States. On the other hand, the regulations may slightly increase the effective tax rate and compliance costs on U.S. inbound investment. While the magnitude of this increase is small because of those provisions that exempt transactions financing new

investment, to the extent that it reduces new capital investment in the U.S. its effects would be efficiency and growth reducing. On balance, the likely effect of the regulations is to improve the efficiency of the corporate tax system.

The extent to which the regulations' changes in tax prices affect real U.S. economic activity depends on their size and on taxpayers' reaction to the changes. At the outset, it is important to realize that the change in tax prices associated with the regulations are likely to be small. The estimated total tax paid by the 1,200 taxpayers affected by the §1.385-3 rules was $13 billion in 2016 dollars. The annualized 3 percent discounted revenue effect is $600 million per year in 2016 dollars. Even assuming that all of the revenue comes from the §1.385-3 rules (which overstates the relevant revenue) implies that the affected taxpayers would pay less than 5 percent (roughly 1 percentage point) in additional tax, which is likely far less than their current tax advantage relative to domestic non-FCDCs corporations. (For example, Seida and Wempe find that the average reduction in effective tax rates of corporations in their inversion sample was 11.57 percentage points.) Furthermore, much evidence points to relatively small behavioral reactions to such tax changes. Many analysts have argued that even major changes in tax policy have no more than modest effects on the economy. For an idea of the range of results, see Congressional Research Service Report R42111, Tax Rates and Economic Growth, by Jane G. Gravelle and Donald J. Marples, January, 2015; Joint Committee on Taxation Staff, Macroeconomic Analysis of the *"*Tax Reform Act of 2014*"*, JCX 22-14, February 26, 2014; Robert Carroll, John Diamond, Craig Johnson, and James Mackie, A Summary of the Dynamic Analysis of the Tax Reform Options Prepared for the President's Advisory Panel on Federal Tax

Reform, Office of Tax Analysis Paper Prepared for the American Enterprise Institute Conference on Tax Reform and Dynamic Analysis, May 25, 2006. It is unlikely, then, that a small tax increase on a small set of companies would have a measurable effect on major economic aggregates.

Although the rules are designed to minimize any detrimental effect on U.S. investment, the regulations do to some extent make the U.S. a less attractive location for foreign investment. The effect is likely to be small, however because the rules exclude financing activities that are clearly associated with new investment in the U.S. For example, interest paid by a FCDC to a related party on new borrowing used to make a new investment in the U.S. would continue to be deductible. This is true, moreover, even if the new debt comes in the form of a "dividend" note paid out of E&P generated after the regulation's effective date. Such new debt finances new U.S. investment in the sense that the FCDC retains and invests in the United States cash earned on U.S. profits, rather than sending the cash to its foreign parent as a dividend.

Furthermore, most inbound investment is via acquisition of existing U.S. companies rather than greenfield (new) investment in the U.S., and so changes the ownership of existing assets, without necessarily adding to the stock of capital employed in the U.S. Such acquisitions and cross-border mergers can make the U.S. economy stronger by encouraging foreign investment to flow into the United States and by enabling U.S. companies to invest overseas. But in an efficient market, these transactions should be driven by genuine business strategies and economic benefits, not simply by a desire to avoid U.S. taxes. One effect of the regulations is to reduce tax-motivated incentives for foreign ownership instead of domestic ownership of

domestic companies and thus to improve economic efficiency. As Mihir A. Desai and James R. Hines, Jr. write, "given the central importance of ownership to the nature of multinational firms, there is good reason to be particularly concerned about the potential for economic inefficiency due to distortions to ownership patterns." "Evaluating International Tax Reform," National Tax Journal 56 No. 3 (September, 2003): 487-502. By reducing the tax advantage to foreign ownership, the regulations may help to promote a more efficient ownership structure, one guided more by economic fundamentals and less by tax benefits.

Recently, apparently tax-motivated acquisitions of U.S. companies by foreign businesses have attracted much attention in the debate over inversions. Much of this debate has focused on the tax cost to the U.S. government, which can be substantial. But there could be other costs as well. For example, headquarters jobs may leave the United States. In addition, formerly U.S. headquartered companies may lose their U.S. focus and identity over time, which could reduce the incentive to keep production and research in the United States. Interest stripping is a primary tax benefit of inversions. By reducing the tax benefit of certain types of interest stripping, the regulations thus are likely to reduce, to some extent, the tax incentive for inversions. However, any reduction in inversion activity is likely to be modest because the tax change is small and leaves in place tax advantages for foreign ownership, e.g., through interest stripping not prohibited by the regulation.

Finally, because FCDCs currently face lower effective tax rates than can be achieved by domestic U.S. firms, even when operating in domestic markets, they currently enjoy a competitive advantage in pricing, marketshare, and profitability. To the

extent that this rule reduces this tax advantage, it levels the playing field relative to U.S. corporations, and thereby promotes efficient economic choices -- choices motivated by underlying economic fundamentals, rather than by tax differences.

c. Lower Tax Administrative Costs for the IRS.

The increased loan documentation required of large corporations will help the IRS to more effectively administer the tax laws by making it easier for the IRS to evaluate whether purported debt transactions are legitimate loans. This will lower the cost of auditing and evaluating the tax returns of companies engaged in these transactions. The lower administrative cost for the IRS offsets to some degree the higher compliance cost placed on corporations. It has not been possible, however, to quantify the cost savings.

II. Regulatory Flexibility Act

Pursuant to the Regulatory Flexibility Act (5 U.S.C. Chapter 6), it is hereby certified that the final and temporary regulations will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required.

The Commissioner and the courts historically have analyzed whether an interest in a corporation should be treated as stock or indebtedness for federal tax purposes by applying various sets of factors to the facts of a particular case. Section 1.385-1 does not require taxpayers to take any additional actions or to engage in any new procedures or documentation. Because §1.385-1 contains no such requirements, it does not have an effect on small entities.

To facilitate the federal tax analysis of an interest in a corporation, taxpayers are required under existing law to substantiate their classification of an interest as stock or indebtedness for federal tax purposes. Section 1.385-2 provides minimum standards on documentation needed to substantiate the treatment of certain related-party instruments as indebtedness, and provides rules on the weighting of particular factors in conducting such analysis. Section 1.385-2 will not have an impact on a substantial number of small entities for several reasons. First, the rules do not apply to S corporations or non-controlled pass-through entities. Second, the rules apply only to debt in form issued within expanded groups of corporations. Third, §1.385-2 only applies to expanded groups if the stock of a member of the expanded group is publicly traded, or financial statements of the expanded group or its members show total assets exceeding $100 million or annual total revenue exceeding $50 million. Because the rules are limited to larger expanded groups, they will not affect a substantial number of small entities.

Section 1.385-3 provides that certain interests in a corporation that are held by a member of the corporation's expanded group and that otherwise would be treated as indebtedness for federal tax purposes are treated as stock. Section 1.385-3T provides that for certain debt instruments issued by a controlled partnership, the holder is deemed to transfer all or a portion of the debt instrument to the partner or partners in the partnership in exchange for stock in the partner or partners. Section 1.385-4T provides rules regarding the application of §§1.385-3 and 1.385-3T to members of a consolidated group. Sections 1.385-3 and 1.385-3T include multiple exceptions that limit their application. In particular, the threshold exception provides that the first $50

million of expanded group debt instruments that otherwise would be reclassified as stock or deemed to be transferred to a partner in a controlled partnership under §1.385-3 or §1.385-3T will not be reclassified or deemed transferred under §1.385-3 or §1.385-3T. Although it is possible that the classification rules in §§1.385-3, 1.385-3T, and 1.385-4T could have an effect on small entities, the threshold exception of the first $50 million of debt instruments otherwise subject to recharacterization or deemed transfer under §§1.385-3, 1.385-3T, and 1.385-4T makes it unlikely that a substantial number of small entities will be affected by §§1.385-3, 1.385-3T, and 1.385-4T.

Pursuant to section 7805(f) of the Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business. Comments were received requesting that the monetary thresholds contained in proposed §§1.385-2, 1.385-3, and 1.385-4 be increased in order to mitigate the impact on small businesses. These comments are addressed in Parts IV.B.1.d and V.E.4 of the Summary of Comments and Explanation of Revisions. No comments were received concerning the economic impact on small entities from the Small Business Administration.

III. Congressional Review Act

The Congressional Review Act, 5 U.S.C. 801 et seq., generally provides that before a rule may take effect, the agency promulgating the rule must submit a rule report, which includes a copy of the rule, to each House of the Congress and to the Comptroller General of the United States. A major rule cannot take effect until 60 days after it is published in the Federal Register. This action is a “major rule” as defined by

5 U.S.C. 804(2) and will become applicable more than 60 days after publication (see §§1.385-1(g), 1.385-2(i), 1.385-3(j), 1.385-3T(k), 1.385-4T(g), and 1.752-2T(l)(4)).

IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 ("Unfunded Mandates Act"), Public Law 104-4 (March 22, 1995), requires that an agency prepare a budgetary impact statement before promulgating a rule that may result in expenditure by state, local, and tribal governments, in the aggregate, or by the private sector, of $100 million or more in any one year. If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. See Part I of this Special Analyses for a discussion of the budgetary impact of this final rule.

Drafting Information

The principal authors of these regulations are Austin M. Diamond-Jones of the Office of Associate Chief Counsel (Corporate) and Joshua G. Rabon of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.385-1 also issued under 26 U.S.C. 385.

Section 1.385-2 also issued under 26 U.S.C. 385, 6001, 6011, and 7701(l).

Section 1.385-3 also issued under 26 U.S.C. 385, 701, 1502, 1504(a)(5)(A), and 7701(l).

Section 1.385-3T also issued under 26 U.S.C. 385, 701, 1504(a)(5)(A), and 7701(l).

Section 1.385-4T also issued under 26 U.S.C. 385 and 1502.

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Par. 2. Section 1.385-1 is added to read as follows:

§1.385-1 General provisions.

(a) Overview of section 385 regulations. This section and §§1.385-2 through 1.385-4T (collectively, the section 385 regulations) provide rules under section 385 to determine the treatment of an interest in a corporation as stock or indebtedness (or as in part stock and in part indebtedness) in particular factual situations. Paragraph (b) of this section provides the general rule for determining the treatment of an interest based on provisions of the Internal Revenue Code and on common law, including the factors prescribed under common law. Paragraphs (c), (d), and (e) of this section provide definitions and rules of general application for purposes of the section 385 regulations. Section 1.385-2 provides additional guidance regarding the application of certain factors in determining the federal tax treatment of an interest in a corporation that is held by a

member of the corporation's expanded group. Section 1.385-3 sets forth additional factors that, when present, control the determination of whether an interest in a corporation that is held by a member of the corporation's expanded group is treated (in whole or in part) as stock or indebtedness. Section 1.385-3T(f) provides rules on the treatment of debt instruments issued by certain partnerships. Section 1.385-4T provides rules regarding the application of the factors set forth in §1.385-3 and the rules in §1.385-3T to transactions described in those sections as they relate to consolidated groups.

(b) General rule. Except as otherwise provided in the Internal Revenue Code and the regulations thereunder, including the section 385 regulations, whether an interest in a corporation is treated for purposes of the Internal Revenue Code as stock or indebtedness (or as in part stock and in part indebtedness) is determined based on common law, including the factors prescribed under such common law.

(c) Definitions. The definitions in this paragraph (c) apply for purposes of the section 385 regulations. For additional definitions that apply for purposes of their respective sections, see §§1.385-2(d), 1.385-3(g), and 1.385-4T(e).

(1) Controlled partnership. The term controlled partnership means, with respect to an expanded group, a partnership with respect to which at least 80 percent of the interests in partnership capital or profits are owned, directly or indirectly, by one or more members of the expanded group. For purposes of identifying a controlled partnership, indirect ownership of a partnership interest is determined by applying the principles of paragraph (c)(4)(iii) of this section. Such determination is separate from the determination of the status of a corporation as a member of an expanded group. An

unincorporated organization described in §1.761-2 that elects to be excluded from all of subchapter K of chapter 1 of the Internal Revenue Code is not a controlled partnership.

(2) Covered member. The term covered member means a member of an expanded group that is--

(i) A domestic corporation; and

(ii) [Reserved]

(3) Disregarded entity. The term disregarded entity means a business entity (as defined in §301.7701-2(a) of this chapter) that is disregarded as an entity separate from its owner for federal income tax purposes under §§301.7701-1 through 301.7701-3 of this chapter.

(4) Expanded group--(i) In general. The term expanded group means one or more chains of corporations (other than corporations described in section 1504(b)(8)) connected through stock ownership with a common parent corporation not described in section 1504(b)(6) or (b)(8) (an expanded group parent), but only if--

(A) The expanded group parent owns directly or indirectly stock meeting the requirements of section 1504(a)(2) (modified by substituting “or” for “and” in section 1504(a)(2)(A)) in at least one of the other corporations; and

(B) Stock meeting the requirements of section 1504(a)(2) (modified by substituting “or” for “and” in section 1504(a)(2)(A)) in each of the other corporations (except the expanded group parent) is owned directly or indirectly by one or more of the other corporations.

(ii) Definition of stock. For purposes of paragraph (c)(4)(i) of this section, the term stock has the same meaning as “stock” in section 1504 (without regard to §1.1504-

4) and all shares of stock within a single class are considered to have the same value. Thus, control premiums and minority and blockage discounts within a single class are not taken into account.

(iii) Indirect stock ownership. For purposes of paragraph (c)(4)(i) of this section, indirect stock ownership is determined by applying the constructive ownership rules of section 318(a) with the following modifications:

(A) Section 318(a)(1) and (a)(3) do not apply except as set forth in paragraph (c)(4)(v) of this section;

(B) Section 318(a)(2)(C) applies by substituting "5 percent" for "50 percent;" and

(C) Section 318(a)(4) only applies to options (as defined in §1.1504-4(d)) that are reasonably certain to be exercised as described in §1.1504-4(g).

(iv) Member of an expanded group or expanded group member. The expanded group parent and each of the other corporations described in paragraphs (c)(4)(i)(A) and (c)(4)(i)(B) of this section is a member of an expanded group (also referred to as an expanded group member). For purposes of the section 385 regulations, a corporation is a member of an expanded group if it is described in this paragraph (c)(4)(iv) of this section immediately before the relevant time for determining membership (for example, immediately before the issuance of an EGI (as defined in §1.385-2(d)(3)) or a debt instrument (as defined in §1.385-3(g)(4)) or immediately before a distribution or acquisition that may be subject to §1.385-3(b)(2) or (3)).

(v) Brother-sister groups with non-corporate owners. [Reserved]

(vi) Special rule for indirect ownership through options for certain members of consolidated groups. In the case of an option of which a member of a consolidated

group, other than the common parent, is the issuing corporation (as defined in §1.1504-4(c)(1)), section 318(a)(4) only applies (for purposes of applying paragraph (c)(4)(iii)(C) of this section) to the option if the option is treated as stock or as exercised under §1.1504-4(b) for purposes of determining whether a corporation is a member of an affiliated group.

(vii) Examples. The following examples illustrate the rules of this paragraph (c)(4). Except as otherwise stated, for purposes of the examples in this paragraph (c)(4)(vii), all persons described are corporations that have a single class of stock outstanding and file separate federal tax returns and are not described in section 1504(b)(6) or (b)(8). In addition, the stock of each publicly traded corporation is widely held such that no person directly or indirectly owns stock in the publicly traded corporation meeting the requirements of section 1504(a)(2) (as modified by this paragraph (c)(4)).

Example 1. Two different expanded group parents. (i) Facts. P has two classes of common stock outstanding: Class A and Class B. X, a publicly traded corporation, directly owns all shares of P's Class A common stock, which is high-vote common stock representing 85% of the vote and 15% of the value of the stock of P. Y, a publicly traded corporation, directly owns all shares of P's Class B common stock, which is low-vote common stock representing 15% of the vote and 85% of the value of the stock of P. P directly owns 100% of the stock of S1.

(ii) Analysis. X owns directly 85% of the vote of the stock of P, which is stock meeting the requirements of section 1504(a)(2) (as modified by paragraph (c)(4)(i)(A) of this section). Therefore, X is an expanded group parent described in paragraph (c)(4)(i) of this section with respect to P. Y owns 85% of the value of the stock of P, which is stock meeting the requirements of section 1504(a)(2) (as modified by paragraph (c)(4)(i)(A) of this section). Therefore, Y is also an expanded group parent described in paragraph (c)(4)(i) of this section with respect to P. P owns directly 100% of the voting power and value of the stock of S1, which is stock meeting the requirements of section 1504(a)(2) (as modified by paragraph (c)(4)(i)(B) of this section). Therefore, X, P, and S1 constitute an expanded group as defined in paragraph (c)(4)(i) of this section. Additionally, Y, P, and S1 constitute an expanded group as defined in paragraph (c)(4) of this section. X and Y are not members of the same expanded group under

paragraph (c)(4) of this section because X does not directly or indirectly own any of the stock of Y and Y does not directly or indirectly own any of the stock of X, such that X and Y do not comprise a chain of corporations described in paragraph (c)(4)(i) of this section.

Example 2. Inclusion of a REIT within an expanded group. (i) Facts. All of the stock of P is publicly traded. In addition to other assets representing 85% of the value of its total assets, P directly owns all of the stock of S1. S1 owns 99% of the stock of S2. The remaining 1% of the stock of S2 is owned by 100 unrelated individuals. In addition to other assets representing 85% of the value of its total assets, S2 owns all of the stock of S3. Both P and S2 are real estate investment trusts described in section 1504(b)(6).

(ii) Analysis. P directly owns 100% of the stock of S1. However, under paragraph (c)(4)(i) of this section, P cannot be the expanded group parent because P is a real estate investment trust described in section 1504(b)(6). Because no other corporation owns stock in P meeting the requirements described in paragraph (c)(4)(i) of this section, P is not an expanded group member. S1 directly owns 99% of the stock of S2, which is stock meeting the requirements of section 1504(a)(2) (as modified by paragraph (c)(4)(i)(A) of this section). Although S2 is a corporation described in section 1504(b)(6), a corporation described in section 1504(b)(6) may be a member of an expanded group described under paragraph (c)(4)(i) of this section provided the corporation is not the expanded group parent. In this case, S1 is the expanded group parent. S2 directly owns 100% of the stock of S3, which is stock meeting the requirements of section 1504(a)(2) (as modified by paragraph (c)(4)(i)(B) of this section). Therefore, S1, S2, and S3 constitute an expanded group as defined in paragraph (c)(4) of this section.

Example 3. Attribution of hook stock. (i) Facts. P, a publicly traded corporation, directly owns 50% of the stock of S1. S1 directly owns 100% of the stock of S2. S2 directly owns the remaining 50% of the stock of S1.

(ii) Analysis. (A) P directly owns 50% of the stock of S1. Under paragraph (c)(4)(iii) of this section (which applies section 318(a)(2) with modifications), P constructively owns 50% of the stock of S2 because P directly owns 50% of the stock of S1, which directly owns 100% of S2. Under section 318(a)(5)(A), stock constructively owned by P by reason of the application of section 318(a)(2) is, for purposes of section 318(a)(2), considered as actually owned by P.

(B) S2 directly owns 50% of the stock of S1. Thus, under paragraph (c)(4)(iii) of this section, P is treated as constructively owning an additional 25% of the stock of S1. For purposes of determining the expanded group, P's ownership must be recalculated treating the additional 25% of S1 stock as actually owned. Under the second application of section 318(a)(2)(C) as modified by paragraph (c)(4)(iii) of this section, P constructively owns an additional 12.5% of the stock of S1 as follows: 25% (P's new attributed ownership of S1) x 100% (S1's ownership of S2) x 50% (S2's ownership of

S1) = 12.5%. After two iterations, P's ownership in S1 is 87.5% (50% direct ownership + 25% first order constructive ownership + 12.5% second order constructive ownership) and thus S1 is a member of the expanded group that includes P and S2. Subsequent iterative calculations of P's ownership, treating constructive ownership as actual ownership, would demonstrate that P owns, directly and indirectly, 100% of the stock of S1. P, S1, and S2 therefore constitute an expanded group as defined in paragraph (c)(4) of this section and P is the expanded group parent.

Example 4. Attribution of hook stock when an intermediary has multiple owners. (i) Facts. The facts are the same as in Example 3, except that P directly owns only 25% of the stock of S1. X, a corporation unrelated to P, also directly owns 25% of the stock of S1.

(ii) Analysis. (A) P and X each directly owns 25% of the stock of S1. Under paragraph (c)(4)(iii) of this section, P and X each constructively owns 25% of the stock of S2 because P and X each directly owns 25% of the stock of S1, which directly owns 100% of the stock of S2. Under section 318(a)(5)(A), stock constructively owned by P or X by reason of the application of section 318(a)(2) is, for purposes of section 318(a)(2), considered as actually owned by P or X, respectively.

(B) S2 directly owns 50% of the stock of S1. Thus, under paragraph (c)(4)(iii) of this section, P and X each is treated as constructively owning an additional 12.5% of the stock of S1. Under a second application of section 318(a)(2)(C) as modified by paragraph (c)(4)(iii) of this section, P and X each constructively owns an additional 6.25% of the stock of S1 as follows: 12.5% (each of P's and X's new attributed ownership of S1) x 100% (S1's ownership of S2) x 50% (S2's ownership of S1) = 6.25%. After two iterations, each of P's and X's ownership in S1 is 43.75% (25% direct ownership + 12.5% first order constructive ownership + 6.25% second order constructive ownership). Subsequent iterative calculations of each of P's and X's ownership, treating constructive ownership as actual ownership, would demonstrate that P and X each owns, directly and indirectly, 50% of the stock of S1.

(C) S1 and S2 constitute an expanded group as defined under paragraph (c)(4)(i) of this section because S1 directly owns 100% of the stock of S2. S1 is the expanded group parent of the expanded group and neither P nor X are a member of the expanded group that includes S1 and S2.

(5) Regarded owner. The term regarded owner means a person (which cannot be a disregarded entity) that is the single owner (within the meaning of §301.7701-2(c)(2)(i) of this chapter) of a disregarded entity.

(d) Treatment of deemed exchanges--(1) Debt instrument deemed to be exchanged for stock--(i) In general. If a debt instrument (as defined in §1.385-3(g)(4))

or an EGI (as defined in §1.385-2(d)(3)) is deemed to be exchanged under the section 385 regulations, in whole or in part, for stock, the holder is treated for all federal tax purposes as having realized an amount equal to the holder's adjusted basis in that portion of the debt instrument or EGI as of the date of the deemed exchange (and as having basis in the stock deemed to be received equal to that amount), and, except as provided in paragraph (d)(1)(iv)(B) of this section, the issuer is treated for all federal tax purposes as having retired that portion of the debt instrument or EGI for an amount equal to its adjusted issue price as of the date of the deemed exchange. In addition, neither party accounts for any accrued but unpaid qualified stated interest on the debt instrument or EGI or any foreign exchange gain or loss with respect to that accrued but unpaid qualified stated interest (if any) as of the deemed exchange. This paragraph (d)(1)(i) does not affect the rules that otherwise apply to the debt instrument or EGI prior to the date of the deemed exchange (for example, this paragraph (d)(1)(i) does not affect the issuer's deduction of accrued but unpaid qualified stated interest otherwise deductible prior to the date of the deemed exchange). Moreover, the stock issued in the deemed exchange is not treated as a payment of accrued but unpaid original issue discount or qualified stated interest on the debt instrument or EGI for federal tax purposes.

(ii) Section 988. Notwithstanding the first sentence of paragraph (d)(1)(i) of this section, the rules of §1.988-2(b)(13) apply to require the holder and the issuer of a debt instrument or an EGI that is deemed to be exchanged under the section 385 regulations, in whole or in part, for stock to recognize any exchange gain or loss, other than any exchange gain or loss with respect to accrued but unpaid qualified stated

interest that is not taken into account under paragraph (d)(1)(i) of this section at the time of the deemed exchange. For purposes of this paragraph (d)(1)(ii), in applying §1.988-2(b)(13) the exchange gain or loss under section 988 is treated as the total gain or loss on the exchange.

(iii) Section 108(e)(8). For purposes of section 108(e)(8), if the issuer of a debt instrument or EGI is treated as having retired all or a portion of the debt instrument or EGI in exchange for stock under paragraph (d)(1)(i) of this section, the stock is treated as having a fair market value equal to the adjusted issue price of that portion of the debt instrument or EGI as of the date of the deemed exchange.

(iv) Issuer of stock deemed exchanged for debt. For purposes of applying paragraph (d)(1)(i) of this section--

(A) A debt instrument that is issued by a disregarded entity is deemed to be exchanged for stock of the regarded owner under §§1.385-2(e)(4) and 1.385-3T(d)(4);

(B) A debt instrument that is issued by a partnership that becomes a deemed transferred receivable, in whole or in part, is deemed to be exchanged by the holder for deemed partner stock under §1.385-3T(f)(4) and the partnership is therefore not treated for any federal tax purpose as having retired any portion of the debt instrument; and

(C) A debt instrument that is issued in any situation not described in paragraph (d)(1)(iv)(A) or (B) of this section is deemed to be exchanged for stock of the issuer of the debt instrument.

(2) Stock deemed to be exchanged for newly-issued debt instrument--(i) EGIs. If an EGI treated as stock under §1.385-2(e)(1) ceases to be an EGI and is deemed to be exchanged pursuant to §1.385-2(e)(2), in whole or in part, for a newly-issued debt

instrument, the issue price of the newly-issued debt instrument is determined under either section 1273(b)(4) or 1274, as applicable.

(ii) Debt instruments recharacterized under §1.385-3. If a debt instrument treated as stock under §1.385-3(b) is deemed to be exchanged under §1.385-3(d)(2), in whole or in part, for a newly-issued debt instrument, the issue price of the newly-issued debt instrument is determined under either section 1273(b)(4) or 1274, as applicable.

(e) Indebtedness in part. [Reserved]

(f) Applicability date. This section applies to taxable years ending on or after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Par. 3. Section 1.385-2 is added to read as follows:

§1.385-2 Treatment of certain interests between members of an expanded group.

(a) In general--(1) Scope. This section provides rules for the preparation and maintenance of the documentation and information necessary for the determination of whether certain instruments will be treated as indebtedness for federal tax purposes. It also prescribes presumptions and factors as well as the weighting of certain factors to be taken into account in the making of that determination. For definitions applicable to this section, including the terms “applicable interest” and “expanded group interest” (EGI), see paragraph (d) of this section.

(2) Purpose. The rules in this section have two principal purposes. The first is to provide guidance regarding the documentation and other information that must be prepared, maintained, and provided to be used in the determination of whether an instrument subject to this section will be treated as indebtedness for federal tax

purposes. The second is to establish certain operating rules, presumptions, and factors to be taken into account in the making of any such determination. Thus, compliance with this section does not establish that an interest is indebtedness; it serves only to satisfy the minimum documentation for the determination to be made under general federal tax principles.

(3) Applicability of section. The application of this section is subject to the following limitations:

(i) Covered member. An EGI is subject to this section only if it is issued by a covered member, as defined in §1.385-1(c)(2), or by a disregarded entity, as defined in §1.385-1(c)(3), that has a regarded owner that is a covered member.

(ii) Threshold limitation--(A) In general. An EGI is subject to this section only if on the date that an applicable interest first becomes an EGI--

(1) The stock of any member of the expanded group is traded on (or subject to the rules of) an established financial market within the meaning of §1.1092(d)-1(b);

(2) Total assets exceed $100 million on any applicable financial statement (as defined in paragraph (d)(1) of this section) or combination of applicable financial statements; or

(3) Annual total revenue exceeds $50 million on any applicable financial statement or combination of applicable financial statements.

(B) Non-U.S. dollar applicable financial statements. If an applicable financial statement is denominated in a currency other than the U.S. dollar, the amount of total assets is translated into U.S. dollars at the spot rate (as defined in §1.988-1(d)) as of the date of the applicable financial statement. The amount of annual total revenue is

translated into U.S. dollars at the weighted average exchange rate (as defined in §1.989(b)-1) for the year for which the annual total revenue was calculated.

(C) Integration and combination of multiple applicable financial statements--(1) In general. If there are multiple applicable financial statements that reflect the assets, portion of the assets, or annual total revenue of different members of the expanded group, the aggregate amount of total assets and annual total revenue must be used to determine whether the threshold limitation in paragraph (a)(3)(ii)(A) of this section applies. For this purpose, the use of the aggregate amount of total assets or annual total revenue in different applicable financial statements is required except to the extent that two or more applicable financial statements reflect the total assets and annual total revenue of a member of the expanded group.

(2) Overlapping applicable financial statements. To the extent that two or more applicable financial statements reflect the total assets or annual total revenue of the same expanded group member, the applicable financial statement with the higher amount of total assets must be used for purposes of paragraph (a)(3)(ii) of this section.

(3) Overlapping assets and revenue. If there are multiple applicable financial statements that reflect the assets, portion of the assets, or revenue of the same expanded group member, any duplication (by stock, consolidation, or otherwise) of that expanded group member's assets or revenue may be disregarded for purposes of paragraph (a)(3)(ii) of this section such that the total assets or annual total revenue of that expanded group member are only reflected once.

(4) Coordination with other rules of law--(i) Substance of transaction controls. Nothing in this section prevents the Commissioner from asserting that the substance of

a transaction involving an EGI (or the EGI itself) is different from the form of the transaction (or the EGI) or treating the transaction (or the EGI) in accordance with its substance for federal tax purposes, which may involve disregarding the transaction (or the EGI).

(ii) Commissioner's authority under section 7602 unaffected. This section does not otherwise affect the authority of the Commissioner under section 7602 to request and obtain documentation and information regarding transactions and instruments that purport to create an interest in a corporation.

(iii) Covered debt instruments. If the requirements of this section are satisfied or otherwise do not apply, see §§1.385-3 and 1.385-4T for additional rules for determining whether and the extent to which an interest otherwise treated as indebtedness under general federal tax principles is recharacterized as stock for federal tax purposes.

(5) Consistency rule--(i) In general. If an issuer (as defined in paragraph (d)(4) of this section) characterizes an EGI as indebtedness, the issuer and the holder are each required to treat the EGI as indebtedness for all federal tax purposes. For purposes of this paragraph (a)(5)(i), an issuer is considered to have characterized an EGI as indebtedness if the legal form of the EGI is debt, as described in paragraph (d)(2)(i)(A) of this section. An issuer is also considered to have characterized an EGI as indebtedness if the issuer claims any federal income tax benefit with respect to an EGI resulting from characterizing the EGI as indebtedness for federal tax purposes, such as by claiming an interest deduction under section 163 in respect of interest paid or accrued on the EGI on a federal income tax return (or, if the issuer is a member of a consolidated group, the issuer or the common parent of the consolidated group claims a

federal income tax benefit by claiming such an interest deduction), or if the issuer reports the EGI as indebtedness or amounts paid or accrued on the EGI as interest on an applicable financial statement. Pursuant to section 385(c)(1), the Commissioner is not bound by the issuer's characterization of an EGI.

(ii) EGI characterized as stock. The consistency rule in paragraph (a)(5)(i) of this section and section 385(c)(1) does not apply with respect to an EGI to the extent that the EGI is treated as stock under this section or it has been determined that the EGI is treated as stock under applicable federal tax principles. In such case, the issuer and the holder are each required to treat the EGI as stock for all federal tax purposes.

(b) Documentation rules and weighting of indebtedness factors--(1) General rule. Documentation and information evidencing the indebtedness factors set forth in paragraph (c) of this section must be prepared and maintained in accordance with the provisions of this section with respect to each EGI. If the documentation and information described in paragraph (c) of this section are prepared and maintained as required by this section, the determination of whether an EGI is properly treated as indebtedness (or otherwise) for federal tax purposes will be made under general federal tax principles. If the documentation and information described in paragraph (c) of this section are not prepared and maintained in respect of an EGI in accordance with this section, and no exception listed in paragraph (b)(2) of this section applies, the EGI is treated as stock for all federal tax purposes. If a taxpayer characterizes an EGI as indebtedness but fails to provide the documentation and information described in paragraph (c)(2) of this section upon request by the Commissioner, the Commissioner will treat such documentation and information as not prepared or maintained.

(2) Exceptions from per se treatment--(i) Rebuttable presumption rules--(A) General rule. If documentation and information evidencing the indebtedness factors set forth in paragraph (c) of this section are not prepared and maintained with respect to a particular EGI but a taxpayer demonstrates that with respect to an expanded group of which the issuer and holder of the EGI are members such expanded group is otherwise highly compliant with the documentation rules (as such compliance is described in paragraph (b)(2)(i)(B) of this section), the EGI is not automatically treated as stock but is presumed, subject to rebuttal, to be stock for federal tax purposes. A taxpayer can overcome the presumption that an EGI is stock if the taxpayer clearly establishes that there are sufficient common law factors present to treat the EGI as indebtedness, including that the issuer intended to create indebtedness when the EGI was issued.

(B) High percentage of EGIs compliant with this section as evidence that the expanded group is highly compliant with the documentation rules. The rebuttable presumption in paragraph (b)(2)(i)(A) of this section applies if an expanded group of which the issuer and holder are members has a high percentage of EGIs compliant with paragraph (c) of this section. For this purpose, an expanded group is treated as having a high percentage of EGIs compliant with paragraph (c) of this section if during the calendar year in which an EGI does not meet the requirements of paragraph (c) of this section--

(1) The average total adjusted issue price of all EGIs that are undocumented (as defined in paragraph (b)(2)(i)(B)(3) of this section) and outstanding as of the close of each calendar quarter is less than 10 percent of the average amount of total adjusted issue price of all EGIs that are outstanding as of the close of each calendar quarter; or

(2) If no EGI that is undocumented during the calendar year has an issue price in excess of--

(i) $100,000,000, the average total number of EGIs that are undocumented and outstanding as of the close of each calendar quarter is less than 5 percent of the average total number of all EGIs that are outstanding as of the close of each calendar quarter; or

(ii) $25,000,000, the average total number of EGIs that are undocumented and outstanding as of the close of each calendar quarter is less than 10 percent of the average total number of all EGIs that are outstanding as of the close of each calendar quarter.

(3) Undocumented EGI. For purposes of paragraph (b)(2)(i)(B) of this section, an undocumented EGI is an EGI for which documentation has not been both prepared and maintained for one or more of the indebtedness factors in paragraph (c)(2) of this section by the time required under paragraph (c)(4) of this section.

(4) Anti-stuffing rule. If a member of the expanded group increases the adjusted issue price of EGIs outstanding on a quarterly testing date with a principal purpose of satisfying the requirements of paragraph (b)(2)(i)(B)(1) of this section or increases the number of EGIs outstanding on a quarterly testing date with a principal purpose of satisfying the requirements of paragraph (b)(2)(ii)(B)(2) of this section, such increase will not be taken into account in calculating whether a taxpayer has met these requirements.

(5) EGIs subject to this section. For purposes of determining whether the requirements of paragraph (b)(2)(i)(B)(1) or (b)(2)(i)(B)(2) of this section are met, only

EGIs subject to the rules of this section are taken into account. Thus, for example, an EGI issued by an issuer other than a covered member is not taken into account.

(C) Application of federal tax principles if presumption rebutted. If the presumption of stock treatment for federal tax purposes under paragraph (b)(2)(i)(A) of this section is rebutted, the determination of whether an EGI is properly treated as indebtedness (or otherwise) for federal tax purposes will be made under general federal tax principles. See paragraph (b)(3) of this section for the weighting of factors that must be made in this determination.

(ii) Reasonable cause--(A) In general. To the extent a taxpayer establishes that there was reasonable cause for a failure to comply, in whole or in part, with the requirements of this section, such failure will not be taken into account in determining whether the requirements of this section have been satisfied, and the character of the EGI will be determined under general federal tax principles. The principles of §301.6724-1 of this chapter apply in interpreting whether reasonable cause exists in any particular case.

(B) Requirement to document once reasonable cause established. If a taxpayer establishes that there was reasonable cause for a failure to comply, in whole or in part, with the requirements of this section, the documentation and information required under paragraph (c) of this section must be prepared within a reasonable time and maintained for the EGIs for which such reasonable cause was established.

(iii) Taxpayer discovery and remedy of ministerial or non-material failure or error. If a taxpayer discovers and corrects a ministerial or non-material failure or error in complying with this section prior to the Commissioner's discovery of the failure or error,

such failure or error will not be taken into account in determining whether the requirements of this section have been satisfied.

(3) Weighting of indebtedness factors. In applying federal tax principles to the determination of whether an EGI is indebtedness or stock, the indebtedness factors in paragraph (c)(2) of this section are significant factors to be taken into account. Other relevant factors are taken into account in the determination as lesser factors, with the relative weighting of each lesser factor based on facts and circumstances.

(c) Documentation and information to be prepared and maintained--(1) In general--(i) Application. The indebtedness factors and the documentation and information that evidence each indebtedness factor are set forth in paragraph (c)(2) of this section. The requirement to prepare and maintain documentation and information with respect to each indebtedness factor applies to each EGI separately, but the same documentation and information may satisfy the requirements of this section for more than one EGI (see paragraph (c)(2)(iii)(B) of this section for rules relating to documentation that may be applicable to multiple EGIs issued by the same issuer for purposes of the indebtedness factor in paragraph (c)(2)(iii) of this section and paragraph (c)(3)(i) of this section for rules relating to certain master arrangements). Documentation must include complete copies of all instruments, agreements, subordination agreements, and other documents evidencing the material rights and obligations of the issuer and the holder relating to the EGI, and any associated rights and obligations of other parties, such as guarantees. For documents that are executed, such copies must be copies of documents as executed. Additional documentation and information may be provided to supplement, but not substitute for, the documentation

and information required under this section.

(ii) Market standard safe harbor. Documentation of a kind customarily used in comparable third-party transactions treated as indebtedness for federal tax purposes may be used to satisfy the indebtedness factors in paragraphs (c)(2)(i) and (c)(2)(ii) of this section. Thus, for example, documentation of a kind that a taxpayer uses for trade payables with unrelated parties will generally satisfy the documentation requirements of this paragraph (c) for documenting trade payables with members of the expanded group.

(iii) EGIs with terms required by certain regulators. Notwithstanding any other provision in this paragraph (c), an EGI that is described in this paragraph (c)(1)(iii) is treated as meeting the documentation and information requirements described in this paragraph (c), provided that documentation necessary to establish that the EGI is an instrument described in this paragraph (c)(1)(iii) is prepared and maintained in accordance with paragraph (b) of this section. An EGI described in this paragraph (c)(1)(iii) is--

(A) An EGI issued by an excepted regulated financial company (as defined in §1.385-3(g)(3)(iv)) that contains terms required by a regulator of that company in order for the EGI to satisfy regulatory capital or similar rules that govern resolution or orderly liquidation of the excepted regulated financial company (including rules that require an excepted regulated financial company to issue EGIs in the form of Total Loss-Absorbing Capacity), provided that at the time of issuance it is expected that the EGI will be paid in accordance with its terms; and

(B) An EGI issued by a regulated insurance company (as defined in §1.385-

3(g)(3)(v)) that requires the issuer to receive approval or consent of an insurance regulatory authority prior to making payments of principal or interest on the EGI, provided that at the time of issuance it is expected that the EGI will be paid in accordance with its terms.

(2) Indebtedness factors relating to documentation and information to be prepared and maintained in support of indebtedness. The indebtedness factors that must be documented to establish that an EGI is indebtedness for federal tax purposes, and the documentation and information that must be prepared and maintained with respect to each such factor, are described in paragraphs (c)(2)(i) through (c)(2)(iv) of this section.

(i) Unconditional obligation to pay a sum certain. There must be written documentation establishing that the issuer has entered into an unconditional and legally binding obligation to pay a fixed or determinable sum certain on demand or at one or more fixed dates.

(ii) Creditor's rights. There must be written documentation establishing that the holder has the rights of a creditor to enforce the obligation. The rights of a creditor typically include, but are not limited to, the right to cause or trigger an event of default or acceleration of the EGI (when the event of default or acceleration is not automatic) for non-payment of interest or principal when due under the terms of the EGI and the right to sue the issuer to enforce payment. The rights of a creditor must include rights that are superior to the rights of shareholders (other than holders of interests treated as stock solely by reason of §1.385-3) to receive assets of the issuer in case of dissolution. An EGI that is a nonrecourse obligation has creditor's rights for this purpose if it

provides sufficient remedies against a specified subset of the issuer's assets. For purposes of this paragraph (c)(2)(ii), creditor's rights may be provided either in the legal agreements that contain the terms of the EGI or under local law. If local law provides for creditor's rights under an EGI even if such rights are not specified in the legal agreements that contain the terms of the EGI, such creditor's rights do not need to be included in the EGI provided that written documentation for purposes of this paragraph (c)(2)(ii) contains a reference to the provisions of local law providing such rights.

(iii) Reasonable expectation of ability to repay EGI--(A) In general. There must be written documentation containing information establishing that, as of the date of issuance of the applicable interest and taking into account all relevant circumstances (including all other obligations incurred by the issuer as of the date of issuance of the applicable interest or reasonably anticipated to be incurred after the date of issuance of the applicable interest), the issuer's financial position supported a reasonable expectation that the issuer intended to, and would be able to, meet its obligations pursuant to the terms of the applicable interest. Documentation in respect of an EGI that is nonrecourse under its terms must include information on any cash and property that secures the EGI, including--

(1) The fair market value of publicly traded property that is recourse property with respect to the EGI; and

(2) An appraisal (if any) of recourse property that was prepared pursuant to the issuance of the EGI or within the three years preceding the issuance of the EGI. Thus, the documentation required by this paragraph (c)(2)(iii)(A) does not require that an appraisal be prepared for non-publicly traded property that secures nonrecourse debt,

but does require that the documentation include any appraisal that was prepared for any purpose.

(B) Documentation of ability to pay applicable to multiple EGIs issued by same issuer--(1) In general. Written documentation that applies to more than one EGI issued by a single issuer may be prepared on an annual basis to satisfy the requirements in paragraph (c)(2)(iii)(A) of this section (an annual credit analysis). An annual credit analysis can be used to support the reasonable expectation that the issuer has the ability to repay multiple EGIs, including a specified combined amount of indebtedness, provided any such EGIs are issued on any day within the 12-month period beginning on the date the analysis in the annual credit analysis is based on (an analysis date). An annual credit analysis must establish that, as of its analysis date and taking into account all relevant circumstances (including all other obligations incurred by the issuer as of such analysis date or reasonably anticipated to be incurred after such analysis date), the issuer's financial position supported a reasonable expectation that the issuer would be able to pay interest and principal in respect of the amount of indebtedness set forth in the annual credit analysis.

(2) Material event of the issuer. If there is a material event (as defined in paragraph (d)(5) of this section) with respect to the issuer within the year beginning on the analysis date for written documentation described in paragraph (c)(2)(iii)(B)(1) of this section, such written documentation may not be used to satisfy the requirements in paragraph (c)(2)(iii)(A) of this section for EGIs with relevant dates (as described in paragraph (c)(4) of this section) on or after the date of the material event. However, an additional set of written documentation described in paragraph (c)(2)(iii)(B)(1) of this

section may be prepared with an analysis date on or after the date of the material event of the issuer.

(C) Third party reports or analysis. If any member of an expanded group relied on any report or analysis prepared by a third party in analyzing whether the issuer would be able to meet its obligations pursuant to the terms of the EGI, the documentation must include the report or analysis. If the report or analysis is protected or privileged under law governing an inquiry or proceeding with respect to the EGI and the protection or privilege is asserted, neither the existence nor the contents of the report or analysis is taken into account in determining whether the requirements of this section are satisfied.

(D) EGI issued by disregarded entity. For purposes of this paragraph (c)(2)(iii), if a disregarded entity is the issuer of an EGI, and the owner of the disregarded entity has limited liability within the meaning of §301.7701-3(b)(2)(ii) of this chapter, only the assets and liabilities and the financial position of the disregarded entity are relevant for purposes of paragraph (c)(2)(iii)(A) of this section. If the owner of such a disregarded entity does not have limited liability within the meaning of §301.7701-3(b)(2)(ii) of this chapter (including by reason of a guarantee, keepwell, or other agreement), all of the assets and liabilities, and the financial position of the disregarded entity and the owner are relevant for purposes of paragraph (c)(2)(iii)(A) of this section.

(E) Acceptable documentation. The documentation required under this paragraph (c)(2)(iii) may include cash flow projections, financial statements, business forecasts, asset appraisals, determination of debt-to-equity and other relevant financial ratios of the issuer in relation to industry averages, and other information regarding the

sources of funds enabling the issuer to meet its obligations pursuant to the terms of the applicable interest. For this purpose, such documentation may assume that the principal amount of an EGI may be satisfied with the proceeds of another borrowing by the issuer, provided that such assumption is reasonable. Documentation required under paragraph (c)(2) of this section may be prepared by employees of expanded group members, by agents of expanded group members or by third parties.

(F) Third party financing terms. Documentation required under this paragraph (c)(2)(iii) may include evidence that a third party lender would have made a loan to the issuer with the same or substantially similar terms as the EGI.

(iv) Actions evidencing debtor-creditor relationship--(A) Payments of principal and interest. If an issuer made any payment of interest or principal with respect to the EGI (whether in accordance with the terms of the EGI or otherwise, including prepayments), and such payment is claimed to support the treatment of the EGI as indebtedness under federal tax principles, documentation must include written evidence of such payment. Such evidence could include, for example, a wire transfer record or a bank statement. Such evidence could also include a netting of payables or receivables between the issuer and holder, or payments of interest, evidenced by journal entries in a centralized cash management system or in the accounting system of the expanded group (or a subset of the members of the expanded group) reflecting the payment.

(B) Events of default and similar events--(1) Enforcement of creditor's rights. If the issuer did not make a payment of interest or principal that was due and payable under the terms of the EGI, or if any other event of default or similar event has occurred, there must be written documentation evidencing the holder's reasonable exercise of the

diligence and judgment of a creditor. Such documentation may include evidence of the holder's assertion of its rights under the terms of the EGI, including the parties' efforts to renegotiate the EGI or to mitigate the breach of an obligation under the EGI, or any change in material terms of the EGI, such as maturity date, interest rate, or obligation to pay interest or principal.

(2) Non-enforcement of creditor's rights. If the holder does not enforce its rights with respect to a payment of principal or interest, or with respect to an event of default or similar event, there must be documentation that supports the holder's decision to refrain from pursuing any actions to enforce payment as being consistent with the reasonable exercise of the diligence and judgment of a creditor. For example, if the issuer is unable to make a timely payment of principal or interest and the holder reasonably believes that the issuer's business or cash flow will improve such that the issuer will be able to comply with the terms of the EGI, the holder may be exercising the reasonable diligence and judgment of a creditor by granting an extension of time for the issuer to pay such interest or principal. However, if a holder fails to enforce its rights and there is no documentation explaining this failure, the holder will not be treated as exercising the reasonable due diligence and judgment of a creditor. See, however, §1.1001-3(c)(4)(ii) for rules regarding when a forbearance may be a modification of a debt instrument and therefore may result in an exchange subject to §1.1001-1(a).

(3) Special documentation rules--(i) Agreements that cover multiple EGIs--(A) Revolving credit agreements, omnibus, umbrella, master, cash pool, and similar agreements--(1) In general. If an EGI is not evidenced by a separate note or other writing executed with respect to the initial principal balance or any increase in principal

balance (for example, an EGI documented as a revolving credit agreement, a cash pool agreement, an omnibus or umbrella agreement that governs open account obligations or any other identified set of payables or receivables, or a master agreement that sets forth general terms of an EGI with an associated schedule or ticket that sets forth the specific terms of an EGI), the EGI is subject to the special rules of this paragraph (c)(3)(i)(A). A notional cash pool is subject to the rules of this paragraph (c)(3)(i) to the extent that the notional cash pool would be treated as an EGI issued directly between expanded group members.

(2) Special rules with respect to paragraphs (c)(2)(i) and (c)(2)(ii) of this section regarding unconditional obligation to pay a sum certain and creditor's rights. An EGI subject to the special rules of paragraph (c)(3)(i)(A) of this section satisfies the requirements of paragraphs (c)(2)(i) and (c)(2)(ii) of this section only if the material documentation associated with the EGI, including all relevant enabling documents, is prepared and maintained in accordance with the requirements of this section. Relevant enabling documents may include board of directors' resolutions, credit agreements, omnibus agreements, security agreements, or agreements prepared in connection with the execution of the legal documents governing the EGI as well as any relevant documentation executed with respect to an initial principal balance or increase in the principal balance of the EGI.

(3) Special rules under paragraph (c)(2)(iii) of this section regarding reasonable expectation of ability to repay--(i) In general. If an EGI is issued under an agreement described in paragraph (c)(3)(i)(A) of this section, written documentation must be prepared with respect to the date used for the analysis (an analysis date) and written

documentation with a new analysis date must prepared at least annually to satisfy the requirements in paragraph (c)(2)(iii) of this section for EGIs issued under such an agreement on or after the most recent analysis date. Such written documentation satisfies the requirements in paragraph (c)(2)(iii) of this section with respect to EGIs issued under such an agreement on any day within the year beginning on the analysis date of the annual credit analysis. Such written documentation must contain information establishing that, as of the analysis date of the annual credit analysis and taking into account all relevant circumstances (including all other obligations incurred by the issuer as of the analysis date of the written documentation or reasonably anticipated to be incurred after the analysis date of the written documentation), the issuer's financial position supported a reasonable expectation that the issuer would be able to pay interest and principal in respect of the maximum principal amount permitted under the terms of the revolving credit agreement, omnibus, umbrella, master, cash pool or similar agreement. Notwithstanding the foregoing, written documentation described in paragraph (c)(2)(iii)(B) of this section can be used to satisfy the requirements in paragraph (c)(2)(iii)(A) of this section with respect to such EGIs.

(ii) Material event of the issuer. If there is a material event with respect to the issuer within the year beginning on the analysis date for the written documentation described in paragraph (c)(3)(i)(A)(3) of this section, such written documentation may not be used to satisfy the requirements in paragraph (c)(3)(i)(A)(3) of this section for EGIs with relevant dates (as described in paragraph (c)(4) of this section) on or after the date of the material event. However, an additional set of written documentation as described in paragraph (c)(3)(i)(A)(3) of this section may be prepared with an analysis

date on the date of the material event of the issuer or if subsequent EGIs are issued, with respect to those issuances.

(B) Additional requirements for cash pooling arrangements. Notwithstanding paragraphs (c)(2)(i) and (c)(2)(ii) of this section, and in addition to the requirements in paragraph (c)(3)(i)(A)(2) of this section, if an EGI is issued pursuant to a cash pooling arrangement (including a notional cash pooling arrangement) or internal banking service that involves account sweeps, revolving cash advance facilities, overdraft set-off facilities, operational facilities, or similar features, the EGI satisfies the requirements of paragraphs (c)(2)(i) and (c)(2)(ii) of this section only if the material documentation governing the ongoing operations of the cash pooling arrangement or internal banking service, including any agreements with entities that are not members of the expanded group, are also prepared and maintained in accordance with the requirements of this section. Such documentation must contain the relevant legal rights and obligations of any members of the expanded group and any entities that are not members of the expanded group in conducting the operation of the cash pooling arrangement or internal banking service.

(ii) Debt not in form. [Reserved]

(4) Timely preparation requirement--(i) General rule. Documentation and information required under this section must be timely prepared. For purposes of this section, documentation is treated as timely prepared if it is completed no later than the time for filing the issuer's federal income tax return (taking into account any applicable extensions) for the taxable year that includes the relevant date for such documentation or information, as specified in paragraph (c)(4)(ii) of this section.

(ii) Relevant date. For purposes of this paragraph (c)(4), the term relevant date has the following meaning:

(A) Issuer's obligation, creditor's rights. For documentation and information described in paragraphs (c)(2)(i) and (ii) of this section (relating to an issuer's unconditional obligation to repay and establishment of holder's creditor's rights), the relevant date is the date on which a covered member becomes an issuer of a new or existing EGI. A relevant date for such documentation and information does not include the date of any deemed issuance of the EGI resulting from as exchange under §1.1001-3 unless such deemed issuance relates to an alteration in the terms of the EGI reflected in an express written agreement or written amendment to the EGI. In the case of an applicable interest that becomes an EGI subsequent to issuance, including an intercompany obligation, as defined in §1.1502-13(g)(2)(ii), that ceases to be an intercompany obligation, the relevant date is the day on which the applicable interest becomes an EGI.

(B) Reasonable expectation of payment--(1) In general. For documentation and information described in paragraph (c)(2)(iii) of this section (relating to reasonable expectation of issuer's repayment), each date on which a covered member of the expanded group becomes an issuer with respect to an EGI and any later date on which an issuance is deemed to occur under §1.1001-3, and any date described in the special rules in paragraph (c)(4)(ii)(E) of this section, is a relevant date for that EGI. In the case of an applicable interest that becomes an EGI subsequent to issuance, the relevant date is the day on which the applicable interest becomes an EGI and any relevant date after the date that the applicable interest becomes an EGI.

(2) Annual credit analysis--(i) With respect to documentation described in paragraph (c)(2)(iii)(B) of this section (documentation of ability to pay applicable to multiple EGIs issued by same issuer), the relevant date is the date used for the analysis in the annual credit analysis that is first prepared and the annual anniversary of such date unless a material event has occurred in respect of the issuer.

(ii) Material event. With respect to the documentation described in paragraph (c)(2)(iii)(B) of this section, the date on which a material event has occurred in respect of an issuer is also a relevant date. If the precise date on which a material event occurred is uncertain, a taxpayer may choose a date on which the taxpayer reasonably believes that the material event occurred. If documentation described in paragraph (c)(2)(iii)(B) of this section is prepared with the relevant date of a material event, the next relevant date will be the annual anniversary of that relevant date (unless another material event occurs in respect of the issuer).

(C) Subsequent actions--(1) Payment. For documentation and information described in paragraph (c)(2)(iv)(A) of this section (relating to payments of principal and interest), each date on which a payment of interest or principal is due, taking into account all additional time permitted under the terms of the EGI before there is (or holder can declare) an event of default for nonpayment, is a relevant date.

(2) Default. For documentation and information described in paragraph (c)(2)(iv)(B) of this section (relating to events of default and similar events), each date on which an event of default, acceleration event or similar event occurs under the terms of the EGI is a relevant date. For example, if the terms of the EGI require the issuer to maintain a certain financial ratio, any date on which the issuer fails to maintain the

specified financial ratio (and such failure results in an event of default under the terms of the EGI) is a relevant date.

(D) Applicable interest that becomes an EGI. In the case of an applicable interest that becomes an EGI subsequent to issuance, no date before the applicable interest becomes an EGI is a relevant date.

(E) Revolving credit agreements, omnibus, umbrella, master, cash pool, and similar agreements--(1) Relevant dates for purposes of indebtedness factors in paragraphs (c)(2)(i) and (c)(2)(ii) of this section for overall arrangements. In the case of an arrangement described in paragraph (c)(3)(i)(A) of this section for purposes of the indebtedness factors in paragraphs (c)(2)(i) and (c)(2)(ii) of this section, each of the following dates is a relevant date:

(i) The date of the execution of the legal documents governing the overall arrangement.

(ii) The date of any amendment to those documents that provides for an increase in the maximum amount of principal.

(iii) The date of any amendment to those documents that permits an additional entity to borrow under the documents (but only with respect to EGIs issued by that entity).

(2) Relevant dates for purposes of indebtedness factor in paragraph (c)(2)(iii) of this section for overall arrangements. The relevant dates with respect to the arrangements described in paragraph (c)(3)(i)(A) of this section for purposes of the indebtedness factor in paragraph (c)(2)(iii) of this section are--

(i) Each anniversary of the date of execution of the legal documents during the

life of the legal documents; and

(ii) The date that a material event has occurred in respect of an issuer, unless the precise date on which a material event occurred is uncertain, in which case a taxpayer may use a date on which the taxpayer reasonably believes that the material event occurred.

(3) Relevant dates for EGIs documented under an overall arrangement. A relevant date of an EGI under paragraphs (c)(4)(ii)(A) through (C) of this section is also a relevant date for each EGI documented under an overall arrangement described in paragraph (c)(2)(iii) of this section.

(5) Maintenance requirements. The documentation and information described in paragraph (c) of this section must be maintained for all taxable years that the EGI is outstanding and until the period of limitations expires for any federal tax return with respect to which the treatment of the EGI is relevant. See section 6001 (requirement to keep books and records).

(d) Definitions. For purposes of this section, the following definitions apply:

(1) Applicable financial statement. The term applicable financial statement means a financial statement that is described in paragraphs (d)(1)(i) through (iii) of this section, that includes the assets, portion of the assets, or annual total revenue of any member of the expanded group, and that is prepared as of any date within 3 years prior to the date the applicable interest at issue first becomes an EGI. The financial statement may be a separate company financial statement of any member of the expanded group, if done in the ordinary course; otherwise, it is the consolidated financial statement that includes the assets, portion of the assets, or annual total

revenue of any member of the expanded group. A financial statement includes--

(i) A financial statement required to be filed with the Securities and Exchange Commission (the Form 10-K or the Annual Report to Shareholders);

(ii) A certified audited financial statement that is accompanied by the report of an independent certified public accountant (or in the case of a foreign entity, by the report of a similarly qualified independent professional) that is used for--

(A) Credit purposes;

(B) Reporting to shareholders, partners, or similar persons; or

(C) Any other substantial non-tax purpose; or

(iii) A financial statement (other than a tax return) required to be provided to the federal, state, or foreign government or any federal, state, or foreign agency.

(2) Applicable interest--(i) In general. Except to the extent provided in paragraph (d)(2)(ii) and (iii) of this section, the term applicable interest means--

(A) Any interest that is issued or deemed issued in the legal form of a debt instrument, which therefore does not include, for example, a sale-repurchase agreement treated as indebtedness under federal tax principles; or

(B) An intercompany payable and receivable documented as debt in a ledger, accounting system, open account intercompany debt ledger, trade payable, journal entry or similar arrangement if no written legal instrument or written legal arrangement governs the legal treatment of such payable and receivable.

(ii) Certain intercompany obligations and statutory or regulatory debt instruments excluded. The term applicable interest does not include--

(A) An intercompany obligation as defined in §1.1502-13(g)(2)(ii) or an interest

issued by a member of a consolidated group and held by another member of the same consolidated group, but only for the period during which both parties are members of the same consolidated group; for this purpose, a member includes any disregarded entity owned by a member;

(B) Production payments treated as a loan under section 636(a) or (b);

(C) A "regular interest" in a real estate mortgage investment conduit described in section 860G(a)(1);

(D) A debt instrument that is deemed to arise under §1.482-1(g)(3) (including adjustments made pursuant to Revenue Procedure 99-32, 1999-2 C.B. 296); or

(E) Any other instrument or interest that is specifically treated as indebtedness for federal tax purposes under a provision of the Internal Revenue Code or the regulations thereunder.

(iii) Interests issued before January 1, 2018. The term applicable interest does not include any interest issued or deemed issued before January 1, 2018.

(3) Expanded Group Interest (EGI). The term expanded group interest (EGI) means an applicable interest the issuer of which is a member of an expanded group (or a disregarded entity whose regarded owner is a member of an expanded group) and the holder of which is another member of the same expanded group, a disregarded entity whose regarded owner is another member of the same expanded group, or a controlled partnership (as defined in §1.385-1(c)(1)) with respect to the same expanded group.

(4) Issuer. Solely for purposes of this section, the term issuer means a person (including a disregarded entity defined in §1.385-1(c)(3)) that is obligated to satisfy any material obligations created under the terms of an EGI. A person can be an issuer if

that person is expected to satisfy a material obligation under an EGI, even if that person is not the primary obligor. A guarantor, however, is not an issuer unless the guarantor is expected to be the primary obligor. An issuer may include a person that, after the date that the EGI is issued, becomes obligated to satisfy a material obligation created under the terms of an EGI. For example, a person that becomes a co-obligor on an EGI after the date of issuance of the EGI is an issuer of the EGI for purposes of this section if such person is expected to satisfy the obligations thereunder without indemnification.

(5) Material event. The term material event means, with respect to an entity--

(i) The entity comes under the jurisdiction of a court in a case under--

(A) Title 11 of the United States Code (relating to bankruptcy); or

(B) A receivership, foreclosure, or similar proceeding in a federal or state court;

(ii) The entity becomes insolvent within the meaning of section 108(d)(3);

(iii) The entity materially changes its line of business;

(iv) The entity sells, alienates, distributes, leases, or otherwise disposes of 50 percent or more of the total fair market value of its included assets; or

(v) The entity consolidates or merges into another person and the person formed by or surviving such merger or consolidation does not assume liability for any of the entity's outstanding EGIs as of the time of the merger or consolidation.

(6) Included assets. The term included assets means, with respect to an entity all assets other than--

(i) Inventory sold in the ordinary course of business;

(ii) Assets contributed to another entity in exchange for equity in such entity; and

(iii) Investment assets such as portfolio stock investments to the extent that other

investment assets or cash of equivalent value is substituted.

(7) Regarded owner. For purposes of this section, the term regarded owner means a person (that is that is not a disregarded entity) that is the single owner (within the meaning of §301.7701-2(c)(2) of this chapter) of a disregarded entity.

(e) Operating rules--(1) Applicable interest that becomes an EGI. If an applicable interest that is not an EGI becomes an EGI, this section applies to the applicable interest immediately after the applicable interest becomes an EGI and at all times thereafter during which the applicable interest remains an EGI.

(2) EGI treated as stock ceases to be an EGI. If an EGI treated as stock due to the application of this section ceases to be an EGI, the character of the applicable interest is determined under general federal tax principles at the time that the applicable interest ceases to be an EGI. If the applicable interest is characterized as indebtedness under general federal tax principles, the issuer is treated for federal tax purposes as issuing a new debt instrument to the holder in exchange for the EGI immediately before the transaction that causes the EGI to cease to be treated as an EGI in a transaction that is disregarded for purposes of §1.385-3(b)(2) and (3). See §1.385-1(d).

(3) Date of characterizations under this section--(i) In general. If an applicable interest that is an EGI when issued is determined to be stock due to the application of this section, the EGI is treated as stock from the date it was issued. However, if an applicable interest that is not an EGI when issued subsequently becomes an EGI and is then determined to be stock due to the application of this section, the EGI is treated as stock as of the date it becomes an EGI.

(ii) Recharacterization of EGI based on behavior of issuer or holder after

issuance. Notwithstanding paragraph (e)(3)(i) of this section, if an EGI initially treated as indebtedness is recharacterized as stock as a result of failing to satisfy paragraph (c)(2)(iv) of this section (actions evidencing debtor-creditor relationship), the EGI will cease to be treated as indebtedness as of the time the facts and circumstances regarding the behavior of the issuer or the holder with respect to the EGI cease to evidence a debtor-creditor relationship. For purposes of determining whether an EGI originally treated as indebtedness ceases to be treated as indebtedness by reason of paragraph (c)(2)(iv) of this section, the rules of this section apply before the rules of §1.1001-3. Thus, an EGI initially treated as indebtedness may be recharacterized as stock regardless of whether the indebtedness is altered or modified (as defined in §1.1001-3(c)) and, in determining whether indebtedness is recharacterized as stock, §1.1001-3(f)(7)(ii)(A) does not apply.

(4) Disregarded entities of regarded corporate owners. This paragraph (e)(4) applies to an EGI issued by a disregarded entity, the regarded owner of which is a covered member, if such EGI would, absent the application of this paragraph (e)(4), be treated as stock under this section. In this case, rather than the EGI being treated as stock, the covered member that is the regarded owner of the disregarded entity is deemed to issue its stock in the manner described in this paragraph (e)(4). If the EGI would have been recharacterized as stock from the date it was issued under paragraph (e)(3)(i) of this section, then the covered member is deemed to issue its stock to the actual holder to which the EGI was, in form, issued. If the EGI would have been recharacterized as stock at any other time, then the covered member is deemed to issue its stock to the holder of the EGI in exchange for the EGI. In each case, the

covered member that is the regarded owner of the disregarded entity is treated as the holder of the EGI issued by the disregarded entity, and the actual holder is treated as the holder of the stock deemed to be issued by the regarded owner. Under federal tax principles, the EGI issued by the disregarded entity generally is disregarded. The stock deemed issued is deemed to have the same terms as the EGI issued by the disregarded entity, other than the identity of the issuer, and payments on the stock are determined by reference to payments made on the EGI issued by the disregarded entity.

(f) Anti-avoidance. If an applicable interest that is not an EGI is issued with a principal purpose of avoiding the application of this section, the applicable interest is treated as an EGI subject to this section.

(g) Affirmative use. [Reserved]

(h) Example. The following example illustrates the rules of this section. Except as otherwise stated, the following facts are assumed for purposes of the example in this paragraph (h):

(1) FP is a foreign corporation that owns 100% of the stock of USS1, a domestic corporation, and 100% of the stock of USS2, a domestic corporation.

(2) USS1 and USS2 file separate federal income tax returns and have a calendar year taxable year.

(3) USS1 and USS2 timely file their federal income tax returns on September 15 of the calendar year following each taxable year.

(4) FP is traded on an established financial market within the meaning of §1.1092(d)-1(b).

Example. Application of paragraphs (c)(2)(iii) and (c)(4) of this section to an EGI-(i) Facts. USS1 issues an EGI (EGI A) to FP on Date A in Year 1. USS1 issues an EGI (EGI B) to USS2 on Date B in Year 1. Date B is after Date A. USS1 issues another EGI (EGI C) to FP on Date A in Year 2. USS1 prepares documentation sufficient to meet the requirements of paragraphs (c)(2)(i) and (ii) of this section on or before September 15 of Year 2. USS1, FP and USS2 also contemporaneously document the timely payment of interest by USS1 on EGI A and EGI B sufficient to meet the requirements of paragraph (c)(2)(iv) of this section. USS1 prepares documentation on Date C in Year 2, which is prior to September 15, to satisfy the requirements of paragraph (c)(2)(iii)(B) of this section (the credit analysis). The credit analysis concludes that as of Date B in Year 1, USS1 would be able to pay interest and principal on an amount greater than the combined principal amounts of EGI A, EGI B and EGI C.

(ii) Analysis. (A) P, USS1, and USS2 are members of an expanded group. Because FP is traded on an established financial market within the meaning of §1.1092(d)-1(b) and USS1 is a covered issuer, EGI A, EGI B, and EGI C are subject to the rules of this section.

(B) The documentation evidencing USS1's obligation to pay a sum certain and the creditor's rights of the holders was prepared by September 15, Year 2, which is the time for filing USS1's federal income tax return (taking into account any applicable extensions) for the taxable year that includes the relevant date specified in paragraph (c)(4)(ii)(A) of this section. Thus, USS1 is treated as having timely documented its obligation to pay a sum certain and the creditor's rights of the holders of EGI A and EGI B for purposes of paragraph (c)(4)(i) of this section.

(C) The credit analysis was prepared with a relevant date of Date B of Year 1. EGI A was issued prior to Date B in Year 1. Under paragraph (c)(4)(ii)(B) of this section, the date when USS1 became an issuer of EGI A (Date A of Year 1) is a relevant date for the documentation and information described in paragraph (c)(2)(iii) of this section. As a result, EGI A does not satisfy the indebtedness factor in paragraph (c)(2)(iii) of this section (reasonable expectation of ability to repay EGI).

(D) Similarly, under paragraph (c)(4)(ii)(B) of this section, the date when USS1 became an issuer of EGI B (Date B of Year 1) is a relevant date for the documentation and information described in paragraph (c)(2)(iii) of this section. The credit analysis was timely prepared under paragraph (c)(4)(i) of this section because it was prepared before the filing of the USS1 federal income tax return for Year 1. As a result, EGI B does satisfy the indebtedness factor in paragraph (c)(2)(iii) of this section (reasonable expectation of ability to repay EGI).

(E) Finally, the date when USS1 became an issuer of EGI C (Date A of Year 2) is also a relevant date for the documentation and information described in paragraph (c)(2)(iii) of this section. Under paragraph (c)(2)(iii)(B) of this section, the credit analysis can be used to support the reasonable expectation that USS1 has the ability to repay multiple EGIs issued on any day within the 12-month period following the analysis date.

Date A of Year 2 is within the 12-month period following the analysis date. The credit analysis was timely prepared under paragraph (c)(4)(i) of this section because it was prepared before the filing of the USS1 federal income tax return for Year 2. As a result, EGI C does satisfy the indebtedness factor in paragraph (c)(2)(iii) of this section (reasonable expectation of ability to repay EGI).

(i) Applicability date. This section applies to taxable years ending on or after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Par. 4. Section 1.385-3 is added to read as follows:

§1.385-3 Transactions in which debt proceeds are distributed or that have a similar effect.

(a) Scope. This section sets forth factors that control the determination of whether an interest is treated as stock or indebtedness. Specifically, this section addresses the issuance of a covered debt instrument to a related person as part of a transaction or series of transactions that does not result in new investment in the operations of the issuer. Paragraph (b) of this section sets forth rules for determining when these factors are present, such that a covered debt instrument is treated as stock under this section. Paragraph (c) of this section provides exceptions to the application of paragraph (b) of this section. Paragraph (d) of this section provides operating rules. Paragraph (e) of this section reserves on the affirmative use of this section. Paragraph (f) of this section provides rules for the aggregate treatment of controlled partnerships. Paragraph (g) of this section provides definitions. Paragraph (h) of this section provides examples illustrating the application of the rules of this section. Paragraph (j) of this section provides dates of applicability. For rules regarding the application of this section to members of a consolidated group, see generally §1.385-4T.

(b) Covered debt instrument treated as stock--(1) Effect of characterization as

stock. Except as otherwise provided in paragraph (d)(7) of this section, to the extent a covered debt instrument is treated as stock under paragraphs (b)(2), (3), or (4) of this section, it is treated as stock for all federal tax purposes.

(2) General rule. Except as otherwise provided in paragraphs (c) and (e) of this section, a covered debt instrument is treated as stock to the extent the covered debt instrument is issued by a covered member to a member of the covered member's expanded group in one or more of the following transactions:

(i) In a distribution;

(ii) In exchange for expanded group stock, other than in an exempt exchange; or

(iii) In exchange for property in an asset reorganization, but only to the extent that, pursuant to the plan of reorganization, a shareholder in the transferor corporation that is a member of the issuer's expanded group immediately before the reorganization receives the covered debt instrument with respect to its stock in the transferor corporation.

(3) Funding rule--(i) In general. Except as otherwise provided in paragraphs (c) and (e) of this section, a covered debt instrument that is not a qualified short-term debt instrument (as defined in paragraph (b)(3)(vii) of this section) is treated as stock to the extent that it is both issued by a covered member to a member of the covered member's expanded group in exchange for property and, pursuant to paragraph (b)(3)(iii) or (b)(3)(iv) of this section, treated as funding a distribution or acquisition described in one or more of paragraphs (b)(3)(i)(A) through (C) of this section. A covered member that makes a distribution or acquisition described in paragraphs (b)(3)(i)(A) through (C) is referred to as a "funded member," regardless of when it issues a covered debt

instrument in exchange for property.

(A) A distribution of property by the funded member to a member of the funded member's expanded group, other than in an exempt distribution;

(B) An acquisition of expanded group stock, other than an exempt exchange, by the funded member from a member of the funded member's expanded group in exchange for property other than expanded group stock; or

(C) An acquisition of property by the funded member in an asset reorganization but only to the extent that, pursuant to the plan of reorganization, a shareholder in the transferor corporation that is a member of the funded member's expanded group immediately before the reorganization receives other property or money within the meaning of section 356 with respect to its stock in the transferor corporation.

(ii) Transactions described in more than one paragraph. For purposes of this section, to the extent that a distribution or acquisition by a funded member is described in more than one of paragraphs (b)(3)(i)(A) through (C) of this section, the funded member is treated as making only a single distribution or acquisition described in paragraph (b)(3)(i) of this section. In the case of an asset reorganization, to the extent an acquisition by the transferee corporation is described in paragraph (b)(3)(i)(C) of this section, a distribution or acquisition by the transferor corporation is not also described in paragraph (b)(3)(i)(A) through (C) of this section. For purposes of this paragraph (b)(3)(ii), whether a distribution or acquisition is described in paragraphs (b)(3)(i)(A) through (C) of this section is determined without regard to paragraph (c) of this section.

(iii) Per se funding rule--(A) In general. A covered debt instrument is treated as funding a distribution or acquisition described in paragraphs (b)(3)(i)(A) through (C) of

this section if the covered debt instrument is issued by a funded member during the period beginning 36 months before the date of the distribution or acquisition, and ending 36 months after the date of the distribution or acquisition (per se period).

(B) Multiple interests. If, pursuant to paragraph (b)(3)(iii)(A) of this section, two or more covered debt instruments may be treated as stock by reason of this paragraph (b)(3), the covered debt instruments are tested under paragraph (b)(3)(iii)(A) of this section based on the order in which they are issued, with the earliest issued covered debt instrument tested first. See paragraph (h)(3) of this section, Example 6, for an illustration of this rule.

(C) Multiple distributions or acquisitions. If, pursuant to paragraph (b)(3)(iii)(A) of this section, a covered debt instrument may be treated as funding more than one distribution or acquisition described in paragraphs (b)(3)(i)(A) through (C) of this section, the covered debt instrument is treated as funding one or more distributions or acquisitions based on the order in which the distributions or acquisitions occur, with the earliest distribution or acquisition treated as the first distribution or acquisition that is funded. See paragraph (h)(3) of this section, Example 9, for an illustration of this rule.

(D) Transactions that straddle different expanded groups--(1) In general. For purposes of paragraph (b)(3)(iii)(A) of this section, a covered debt instrument is not treated as issued by a funded member during the per se period with respect to a distribution or acquisition described in paragraphs (b)(3)(i)(A) through (C) of this section if all of the conditions described in paragraphs (b)(3)(iii)(D)(1)(i) through (iii) of this section are satisfied.

(i) The distribution or acquisition occurs prior to the issuance of the covered debt

instrument by the funded member or, if the funded member is treated as making the distribution or acquisition of a predecessor or a successor, the predecessor or successor is not a member of the expanded group of which the funded member is a member on the date on which the distribution or the acquisition occurs.

(ii) The distribution or acquisition is made by the funded member when the funded member is a member of an expanded group that does not have an expanded group parent that is the funded member's expanded group parent when the covered debt instrument is issued. For purposes of the preceding sentence, a reference to an expanded group parent includes a reference to a predecessor or successor of the expanded group parent.

(iii) On the date of the issuance of the covered debt instrument, the recipient member (as defined in paragraph (b)(3)(iii)(D)(2) of this section) is neither a member nor a controlled partnership of an expanded group of which the funded member is a member.

(2) Recipient member. For purposes of this paragraph (b)(3)(iii)(D), the term recipient member means, with respect to a distribution or acquisition by a funded member described in paragraphs (b)(3)(i)(A) through (C) of this section, the expanded group member that receives a distribution of property, property in exchange for expanded group stock, or other property or money within the meaning of section 356 with respect to its stock in the transferor corporation. For purposes of this paragraph (b)(3)(iii)(D), a reference to the recipient member includes a predecessor or successor of the recipient member or one or more other entities that, in the aggregate, acquire substantially all of the property of the recipient member.

(E) Modifications of a covered debt instrument--(1) In general. For purposes of paragraph (b)(3)(iii)(A) of this section, if a covered debt instrument is treated as exchanged for a modified covered debt instrument pursuant to §1.1001-3(b), the modified covered debt instrument is treated as issued on the original issue date of the covered debt instrument.

(2) Effect of certain modifications. Notwithstanding paragraph (b)(3)(iii)(E)(1) of this section, if a covered debt instrument is treated as exchanged for a modified covered debt instrument pursuant to §1.1001-3(b) and the modification, or one of the modifications, that results in the deemed exchange includes the substitution of an obligor on the covered debt instrument, the addition or deletion of a co-obligor on the covered debt instrument, or the material deferral of scheduled payments due under the covered debt instrument, then the covered debt instrument is treated as issued on the date of the deemed exchange for purposes of paragraph (b)(3)(iii)(A) of this section.

(3) Additional principal amount. For purposes of paragraph (b)(3)(iii)(A) of this section, if the principal amount of a covered debt instrument is increased, the portion of the covered debt instrument attributable to such increase is treated as issued on the date of such increase.

(iv) Principal purpose rule. For purposes of this paragraph (b)(3), a covered debt instrument that is not issued by a funded member during the per se period with respect to a distribution or acquisition described in paragraphs (b)(3)(i)(A) through (C) of this section is treated as funding the distribution or acquisition to the extent that it is issued by a funded member with a principal purpose of funding a distribution or acquisition described in paragraphs (b)(3)(i)(A) through (C) of this section. Whether a covered debt

instrument is issued with a principal purpose of funding a distribution or acquisition described in paragraphs (b)(3)(i)(A) through (C) of this section is determined based on all the facts and circumstances. A covered debt instrument may be treated as issued with a principal purpose of funding a distribution or acquisition described in paragraphs (b)(3)(i)(A) through (C) of this section regardless of whether it is issued before or after the distribution or acquisition.

(v) Predecessors and successors--(A) In general. Subject to the limitations in paragraph (b)(3)(v)(B) of this section, for purposes of this paragraph (b)(3), references to a funded member include references to any predecessor or successor of such member. See paragraph (h)(3) of this section, Examples 9 and 10, for illustrations of this rule.

(B) Limitations to the application of the per se funding rule. For purposes of paragraph (b)(3)(iii)(A) of this section, a covered debt instrument issued by a funded member that satisfies the condition described in paragraph (b)(3)(iii)(A) with respect to a distribution or acquisition described in paragraphs (b)(3)(i)(A) through (C) of this section made by a predecessor or successor of the funded member is not treated as issued during the per se period with respect to the distribution or acquisition unless the conditions described in paragraphs (b)(3)(v)(B)(1) and (2) of this section are satisfied:

(1) The covered debt instrument is issued by the funded member during the period beginning 36 months before the date of the transaction in which the predecessor or successor becomes a predecessor or successor and ending 36 months after the date of the transaction.

(2) The distribution or acquisition is made by the predecessor or successor

during the period beginning 36 months before the date of the transaction in which the predecessor or successor becomes a predecessor or successor of the funded member and ending 36 months after the date of the transaction.

(vi) Treatment of funded transactions. When a covered debt instrument is treated as stock pursuant to paragraph (b)(3) of this section, the distribution or acquisition described in paragraphs (b)(3)(i)(A) through (C) of this section that is treated as funded by such covered debt instrument is not recharacterized as a result of the treatment of the covered debt instrument as stock.

(vii) Qualified short-term debt instrument. [Reserved]. For further guidance, see §1.385-3T(b)(3)(vii).

(viii) Distributions or acquisitions occurring before April 5, 2016. A distribution or acquisition that occurs before April 5, 2016, is not taken into account for purposes of applying this paragraph (b)(3).

(4) Anti-abuse rule. If a member of an expanded group enters into a transaction with a principal purpose of avoiding the purposes of this section or §1.385-3T, an interest issued or held by that member or another member of the member's expanded group may, depending on the relevant facts and circumstances, be treated as stock. Paragraphs (b)(4)(i) and (ii) of this section include a non-exhaustive list of transactions that could result in an interest being treated as stock under this paragraph (b)(4).

(i) Interests. An interest is treated as stock if it is issued with a principal purpose of avoiding the purposes of this section or §1.385-3T. Interests subject to this paragraph (b)(4)(i) may include:

(A) An interest that is not a covered debt instrument for purposes of this section

(for example, a contract to which section 483 applies that is not otherwise a covered debt instrument or a non-periodic swap payment that is not otherwise a covered debt instrument).

(B) A covered debt instrument issued to a person that is not a member of the issuer's expanded group, if the covered debt instrument is later acquired by a member of the issuer's expanded group or such person later becomes a member of the issuer's expanded group.

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

(D) A covered debt instrument issued in connection with a reorganization or similar transaction.

(E) A covered debt instrument issued as part of a plan or a series of transactions to expand the applicability of the transition rules described in §1.385-3(j)(2) or §1.385-3T(k)(2).

(ii) Other transactions. A covered debt instrument is treated as stock if the funded member or any member of the expanded group engages in a transaction (including a distribution or acquisition) with a principal purpose of avoiding the purposes of this section or §1.385-3T. Transactions subject to this paragraph (b)(4)(ii) may include:

(A) A member of the issuer's expanded group is substituted as a new obligor or added as a co-obligor on an existing covered debt instrument.

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

(C) A covered debt instrument funds a distribution or acquisition where the distribution or acquisition is made by a member other than the funded member and the funded member acquires the assets of the other member in a transaction that does not make the other member a predecessor to the funded member.

(D) Members of a consolidated group engage in transactions as part of a plan or a series of transactions through the use of the consolidated group rules set forth in §1.385-4T, including through the use of the departing member rules.

(5) Coordination between general rule and funding rule in an asset reorganization. For purposes of this section, a distribution or acquisition described in paragraph (b)(2) of this section is not also described in paragraph (b)(3)(i) of this section. In the case of an asset reorganization, an acquisition described in paragraph (b)(2)(iii) of this section by the transferee corporation is not also a distribution or acquisition described in paragraph (b)(3)(i) of this section by the transferor corporation. For purposes of this paragraph (b)(5), whether a distribution or acquisition is described in paragraphs (b)(2)(i) through (iii) of this section is determined without regard to paragraph (c) of this section.

(6) Non-duplication. Except as otherwise provided in paragraph (d)(2) of this section, to the extent a distribution or acquisition described in paragraphs (b)(3)(i)(A) through (C) of this section is treated as funded by a covered debt instrument under paragraph (b)(3) of this section, the distribution or acquisition is not treated as funded by another covered debt instrument and the covered debt instrument is not treated as funding another distribution or acquisition for purposes of paragraph (b)(3).

(c) Exceptions--(1) In general. This paragraph (c) provides exceptions for

purposes of applying paragraphs (b)(2) and (b)(3) of this section to a covered member. These exceptions are applied in the following order: first, paragraph (c)(2) of this section; second, paragraph (c)(3) of this section; and, third, paragraph (c)(4) of this section. The exceptions under §1.385-3(c)(2) and (c)(3) apply to distributions and acquisitions that are otherwise described in paragraph (b)(2) or (b)(3)(i) of this section after applying paragraphs (b)(3)(ii) and (b)(5) of this section. Except as otherwise provided, the exceptions are applied by taking into account the aggregate treatment of controlled partnerships described in §1.385-3T(f).

(2) Exclusions for transactions otherwise described in paragraph (b)(2) or (b)(3)(i) of this section--(i) Exclusion for certain acquisitions of subsidiary stock--(A) In general. An acquisition of expanded group stock (including by issuance) is not treated as described in paragraph (b)(2)(ii) or (b)(3)(i)(B) of this section if, immediately after the acquisition, the covered member that acquires the expanded group stock (acquirer) controls the member of the expanded group from which the expanded group stock is acquired (seller), and the acquirer does not relinquish control of the seller pursuant to a plan that existed on the date of the acquisition, other than in a transaction in which the seller ceases to be a member of the expanded group of which the acquirer is a member. For purposes of the preceding sentence, an acquirer and seller do not cease to be members of the same expanded group by reason of a complete liquidation described in section 331.

(B) Control. For purposes of this paragraph (c)(2)(i) and paragraph (c)(3)(ii)(E) of this section, control of a corporation means the direct or indirect ownership of more than 50 percent of the total combined voting power of all classes of stock of the corporation

entitled to vote and more than 50 percent of the total value of the stock of the corporation. For purposes of the preceding sentence, indirect ownership is determined by applying the principles of section 958(a) without regard to whether an intermediate entity is foreign or domestic.

(C) Rebuttable presumption. For purposes of paragraph (c)(2)(i)(A) of this section, the acquirer is presumed to have a plan to relinquish control of the seller on the date of the acquisition if the acquirer relinquishes control of the seller within the 36-month period following the date of the acquisition. The presumption created by the previous sentence may be rebutted by facts and circumstances clearly establishing that the loss of control was not contemplated on the date of the acquisition and that the avoidance of the purposes of this section or §1.385-3T was not a principal purpose for the subsequent loss of control.

(ii) Exclusion for compensatory stock acquisitions. An acquisition of expanded group stock is not treated as described in paragraph (b)(2)(ii) or (b)(3)(i)(B) of this section if the expanded group stock is delivered to individuals that are employees, directors, or independent contractors in consideration for services rendered by such individuals to a member of the expanded group or a controlled partnership in which a member of the expanded group is an expanded group partner.

(iii) Exclusion for distributions or acquisitions resulting from transfer pricing adjustments. A distribution or acquisition deemed to occur under §1.482-1(g) (including adjustments made pursuant to Revenue Procedure 99-32, 1999-2 C.B. 296) is not treated as described in paragraph (b)(3)(i)(A) or (B) of this section.

(iv) Exclusion for acquisitions of expanded group stock by a dealer in securities.

An acquisition of expanded group stock by a dealer in securities (within the meaning of section 475(c)(1)), or by an expanded group partner treated as acquiring expanded group stock pursuant to §1.385-3T(f)(2) if the relevant controlled partnership is a dealer in securities, is not treated as described in paragraph (b)(2)(ii) or (b)(3)(i)(B) of this section to the extent the expanded group stock is acquired in the ordinary course of the dealer's business of dealing in securities. The preceding sentence applies solely to the extent that--

(A) The dealer accounts for the stock as securities held primarily for sale to customers in the ordinary course of business;

(B) The dealer disposes of the stock within a period of time that is consistent with the holding of the stock for sale to customers in the ordinary course of business, taking into account the terms of the stock and the conditions and practices prevailing in the markets for similar stock during the period in which it is held; and

(C) The dealer does not sell or otherwise transfer the stock to a person in the same expanded group, other than in a sale to a dealer that in turn satisfies the requirements of paragraph (c)(2)(iv) of this section.

(v) Exclusion for certain acquisitions of expanded group stock resulting from application of this section. The following deemed acquisitions are not treated as acquisitions of expanded group stock described in paragraph (b)(3)(i)(B) of this section, provided that they are not part of a plan or arrangement to prevent the application of paragraph (b)(3)(i) to a covered debt instrument:

(A) An acquisition of a covered debt instrument that is treated as stock by means of paragraph (b)(3) of this section.

(B) An acquisition of stock of a regarded owner that is deemed to be issued under §1.385-3T(d)(4).

(C) An acquisition of deemed partner stock pursuant to a deemed transfer or a specified event described in §1.385-3T(f)(4) or (5).

(3) Reductions for transactions described in paragraph (b)(2) or (b)(3)(i) of this section--(i) Reduction for expanded group earnings--(A) In general. The aggregate amount of any distributions or acquisitions by a covered member described in paragraph (b)(2) or (b)(3)(i) of this section in a taxable year during the covered member's expanded group period is reduced by the covered member's expanded group earnings account (as defined in paragraph (c)(3)(i)(B) of this section) for the expanded group period as of the close of the taxable year. The reduction described in this paragraph (c)(3)(i)(A) applies to one or more distributions or acquisitions based on the order in which the distributions or acquisitions occur, regardless of whether any distribution or acquisition would be treated as funded by a covered debt instrument without regard to this paragraph (c)(3).

(B) Expanded group earnings account. The term expanded group earnings account means, with respect to a covered member and an expanded group period (as defined in paragraph (c)(3)(i)(E) of this section) of the covered member, the excess, if any, of the covered member's expanded group earnings (as defined in paragraph (c)(3)(i)(C) of this section) for the expanded group period over the covered member's expanded group reductions (as defined in paragraph (c)(3)(i)(D) of this section) for the expanded group period.

(C) Expanded group earnings--(1) In general. The term expanded group earnings means, with respect to a covered member and an expanded group period of the covered member, the earnings and profits accumulated by the covered member during the expanded group period, computed as of the close of the taxable year of the covered member, without regard to any distributions or acquisitions by the covered member described in paragraphs (b)(2) and (b)(3)(i) of this section. Notwithstanding the preceding sentence, the expanded group earnings of a covered member do not include earnings and profits accumulated by the covered member in any taxable year ending before April 5, 2016.

(2) Special rule for change in expanded group within a taxable year. For purposes of calculating a covered member's expanded group earnings for a taxable year that is not wholly included in an expanded group period, the covered member's expanded group earnings are ratably allocated among the portion of the taxable year included in the expanded group period and the portion of the taxable year not included in the expanded group period. For purposes of the preceding sentence, the expanded group period is determined by excluding the day on which the covered member becomes a member of an expanded group with the same expanded group parent and including the day on which the covered member ceases to be a member of an expanded group with the same expanded group parent.

(3) Look-thru rule for dividends--(i) In general. For purposes of paragraph (c)(3)(i)(C)(1) of this section, a dividend from a member of the same expanded group (distributing member) is not taken into account for purposes of calculating a covered member's expanded group earnings, except to the extent the dividend is attributable to

earnings and profits accumulated by the distributing member in a taxable year ending after April 4, 2016, during its expanded group period (qualified earnings and profits). For purposes of the preceding sentence, a dividend received from a member (intermediate distributing member) is not taken into account for purposes of calculating the qualified earnings and profits of a distributing member (or another intermediate distributing member), except to the extent the dividend is attributable to qualified earnings and profits of the intermediate distributing member. A dividend from distributing member or an intermediate distributing member is considered to be attributable to qualified earnings and profits to the extent thereof. If a controlled partnership receives a dividend from a distributing member and a portion of the dividend is allocated (including through one or more partnerships) to a covered member, then, for purposes of this paragraph (c)(3)(i)(C)(3), the covered member is treated as receiving the dividend from the distributing member.

(ii) Dividend. For purposes of paragraph (c)(3)(i)(C)(3)(i) of this section, the term dividend has the meaning specified in section 316, including the portion of gain recognized under section 1248 that is treated as a dividend and deemed dividends under section 367(b) and the regulations thereunder. In addition, the term dividend includes inclusions with respect to stock (for example, inclusions under sections 951(a) and 1293).

(4) Effect of interest deductions. For purposes of calculating the expanded group earnings of a covered member for a taxable year, expanded group earnings are calculated without regard to the application of this section during the taxable year to a covered debt instrument issued by the covered member that was not treated as stock

under paragraph (b) of this section as of the close of the preceding taxable year, or, if the covered member is an expanded group partner in a controlled partnership that is the issuer of a debt instrument, without regard to the application of §1.385-3T(f)(4)(i) during the taxable year with respect to the covered member's share of the debt instrument. To the extent that the application of this paragraph (c)(3)(i)(C)(4) reduces the expanded group earnings of the covered member for the taxable year, the expanded group earnings of the covered member are increased as of the beginning of the succeeding taxable year during the expanded group period.

(D) Expanded group reductions. The term expanded group reductions means, with respect to a covered member and an expanded group period of the covered member, the amounts by which acquisitions or distributions described in paragraph (b)(2) or (b)(3)(i) of this section were reduced by reason of paragraph (c)(3)(i)(A) of this section during the portion of the expanded group period preceding the taxable year.

(E) Expanded group period--(1) In general. For purposes of this paragraph (c)(3)(i) and paragraph (c)(3)(ii) of this section, the term expanded group period means, with respect to a covered member, the period during which a covered member is a member of an expanded group with the same expanded group parent.

(2) Mere change. For purposes of paragraph (c)(3)(i)(E)(1) of this section, an expanded group parent that is a resulting corporation (within the meaning of §1.368-2(m)(1)) in a reorganization described in section 368(a)(1)(F) is treated as the same expanded group parent as an expanded group parent that is a transferor corporation (within the meaning of §1.368-2(m)(1)) in the same reorganization, provided that either--

(i) The transferor corporation is not a covered member; or

(ii) Both the transferor corporation and the resulting corporation are covered members.

(F) Special rules for certain corporate transactions--(1) Reduction for expanded group earnings in an asset reorganization. For purposes of applying paragraph (c)(3)(i) of this section, a distribution or acquisition described in paragraph (b)(2) or (b)(3)(i) of this section that occurs pursuant to a reorganization described in section 381(a)(2) is reduced solely by the expanded group earnings account of the acquiring member after taking into account the adjustment to its expanded group earnings account provided in paragraph (c)(3)(i)(F)(2)(ii) of this section.

(2) Effect of certain corporate transactions on the calculation of expanded group earnings account--(i) In general. Section 381 and §1.312-10 are not taken into account for purposes of calculating a covered member's expanded group earnings account for an expanded group period. The expanded group earnings account that a covered member succeeds to under paragraphs (c)(3)(i)(F)(2)(ii) through (iv) of this section is attributed to the covered member's expanded group period as of the close of the date of the distribution or transfer.

(ii) Section 381 transactions. If a covered member (acquiring member) acquires the assets of another covered member (acquired member) in a transaction described in section 381(a), and, immediately before the transaction, both corporations are members of the same expanded group, then the acquiring member succeeds to the expanded group earnings account of the acquired member, if any, determined after application of paragraph (c)(3)(i) of this section with respect to the final taxable year of the acquired member.

(iii) Section 1.312-10(a) transactions. If a covered member (transferor member) transfers property to another covered member (transferee member) in a transaction described in §1.312-10(a), the expanded group earnings account of the transferor member is allocated between the transferor member and the transferee member in the same proportion as the earnings and profits of the transferor member are allocated between the transferor member and the transferee member under §1.312-10(a).

(iv) Section 1.312-10(b) transactions. If a covered member (distributing member) distributes the stock of another covered member (controlled member) in a transaction described in §1.312-10(b), the expanded group earnings account of the distributing member is decreased by the amount that the expanded group earnings account of the distributing member would have been decreased under paragraph (c)(3)(i)(F)(2)(iii) of this section if the distributing member had transferred the stock of the controlled member to a newly formed corporation in a transaction described in §1.312-10(a). If the amount of the decrease described in the preceding sentence exceeds the expanded group earnings account of the controlled member immediately before the transaction described in §1.312-10(b), then the expanded group earnings account of the controlled member after the transaction is equal to the amount of the decrease.

(G) Overlapping expanded groups. A covered member that is a member of two expanded groups at the same time has a single expanded group earnings account with respect to a single expanded group period. In this case, the expanded group period is determined by reference to the shorter of the two periods during which the covered member is a member of an expanded group with the same expanded group parent.

(ii) Reduction for qualified contributions--(A) In general. The amount of a

distribution or acquisition by a covered member described in paragraph (b)(2) or (b)(3)(i) of this section is reduced by the aggregate fair market value of the stock issued by the covered member in one or more qualified contributions (as defined in paragraph (c)(3)(ii)(B) of this section) during the qualified period (as defined in paragraph (c)(3)(ii)(C) of this section), but only to the extent the qualified contribution or qualified contributions have not reduced another distribution or acquisition. The reduction described in this paragraph (c)(3)(ii)(A) applies to one or more distributions or acquisitions based on the order in which the distributions or acquisitions occur, regardless of whether any distribution or acquisition would be treated as funded by a covered debt instrument without regard to this paragraph (c)(3).

(B) Qualified contribution. The term qualified contribution means, with respect to a covered member, except as provided in paragraph (c)(3)(ii)(E) of this section, a contribution of property, other than excluded property (defined in paragraph (c)(3)(ii)(D) of this section), to the covered member by a member of the covered member's expanded group (or by a controlled partnership of the expanded group) in exchange for stock.

(C) Qualified period. The term qualified period means, with respect to a covered member, a qualified contribution, and a distribution or acquisition described in paragraph (b)(2) or (b)(3)(i) of this section, the period beginning on the later of the beginning of the periods described in paragraphs (c)(3)(ii)(C)(1) and (2) of this section, and ending on the earlier of the ending of the periods described in paragraphs (c)(3)(ii)(C)(1) and (2) of this section or the date described in paragraph (c)(3)(ii)(C)(3) of this section.

(1) The period beginning 36 months before the date of the distribution or acquisition, and ending 36 months after the date of the distribution or acquisition.

(2) The covered member's expanded group period (as defined in paragraph (c)(3)(i)(E) of this section) that includes the distribution or acquisition.

(3) The last day of the first taxable year that a covered debt instrument issued by the covered member would, absent the application of this paragraph (c)(3)(ii) with respect to the distribution or acquisition, be treated, in whole or in part, as stock under paragraph (b) of this section or, in the case of a covered debt instrument issued by a controlled partnership in which the covered member is an expanded group partner, the covered debt instrument would be treated, in whole or in part, as a specified portion.

(D) Excluded property. The term excluded property means--

(1) Expanded group stock;

(2) Property acquired by the covered member in an asset reorganization from a member of the expanded group of which the covered member is a member;

(3) A covered debt instrument of any member of the same expanded group, including a covered debt instrument issued by the covered member;

(4) Property acquired by the covered member in exchange for a covered debt instrument issued by the covered member that is recharacterized under paragraph (b)(3) of this section;

(5) A debt instrument issued by a controlled partnership of the expanded group of which the covered member is a member, including the portion of such a debt instrument that is a deemed transferred receivable or a retained receivable; and

(6) Any other property acquired by the covered member with a principal purpose

to avoid the purposes of this section or §1.385-3T, including a transaction involving an indirect transfer of property described in paragraphs (c)(3)(ii)(D)(1) through (5) of this section.

(E) Excluded contributions--(1) Upstream contributions from certain subsidiaries. For purposes of paragraph (c)(3)(ii)(B) of this section, a contribution of property from a corporation (controlled member) that the covered member controls, within the meaning of paragraph (c)(2)(i)(B) of this section, is not a qualified contribution.

(2) Contributions to a predecessor or successor. For purposes of paragraph (c)(3)(ii)(B) of this section, a contribution of property to a covered member from a corporation of which the covered member is a predecessor or successor, or from a corporation controlled by that corporation within the meaning of paragraph (c)(2)(i)(B) of this section, is not a qualified contribution.

(3) Contributions that do not increase fair market value. A contribution of property to a covered member that is not described in paragraph (c)(3)(ii)(E)(1) or (2) of this section is not a qualified contribution to the extent that the contribution does not increase the aggregate fair market value of the outstanding stock of the covered member immediately after the transaction and taking into account all related transactions, other than distributions and acquisitions described in paragraphs (b)(2) and (b)(3)(i) of this section.

(4) Contributions that become excluded contributions after the date of the contribution. If a contribution of property described in paragraph (c)(3)(ii)(E)(1) or (2) of this section occurs before the covered member acquires control of the controlled member described in paragraph (c)(3)(ii)(E)(1) or before the transaction in which the

corporation described in paragraph (c)(3)(ii)(E)(2) becomes a predecessor or successor to the covered member, the contribution of property ceases to be a qualified contribution on the date that the covered member acquires control of the controlled member or on the date of the transaction in which the corporation becomes a predecessor or successor to the covered member (transaction date). If the contribution of property occurs within 36 months before the transaction date, the covered member is treated as making a distribution described in paragraph (b)(3)(i)(A) of this section on the transaction date equal to the amount by which any distribution or acquisition described in paragraph (b)(2) or (b)(3)(i) of this section was reduced under paragraph (c)(3)(ii)(A) of this section because the contribution of property was treated as a qualified contribution.

(F) Special rules for certain corporate transactions--(1) Reduction for qualified contributions in an asset reorganization. For purposes of applying paragraph (c)(3)(ii)(A) of this section, a distribution or acquisition described in paragraph (b)(2) or (b)(3)(i) of this section that occurs pursuant to a reorganization described in section 381(a)(2) is reduced solely by the qualified contributions of the acquiring member after taking into account the adjustment to its qualified contributions provided in paragraph (c)(3)(ii)(F)(2) of this section.

(2) Effect of certain corporate transactions on the calculation of qualified contributions--(i) In general. This paragraph (c)(3)(ii)(F)(2) provides rules for allocating or reducing the qualified contributions of a covered member as a result of certain corporation transactions. For purposes of paragraph (c)(3)(ii)(C)(1) of this section, a qualified contribution that a covered member succeeds to under paragraphs

(c)(3)(ii)(F)(2)(ii) and (iii) of this section is treated as made to the covered member on the date on which the qualified contribution was made to the covered member that received the qualified contribution. For purposes of paragraph (c)(3)(ii)(C)(2) of this section, a qualified contribution that a covered member succeeds to under paragraphs (c)(3)(ii)(F)(2)(ii) and (iii) of this section is attributed to the covered member's expanded group period as of the close of the date of the distribution or transfer. For purposes of paragraph (c)(3)(ii)(C)(3) of this section, a qualified contribution a covered member succeeds to under paragraphs (c)(3)(ii)(F)(2)(ii) and (iii) of this section is treated as made to the covered member as of the close of the date of the distribution or transfer.

(ii) Section 381 transactions. If a covered member (acquiring member) acquires the assets of another covered member (acquired member) in a transaction described in section 381(a), and, immediately before the transaction, both corporations are members of the same expanded group, the acquiring member succeeds to the qualified contributions of the acquired member, if any, adjusted for the application of paragraph (c)(3)(ii)(E)(4) of this section.

(iii) Section 1.312-10(a) transactions. If a covered member (transferor member) transfers property to another covered member (transferee member) in a transaction described in §1.312-10(a), each qualified contribution of the transferor member is allocated between the transferor member and the transferee member in the same proportion as the earnings and profits of the transferor member are allocated between the transferor member and the transferee member under §1.312-10(a).

(iv) Section 1.312-10(b) transactions. If a covered member (distributing member) distributes the stock of another covered member (controlled member) in a transaction

described in §1.312-10(b), each qualified contribution of the distributing member is decreased by the amount that each qualified contribution of the distributing member would have been decreased under paragraph (c)(3)(ii)(F)(2)(iii) of this section if the distributing member had transferred the stock of the controlled member to a newly formed corporation in a transaction described in §1.312-10(a). No amount of the qualified contributions of the distributing member is allocated to the controlled member.

(iii) Predecessors and successors. For purposes of this paragraph (c)(3), references to a covered member do not include references to any corporation of which the covered member is a predecessor or successor. Accordingly, a distribution or acquisition by a covered member described in paragraphs (b)(3)(i)(A) through (C) is reduced solely by the expanded group earnings account of the covered member (taking into account the application of paragraph (c)(3)(i)(F)(2) of this section) and the qualified contributions of the covered member (taking into account the application of paragraph (c)(3)(ii)(F)(2) of this section), notwithstanding that the distribution or acquisition is treated as made by a funded member of which the covered member is a predecessor or successor.

(iv) Ordering rule. The exceptions described in this paragraph (c)(3) are applied in the following order: first, paragraph (c)(3)(i) of this section; and, second, paragraph (c)(3)(ii) of this section.

(4) Threshold exception. A covered debt instrument is not treated as stock under this section if, immediately after the covered debt instrument would be treated as stock under this section but for the application of this paragraph (c)(4), the aggregate adjusted issue price of covered debt instruments held by members of the issuer's expanded

group that would be treated as stock under this section but for the application of this paragraph (c)(4) does not exceed $50 million. To the extent a debt instrument issued by a controlled partnership would be treated as a specified portion (as defined in paragraph (g)(23) of this section) but for the application of this paragraph (c)(4), the debt instrument is treated as a covered debt instrument described in the preceding sentence for purposes of this paragraph (c)(4). To the extent that, immediately after a covered debt instrument would be treated as stock under this section but for the application of this paragraph (c)(4), the aggregate adjusted issue price of covered debt instruments held by members of the issuer's expanded group that would be treated as stock under this section but for the application of this paragraph (c)(4) exceeds $50 million, only the amount of the covered debt instrument in excess of $50 million is treated as stock under this section. For purposes of this rule, any covered debt instrument that is not denominated in U.S. dollars is translated into U.S. dollars at the spot rate (as defined in §1.988-1(d)) on the date that the covered debt instrument is issued.

(d) Operating rules--(1) Timing. This paragraph (d)(1) provides rules for determining when a covered debt instrument is treated as stock under paragraph (b) of this section. For special rules regarding the treatment of a deemed exchange of a covered debt instrument that occurs pursuant to paragraphs (d)(1)(ii), (d)(1)(iii), or (d)(1)(iv) of this section, see §1.385-1(d).

(i) General timing rule. Except as otherwise provided in this paragraph (d)(1), when paragraph (b) of this section applies to treat a covered debt instrument as stock, the covered debt instrument is treated as stock when the covered debt instrument is

issued. When paragraph (b)(3) of this section applies to treat a covered debt instrument as stock when the covered debt instrument is issued, see also paragraph (b)(3)(vi) of this section.

(ii) Exception when a covered debt instrument is treated as funding a distribution or acquisition that occurs after the issuance of the covered debt instrument. When paragraph (b)(3)(iii) of this section applies to treat a covered debt instrument as funding a distribution or acquisition described in paragraph (b)(3)(i)(A) through (C) of this section that occurs after the covered debt instrument is issued, the covered debt instrument is deemed to be exchanged for stock on the date that the distribution or acquisition occurs. See paragraph (h)(3) of this section, Examples 4 and 9, for an illustration of this rule.

(iii) Exception for certain predecessor and successor transactions. To the extent that a covered debt instrument would not be treated as stock but for the fact that a funded member is treated as the predecessor or successor of another expanded group member under paragraph (b)(3)(v) of this section, the covered debt instrument is deemed to be exchanged for stock on the later of the date that the funded member completes the transaction causing it to become a predecessor or successor of the other expanded group member or the date that the covered debt instrument would be treated as stock under paragraph (d)(1)(i) or (ii) of this section.

(iv) Exception when a covered debt instrument is re-tested under paragraph (d)(2) of this section. When paragraph (b)(3)(iii) of this section applies to treat a covered debt instrument as funding a distribution or acquisition described in paragraphs (b)(3)(i)(A) through (C) of this section as a result of a re-testing described in paragraph

(d)(2)(ii) of this section that occurs in a taxable year subsequent to the taxable year in which the covered debt instrument is issued, the covered debt instrument is deemed to be exchanged for stock on the later of the date of the re-testing or the date that the covered debt instrument would be treated as stock under paragraph (d)(1)(i) or (ii) of this section. See paragraph (h)(3) of this section, Example 7, for an illustration of this rule.

(2) Covered debt instrument treated as stock that leaves the expanded group--(i) Events that cause a covered debt instrument to cease to be treated as stock. Subject to paragraph (b)(4) of this section, this paragraph (d)(2)(i) applies with respect to a covered debt instrument that is treated as stock under this section when the holder and issuer of a covered debt instrument cease to be members of the same expanded group, either because the covered debt instrument is transferred to a person that is not a member of the expanded group that includes the issuer or because the holder or the issuer ceases to be a member of the same expanded group, or in the case of a holder that is a controlled partnership, when the holder ceases to be a controlled partnership with respect to the expanded group of which the issuer is a member, either because the partnership ceases to be a controlled partnership or because the issuer ceases to be a member of the same expanded group with respect to which the holder is a controlled partnership. In such a case, the covered debt instrument ceases to be treated as stock under this section. For this purpose, immediately before the transaction that causes the holder and issuer of the covered debt instrument to cease to be members of the same expanded group, or, if the holder is a controlled partnership, that causes the holder to cease to be a controlled partnership with respect to the expanded group of which the

issuer is a member, the issuer is deemed to issue a new covered debt instrument to the holder in exchange for the covered debt instrument that was treated as stock in a transaction that is disregarded for purposes of paragraphs (b)(2) and (b)(3) of this section.

(ii) Re-testing of covered debt instruments and certain distributions and acquisitions--(A) General rule. For purposes of paragraph (b)(3)(iii) of this section, when paragraph (d)(2)(i) of this section or §1.385-4T(c)(2) causes a covered debt instrument that previously was treated as stock pursuant to paragraph (b)(3) of this section to cease to be treated as stock, all other covered debt instruments of the issuer that are not treated as stock on the date that the transaction occurs that causes paragraph (d)(2)(i) of this section to apply are re-tested to determine whether those other covered debt instruments are treated as funding the distribution or acquisition that previously was treated as funded by the covered debt instrument that ceases to be treated as stock pursuant to paragraph (d)(2)(i) of this section. In addition, a covered debt instrument that is issued after an application of paragraph (d)(2)(i) of this section and within the per se period may also be treated as funding that distribution or acquisition. See paragraph (h)(3) of this section, Example 7, for an illustration of this rule.

(B) Re-testing upon a specified event with respect to a debt instrument issued by a controlled partnership. If, with respect to a covered member that is an expanded group partner and a debt instrument issued by the controlled partnership, there is reduction in the covered member's specified portion under §1.385-3T(f)(5)(i) by reason of a specified event, the covered member must re-test its debt instruments as described

in paragraph (d)(2)(ii)(A) of this section.

(3) Inapplicability of section 385(c)(1). Section 385(c)(1) does not apply with respect to a covered debt instrument to the extent that it is treated as stock under this section.

(4) Treatment of disregarded entities. [Reserved]. For further guidance, see §1.385-3T(d)(4).

(5) Payments with respect to partially recharacterized covered debt instruments--(i) General rule. Except as otherwise provided in paragraph (d)(5)(ii) of this section, a payment with respect to an instrument that is partially recharacterized as stock is treated as made pro rata to the portion treated as stock and to the portion treated as indebtedness.

(ii) Special rule for payments not required pursuant to the terms of the instrument. A payment with respect to an instrument that is partially recharacterized as stock and that is a payment that is not required to be made pursuant to the terms of the instrument (for example, a prepayment of principal) may be designated by the issuer and the holder as with respect to the portion treated as stock or to the portion treated as indebtedness, in whole or in part. In the absence of such designation, see paragraph (d)(5)(i) of this section.

(6) Treatment of a general rule transaction to which an exception applies. To the extent a covered member would, absent the application of paragraph (c)(2) or (c)(3) of this section, be treated as making a distribution or acquisition described in paragraph (b)(2) of this section, then, solely for purposes of applying paragraph (b)(3) of this section, the covered member is treated as issuing the covered debt instrument issued in

the distribution or acquisition to a member of the covered member's expanded group in exchange for property.

(7) Treatment for purposes of section 1504(a)--(i) Debt instruments treated as stock. A covered debt instrument that is treated as stock under paragraph (b)(2), (3), or (4) of this section and that is not described in section 1504(a)(4) is not treated as stock for purposes of determining whether the issuer is a member of an affiliated group (within the meaning of section 1504(a)).

(ii) Deemed partner stock and stock deemed issued by a regarded owner. If deemed partner stock or stock that is deemed issued by a regarded owner under §1.385-3T(d)(4) is not described in section 1504(a)(4), then that stock is not treated as stock for purposes of determining whether the issuer of the stock is a member of an affiliated group (within the meaning of section 1504(a)).

(e) No affirmative use. [Reserved]

(f) Treatment of controlled partnerships. [Reserved]. For further guidance, see §1.385-3T(f).

(g) Definitions. The definitions in this paragraph (g) apply for purposes of this section and §§1.385-3T and 1.385-4T.

(1) Asset reorganization. The term asset reorganization means a reorganization described in section 368(a)(1)(A), (C), (D), (F), or (G).

(2) Consolidated group. The term consolidated group has the meaning specified in §1.1502-1(h).

(3) Covered debt instrument--(i) In general. The term covered debt instrument means a debt instrument issued after April 4, 2016, that is not a qualified dealer debt

instrument (as defined in paragraph (g)(3)(ii) of this section) or an excluded statutory or regulatory debt instrument (as defined in paragraph (g)(3)(iii) of this section), and that is issued by a covered member that is not an excepted regulated financial company (as defined in paragraph (g)(3)(iv) of this section) or a regulated insurance company (as defined in paragraph (g)(3)(v) of this section).

(ii) For purposes of this paragraph (g)(3), the term qualified dealer debt instrument means a debt instrument that is issued to or acquired by an expanded group member that is a dealer in securities (within the meaning of section 475(c)(1)) in the ordinary course of the dealer's business of dealing in securities. The preceding sentence applies solely to the extent that--

(A) The dealer accounts for the debt instruments as securities held primarily for sale to customers in the ordinary course of business;

(B) The dealer disposes of the debt instruments (or the debt instruments mature) within a period of time that is consistent with the holding of the debt instruments for sale to customers in the ordinary course of business, taking into account the terms of the debt instruments and the conditions and practices prevailing in the markets for similar debt instruments during the period in which it is held; and

(C) The dealer does not sell or otherwise transfer the debt instrument to a member of the dealer's expanded group unless that sale or transfer is to a dealer that satisfies the requirements of this paragraph (g)(3)(ii).

(iii) For purposes of this paragraph (g)(3), the term excluded statutory or regulatory debt instrument means a debt instrument that is described in any of the following paragraphs:

(A) Production payments treated as a loan under section 636(a) or (b).

(B) A “regular interest” in a real estate mortgage investment conduit described in section 860G(a)(1).

(C) A debt instrument that is deemed to arise under §1.482-1(g)(3) (including adjustments made pursuant to Revenue Procedure 99-32, 1999-2 C.B. 296).

(D) A stripped bond or coupon described in section 1286, unless such instrument was issued with a principal purpose of avoiding the purposes of this section or §1.385-3T.

(E) A lease treated as a loan under section 467.

(iv) For purposes of this paragraph (g)(3), the term excepted regulated financial company means a covered member that is a regulated financial company (as defined in paragraph (g)(3)(iv)(A) of this section) or a member of a regulated financial group (as defined in paragraph (g)(3)(iv)(B) of this section).

(A) Regulated financial company. For purposes of paragraph (g)(3)(iv), the term regulated financial company means--

(1) A bank holding company, as defined in 12 U.S.C. 1841;

(2) A covered savings and loan holding company, as defined in 12 CFR 217.2;

(3) A national bank;

(4) A bank that is a member of the Federal Reserve System and is incorporated by special law of any State, or organized under the general laws of any State, or of the United States, including a Morris Plan bank, or other incorporated banking institution engaged in a similar business;

(5) An insured depository institution, as defined in 12 U.S.C. 1813(c)(2);

(6) A nonbank financial company subject to a determination under 12 U.S.C. 5323(a)(1) or (b)(1);

(7) A U.S. intermediate holding company formed by a foreign banking organization in compliance with 12 C.F.R. 252.153;

(8) An Edge Act corporation organized under section 25A of the Federal Reserve Act (12 U.S.C. 611-631);

(9) Corporations having an agreement or undertaking with the Board of Governors of the Federal Reserve System under section 25 of the Federal Reserve Act (12 U.S.C. 601-604a);

(10) A supervised securities holding company, as defined in 12 U.S.C. 1850a(a)(5);

(11) A broker or dealer that is registered with the Securities and Exchange Commission under 15 U.S.C. 78o(b);

(12) A futures commission merchant, as defined in 7 U.S.C. 1a(28);

(13) A swap dealer, as defined in 7 U.S.C. 1a(49);

(14) A security-based swap dealer, as defined in 15 U.S.C. 78c(a)(71);

(15) A Federal Home Loan Bank, as defined in 12 U.S.C. 1422(1)(A);

(16) A Farm Credit System Institution chartered and subject to the provisions of the Farm Credit Act of 1971 (12 U.S.C. 2001 et seq.); or

(17) A small business investment company, as defined in 15 U.S.C. 662(3).

(B) Regulated financial group--(1) General rule. For purposes of paragraph (g)(3)(iv) of this section, except as otherwise provided in paragraph (g)(3)(iv)(B)(2) of this section, the term regulated financial group means any expanded group of which a

covered member that is a regulated financial company within the meaning of paragraphs (g)(3)(iv)(A)(1) through (10) of this section would be the expanded group parent if no person owned, directly or indirectly (as defined in §1.385-1(c)(4)(iii)), the regulated financial company.

(2) Exception for certain non-financial entities. A corporation is not a member of a regulated financial group if it is held by a regulated financial company pursuant to 12 U.S.C. 1843(k)(1)(B), 12 U.S.C. 1843(k)(4)(H), or 12 U.S.C. 1843(o).

(v) For purposes of this paragraph (g)(3), the term regulated insurance company means a covered member that is--

(A) Subject to tax under subchapter L of chapter 1 of the Internal Revenue Code;

(B) Domiciled or organized under the laws of one of the 50 states or the District of Columbia (for purposes of paragraph (g)(3)(v) of this section, each being a “state”);

(C) Licensed, authorized, or regulated by one or more states to sell insurance, reinsurance, or annuity contracts to persons other than related persons (within the meaning of section 954(d)(3)) in such states, but in no case will a corporation satisfy the requirements of this paragraph (g)(3)(v)(C) if a principal purpose for obtaining such license, authorization, or regulation was to qualify the issuer as a regulated insurance company; and

(D) Engaged in regular issuances of (or subject to ongoing liability with respect to) insurance, reinsurance, or annuity contracts with persons that are not related persons (within the meaning of section 954(d)(3)).

(4) Debt instrument. The term debt instrument means an interest that would, but for the application of this section, be treated as a debt instrument as defined in section

1275(a) and §1.1275-1(d), provided that the interest is not recharacterized as stock under §1.385-2.

(5) Deemed holder. [Reserved]. For further guidance, see §1.385-3T(g)(5).

(6) Deemed partner stock. [Reserved]. For further guidance, see §1.385-3T(g)(6).

(7) Deemed transfer. [Reserved]. For further guidance, see §1.385-3T(g)(7).

(8) Deemed transferred receivable. [Reserved]. For further guidance, see §1.385-3T(g)(8).

(9) Distribution. The term distribution means any distribution made by a corporation with respect to its stock.

(10) Exempt distribution. The term exempt distribution means either--

(i) A distribution of stock that is permitted to be received without the recognition of gain or income under section 354(a)(1) or 355(a)(1), or, if section 356 applies, that is not treated as other property or money described in section 356; or

(ii) A distribution of property in a complete liquidation under section 336(a) or 337(a).

(11) Exempt exchange. The term exempt exchange means an acquisition of expanded group stock in which either--

(i) In a case in which the transferor and transferee of the expanded group stock are parties to an asset reorganization, either--

(A) Section 361(a) or (b) applies to the transferor of the expanded group stock and the stock is not transferred by issuance; or

(B) Section 1032 or §1.1032-2 applies to the transferor of the expanded group

stock and the stock is distributed by the transferee pursuant to the plan of reorganization;

(ii) The transferor of the expanded group stock is a shareholder that receives property in a complete liquidation to which section 331 or 332 applies; or

(iii) The transferor of the expanded group stock is an acquiring entity that is deemed to issue the stock in exchange for cash from an issuing corporation in a transaction described in §1.1032-3(b).

(12) Expanded group partner. The term expanded group partner means, with respect to a controlled partnership of an expanded group, a member of the expanded group that is a partner (directly or indirectly through one or more partnerships).

(13) Expanded group stock. The term expanded group stock means, with respect to a member of an expanded group, stock of a member of the same expanded group.

(14) Funded member. The term funded member has the meaning provided in paragraph (b)(3)(i) of this section.

(15) Holder-in-form. [Reserved]. For further guidance, see §1.385-3T(g)(15).

(16) Issuance percentage. [Reserved]. For further guidance, see §1.385-3T(g)(16).

(17) Liquidation value percentage. [Reserved]. For further guidance, see §1.385-3T(g)(17).

(18) Member of a consolidated group. The term member of a consolidated group means a corporation described in §1.1502-1(b).

(19) Per se period. The term per se period has the meaning provided in

paragraph (b)(3)(iii)(A) of this section.

(20) Predecessor--(i) In general. Except as otherwise provided in paragraph (g)(20)(ii) of this section, the term predecessor means, with respect to a corporation--

(A) The distributor or transferor corporation in a transaction described in section 381(a) in which the corporation is the acquiring corporation; or

(B) The distributing corporation in a distribution or exchange to which section 355 (or so much of section 356 that relates to section 355) applies in which the corporation is a controlled corporation.

(ii) Predecessor ceasing to be a member of the same expanded group as corporation. The term predecessor does not include the distributing corporation described in paragraph (g)(20)(i)(B) of this section from the date that the distributing corporation ceases to be a member of the expanded group of which the controlled corporation is a member.

(iii) Multiple predecessors. A corporation may have more than one predecessor, including by reason of a predecessor of the corporation having a predecessor or successor. Accordingly, references to a corporation also include references to a predecessor or successor of a predecessor of the corporation.

(21) Property. The term property has the meaning specified in section 317(a).

(22) Retained receivable. [Reserved]. For further guidance, see §1.385-3T(g)(22).

(23) Specified portion. [Reserved]. For further guidance, see §1.385-3T(g)(23).

(24) Successor--(i) In general. Except as otherwise provided in paragraph (g)(24)(iii) of this section, the term successor means, with respect to a corporation—

(A) The acquiring corporation in a transaction described in section 381(a) in which the corporation is the distributor or transferor corporation;

(B) A controlled corporation in a distribution or exchange to which section 355 (or so much of section 356 that relates to section 355) applies in which the corporation is the distributing corporation; or

(C) Subject to the rules in paragraph (g)(24)(ii) of this section, a seller in an acquisition described in paragraph (c)(2)(i)(A) of this section in which the corporation is the acquirer.

(ii) Special rules for certain acquisitions of subsidiary stock. The following rules apply with respect to a successor described in paragraph (g)(24)(i)(C) of this section:

(A) The seller is a successor to the acquirer only to the extent of the value (adjusted as described in paragraph (g)(24)(ii)(C) of this section) of the expanded group stock acquired from the seller in exchange for property (other than expanded group stock) in the acquisition described in paragraph (c)(2)(i)(A) of this section.

(B) A distribution or acquisition by the seller to or from the acquirer is not taken into account for purposes of applying paragraph (b)(3) of this section to a covered debt instrument of the acquirer.

(C) To the extent that a covered debt instrument of the acquirer is treated as funding a distribution or acquisition by the seller described in paragraphs (b)(3)(i)(A) through (C) of this section, or would be treated but for the exceptions described in paragraphs (c)(3)(i) and (ii) of this section, the value of the expanded group stock described in paragraph (g)(24)(ii)(A) of this section is reduced by an amount equal to the distribution or acquisition for purposes of any further application of paragraph

(g)(24)(ii)(A) of this section with respect to the acquirer and seller.

(iii) Successor ceasing to be a member of the same expanded group as corporation. The term successor does not include a controlled corporation described in paragraph (g)(24)(i)(B) of this section with respect to a distributing corporation or a seller described in paragraph (g)(24)(i)(C) of this section with respect to an acquirer from the date that the controlled corporation or the seller ceases to be a member of the expanded group of which the controlled corporation or acquirer, respectively, is a member.

(iv) Multiple successors. A corporation may have more than one successor, including by reason of a successor of the corporation having a predecessor or successor. Accordingly, references to a corporation also include references to a predecessor or successor of a successor of the corporation.

(25) Taxable year. The term taxable year refers to the taxable year of the issuer of the covered debt instrument.

(h) Examples--(1) Assumed facts. Except as otherwise stated, the following facts are assumed for purposes of the examples in paragraph (h)(3) of this section:

(i) FP is a foreign corporation that owns 100% of the stock of USS1, a covered member, 100% of the stock of USS2, a covered member, and 100% of the stock of FS, a foreign corporation;

(ii) USS1 owns 100% of the stock of DS, a covered member, and CFC, which is a controlled foreign corporation within the meaning of section 957;

(iii) At the beginning of Year 1, FP is the common parent of an expanded group comprised solely of FP, USS1, USS2, FS, DS, and CFC (the FP expanded group);

(iv) The FP expanded group has more than $50 million of covered debt instruments described in paragraph (c)(4) of this section at all times;

(v) No issuer of a covered debt instrument has a positive expanded group earnings account within the meaning of paragraph (c)(3)(i)(B) of this section or has received qualified contributions within the meaning of paragraph (c)(3)(ii) of this section;

(vi) All notes are covered debt instruments (as defined in paragraph (g)(3) of this section) and are not qualified short-term debt instruments (as defined in paragraph (b)(3)(vii) of this section);

(vii) Each entity has as its taxable year the calendar year;

(viii) PRS is a partnership for federal income tax purposes;

(ix) No corporation is a member of a consolidated group;

(x) No domestic corporation is a United States real property holding corporation within the meaning of section 897(c)(2);

(xi) Each note is issued with adequate stated interest (as defined in section 1274(c)(2)); and

(xii) Each transaction occurs after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].**

(2) No inference. Except as otherwise provided in this section, it is assumed for purposes of the examples in paragraph (h)(3) of this section that the form of each transaction is respected for federal tax purposes. No inference is intended, however, as to whether any particular note would be respected as indebtedness or as to whether the form of any particular transaction described in an example in paragraph (h)(3) of this section would be respected for federal tax purposes.

(3) Examples. The following examples illustrate the rules of this section.

Example 1. Distribution of a covered debt instrument. (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 is has a value of $100x, to FP in a distribution.

(ii) Analysis. USS1 Note B is a covered debt instrument that is issued by USS1 to FP, a member of the expanded group of which USS1 is a member, in a distribution. Accordingly, USS1 Note B is treated as stock under paragraph (b)(2)(i) of this section. Under paragraph (d)(1)(i) of this section, 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. Under paragraph (b)(5) of this section, because the distribution of USS1 Note B is described in paragraph (b)(2)(i) of this section, the distribution of USS1 Note B is not treated as a distribution of property described in paragraph (b)(3)(i)(A) of this section. Accordingly, USS1 Note A is not treated as funding the distribution of USS1 Note B for purposes of paragraph (b)(3)(i)(A) of this section.

Example 2. Covered debt instrument issued for expanded group stock that is exchanged for stock in a corporation that is not a member of the same expanded group. (i) Facts. UST is a publicly traded domestic corporation. On Date A in Year 1, USS1 issues USS1 Note to FP in exchange for FP stock. Subsequently, on Date B of Year 1, USS1 transfers the FP stock to UST's shareholders, which are not members of the FP expanded group, in exchange for all of the stock of UST.

(ii) Analysis. (A) Because USS1 and FP are both members of the FP expanded group, USS1 Note is treated as stock when it is issued by USS1 to FP in exchange for FP stock on Date A in Year 1 under paragraphs (b)(2)(ii) and (d)(1)(i) of this section. This result applies even though, pursuant to the same plan, USS1 transfers the FP stock to persons that are not members of the FP expanded group. The exchange of USS1 Note for FP stock is not an exempt exchange within the meaning of paragraph (g)(11) of this section.

(B) Because USS1 Note is treated as stock for federal tax purposes when it is issued by USS1, pursuant to section §1.367(b)-10(a)(3)(ii) (defining property for purposes of §1.367(b)-10) there is no potential application of §1.367(b)-10(a) to USS1's acquisition of the FP stock.

Example 3. Issuance of a note in exchange for expanded group stock. (i) Facts. On Date A in Year 1, USS1 issues USS1 Note to FP in exchange for 40% of the FS stock owned by FP.

(ii) Analysis. (A) Because USS1 and FP are both members of the FP expanded group, USS1 Note is treated as stock when it is issued by USS1 to FP in exchange for FS stock on Date A in Year 1 under paragraphs (b)(2)(ii) and (d)(1)(i) of this section. The exchange of USS1 Note for FS stock is not an exempt exchange within the meaning of paragraph (g)(11) of this section.

(B) Because USS1 Note is treated as stock for federal tax purposes when it is issued by USS1, USS1 Note is not treated as property for purposes of section 304(a) because it is not property within the meaning specified in section 317(a). Therefore, USS1's acquisition of FS stock from FP in exchange for USS1 Note is not an acquisition described in section 304(a)(1).

Example 4. Funding occurs in same taxable year as distribution. (i) Facts. On Date A in Year 1, FP lends $200x to DS in exchange for DS Note A. On Date B in Year 1, DS distributes $400x of cash to USS1 in a distribution.

(ii) Analysis. Under paragraph (b)(3)(iii)(A) of this section, DS Note A is treated as funding the distribution by DS to USS1 because DS Note A is issued to a member of the FP expanded group during the per se period with respect to DS's distribution to USS1. Accordingly, under paragraphs (b)(3)(i)(A) and (d)(1)(ii) of this section, DS Note A is treated as stock on Date B in Year 1.

Example 5. Additional funding. (i) Facts. The facts are the same as in Example 4 of this paragraph (h)(3), except that, in addition, on Date C in Year 2, FP lends an additional $300x to DS in exchange for DS Note B.

(ii) Analysis. The analysis is the same as in Example 4 of this paragraph (h)(3) with respect to DS Note A. DS Note B is also issued to a member of the FP expanded group during the per se period with respect to DS's distribution to USS1. Under paragraphs (b)(3)(iii)(A) and (b)(6) of this section, DS Note B is treated as funding only the remaining portion of DS's distribution to USS1, which is $200x. Accordingly, $200x of DS Note B is treated as stock under paragraph (b)(3)(i)(A) of this section. Under paragraph (d)(1)(i) of this section, $200x of DS Note B is treated as stock when it is issued by DS to FP on Date C in Year 2. The remaining $100x of DS Note B continues to be treated as indebtedness.

Example 6. Funding involving multiple interests. (i) Facts. On Date A in Year 1, FP lends $300x to USS1 in exchange for USS1 Note A. On Date B in Year 2, USS1 distributes $300x of cash to FP. On Date C in Year 3, FP lends another $300x to USS1 in exchange for USS1 Note B.

(ii) Analysis. (A) Under paragraph (b)(3)(iii)(B) of this section, USS1 Note A is tested under paragraph (b)(3) of this section before USS1 Note B is tested. USS1 Note A is issued during the per se period with respect to USS1's $300x distribution to FP and, therefore, is treated as funding the distribution under paragraph (b)(3)(iii)(A) of this section. Beginning on Date B in Year 2, USS1 Note A is treated as stock under paragraphs (b)(3)(i)(A) and (d)(1)(ii) of this section.

(B) Under paragraph (b)(3)(iii)(B) of this section, USS1 Note B is tested under paragraph (b)(3) of this section after USS1 Note A is tested. Because USS1 Note A is treated as funding the entire $300x distribution by USS1 to FP, USS1 Note B will continue to be treated as indebtedness. See paragraph (b)(6) of this section.

Example 7. Re-testing. (i) Facts. The facts are the same as in Example 6 of this

paragraph (h)(3), except that on Date D in Year 4, FP sells USS1 Note A to Bank.

(ii) Analysis. (A) Under paragraph (d)(2)(i) of this section, USS1 Note A ceases to be treated as stock when FP sells USS1 Note A to Bank on Date D in Year 4. Immediately before FP sells USS1 Note A to Bank, USS1 is deemed to issue a debt instrument to FP in exchange for USS1 Note A in a transaction that is disregarded for purposes of paragraphs (b)(2) and (b)(3) of this section.

(B) Under paragraph (d)(2)(ii) of this section, after USS1 Note A is deemed exchanged for a new debt instrument, USS1's other covered debt instruments that are not treated as stock as of Date D in Year 4 (USS1 Note B) are re-tested for purposes of paragraph (b)(3)(iii) of this section to determine whether the instruments are treated as funding the $300x distribution by USS1 to FP on Date B in Year 2. USS1 Note B was issued by USS1 to FP during the per se period. Accordingly, USS1 Note B is re-tested under paragraph (b)(3)(iii) of this section. Under paragraph (b)(3)(iii) of this section, USS1 Note B is treated as funding the distribution on Date C in Year 3 and, accordingly, is treated as stock under paragraph (b)(3)(i)(A) of this section. USS1 Note B is deemed to be exchanged for stock on Date D in Year 4, the re-testing date, under paragraph (d)(1)(iv) of this section. See §1.385-1(d) for rules regarding the treatment of this deemed exchange.

Example 8. Distribution of expanded group stock and covered debt instrument in a reorganization that qualifies under section 355. (i) Facts. On Date A in Year 1, FP lends $200x to USS2 in exchange for USS2 Note. In a transaction that is treated as independent from the transaction on Date A in Year 1, on Date B in Year 2, USS2 transfers a portion of its assets to DS2, a newly formed domestic corporation, in exchange for all of the stock of DS2 and DS2 Note. Immediately afterwards, USS2 distributes all of the DS2 stock and the DS2 Note to FP with respect to FP's USS2 stock in a transaction that qualifies under section 355. USS2's transfer of a portion of its assets to DS2 qualifies as a reorganization described in section 368(a)(1)(D). The DS2 stock has a value of $150x and DS2 Note has a value of $50x. The DS2 stock is not non-qualified preferred stock as defined in section 351(g)(2). Absent the application of this section, DS2 Note would be treated by FP as other property within the meaning of section 356.

(ii) Analysis. (A) The contribution and distribution transaction is a reorganization described in section 368(a)(1)(D) involving a transfer of property by USS2 to DS2 in exchange for DS2 stock and DS2 Note. The transfer of property by USS2 to DS2 is a contribution of excluded property described in paragraph (c)(3)(ii)(D)(2) of this section and an excluded contribution described in paragraph (c)(3)(ii)(E)(2) of this section. Accordingly, USS2's contribution of property to DS2 is not a qualified contribution described in paragraph (c)(3)(ii)(B) of this section.

(B) DS2 Note is a covered debt instrument that is issued by DS2 to USS2, both members of the FP expanded group, in exchange for property of USS2 in an asset reorganization (as defined in paragraph (g)(1) of this section), and received by FP, another FP expanded group member immediately before the reorganization, as other

property with respect to FP's USS2 stock. Accordingly, the transaction is described in paragraph (b)(2)(iii) of this section, and DS2 Note is treated as stock when it is issued by DS2 to USS2 on Date B in Year 2 pursuant to paragraphs (b)(2)(iii) and (d)(1)(i) of this section.

(C) Because the issuance of DS2 Note by DS2 in exchange for the property of USS2 in an asset reorganization is described in paragraph (b)(2)(iii) of this section, the distribution and acquisition of DS2 Note by USS2 is not treated as a distribution or acquisition described in paragraph (b)(3)(i) of this section. Accordingly, USS2 Note is not treated as funding the distribution of DS2 Note for purposes of paragraph (b)(3)(i) of this section.

(D) USS2's acquisition of DS2 stock is not an acquisition described in paragraph (b)(3)(i)(B) of this section because it is an exempt exchange (as defined in paragraph (g)(11) of this section). USS2's acquisition of DS2 stock is an exempt exchange because USS2 and DS2 are both parties to a reorganization that is an asset reorganization, section 1032 applies to DS2, the transferor of the expanded group stock, and the DS2 stock is distributed by USS2, the transferee of the expanded group stock, pursuant to the plan of reorganization.

(E) USS2's distribution of $150x of the DS2 stock is a distribution of stock that is permitted to be received by FP without recognition of gain under section 355(a)(1). Accordingly, USS2's distribution of the DS2 stock (other than the DS2 Note) to FP is an exempt distribution, and is not described in paragraph (b)(3)(i)(A) of this section.

(F) Because USS2 has not made a distribution or acquisition that is described in paragraph (b)(3)(i)(A), (B), or (C) of this section, USS2 Note is not treated as stock.

Example 9. Funding a distribution by a successor to funded member. (i) Facts. The facts are the same as in Example 8 of this paragraph (h)(3), except that on Date C in Year 3, DS2 distributes $200x of cash to FP and, subsequently, on Date D in Year 3, USS2 distributes $100x of cash to FP.

(ii) Analysis. (A) USS2 is a predecessor of DS2 under paragraph (g)(20)(i)(B) of this section and DS2 is a successor to USS2 under paragraph (g)(24)(i)(B) of this section because USS2 is the distributing corporation and DS2 is the controlled corporation in a distribution to which section 355 applies. Accordingly, under paragraph (b)(3)(v) of this section, a distribution by DS2 is treated as a distribution by USS2. Under paragraphs (b)(3)(iii)(A) and (b)(3)(v)(B) of this section, USS2 Note is treated as funding the distribution by DS2 to FP because USS2 Note was issued during the per se period with respect to DS2's $200x cash distribution, and because both the issuance of USS2 Note and the distribution by DS2 occur during the per se period with respect to the section 355 distribution. Accordingly, under paragraphs (b)(3)(i)(A) and (d)(1)(ii) of this section, USS2 Note is treated as stock beginning on Date C in Year 3. See §1.385-1(d) for rules regarding the treatment of this deemed exchange.

(B) Because the entire amount of USS2 Note is treated as funding DS2's $200x distribution to FP, under paragraph (b)(3)(iii)(C) of this section, USS2 Note is not treated as funding the subsequent distribution by USS2 on Date D in Year 3.

Example 10. Asset reorganization; section 354 qualified property. (i) Facts. On Date A in Year 1, FS lends $100x to USS2 in exchange for USS2 Note. On Date B in Year 2, in a transaction that qualifies as a reorganization described in section 368(a)(1)(D), USS2 transfers all of its assets to USS1 in exchange for stock of USS1 and the assumption by USS1 of all of the liabilities of USS2, and USS2 distributes to FP, with respect to FP's USS2 stock, all of the USS1 stock that USS2 receives. FP does not recognize gain under section 354(a)(1).

(ii) Analysis. (A) USS1 is a successor to USS2 under paragraph (g)(24)(i)(A) of this section. For purposes of paragraph (b)(3) of this section, USS2 and, under paragraph (b)(3)(v)(A) of this section, its successor, USS1, are funded members with respect to USS2 Note. Although USS2, a funded member, distributes property (USS1 stock) to its shareholder, FP, pursuant to the reorganization, the distribution of USS1 stock is not described in paragraph (b)(3)(i)(A) of this section because the stock is distributed in an exempt distribution (as defined in paragraph (g)(10) of this section). In addition, neither USS1's acquisition of the assets of USS2 nor USS2's acquisition of USS1 stock is described in paragraph (b)(3)(i)(C) of this section because FP does not receive other property within the meaning of section 356 with respect to its stock in USS2.

(B) USS2's acquisition of USS1 stock is not an acquisition described in paragraph (b)(3)(i)(B) of this section because it is an exempt exchange (as defined in paragraph (g)(11) of this section). USS2's acquisition of USS1 stock is an exempt exchange because USS1 and USS2 are both parties to an asset reorganization, section 1032 applies to USS1, the transferor of the USS1 stock, and the USS1 stock is distributed by USS2, the transferee, pursuant to the plan of reorganization. Furthermore, USS2's acquisition of its own stock from FS is not an acquisition described in paragraph (b)(3)(i)(B) of this section because USS2 acquires its stock in exchange for USS1 stock.

(C) Because neither USS1 nor USS2 has made a distribution or acquisition described in paragraph (b)(3)(i)(A), (B), or (C) of this section, USS2 Note is not treated as stock under paragraph (b)(3)(iii)(A) of this section.

Example 11. Distribution of a covered debt instrument and issuance of a covered debt instrument with a principal purpose of avoiding the purposes of this section. (i) Facts. On Date A in Year 1, USS1 issues USS1 Note A, which has a value of $100x, to FP in a distribution. On Date B in Year 1, with a principal purpose of avoiding the purposes of this section, FP sells USS1 Note A to Bank for $100x of cash and lends $100x to USS1 in exchange for USS1 Note B.

(ii) Analysis. USS1 Note A is a covered debt instrument that is issued by USS1 to FP, a member of USS1's expanded group, in a distribution. Accordingly, under

paragraphs (b)(2)(i) and (d)(1)(i) of this section, USS1 Note A is treated as stock when it is issued by USS1 to FP on Date A in Year 1. Accordingly, USS1 is treated as distributing USS1 stock to FP. Because the distribution of USS1 Note A is described in paragraph (b)(2)(i) of this section, the distribution of USS1 Note A is not described in paragraph (b)(3)(i)(A) of this section under paragraph (b)(5) of this section. Under paragraph (d)(2)(i) of this section, USS1 Note A ceases to be treated as stock when FP sells USS1 Note A to Bank on Date B in Year 1. Immediately before FP sells USS1 Note A to Bank, USS1 is deemed to issue a debt instrument to FP in exchange for USS1 Note A in a transaction that is disregarded for purposes of paragraphs (b)(2) and (b)(3)(i) of this section. USS1 Note B is not treated as stock under paragraph (b)(3)(i)(A) of this section because the funded member, USS1, has not made a distribution of property. However, because the transactions occurring on Date B of Year 1 were undertaken with a principal purpose of avoiding the purposes of this section, USS1 Note B is treated as stock on Date B of Year 1 under paragraph (b)(4) of this section.

Example 12. [Reserved]. For further guidance, see §1.385-3T(h)(3), Example 12.

Example 13. [Reserved]. For further guidance, see §1.385-3T(h)(3), Example 13.

Example 14. [Reserved]. For further guidance, see §1.385-3T(h)(3), Example 14.

Example 15. [Reserved]. For further guidance, see §1.385-3T(h)(3), Example 15.

Example 16. [Reserved]. For further guidance, see §1.385-3T(h)(3), Example 16.

Example 17. [Reserved]. For further guidance, see §1.385-3T(h)(3), Example 17.

Example 18. [Reserved]. For further guidance, see §1.385-3T(h)(3), Example 18.

Example 19. [Reserved]. For further guidance, see §1.385-3T(h)(3), Example 19.

(i) [Reserved]

(j) Applicability date and transition rules--(1) In general. This section applies to taxable years ending on or after **[INSERT DATE 90 DAYS AFTER DATE OF**

PUBLICATION IN THE FEDERAL REGISTER].

(2) Transition rules--(i) Transition rule for covered debt instruments that would be treated as stock in taxable years ending before **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. If paragraphs (b) and (d)(1) of this section, taking into account §§1.385-1, 1.385-3T, and 1.385-4T, would have treated a covered debt instrument as stock in a taxable year ending before **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]** but for the application of paragraph (j)(1) of this section, to the extent that the covered debt instrument is held by a member of the expanded group of which the issuer is a member immediately after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, then the covered debt instrument is deemed to be exchanged for stock immediately after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

(ii) Transition rule for certain covered debt instruments treated as stock in taxable years ending on or after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. If paragraphs (b) and (d)(1) of this section, taking into account §§1.385-1, 1.385-3T, and 1.385-4T, would treat a covered debt instrument as stock on or before **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]** but in a taxable year ending on or after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, that covered debt instrument is not treated as stock during the 90-day period after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. Instead, to the extent that the covered debt instrument is held by a member of the expanded group of which the issuer

is a member immediately after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, the covered debt instrument is deemed to be exchanged for stock immediately after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

(iii) Transition funding rule. When a covered debt instrument would be recharacterized as stock after April 4, 2016, and on or before **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]** (the transition period), but that covered debt instrument is not recharacterized as stock on such date due to the application of paragraph (j)(1), (j)(2)(i), or (j)(2)(ii) of this section, any payments made with respect to such covered debt instrument (other than stated interest), including pursuant to a refinancing, after the date that the covered debt instrument would have been recharacterized as stock and through the remaining portion of the transition period are treated as distributions for purposes of applying paragraph (b)(3) of this section for taxable years ending on or after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. In addition, to the extent that the holder and the issuer of the covered debt instrument cease to be members of the same expanded group during the transition period, the distribution or acquisition that would have caused the covered debt instrument to be treated as stock is available to be treated as funded by other covered debt instruments of the issuer for purposes of paragraph (b)(3) of this section (to the extent provided in paragraph (b)(3)(iii) of this section). The prior sentence is applied in a manner that is consistent with the rules set forth in paragraph (d)(2) of this section.

(iv) Coordination between the general rule and funding rule. When a covered

debt instrument would be recharacterized as stock pursuant to paragraph (b)(2) of this section after April 4, 2016, and on or before **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, but that covered debt instrument is not recharacterized as stock on such date due to the application of paragraph (j)(1), (j)(2)(i), or (j)(2)(ii) of this section, the issuance of such covered debt instrument is not treated as a distribution or acquisition described in §1.385-3(b)(3)(i), but only to the extent that the covered debt instrument is held by a member of the expanded group of which the issuer is a member immediately after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

(v) Option to apply proposed regulations. In lieu of applying §§1.385-1, 1.385-3, 1.385-3T, and 1.385-4T, taxpayers may apply the provisions matching §§1.385-1, 1.385-3, and 1.385-4 from the Internal Revenue Bulletin (IRB) 2016-17 (https://www.irs.gov/pub/irs-irbs/irb16-17.pdf) to all debt instruments issued by a particular issuer (and members of its expanded group that are covered members) after April 4, 2016, and before **October 13, 2016**, solely for purposes of determining whether a debt instrument is treated as stock, provided that those sections are consistently applied.

Par. 5. Section 1.385-3T is added to read as follows:

§1.385-3T Certain distributions of debt instruments and similar transactions (temporary).

(a) [Reserved]. For further guidance, see §1.385-3(a).

(b)(1) through (b)(2). [Reserved]. For further guidance, see §1.385-3(b)(1) through (b)(2).

(b)(3)(i) through (vi). [Reserved]. For further guidance, see §1.385-3(b)(3)(i)

through (vi).

(vii) Qualified short-term debt instrument. The term qualified short-term debt instrument means a covered debt instrument that is described in paragraph (b)(3)(vii)(A), (b)(3)(vii)(B), (b)(3)(vii)(C), or (b)(3)(vii)(D) of this section.

(A) Short-term funding arrangement. A covered debt instrument is described in this paragraph (b)(3)(vii)(A) if the requirements of the specified current assets test described in paragraph (b)(3)(vii)(A)(1) of this section or the 270-day test described in paragraph (b)(3)(vii)(A)(2) of this section (the alternative tests) are satisfied, provided that an issuer may only claim the benefit of one of the alternative tests with respect to covered debt instruments issued by the issuer in the same taxable year.

(1) Specified current assets test--(i) In general. The requirements of this paragraph (b)(3)(vii)(A)(1) are satisfied with respect to a covered debt instrument if the requirement of paragraph (b)(3)(vii)(A)(1)(ii) of this section is satisfied, but only to the extent the requirement of paragraph (b)(3)(vii)(A)(1)(iii) of this section is satisfied.

(ii) Maximum interest rate. The rate of interest charged with respect to the covered debt instrument does not exceed an arm's length interest rate, as determined under section 482 and the regulations thereunder, that would be charged with respect to a comparable debt instrument of the issuer with a term that does not exceed the longer of 90 days and the issuer's normal operating cycle.

(iii) Maximum outstanding balance. The amount owed by the issuer under covered debt instruments issued to members of the issuer's expanded group that satisfy the requirements of paragraph (b)(3)(vii)(A)(1)(ii), (b)(3)(vii)(A)(2) (if the covered debt instrument was issued in a prior taxable year), (b)(3)(vii)(B), or (b)(3)(vii)(C) of this

section immediately after the covered debt instrument is issued does not exceed the maximum of the amounts of specified current assets reasonably expected to be reflected, under applicable accounting principles, on the issuer's balance sheet as a result of transactions in the ordinary course of business during the subsequent 90-day period or the issuer's normal operating cycle, whichever is longer. For purposes of the preceding sentence, in the case of an issuer that is a qualified cash pool header, the amount owed by the issuer shall not take into account deposits described in paragraph (b)(3)(vii)(D) of this section. Additionally, the amount owned by any issuer shall be reduced by the amount of the issuer's deposits with a qualified cash pool header, but only to the extent of amounts borrowed from the same qualified cash pool header that satisfy the requirements of paragraph (b)(3)(vii)(A)(2) (if the covered debt instrument was issued in a prior taxable year) or (b)(3)(vii)(A)(1)(ii) of this section.

(iv) Specified current assets. For purposes of paragraph (b)(3)(vii)(A)(1)(iii) of this section, the term specified current assets means assets that are reasonably expected to be realized in cash or sold (including by being incorporated into inventory that is sold) during the normal operating cycle of the issuer, other than cash, cash equivalents, and assets that are reflected on the books and records of a qualified cash pool header.

(v) Normal operating cycle. For purposes of paragraph (b)(3)(vii)(A)(1) of this section, the term normal operating cycle means the issuer's normal operating cycle as determined under applicable accounting principles, except that if the issuer has no single clearly defined normal operating cycle, then the normal operating cycle is

determined based on a reasonable analysis of the length of the operating cycles of the multiple businesses and their sizes relative to the overall size of the issuer.

(vi) Applicable accounting principles. For purposes of paragraph (b)(3)(vii)(A)(1) of this section, the term applicable accounting principles means the financial accounting principles generally accepted in the United States, or an international financial accounting standard, that is applicable to the issuer in preparing its financial statements, computed on a consistent basis.

(2) 270-day test--(i) In general. A covered debt instrument is described in this paragraph (b)(3)(vii)(A)(2) if the requirements of paragraphs (b)(3)(vii)(A)(2)(ii) through (b)(3)(vii)(A)(2)(iv) of this section are satisfied.

(ii) Maximum term and interest rate. The covered debt instrument must have a term of 270 days or less or be an advance under a revolving credit agreement or similar arrangement and must bear a rate of interest that does not exceed an arm's length interest rate, as determined under section 482 and the regulations thereunder, that would be charged with respect to a comparable debt instrument of the issuer with a term that does not exceed 270 days.

(iii) Lender-specific indebtedness limit. The issuer is a net borrower from the lender for no more than 270 days during the taxable year of the issuer, and in the case of a covered debt instrument outstanding during consecutive tax years, the issuer is a net borrower from the lender for no more than 270 consecutive days, in both cases taking into account only covered debt instruments that satisfy the requirement of paragraph (b)(3)(vii)(A)(2)(ii) of this section other than covered debt instruments described in paragraph (b)(3)(vii)(B) or (b)(3)(vii)(C) of this section.

(iv) Overall indebtedness limit. The issuer is a net borrower under all covered debt instruments issued to members of the issuer's expanded group that satisfy the requirements of paragraphs (b)(3)(vii)(A)(2)(ii) and (iii) of this section, other than covered debt instruments described in paragraph (b)(3)(vii)(B) or (b)(3)(vii)(C) of this section, for no more than 270 days during the taxable year of the issuer, determined without regard to the identity of the lender under such covered debt instruments.

(v) Inadvertent error. An issuer's failure to satisfy the 270-day test will be disregarded if the failure is reasonable in light of all the facts and circumstances and the failure is promptly cured upon discovery. A failure to satisfy the 270-day test will be considered reasonable if the taxpayer maintains due diligence procedures to prevent such failures, as evidenced by having written policies and operational procedures in place to monitor compliance with the 270-day test and management-level employees of the expanded group having undertaken reasonable efforts to establish, follow, and enforce such policies and procedures.

(B) Ordinary course loans. A covered debt instrument is described in this paragraph (b)(3)(vii)(B) if the covered debt instrument is issued as consideration for the acquisition of property other than money in the ordinary course of the issuer's trade or business, provided that the obligation is reasonably expected to be repaid within 120 days of issuance.

(C) Interest-free loans. A covered debt instrument is described in this paragraph (b)(3)(vii)(C) if the instrument does not provide for stated interest or no interest is charged on the instrument, the instrument does not have original issue discount (as defined in section 1273 and the regulations thereunder), interest is not imputed under

section 483 or section 7872 and the regulations thereunder, and interest is not required to be charged under section 482 and the regulations thereunder.

(D) Deposits with a qualified cash pool header--(1) In general. A covered debt instrument is described in this paragraph (b)(3)(vii)(D) if it is a demand deposit received by a qualified cash pool header described in paragraph (b)(3)(vii)(D)(2) of this section pursuant to a cash-management arrangement described in paragraph (b)(3)(vii)(D)(3) of this section. This paragraph (b)(3)(vii)(D) does not apply if a purpose for making the demand deposit is to facilitate the avoidance of the purposes of this section or §1.385-3 with respect to a qualified business unit (as defined in section 989(a) and the regulations thereunder) (QBU) that is not a qualified cash pool header.

(2) Qualified cash pool header. The term qualified cash pool header means an expanded group member, controlled partnership, or QBU described in §1.989(a)-1(b)(2)(ii), that has as its principal purpose managing a cash-management arrangement for participating expanded group members, provided that the excess (if any) of funds on deposit with such expanded group member, controlled partnership, or QBU (header) over the outstanding balance of loans made by the header is maintained on the books and records of the header in the form of cash or cash equivalents, or invested through deposits with, or the acquisition of obligations or portfolio securities of, persons that do not have a relationship to the header (or, in the case of a header that is a QBU described in §1.989(a)-1(b)(2)(ii), its owner) described in section 267(b) or section 707(b).

(3) Cash-management arrangement. The term cash-management arrangement means an arrangement the principal purpose of which is to manage cash for

participating expanded group members. For purposes of the preceding sentence, managing cash means borrowing excess funds from participating expanded group members and lending funds to participating expanded group members, and may also include foreign exchange management, clearing payments, investing excess cash with an unrelated person, depositing excess cash with another qualified cash pool header, and settling intercompany accounts, for example through netting centers and pay-on-behalf-of programs.

(b)(viii) [Reserved]. For further guidance, see §1.385-3(b)(viii).

(c) [Reserved]. For further guidance, see §1.385-3(c).

(d)(1) through (d)(3) [Reserved]. For further guidance, see §1.385-3(d)(1) through (d)(3).

(4) Treatment of disregarded entities. This paragraph (d)(4) applies to the extent that a covered debt instrument issued by a disregarded entity, the regarded owner of which is a covered member, would, absent the application of this paragraph (d)(4), be treated as stock under §1.385-3. In this case, rather than the covered debt instrument being treated as stock to such extent (applicable portion), the covered member that is the regarded owner of the disregarded entity is deemed to issue its stock in the manner described in this paragraph (d)(4). If the applicable portion otherwise would have been treated as stock under §1.385-3(b)(2), then the covered member is deemed to issue its stock to the expanded group member to which the covered debt instrument was, in form, issued (or transferred) in the transaction described in §1.385-3(b)(2). If the applicable portion otherwise would have been treated as stock under §1.385-3(b)(3)(i), then the covered member is deemed to issue its stock to the holder of the covered debt

instrument in exchange for a portion of the covered debt instrument equal to the applicable portion. In each case, the covered member that is the regarded owner of the disregarded entity is treated as the holder of the applicable portion of the debt instrument issued by the disregarded entity, and the actual holder is treated as the holder of the remaining portion of the covered debt instrument and the stock deemed to be issued by the regarded owner. Under federal tax principles, the applicable portion of the debt instrument issued by the disregarded entity generally is disregarded. This paragraph (d)(4) must be applied in a manner that is consistent with the principles of paragraph (f)(4) of this section. Thus, for example, stock deemed issued is deemed to have the same terms as the covered debt instrument issued by the disregarded entity, other than the identity of the issuer, and payments on the stock are determined by reference to payments made on the covered debt instrument issued by the disregarded entity. See §1.385-4T(b)(3) for additional rules that apply if the regarded owner of the disregarded entity is a member of a consolidated group. If the regarded owner of a disregarded entity is a controlled partnership, then paragraph (f) of this section applies as though the controlled partnership were the issuer in form of the debt instrument.

(d)(5) through (d)(7). [Reserved]. For further guidance, see §1.385-3(d)(5) through (d)(7).

(e) [Reserved]. For further guidance, see §1.385-3(e).

(f) Treatment of controlled partnerships--(1) In general. For purposes of this section and §§1.385-3 and 1.385-4T, a controlled partnership is treated as an aggregate of its partners in the manner described in this paragraph (f). Paragraph (f)(2) of this section sets forth rules concerning the aggregate treatment when a controlled

partnership acquires property from a member of the expanded group. Paragraph (f)(3) of this section sets forth rules concerning the aggregate treatment when a controlled partnership issues a debt instrument. Paragraph (f)(4) of this section deems a debt instrument issued by a controlled partnership to be held by an expanded group partner rather than the holder-in-form in certain cases. Paragraph (f)(5) of this section sets forth the rules concerning events that cause the deemed results described in paragraph (f)(4) of this section to cease. Paragraph (f)(6) of this section exempts certain issuances of a controlled partnership's debt to a partner and a partner's debt to a controlled partnership from the application of this section and §1.385-3. For definitions applicable for this section, see paragraph (g) of this section and §1.385-3(g). For examples illustrating the application of this section, see paragraph (h) of this section.

(2) Acquisitions of property by a controlled partnership--(i) Acquisitions of property when a member of the expanded group is a partner on the date of the acquisition--(A) Aggregate treatment. Except as otherwise provided in paragraphs (f)(2)(i)(C) and (f)(6) of this section, if a controlled partnership, with respect to an expanded group, acquires property from a member of the expanded group (transferor member), then, for purposes of this section and §1.385-3, a member of the expanded group that is an expanded group partner on the date of the acquisition is treated as acquiring its share (as determined under paragraph (f)(2)(i)(B) of this section) of the property. The expanded group partner is treated as acquiring its share of the property from the transferor member in the manner (for example, in a distribution, in an exchange for property, or in an issuance), and on the date on which, the property is actually acquired by the controlled partnership from the transferor member.

Accordingly, this section and §1.385-3 apply to a member's acquisition of property described in this paragraph (f)(2)(i)(A) in the same manner as if the member actually acquired the property from the transferor member, unless explicitly provided otherwise.

(B) Expanded group partner's share of property. For purposes of paragraph (f)(2)(i)(A) of this section, a partner's share of property acquired by a controlled partnership is determined in accordance with the partner's liquidation value percentage (as defined in paragraph (g)(17) of this section) with respect to the controlled partnership. The liquidation value percentage is determined on the date on which the controlled partnership acquires the property.

(C) Exception if transferor member is an expanded group partner. If a transferor member is an expanded group partner in the controlled partnership, paragraph (f)(2)(i)(A) of this section does not apply to such partner.

(ii) Acquisitions of expanded group stock when a member of the expanded group becomes a partner after the acquisition--(A) Aggregate treatment. Except as otherwise provided in paragraph (f)(2)(ii)(C) of this section, if a controlled partnership, with respect to an expanded group, owns expanded group stock, and a member of the expanded group becomes an expanded group partner in the controlled partnership, then, for purposes of this section and §1.385-3, the member is treated as acquiring its share (as determined under paragraph (f)(2)(ii)(B) of this section) of the expanded group stock owned by the controlled partnership. The member is treated as acquiring its share of the expanded group stock on the date on which the member becomes an expanded group partner. Furthermore, the member is treated as if it acquires its share of the expanded group stock from a member of the expanded group in exchange for property

other than expanded group stock, regardless of the manner in which the partnership acquired the stock and in which the member acquires its partnership interest. Accordingly, this section and §1.385-3 apply to a member's acquisition of expanded group stock described in this paragraph (f)(2)(ii)(A) in the same manner as if the member actually acquired the stock from a member of the expanded group in exchange for property other than expanded group stock, unless explicitly provided otherwise.

(B) Expanded group partner's share of expanded group stock. For purposes of paragraph (f)(2)(ii)(A) of this section, a partner's share of expanded group stock owned by a controlled partnership is determined in accordance with the partner's liquidation value percentage with respect to the controlled partnership. The liquidation value percentage is determined on the date on which a member of the expanded group becomes an expanded group partner in the controlled partnership.

(C) Exception if an expanded group partner acquires its interest in a controlled partnership in exchange for expanded group stock. Paragraph (f)(2)(ii)(A) of this section does not apply to a member of an expanded group that acquires its interest in a controlled partnership either from another partner in exchange solely for expanded group stock or upon a partnership contribution to the controlled partnership comprised solely of expanded group stock.

(3) Issuances of debt instruments by a controlled partnership to a member of an expanded group--(i) Aggregate treatment. If a controlled partnership, with respect to an expanded group, issues a debt instrument to a member of the expanded group, then, for purposes of this section and §1.385-3, a covered member that is an expanded group partner is treated as the issuer with respect to its share (as determined under paragraph

(f)(3)(ii) of this section) of the debt instrument issued by the controlled partnership. This section and §1.385-3 apply to the portion of the debt instrument treated as issued by the covered member as described in this paragraph (f)(3)(i) in the same manner as if the covered member actually issued the debt instrument to the holder-in-form, unless otherwise provided. See paragraph (f)(4) of this section, which deems a debt instrument issued by a controlled partnership to be held by an expanded group partner rather than the holder-in-form in certain cases.

(ii) Expanded group partner's share of a debt instrument issued by a controlled partnership--(A) General rule. An expanded group partner's share of a debt instrument issued by a controlled partnership is determined on each date on which the partner makes a distribution or acquisition described in §1.385-3(b)(2) or (b)(3)(i) (testing date). An expanded group partner's share of a debt instrument issued by a controlled partnership to a member of the expanded group is determined in accordance with the partner's issuance percentage (as defined in paragraph (g)(16) of this section) on the testing date. A partner's share determined under this paragraph (f)(3)(ii)(A) is adjusted as described in paragraph (f)(3)(ii)(B) of this section.

(B) Additional rules if there is a specified portion with respect to a debt instrument--(1) An expanded group partner's share (as determined under paragraph (f)(3)(ii)(A) of this section) of a debt instrument issued by a controlled partnership is reduced, but not below zero, by the sum of all of the specified portions (as defined in paragraph (g)(23) of this section), if any, with respect to the debt instrument that correspond to one or more deemed transferred receivables (as defined in paragraph (g)(8) of this section) that are deemed to be held by the partner.

(2) If the aggregate of all of the expanded group partners' shares (as determined under paragraph (f)(3)(ii)(A) of this section and reduced under paragraph (f)(3)(ii)(B)(1) of this section) of the debt instrument exceeds the adjusted issue price of the debt, reduced by the sum of all of the specified portions with respect to the debt instrument that correspond to one or more deemed transferred receivables that are deemed to be held by one or more expanded group partners (excess amount), then each expanded group partner's share (as determined under paragraph (f)(3)(ii)(A) of this section and reduced under paragraph (f)(3)(ii)(B)(1) of this section) of the debt instrument is reduced. The amount of an expanded group partner's reduction is the excess amount multiplied by a fraction, the numerator of which is the partner's share, and the denominator of which is the aggregate of all of the expanded group partners' shares.

(iii) Qualified short-term debt instrument. The determination of whether a debt instrument is a qualified short-term debt instrument for purposes of §1.385-3(b)(3)(vii) is made at the partnership-level without regard to paragraph (f)(3)(i) of this section.

(4) Recharacterization when there is a specified portion with respect to a debt instrument issued by a controlled partnership--(i) General rule. A specified portion, with respect to a debt instrument issued by a controlled partnership and an expanded group partner, is not treated as stock under §1.385-3(b)(2) or (b)(3)(i). Except as otherwise provided in paragraphs (f)(4)(ii) and (f)(4)(iii) of this section, the holder-in-form (as defined in paragraph (g)(15) of this section) of the debt instrument is deemed to transfer a portion of the debt instrument (a deemed transferred receivable, as defined in paragraph (g)(8) of this section) with a principal amount equal to the adjusted issue price of the specified portion to the expanded group partner in exchange for stock in the

expanded group partner (deemed partner stock, as defined in paragraph (g)(6) of this section) with a fair market value equal to the principal amount of the deemed transferred receivable. Except as otherwise provided in paragraph (f)(4)(vi) of this section (concerning the treatment of a deemed transferred receivable for purposes of section 752) and paragraph (f)(5) of this section (concerning specified events subsequent to the deemed transfer), the deemed transfer described in this paragraph (f)(4)(i) is deemed to occur for all federal tax purposes.

(ii) Expanded group partner is the holder-in-form of a debt instrument. If the specified portion described in paragraph (f)(4)(i) of this section is with respect to an expanded group partner that is the holder-in-form of the debt instrument, then paragraph (f)(4)(i) of this section will not apply with respect to that specified portion except that only the first sentence of paragraph (f)(4)(i) of this section is applicable.

(iii) Expanded group partner is a consolidated group member. This paragraph (f)(4)(iii) applies when one or more expanded group partners is a member of a consolidated group that files (or is required to file) a consolidated U.S. federal income tax return. In this case, notwithstanding §1.385-4T(b)(1) (which generally treats members of a consolidated group as one corporation for purposes of this section and §1.385-3), the holder-in-form of the debt instrument issued by the controlled partnership is deemed to transfer the deemed transferred receivable or receivables to the expanded group partner or partners that are members of a consolidated group that make, or are treated as making under paragraph (f)(2) of this section, the regarded distributions or acquisitions (within the meaning of §1.385-4T(e)(5)) described in §1.385-3(b)(2) or (b)(3)(i) in exchange for deemed partner stock in such partner or partners. To the

extent those regarded distributions or acquisitions are made by a member of the consolidated group that is not an expanded group partner (excess amount), the holder-in-form is deemed to transfer a portion of the deemed transferred receivable or receivables to each member of the consolidated group that is an expanded group partner in exchange for deemed partner stock in the expanded group partner. The portion is the excess amount multiplied by a fraction, the numerator of which is the portion of the consolidated group's share (as determined under paragraph (f)(3)(ii) of this section) of the debt instrument issued by the controlled partnership that would have been the expanded group partner's share if the partner was not a member of a consolidated group, and the denominator of which is the consolidated group's share of the debt instrument issued by the controlled partnership.

(iv) Rules regarding deemed transferred receivables and deemed partner stock--(A) Terms of deemed partner stock. Deemed partner stock has the same terms as the deemed transferred receivable with respect to the deemed transfer, other than the identity of the issuer.

(B) Treatment of payments with respect to a debt instrument for which there is one or more deemed transferred receivables. When a payment is made with respect to a debt instrument issued by a controlled partnership for which there is one or more deemed transferred receivables, then, if the amount of the retained receivable (as defined in paragraph (g)(22) of this section) held by the holder-in-form is zero and a single deemed holder is deemed to hold all of the deemed transferred receivables, the entire payment is allocated to the deemed transferred receivables held by the single deemed holder. If the amount of the retained receivable held by the holder-in-form is

greater than zero or there are multiple deemed holders of deemed transferred receivables, or both, the payment is apportioned among the retained receivable, if any, and each deemed transferred receivable in proportion to the principal amount of all the receivables. The portion of a payment allocated or apportioned to a retained receivable or a deemed transferred receivable reduces the principal amount of, or accrued interest with respect to, as applicable depending on the payment, the retained receivable or deemed transferred receivable. When a payment allocated or apportioned to a deemed transferred receivable reduces the principal amount of the receivable, the expanded group partner that is the deemed holder with respect to the deemed transferred receivable is deemed to redeem the same amount of deemed partner stock, and the specified portion with respect to the debt instrument is reduced by the same amount. When a payment allocated or apportioned to a deemed transferred receivable reduces accrued interest with respect to the receivable, the expanded group partner that is the deemed holder with respect to the deemed transferred receivable is deemed to make a matching distribution in the same amount with respect to the deemed partner stock. The controlled partnership is treated as the paying agent with respect to the deemed partner stock.

(v) Holder-in-form transfers debt instrument in a transaction that is not a specified event. If the holder-in-form transfers the debt instrument (which is disregarded for federal tax purposes) to a member of the expanded group or a controlled partnership (and therefore the transfer is not a specified event described in paragraph (f)(5)(iii)(F) of this section), then, for federal tax purposes, the holder-in-form is deemed to transfer the retained receivable and the deemed partner stock to the transferee.

(vi) Allocation of deemed transferred receivable under section 752. A partnership liability that is a debt instrument with respect to which there is one or more deemed transferred receivables is allocated for purposes of section 752 without regard to any deemed transfer.

(5) Specified events affecting ownership following a deemed transfer--(i) General rule. If a specified event (within the meaning of paragraph (f)(5)(iii) of this section) occurs with respect to a deemed transfer, then, immediately before the specified event, the expanded group partner that is both the issuer of the deemed partner stock and the deemed holder of the deemed transferred receivable is deemed to distribute the deemed transferred receivable (or portion thereof, as determined under paragraph (f)(5)(iv) of this section) to the holder-in-form in redemption of the deemed partner stock (or portion thereof, as determined under paragraph (f)(5)(iv) of this section) deemed to be held by the holder-in-form. The deemed distribution is deemed to occur for all federal tax purposes, except that the distribution is disregarded for purposes of §1.385-3(b). Except when the deemed transferred receivable (or portion thereof, as determined under paragraph (f)(5)(iv) of this section) is deemed to be retransferred under paragraph (f)(5)(ii) of this section, the principal amount of the retained receivable held by the holder-in-form is increased by the principal amount of the deemed transferred receivable, the deemed transferred receivable ceases to exist for federal tax purposes, and the specified portion (or portion thereof) that corresponds to the deemed transferred receivable (or portion thereof) ceases to be treated as a specified portion for purposes of this section and §1.385-3.

(ii) New deemed transfer when a specified event involves a transferee that is a

covered member that is an expanded group partner. If the specified event is described in paragraph (f)(5)(iii)(E) of this section, the holder-in-form of the debt instrument is deemed to retransfer the deemed transferred receivable (or portion thereof, as determined under paragraph (f)(5)(iv) of this section) that the holder-in-form is deemed to have received pursuant to paragraph (f)(5)(i) of this section, to the transferee expanded group partner in exchange for deemed partner stock issued by the transferee expanded group partner with a fair market value equal to the principal amount of the deemed transferred receivable (or portion thereof) that is retransferred. For purposes of this section, this deemed transfer is treated in the same manner as a deemed transfer described in paragraph (f)(4)(i) of this section.

(iii) Specified events. A specified event, with respect to a deemed transfer, occurs when, immediately after the transaction and taking into account all related transactions:

(A) The controlled partnership that is the issuer of the debt instrument either ceases to be a controlled partnership or ceases to have an expanded group partner that is a covered member.

(B) The holder-in-form is a member of the expanded group immediately before the transaction, and the holder-in-form and the deemed holder cease to be members of the same expanded group for the reasons described in §1.385-3(d)(2).

(C) The holder-in-form is a controlled partnership immediately before the transaction, and the holder-in-form ceases to be a controlled partnership.

(D) The expanded group partner that is both the issuer of deemed partner stock and the deemed holder transfers (directly or indirectly through one or more

partnerships) all or a portion of its interest in the controlled partnership to a person that neither is a covered member nor a controlled partnership with an expanded group partner that is a covered member. If there is a transfer of only a portion of the interest, see paragraph (f)(5)(iv) of this section.

(E) The expanded group partner that is both the issuer of deemed partner stock and the deemed holder transfers (directly or indirectly through one or more partnerships) all or a portion of its interest in the controlled partnership to a covered member or a controlled partnership with an expanded group partner that is a covered member. If there is a transfer of only a portion of the interest, see paragraph (f)(5)(iv) of this section.

(F) The holder-in-form transfers the debt instrument (which is disregarded for federal tax purposes) to a person that is neither a member of the expanded group nor a controlled partnership. See paragraph (f)(4)(v) of this section if the holder-in-form transfers the debt instrument to a member of the expanded group or a controlled partnership.

(iv) Specified event involving a transfer of only a portion of an interest in a controlled partnership. If, with respect to a specified event described in paragraph (f)(5)(iii)(D) or (E) of this section, an expanded group partner transfers only a portion of its interest in a controlled partnership, then, only a portion of the deemed transferred receivable that is deemed to be held by the expanded group partner is deemed to be distributed in redemption of an equal portion of the deemed partner stock. The portion of the deemed transferred receivable referred to in the preceding sentence is equal to the product of the entire principal amount of the deemed transferred receivable deemed

to be held by the expanded group partner multiplied by a fraction, the numerator of which is the portion of the expanded group partner's capital account attributable to the interest that is transferred, and the denominator of which is the expanded group partner's capital account with respect to its entire interest, determined immediately before the specified event.

(6) Issuance of a partnership's debt instrument to a partner and a partner's debt instrument to a partnership. If a controlled partnership, with respect to an expanded group, issues a debt instrument to an expanded group partner, or if a covered member that is an expanded group partner issues a covered debt instrument to a controlled partnership, and in each case, no partner deducts or receives an allocation of expense with respect to the debt instrument, then this section and 1.385-3 do not apply to the debt instrument.

(g)(1) through (4) [Reserved]. For further guidance, see §1.385-3(g)(1) through (4).

(5) Deemed holder. The term deemed holder means, with respect to a deemed transfer, the expanded group partner that is deemed to hold a deemed transferred receivable by reason of the deemed transfer.

(6) Deemed partner stock. The term deemed partner stock means, with respect to a deemed transfer, the stock deemed issued by an expanded group partner as described in paragraphs (f)(4)(i), (f)(4)(iii), and (f)(5)(ii) of this section. The amount of deemed partner stock is reduced as described in paragraphs (f)(4)(iv)(B) and (f)(5)(i) of this section.

(7) Deemed transfer. The term deemed transfer means, with respect to a

specified portion, the transfer described in paragraph (f)(4)(i), (f)(4)(iii), or (f)(5)(ii) of this section.

(8) Deemed transferred receivable. The term deemed transferred receivable means, with respect to a deemed transfer, the portion of the debt instrument described in paragraph (f)(4)(i), (f)(4)(iii), or (f)(5)(ii) of this section. The deemed transferred receivable is reduced as described in paragraphs (f)(4)(iv)(B) and (f)(5)(i) of this section.

(g)(9) through (14) [Reserved]. For further guidance, see §1.385-3(g)(9) through (14).

(15) Holder-in-form. The term holder-in-form means, with respect to a debt instrument issued by a controlled partnership, the person that, absent the application of paragraph (f)(4) of this section, would be the holder of the debt instrument for federal tax purposes. Therefore, the term holder-in-form does not include a deemed holder (as defined in paragraph (g)(5) of this section).

(16) Issuance percentage. The term issuance percentage means, with respect to a controlled partnership and an expanded group partner, the ratio (expressed as a percentage) of the partner's reasonably anticipated distributive share of all the partnership's interest expense over a reasonable period, divided by all of the partnership's reasonably anticipated interest expense over that same period, taking into account any and all relevant facts and circumstances. The relevant facts and circumstances include, without limitation, the term of the debt instrument; whether the partnership anticipates issuing other debt instruments; and the partnership's anticipated section 704(b) income and expense, and the partners' respective anticipated allocation percentages, taking into account anticipated changes to those allocation percentages

over time resulting, for example, from anticipated contributions, distributions, recapitalizations, or provisions in the controlled partnership agreement.

(17) Liquidation value percentage. The term liquidation value percentage means, with respect to a controlled partnership and an expanded group partner, the ratio (expressed as a percentage) of the liquidation value of the expanded group partner's interest in the partnership divided by the aggregate liquidation value of all the partners' interests in the partnership. The liquidation value of an expanded group partner's interest in a controlled partnership is the amount of cash the partner would receive with respect to the interest if the partnership (and any partnership through which the partner indirectly owns an interest in the controlled partnership) sold all of its property for an amount of cash equal to the fair market value of the property (taking into account section 7701(g)), satisfied all of its liabilities (other than those described in §1.752-7), paid an unrelated third party to assume all of its §1.752-7 liabilities in a fully taxable transaction, and then the partnership (and any partnership through which the partner indirectly owns an interest in the controlled partnership) liquidated.

(g)(18) through (g)(21) [Reserved]. For further guidance, see §1.385-3(g)(18) through (g)(21).

(22) Retained receivable. The term retained receivable means, with respect to a debt instrument issued by a controlled partnership, the portion of the debt instrument that is not transferred by the holder-in-form pursuant to one or more deemed transfers. The retained receivable is adjusted for decreases described in paragraph (f)(4)(iv)(B) of this section and increases described in paragraph (f)(5)(i) of this section.

(23) Specified portion. The term specified portion means, with respect to a debt

instrument issued by a controlled partnership and a covered member that is an expanded group partner, the portion of the debt instrument that is treated under paragraph (f)(3)(i) of this section as issued on a testing date (within the meaning of paragraph (f)(3)(ii) of this section) by the covered member and that, absent the application of paragraph (f)(4)(i) of this section, would be treated as stock under §1.385-3(b)(2) or (b)(3)(i) on the testing date. A specified portion is reduced as described in paragraphs (f)(4)(iv)(B) and (5)(i) of this section.

(g)(24) through (25) [Reserved]. For further guidance, see §1.385-3(g)(24) through (25).

(h) Introductory text through (h)(3), Example 11 [Reserved]. For further guidance, see §1.385-3(h) introductory text through (h)(3), Example 11.

Example 12. Distribution of a covered debt instrument to a controlled partnership. (i) Facts. CFC and FS are equal partners in PRS. PRS owns 100% of the stock in X Corp, a domestic corporation. On Date A in Year 1, X Corp issues X Note to PRS in a distribution.

(ii) Analysis. (A) Under §1.385-1(c)(4), in determining whether X Corp is a member of the FP expanded group that includes CFC and FS, CFC and FS are each treated as owning 50% of the X Corp stock held by PRS. Accordingly, 100% of X Corp's stock is treated as owned by CFC and FS, and X Corp is a member of the FP expanded group.

(B) Together CFC and FS own 100% of the interests in PRS capital and profits, such that PRS is a controlled partnership under §1.385-1(c)(1). CFC and FS are both expanded group partners on the date on which PRS acquired X Note. Therefore, pursuant to paragraph (f)(2)(i)(A) of this section, each of CFC and FS is treated as acquiring its share of X Note in the same manner (in this case, by a distribution of X Note), and on the date on which, PRS acquired X Note. Likewise, X Corp is treated as issuing to each of CFC and FS its share of X Note. Under paragraph (f)(2)(i)(B) of this section, each of CFC's and FS's share of X Note, respectively, is determined in accordance with its liquidation value percentage determined on Date A in Year 1, the date X Corp distributed X Note to PRS. On Date A in Year 1, pursuant to paragraph (g)(17) of this section, each of CFC's and FS's liquidation value percentages is 50%. Accordingly, on Date A in Year 1, under paragraph (f)(2)(i)(A) of this section, for

purposes of this section and §1.385-3, CFC and FS are each treated as acquiring 50% of X Note in a distribution.

(C) Under §1.385-3(b)(2)(i) and (d)(1)(i), X Note is treated as stock on the date of issuance, which is Date A in Year 1. Under paragraph (f)(2)(i)(A) of this section, each of CFC and FS are treated as acquiring 50% of X Note in a distribution for purposes of this section and §1.385-3. Therefore, X Corp is treated as distributing its stock to PRS in a distribution described in section 305.

Example 13. Loan to a controlled partnership; proportionate distributions by expanded group partners. (i) Facts. DS, USS2, and USP are partners in PRS. USP is a domestic corporation that is not a member of the FP expanded group. Each of DS and USS2 own 45% of the interests in PRS profits and capital, and USP owns 10% of the interests in PRS profits and capital. The PRS partnership agreement provides that all items of PRS income, gain, loss, deduction, and credit are allocated in accordance with the percentages in the preceding sentence. On Date A in Year 1, FP lends $200x to PRS in exchange for PRS Note. PRS uses all $200x in its business and does not distribute any money or other property to a partner. Subsequently, on Date B in Year 1, DS distributes $90x to USS1, USS2 distributes $90x to FP, and USP distributes $20x to its shareholder. Each of DS's and USS2's issuance percentage is 45% on Date B in Year 1, the date of the distributions and therefore a testing date under paragraph (f)(3)(ii)(A) of this section.

(ii) Analysis. (A) DS and USS2 together own 90% of the interests in PRS profits and capital and therefore PRS is a controlled partnership under §1.385-1(c)(1). Under §1.385-1(c)(2), each of DS and USS2 is a covered member.

(B) Under paragraph (f)(3)(i) of this section, each of DS and USS2 is treated as issuing its share of PRS Note, and under paragraph (f)(3)(ii)(A) of this section, DS's and USS2's share is each $90x (45% of $200x). USP is not an expanded group partner and therefore has no issuance percentage and is not treated as issuing any portion of PRS Note.

(C) The $90x distributions made by DS to USS1 and by USS2 to FP are described in §1.385-3(b)(3)(i)(A). Under §1.385-3(b)(3)(iii)(A), the portions of PRS Note treated as issued by each of DS and USS2 are treated as funding the distribution made by DS and USS2 because the distributions occurred within the per se period with respect to PRS Note. Under §1.385-3(b)(3)(i), the portions of PRS Note treated as issued by each of DS and USS2 would, absent the application of (f)(4)(i) of this section, be treated as stock of DS and USS2 on Date B in Year 1, the date of the distributions. See §1.385-3(d)(1)(ii). Under paragraph (g)(23) of this section, each of the $90x portions is a specified portion.

(D) Under paragraph (f)(4)(i) of this section, the specified portions are not treated as stock under §1.385-3(b)(3)(i). Instead, FP is deemed to transfer a portion of PRS Note with a principal amount equal to $90x (the adjusted issue price of the specified

portion with respect to DS) to DS in exchange for deemed partner stock in DS with a fair market value of $90x. Similarly, FP is deemed to transfer a portion of PRS Note with a principal amount equal to $90 (the adjusted issue price of the specified portion with respect to USS2) to USS2 in exchange for deemed partner stock in USS2 with a fair market value of $90x. The principal amount of the retained receivable held by FP is $20x ($200x - $90x - $90x).

Example 14. Loan to a controlled partnership; disproportionate distributions by expanded group partners. (i) Facts. The facts are the same as in Example 13 of this paragraph (h)(3), except that on Date B in Year 1, DS distributes $45x to USS1 and USS2 distributes $135x to FP.

(ii) Analysis. (A) The analysis is the same as in paragraph (ii)(A) of Example 13 of this paragraph (h)(3).

(B) The analysis is the same as in paragraph (ii)(B) of Example 13 of this paragraph (h)(3).

(C) The $45x and $135x distributions made by DS to USS1 and by USS2 to FP, respectively, are described in §1.385-3(b)(3)(i)(A). Under §1.385-3(b)(3)(iii)(A), the portion of PRS Note treated as issued by DS is treated as funding the distribution made by DS because the distribution occurred within the per se period with respect to PRS Note, but under §1.385-3(b)(3)(i), only to the extent of DS's $45x distribution. USS2 is treated as issuing $90x of PRS Note, all of which is treated as funding $90x of USS2's $135x distribution under §1.385-3(b)(3)(iii)(A). Under §1.385-3(b)(3)(i), absent the application of (f)(4)(i) of this section, $45x of PRS Note would be treated as stock of DS and $90x of PRS Note would be treated as stock of USS2 on Date B in Year 1, the date of the distributions. See §1.385-3(d)(1)(ii). Under paragraph (g)(23) of this section, $45x of PRS Note is a specified portion with respect to DS and $90x of PRS Note is a specified portion with respect to USS2.

(D) Under paragraph (f)(4)(i) of this section, the specified portions are not treated as stock under §1.385-3(b)(3)(i). Instead, FP is deemed to transfer a portion of PRS Note with a principal amount equal to $45x (the adjusted issue price of the specified portion with respect to DS) to DS in exchange for stock of DS with a fair market value of $90x. Similarly, FP is deemed to transfer a portion of PRS Note with a principal amount equal to $90 (the adjusted issue price of the specified portion with respect to USS2) to USS2 in exchange for stock of USS2 with a fair market value of $90x. The principal amount of the retained receivable held by FP is $65x ($200x - $45x - $90x).

Example 15. Loan to partnership; distribution in later year. (i) Facts. The facts are the same as in Example 13 of this paragraph (h)(3), except that USS2 does not distribute $90x to FP until Date C in Year 2, which is less than 36 months after Date A in Year 1. No principal or interest payments are made or required until Year 3. On Date C in Year 2, DS's, USS2's, and USP's issuance percentages under paragraph (g)(16) of this section are unchanged at 45%, 45%, and 10%, respectively.

(ii) Analysis. (A) The analysis is the same as in paragraph (ii)(A) of Example 13 of this paragraph (h)(3).

(B) The analysis is the same as in paragraph (ii)(B) of Example 13 of this paragraph (h)(3).

(C) With respect to the distribution made by DS, the analysis is the same as in paragraph (ii)(C) of Example 13 of this paragraph (h)(3).

(D) With respect to the deemed transfer to DS, the analysis is the same as in paragraph (ii)(D) of Example 13 of this paragraph (h)(3). Accordingly, the amount of the retained receivable held by FP as of Date B in Year 1 is $110x ($200x - $90x).

(E) Under paragraph (f)(3)(ii)(A) of this section, USS2's share of PRS Note is determined on Date C in Year 2. On Date C in Year 2, DS's, USS2's, and USP's respective shares of PRS Note under paragraph (f)(3)(ii)(A) of this section $90x, $90x, and $20x. However, because DS is treated as the issuer with respect to a $90x specified portion of PRS Note, DS's share of PRS Note is reduced by $90x to $0 under paragraph (f)(3)(ii)(B)(1) of this section. No reduction to either of USS2's or USP's share of PRS Note is required under paragraph (f)(3)(ii)(B)(2) of this section because the aggregate of DS's, USS2's, and USP's shares of PRS Note as reduced is $110x (DS has a $0 share, USS2 has a $90x share, and USP has a $20x share), which does not exceed $110x (the $200x adjusted issue price of PRS Note reduced by the $90x specified portion with respect to DS). Under paragraph (f)(3)(i) of this section, USS2 is treated as issuing its share of PRS Note.

(F) The $90x distribution made by USS2 to FP is described in §1.385-3(b)(3)(i)(A). Under §1.385-3(b)(3)(iii)(A), the portion of PRS Note treated as issued by USS2 is treated as funding the distribution made by USS2, because the distribution occurred within the per se period with respect to PRS Note. Accordingly, the portion of PRS Note treated as issued by USS2 would, absent the application of paragraph (f)(4)(i) of this section, be treated as stock of USS2 under §1.385-3(b)(3)(i) on Date C in Year 2. See §1.385-3(d)(1)(ii). Under paragraph (g)(23) of this section, the $90x portion is a specified portion.

(G) Under paragraph (f)(4)(i) of this section, the specified portion of PRS Note treated as issued by USS2 is not treated as stock under §1.385-3(b)(3)(i). Instead, on Date C in Year 2, FP is deemed to transfer a portion of PRS Note with a principal amount equal to $90x (the adjusted issue price of the specified portion with respect to USS2) to USS2 in exchange for stock in USS2 with a fair market value of $90x. The principal amount of the retained receivable held by FP is reduced from $110x to $20x.

Example 16. Loan to a controlled partnership; partnership ceases to be a controlled partnership. (i) Facts. The facts are the same as in Example 13 of this

paragraph (h)(3), except that on Date C in Year 4, USS2 sells its entire interest in PRS to an unrelated person.

(ii) Analysis. (A) On date C in Year 4, PRS ceases to be a controlled partnership with respect to the FP expanded group under §1.385-1(c)(1). This is the case because DS, the only remaining partner that is a member of the FP expanded group, only owns 45% of the total interest in PRS profits and capital. Because PRS ceases to be a controlled partnership, a specified event (within the meaning of paragraph (f)(5)(iii)(A) of this section) occurs with respect to the deemed transfers with respect to each of DS and USS2.

(B) Under paragraph (f)(5)(i) of this section, on Date C in Year 4, immediately before PRS ceases to be a controlled partnership, each of DS and USS2 is deemed to distribute its deemed transferred receivable to FP in redemption of FP's deemed partner stock in DS and USS2. The specified portion that corresponds to each of the deemed transferred receivables ceases to be treated as a specified portion. Furthermore, the deemed transferred receivables cease to exist, and the retained receivable held by FP increases from $20x to $200x.

Example 17. Transfer of an interest in a partnership to a covered member. (i) Facts. The facts are the same as in Example 13 of this paragraph (h)(3), except that on Date C in Year 4, USS2 sells its entire interest in PRS to USS1.

(ii) Analysis. (A) After USS2 sells its interest in PRS to USS1, DS and USS1 together own 90% of the interests in PRS profits and capital and therefore PRS continues to be a controlled partnership under §1.385-1(c)(1). A specified event (within the meaning of paragraph (f)(5)(iii)(E) of this section) occurs as result of the sale only with respect to the deemed transfer with respect to USS2.

(B) Under paragraph (f)(5)(i) of this section, on Date C in Year 4, immediately before USS2 sells its entire interest in PRS to USS1, USS2 is deemed to distribute its deemed transferred receivable to FP in redemption of FP's deemed partner stock in USS2. Because the specified event is described in paragraph (f)(5)(iii)(E) of this section, under paragraph (f)(5)(ii) of this section, FP is deemed to retransfer the deemed transferred receivable deemed received from USS2 to USS1 in exchange for deemed partner stock in USS1 with a fair market value equal to the principal amount of the deemed transferred receivable that is retransferred to USS1.

Example 18. Loan to partnership and all partners are members of a consolidated group. (i) Facts. USS1 and DS are equal partners in PRS. USS1 and DS are members of a consolidated group, as defined in §1.1502-1(h). The PRS partnership agreement provides that all items of PRS income, gain, loss, deduction, and credit are allocated equally between USS1 and DS. On Date A in Year 1, FP lends $200x to PRS in exchange for PRS Note. PRS uses all $200x in its business and does not distribute any money or other property to any partner. On Date B in Year 1, DS distributes $200x to USS1, and USS1 distributes $200x to FP. If neither of USS1 or DS were a member

of the consolidated group, each would have an issuance percentage under paragraph (g)(16) of this section, determined as of Date A in Year 1, of 50%.

(ii) Analysis. (A) Pursuant to §1.385-4T(b)(6), PRS is treated as a partnership for purposes of §1.385-3. Under §1.385-4T(b)(1), DS and USS1 are treated as one corporation for purposes of this section and §1.385-3, and thus a single covered member under §1.385-1(c)(2). For purposes of this section, the single covered member owns 100% of the PRS profits and capital and therefore PRS is a controlled partnership under §1.385-1(c)(1). Under paragraph (f)(3)(i) of this section, the single covered member is treated as issuing all $200x of PRS Note to FP, a member of the same expanded group as the single covered member. DS's distribution to USS1 is a disregarded distribution because it is a distribution between members of a consolidated group that is disregarded under the one-corporation rule of §1.385-4T(b)(1). However, under §1.385-3(b)(3)(iii)(A), PRS Note, treated as issued by the single covered member, is treated as funding the distribution by USS1 to FP, which is described in §1.385-3(b)(3)(i)(A) and which is a regarded distribution. Accordingly, PRS Note, absent the application of (f)(4)(i) of this section, would be treated as stock under §1.385-3(b) on Date B in Year 1. Thus, pursuant to paragraph (g)(23) of this section, the entire PRS Note is a specified portion.

(B) Under paragraphs (f)(4)(i) and (iii) of this section, the specified portion is not treated as stock and, instead, FP is deemed to transfer PRS Note with a principal amount equal to $200x to USS1 in exchange for stock of USS1 with a fair market value of $200x. Under paragraph (f)(4)(iii) of this section, FP is deemed to transfer PRS Note to USS1 because only USS1 made a regarded distribution described in §1.385-3(b)(3)(i).

Example 19. (i) Facts. DS owns DRE, a disregarded entity within the meaning of §1.385-1(c)(3). On Date A in Year 1, FP lends $200x to DRE in exchange for DRE Note. Subsequently, on Date B in Year 1, DS distributes $100x of cash to USS1.

(ii) Analysis. Under §1.385-3(b)(3)(iii)(A), $100x of DRE Note would be treated as funding the distribution by DS to USS1 because DRE Note is issued to a member of the FP expanded group during the per se period with respect to DS's distribution0 to USS1. Accordingly, under §1.385-3(b)(3)(i)(A) and (d)(1)(ii), $100x of DRE Note would be treated as stock on Date B in Year 1. However, under paragraph (d)(4) of this section, DS, as the regarded owner, within the meaning of §1.385-1(c)(5), of DRE is deemed to issue its stock to FP in exchange for a portion of DRE Note equal to the $100x applicable portion (as defined in paragraph (d)(4) of this section). Thus, DS is treated as the holder of $100x of DRE Note, which is disregarded, and FP is treated as the holder of the remaining $100x of DRE Note. The $100x of stock deemed issued by DS to FP has the same terms as DRE Note, other than the issuer, and payments on the stock are determined by reference to payments on DRE Note.

(i) through (j) [Reserved]

(k) Applicability date--(1) In general. This section applies to taxable years ending

on or after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

(2) Transition rules--(i) Transition rule for covered debt instruments issued by partnerships that would have had a specified portion in taxable years ending before **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. If the application of paragraphs (f)(3) through (5) of this section and §1.385-3 would have resulted in a covered debt instrument issued by a controlled partnership having a specified portion in a taxable year ending before **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]** but for the application of paragraph (k)(1) of this section and §1.385-3(j)(1), then, to the extent of the specified portion immediately after **[INSERT DATE 90 DAYS AFTER DATE PUBLICATION IN THE FEDERAL REGISTER]**, there is a deemed transfer immediately after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

(ii) Transition rule for certain covered debt instruments treated as having a specified portion in taxable years ending on or after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. If the application of paragraphs (f)(3) through (5) of this section and §1.385-3 would treat a covered debt instrument issued by a controlled partnership as having a specified portion that gives rise to a deemed transfer on or before **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]** but in a taxable year ending on or after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, that specified portion does not give rise to a deemed transfer during the

90-day period after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. Instead, to the extent of the specified portion immediately after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, there is a deemed transferred immediately after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

(iii) Transition funding rule. This paragraph (k)(2)(iii) applies if the application of paragraphs (f)(3) through (5) of this section and §1.385-3 would have resulted in a deemed transfer with respect to a specified portion of a debt instrument issued by a controlled partnership on a date after April 4, 2016, and on or before **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]** (the transition period) but for the application of paragraph (k)(1), (k)(2)(i), or (k)(2)(ii) of this section and §1.385-3(j). In this case, any payments made with respect to the covered debt instrument (other than stated interest), including pursuant to a refinancing, a portion of which would be treated as made with respect to deemed partner stock if there would have been a deemed transfer, after the date that there would have been a deemed transfer and through the remaining portion of the transition period are treated as distributions for purposes of applying §1.385-3(b)(3) for taxable years ending on or after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. In addition, if an event occurs during the transition period that would have been a specified event with respect to the deemed transfer described in the preceding sentence but for the application of paragraph (k)(1) of this section and §1.385-3(j), the distribution or acquisition that would have resulted in the deemed transfer is available to be treated as funded by other covered debt instruments of the covered member for

purposes of §1.385-3(b)(3) (to the extent provided in §1.385-3(b)(3)(iii)). The prior sentence shall be applied in a manner that is consistent with the rules set forth in paragraph (f)(5) of this section and §1.385-3(d)(2)(ii).

(iv) Coordination between the general rule and funding rule. This paragraph (k)(2)(iv) applies when a covered debt instrument issued by a controlled partnership in a transaction described in §1.385-3(b)(2) would have resulted in a specified portion that gives rise to a deemed transfer on a date after April 4, 2016, and on or before **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, but there is not a deemed transfer on such date due to the application of paragraph (k)(1), (k)(2)(i), or (k)(2)(ii) of this section and §1.385-3(j). In this case, the issuance of such covered debt instrument is not treated as a distribution or acquisition described in §1.385-3(b)(3)(i), but only to the extent of the specified portion immediately after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

(v) Option to apply proposed regulations. See §1.385-3(j)(2)(v).

(l) Expiration date. This section expires on **October 11, 2019**.

Par. 6. Section 1.385-4T is added to read as follows:

§1.385-4T Treatment of consolidated groups.

(a) Scope. This section provides rules for applying §§1.385-3 and 1.385-3T to members of consolidated groups. Paragraph (b) of this section sets forth rules concerning the extent to which, solely for purposes of applying §§1.385-3 and 1.385-3T, members of a consolidated group that file (or that are required to file) a consolidated U.S. federal income tax return are treated as one corporation. Paragraph (c) of this

section sets forth rules concerning the treatment of a debt instrument that ceases to be, or becomes, a consolidated group debt instrument. Paragraph (d) of this section provides rules for applying the funding rule of §1.385-3(b)(3) to members that depart a consolidated group. For definitions applicable to this section, see paragraph (e) of this section and §§1.385-1(c) and 1.385-3(g). For examples illustrating the application of this section, see paragraph (f) of this section.

(b) Treatment of consolidated groups--(1) Members treated as one corporation. For purposes of this section and §§1.385-3 and 1.385-3T, and except as otherwise provided in this section and §1.385-3T, all members of a consolidated group (as defined in §1.1502-1(h)) that file (or that are required to file) a consolidated U.S. federal income tax return are treated as one corporation. Thus, for example, when a member of a consolidated group issues a covered debt instrument that is not a consolidated group debt instrument, the consolidated group generally is treated as the issuer of the covered debt instrument for purposes of this section and §§1.385-3 and 1.385-3T. Also, for example, when one member of a consolidated group issues a covered debt instrument that is not a consolidated group debt instrument and therefore is treated as issued by the consolidated group, and another member of the consolidated group makes a distribution or acquisition described in §1.385-3(b)(3)(i)(A) through (C) with an expanded group member that is not a member of the consolidated group, §1.385-3(b)(3)(i) may treat the covered debt instrument as funding the distribution or acquisition made by the consolidated group. In addition, except as otherwise provided in this section, acquisitions and distributions described in §1.385-3(b)(2) and (b)(3)(i) in which all parties to the transaction are members of the same consolidated group both before

and after the transaction are disregarded for purposes of this section and §§1.385-3 and 1.385-3T.

(2) One-corporation rule inapplicable to expanded group member determination. The one-corporation rule in paragraph (b)(1) of this section does not apply in determining the members of an expanded group. Notwithstanding the previous sentence, an expanded group does not exist for purposes of this section and §§1.385-3 and 1.385-3T if it consists only of members of a single consolidated group.

(3) Application of §1.385-3 to debt instruments issued by members of a consolidated group--(i) Debt instrument treated as stock of the issuing member of a consolidated group. If a covered debt instrument treated as issued by a consolidated group under the one-corporation rule of paragraph (b)(1) of this section is treated as stock under §1.385-3 or §1.385-3T, the covered debt instrument is treated as stock in the member of the consolidated group that would be the issuer of such debt instrument without regard to this section. But see §1.385-3(d)(7) (providing that a covered debt instrument that is treated as stock under §1.385-3(b)(2), (3), or (4) and that is not described in section 1504(a)(4) is not treated as stock for purposes of determining whether the issuer is a member of an affiliated group (within the meaning of section 1504(a)).

(ii) Application of the covered debt instrument exclusions. For purposes of determining whether a debt instrument issued by a member of a consolidated group is a covered debt instrument, each test described in §1.385-3(g)(3) is applied on a separate member basis without regard to the one-corporation rule in paragraph (b)(1) of this section.

(iii) Qualified short-term debt instrument. The determination of whether a member of a consolidated group has issued a qualified short-term debt instrument for purposes of §1.385-3(b)(3)(vii) is made on a separate member basis without regard to the one-corporation rule in paragraph (b)(1) of this section.

(4) Application of the reductions of §1.385-3(c)(3) to members of a consolidated group--(i) Application of the reduction for expanded group earnings--(A) In general. A consolidated group maintains one expanded group earnings account with respect to an expanded group period, and only the earnings and profits, determined in accordance with §1.1502-33 (without regard to the application of §1.1502-33(b)(2), (e), and (f)), of the common parent (within the meaning of section 1504) of the consolidated group are considered in calculating the expanded group earnings for the expanded group period of the consolidated group. Accordingly, a regarded distribution or acquisition made by a member of a consolidated group is reduced to the extent of the expanded group earnings account of the consolidated group.

(B) Effect of certain corporate transactions on the calculation of expanded group earnings--(1) Consolidation. A consolidated group succeeds to the expanded group earnings account of a joining member under the principles of §1.385-3(c)(3)(i)(F)(2)(ii).

(2) Deconsolidation--(i) In general. Except as otherwise provided in paragraph (b)(4)(i)(B)(2)(ii) of this section, no amount of the expanded group earnings account of a consolidated group for an expanded group period, if any, is allocated to a departing member. Accordingly, immediately after leaving the consolidated group, the departing member has no expanded group earnings account with respect to its expanded group period.

(ii) Allocation of expanded group earnings to a departing member in a distribution described in section 355. If a departing member leaves the consolidated group by reason of an exchange or distribution to which section 355 (or so much of section 356 that relates to section 355) applies, the expanded group earnings account of the consolidated group is allocated between the consolidated group and the departing member in proportion to the earnings and profits of the consolidated group and the earnings and profits of the departing member immediately after the transaction.

(ii) Application of the reduction for qualified contributions--(A) In general. For purposes of applying §1.385-3(c)(3)(ii)(A) to a consolidated group--

(1) A qualified contribution to any member of a consolidated group that remains a member of the consolidated group immediately after the qualified contribution from a person other than a member of the same consolidated group is treated as made to the one corporation provided in paragraph (b)(1) of this section;

(2) A qualified contribution that causes a member of a consolidated group to become a departing member of that consolidated group is treated as made to the departing member and not to the consolidated group of which the departing member was a member immediately prior to the qualified contribution; and

(3) No contribution of property by a member of a consolidated group to any other member of the consolidated group is a qualified contribution.

(B) Effect of certain corporate transactions on the calculation of qualified contributions--(1) Consolidation. A consolidated group succeeds to the qualified contributions of a joining member under the principles of §1.385-3(c)(3)(ii)(F)(2)(ii).

(2) Deconsolidation--(i) In general. Except as otherwise provided in paragraph

(b)(4)(ii)(B)(2)(ii) of this section, no amount of the qualified contributions of a consolidated group for an expanded group period, if any, is allocated to a departing member. Accordingly, immediately after leaving the consolidated group, the departing member has no qualified contributions with respect to its expanded group period.

(ii) Allocation of qualified contributions to a departing member in a distribution described in section 355. If a departing member leaves the consolidated group by reason of an exchange or distribution to which section 355 (or so much of section 356 that relates to section 355) applies, each qualified contribution of the consolidated group is allocated between the consolidated group and the departing member in proportion to the earnings and profits of the consolidated group and the earnings and profits of the departing member immediately after the transaction.

(5) Order of operations. For purposes of this section and §§1.385-3 and 1.385-3T, the consequences of a transaction involving one or more members of a consolidated group are determined as provided in paragraphs (b)(5)(i) and (ii) of this section.

(i) First, determine the characterization of the transaction under federal tax law without regard to the one-corporation rule of paragraph (b)(1) of this section.

(ii) Second, apply this section and §§1.385-3 and 1.385-3T to the transaction as characterized to determine whether to treat a debt instrument as stock, treating the consolidated group as one corporation under paragraph (b)(1) of this section, unless otherwise provided.

(6) Partnership owned by a consolidated group. For purposes of this section and §§1.385-3 and §1.385-3T, and notwithstanding the one-corporation rule of paragraph

(b)(1) of this section, a partnership that is wholly owned by members of a consolidated group is treated as a partnership. Thus, for example, if members of a consolidated group own all of the interests in a controlled partnership that issues a debt instrument to a member of the consolidated group, such debt instrument would be treated as a consolidated group debt instrument because, under §1.385-3T(f)(3)(i), for purposes of this section and §1.385-3, a consolidated group member that is an expanded group partner is treated as the issuer with respect to its share of the debt instrument issued by the partnership.

(7) Predecessor and successor--(i) In general. Pursuant to paragraph (b)(5) of this section, the determination as to whether a member of an expanded group is a predecessor or successor of another member of the consolidated group is made without regard to paragraph (b)(1) of this section. For purposes of §1.385-3(b)(3), if a consolidated group member is a predecessor or successor of a member of the same expanded group that is not a member of the same consolidated group, the consolidated group is treated as a predecessor or successor of the expanded group member (or the consolidated group of which that expanded group member is a member). Thus, for example, a departing member that departs a consolidated group in a distribution or exchange to which section 355 applies is a successor to the consolidated group and the consolidated group is a predecessor of the departing member.

(ii) Joining members. For purposes of §1.385-3(b)(3), the term predecessor also means, with respect to a consolidated group, a joining member and the term successor also means, with respect to a joining member, a consolidated group.

(c) Consolidated group debt instruments--(1) Debt instrument ceases to be a

consolidated group debt instrument but continues to be issued and held by expanded group members--(i) Consolidated group member leaves the consolidated group. For purposes of this section and §§1.385-3 and 1.385-3T, when a debt instrument ceases to be a consolidated group debt instrument as a result of a transaction in which the member of the consolidated group that issued the instrument (the issuer) or the member of the consolidated group holding the instrument (the holder) ceases to be a member of the same consolidated group but both the issuer and the holder continue to be a member of the same expanded group, the issuer is treated as issuing a new debt instrument to the holder in exchange for property immediately after the debt instrument ceases to be a consolidated group debt instrument. To the extent the newly-issued debt instrument is a covered debt instrument that is treated as stock under §1.385-3(b)(3), the covered debt instrument is then immediately deemed to be exchanged for stock of the issuer. For rules regarding the treatment of the deemed exchange, see §1.385-1(d). For examples illustrating this rule, see paragraph (f) of this section, Examples 4 and 5.

(ii) Consolidated group debt instrument that is transferred outside of the consolidated group. For purposes of this section and §§1.385-3 and 1.385-3T, when a member of a consolidated group that holds a consolidated group debt instrument transfers the debt instrument to an expanded group member that is not a member of the same consolidated group (transferee expanded group member), the debt instrument is treated as issued by the consolidated group to the transferee expanded group member immediately after the debt instrument ceases to be a consolidated group debt instrument. Thus, for example, for purposes of this section and §§1.385-3 and 1.385-

3T, the sale of a consolidated group debt instrument to a transferee expanded group member is treated as an issuance of the debt instrument by the consolidated group to the transferee expanded group member in exchange for property. To the extent the newly-issued debt instrument is a covered debt instrument that is treated as stock upon being transferred, the covered debt instrument is deemed to be exchanged for stock of the member of the consolidated group treated as the issuer of the debt instrument (determined under paragraph (b)(3)(i) of this section) immediately after the covered debt instrument is transferred outside of the consolidated group. For rules regarding the treatment of the deemed exchange, see §1.385-1(d). For examples illustrating this rule, see paragraph (f) of this section, Examples 2 and 3.

(iii) Overlap transactions. If a debt instrument ceases to be a consolidated group debt instrument in a transaction to which both paragraphs (c)(1)(i) and (ii) of this section apply, then only the rules of paragraph (c)(1)(ii) of this section apply with respect to such debt instrument.

(iv) Subgroup exception. A debt instrument is not treated as ceasing to be a consolidated group debt instrument for purposes of paragraphs (c)(1)(i) and (ii) of this section if both the issuer and the holder of the debt instrument are members of the same consolidated group immediately after the transaction described in paragraph (c)(1)(i) or (ii) of this section.

(2) Covered debt instrument treated as stock becomes a consolidated group debt instrument. When a covered debt instrument that is treated as stock under §1.385-3 becomes a consolidated group debt instrument, then immediately after the covered debt instrument becomes a consolidated group debt instrument, the issuer is deemed to

issue a new covered debt instrument to the holder in exchange for the covered debt instrument that was treated as stock. In addition, in a manner consistent with §1.385-3(d)(2)(ii)(A), when the covered debt instrument that previously was treated as stock becomes a consolidated group debt instrument, other covered debt instruments issued by the issuer of that instrument (including a consolidated group that includes the issuer) that are not treated as stock when the instrument becomes a consolidated group debt instrument are re-tested to determine whether those other covered debt instruments are treated as funding the regarded distribution or acquisition that previously was treated as funded by the instrument (unless such distribution or acquisition is disregarded under paragraph (b)(1) of this section). Further, also in a manner consistent with §1.385-3(d)(2)(ii)(A), a covered debt instrument that is issued by the issuer (including a consolidated group that includes the issuer) after the application of this paragraph and within the per se period may also be treated as funding that regarded distribution or acquisition.

(3) No interaction with the intercompany obligation rules of §1.1502-13(g). The rules of this section do not affect the application of the rules of §1.1502-13(g). Thus, any deemed satisfaction and reissuance of a debt instrument under §1.1502-13(g) and any deemed issuance and deemed exchange of a debt instrument under this paragraph (c) that arise as part of the same transaction or series of transactions are not integrated. Rather, each deemed satisfaction and reissuance under the rules of §1.1502-13(g), and each deemed issuance and exchange under the rules of this section, are respected as separate steps and treated as separate transactions.

(d) Application of the funding rule of §1.385-3(b)(3) to members departing a

consolidated group. This paragraph (d) provides rules for applying the funding rule of §1.385-3(b)(3) when a departing member ceases to be a member of a consolidated group, but only if the departing member and the consolidated group are members of the same expanded group immediately after the deconsolidation.

(1) Continued application of the one-corporation rule. A disregarded distribution or acquisition by any member of the consolidated group continues to be disregarded when the departing member ceases to be a member of the consolidated group.

(2) Continued recharacterization of a departing member's covered debt instrument as stock. A covered debt instrument of a departing member that is treated as stock of the departing member under §1.385-3(b) continues to be treated as stock when the departing member ceases to be a member of the consolidated group.

(3) Effect of issuances of covered debt instruments that are not consolidated group debt instruments on the departing member and the consolidated group. If a departing member has issued a covered debt instrument (determined without regard to the one-corporation rule of paragraph (b)(1) of this section) that is not a consolidated group debt instrument and that is not treated as stock immediately before the departing member ceases to be a consolidated group member, then the departing member (and not the consolidated group) is treated as issuing the covered debt instrument on the date and in the manner the covered debt instrument was issued. If the departing member is not treated as the issuer of a covered debt instrument pursuant to the preceding sentence, then the consolidated group continues to be treated as issuing the covered debt instrument on the date and in the manner the covered debt instrument was issued.

(4) Treatment of prior regarded distributions or acquisitions. This paragraph (d)(4) applies when a departing member ceases to be a consolidated group member in a transaction other than a distribution to which section 355 applies (or so much of section 356 as relates to section 355), and the consolidated group has made a regarded distribution or acquisition. In this case, to the extent the distribution or acquisition has not caused a covered debt instrument of the consolidated group to be treated as stock under §1.385-3(b) on or before the date the departing member leaves the consolidated group, then--

(i) If the departing member made the regarded distribution or acquisition (determined without regard to the one-corporation rule of paragraph (b)(1) of this section), the departing member (and not the consolidated group) is treated as having made the regarded distribution or acquisition.

(ii) If the departing member did not make the regarded distribution or acquisition (determined without regard to the one-corporation rule of paragraph (b)(1) of this section), then the consolidated group (and not the departing member) continues to be treated as having made the regarded distribution or acquisition.

(e) Definitions. The definitions in this paragraph (e) apply for purposes of this section.

(1) Consolidated group debt instrument. The term consolidated group debt instrument means a covered debt instrument issued by a member of a consolidated group and held by a member of the same consolidated group.

(2) Departing member. The term departing member means a member of an expanded group that ceases to be a member of a consolidated group but continues to

be a member of the same expanded group. In the case of multiple members leaving a consolidated group as a result of a single transaction that continue to be members of the same expanded group, if such members are treated as one corporation under paragraph (b)(1) of this section immediately after the transaction, that one corporation is a departing member with respect to the consolidated group.

(3) Disregarded distribution or acquisition. The term disregarded distribution or acquisition means a distribution or acquisition described in §1.385-3(b)(2) or (b)(3)(i) between members of a consolidated group that is disregarded under the one-corporation rule of paragraph (b)(1) of this section.

(4) Joining member. The term joining member means a member of an expanded group that becomes a member of a consolidated group and continues to be a member of the same expanded group. In the case of multiple members joining a consolidated group as a result of a single transaction that continue to be members of the same expanded group, if such members were treated as one corporation under paragraph (b)(1) of this section immediately before the transaction, that one corporation is a joining member with respect to the consolidated group.

(5) Regarded distribution or acquisition. The term regarded distribution or acquisition means a distribution or acquisition described in §1.385-3(b)(2) or (b)(3)(i) that is not disregarded under the one-corporation rule of paragraph (b)(1) of this section.

(f) Examples--(1) Assumed facts. Except as otherwise stated, the following facts are assumed for purposes of the examples in paragraph (f)(3) of this section:

(i) FP is a foreign corporation that owns 100% of the stock of USS1, a covered member, and 100% of the stock of FS, a foreign corporation;

(ii) USS1 owns 100% of the stock of DS1 and DS3, both covered members;

(iii) DS1 owns 100% of the stock of DS2, a covered member;

(iv) FS owns 100% of the stock of UST, a covered member;

(v) At the beginning of Year 1, FP is the common parent of an expanded group comprised solely of FP, USS1, FS, DS1, DS2, DS3, and UST (the FP expanded group);

(vi) USS1, DS1, DS2, and DS3 are members of a consolidated group of which USS1 is the common parent (the USS1 consolidated group);

(vii) The FP expanded group has outstanding more than $50 million of debt instruments described in §1.385-3(c)(4) at all times;

(viii) No issuer of a covered debt instrument has a positive expanded group earnings account, within the meaning of §1.385-3(c)(3)(i)(B), or has received a qualified contribution, within the meaning of §1.385-3(c)(3)(ii)(B);

(ix) All notes are covered debt instruments, within the meaning of §1.385-3(g)(3), and are not qualified short-term debt instruments, within the meaning of §1.385-3(b)(3)(vii);

(x) All notes between members of a consolidated group are intercompany obligations within the meaning of §1.1502-13(g)(2)(ii);

(xi) Each entity has as its taxable year the calendar year;

(xii) No domestic corporation is a United States real property holding corporation within the meaning of section 897(c)(2);

(xiii) Each note is issued with adequate stated interest (as defined in section 1274(c)(2)); and

(xiv) Each transaction occurs after **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

(2) No inference. Except as otherwise provided in this section, it is assumed for purposes of the examples in paragraph (f)(3) of this section that the form of each transaction is respected for federal tax purposes. No inference is intended, however, as to whether any particular note would be respected as indebtedness or as to whether the form of any particular transaction described in an example in paragraph (f)(3) of this section would be respected for federal tax purposes.

(3) Examples. The following examples illustrate the rules of this section.

Example 1. Order of operations. (i) Facts. On Date A in Year 1, UST issues UST Note to USS1 in exchange for DS3 stock representing less than 20% of the value and voting power of DS3.

(ii) Analysis. UST is acquiring the stock of DS3, the non-common parent member of a consolidated group. Pursuant to paragraph (b)(5)(i) of this section, the transaction is first analyzed without regard to the one-corporation rule of paragraph (b)(1) of this section, and therefore UST is treated as issuing a covered debt instrument in exchange for expanded group stock. The exchange of UST Note for DS3 stock is not an exempt exchange within the meaning of §1.385-3(g)(11) because UST and USS1 are not parties to an asset reorganization. Pursuant to paragraph (b)(5)(ii), §1.385-3 (including §1.385-3(b)(2)(ii)) is then applied to the transaction, thereby treating UST Note as stock for federal tax purposes when it is issued by UST to USS1. The UST Note is not treated as property for purposes of section 304(a) because it is not property within the meaning specified in section 317(a). Therefore, UST's acquisition of DS3 stock from USS1 in exchange for UST Note is not an acquisition described in section 304(a)(1).

Example 2. Distribution of consolidated group debt instrument. (i) Facts. On Date A in Year 1, DS1 issues DS1 Note to USS1 in a distribution. On Date B in Year 2, USS1 distributes DS1 Note to FP.

(ii) Analysis. Under paragraph (b)(1) of this section, the USS1 consolidated group is treated as one corporation for purposes of §1.385-3. Accordingly, when DS1 issues DS1 Note to USS1 in a distribution on Date A in Year 1, DS1 is not treated as issuing a debt instrument to another member of DS1's expanded group in a distribution for purposes of §1.385-3(b)(2), and DS1 Note is not treated as stock under §1.385-3. When USS1 distributes DS1 Note to FP, DS1 Note is deemed satisfied and reissued

under §1.1502-13(g)(3)(ii), immediately before DS1 Note ceases to be an intercompany obligation. Under paragraph (c)(1)(ii) of this section, when USS1 distributes DS1 Note to FP, the USS1 consolidated group is treated as issuing DS1 Note to FP in a distribution on Date B in Year 2. Accordingly, DS1 Note is treated as stock under §1.385-3(b)(2)(i). Under paragraph (c)(1)(ii) of this section, DS1 Note is deemed to be exchanged for stock of the issuing member, DS1, immediately after DS1 Note is transferred outside of the USS1 consolidated group. Under paragraph (c)(3) of this section, the deemed satisfaction and reissuance under §1.1502-13(g)(3)(ii) and the deemed issuance and exchange under paragraph (c)(1)(ii) of this section, are respected as separate steps and treated as separate transactions.

Example 3. Sale of consolidated group debt instrument. (i) Facts. On Date A in Year 1, DS1 lends $200x of cash to USS1 in exchange for USS1 Note. On Date B in Year 2, USS1 distributes $200x of cash to FP. Subsequently, on Date C in Year 2, DS1 sells USS1 Note to FS for $200x.

(ii) Analysis. Under paragraph (b)(1) of this section, the USS1 consolidated group is treated as one corporation for purposes of §1.385-3. Accordingly, when USS1 issues USS1 Note to DS1 for property on Date A in Year 1, the USS1 consolidated group is not treated as a funded member, and when USS1 distributes $200x to FP on Date B in Year 2, that distribution is a transaction described in §1.385-3(b)(3)(i)(A), but does not cause USS1 Note to be recharacterized under §1.385-3(b)(3). When DS1 sells USS1 Note to FS, USS1 Note is deemed satisfied and reissued under §1.1502-13(g)(3)(ii), immediately before USS1 Note ceases to be an intercompany obligation. Under paragraph (c)(1)(ii) of this section, when the USS1 Note is transferred to FS for $200x on Date C in Year 2, the USS1 consolidated group is treated as issuing USS1 Note to FS in exchange for $200x on that date. Because USS1 Note is issued by the USS1 consolidated group to FS within the per se period as defined in §1.385-3(g)(19) with respect to the distribution by the USS1 consolidated group to FP, USS1 Note is treated as funding the distribution under §1.385-3(b)(3)(iii)(A) and, accordingly, is treated as stock under §1.385-3(b)(3). Under §1.385-3(d)(1)(i) and paragraph (c)(1)(ii) of this section, USS1 Note is deemed to be exchanged for stock of the issuing member, USS1, immediately after USS1 Note is transferred outside of the USS1 consolidated group. Under paragraph (c)(3) of this section, the deemed satisfaction and reissuance under §1.1502-13(g)(3)(ii) and the deemed issuance and exchange under paragraph (c)(1)(ii) of this section, are respected as separate steps and treated as separate transactions.

Example 4. Treatment of consolidated group debt instrument and departing member's regarded distribution or acquisition when the issuer of the instrument leaves the consolidated group. (i) Facts. The facts are the same as provided in paragraph (f)(1) of this section, except that USS1 and FS own 90% and 10% of the stock of DS1, respectively. On Date A in Year 1, DS1 distributes $80x of cash and newly-issued DS1 Note, which has a value of $10x, to USS1. Also on Date A in Year 1, DS1 distributes $10x of cash to FS. On Date B in Year 2, FS purchases all of USS1's stock in DS1 (90% of the stock of DS1), resulting in DS1 ceasing to be a member of the USS1

consolidated group.

(ii) Analysis. Under paragraph (b)(1) of this section, the USS1 consolidated group is treated as one corporation for purposes of §1.385-3. Accordingly, DS1's distribution of $80x of cash to USS1 on Date A in Year 1 is a disregarded distribution or acquisition, and under paragraph (d)(1) of this section, continues to be a disregarded distribution or acquisition when DS1 ceases to be a member of the USS1 consolidated group. In addition, when DS1 issues DS1 Note to USS1 in a distribution on Date A in Year 1, DS1 is not treated as issuing a debt instrument to a member of DS1's expanded group in a distribution for purposes of §1.385-3(b)(2)(i), and DS1 Note is not treated as stock under §1.385-3(b)(2)(i). DS1's issuance of DS1 Note to USS1 is also a disregarded distribution or acquisition, and under paragraph (d)(1) of this section, continues to be a disregarded distribution or acquisition when DS1 ceases to be a member of the USS1 consolidated group. The distribution of $10x cash by DS1 to FS on Date A in Year 1 is a regarded distribution or acquisition. When FS purchases 90% of the stock of DS1's from USS1 on Date B in Year 2 and DS1 ceases to be a member of the USS1 consolidated group, DS1 Note is deemed satisfied and reissued under §1.1502-13(g)(3)(ii), immediately before DS1 Note ceases to be an intercompany obligation. Under paragraph (c)(1)(i) of this section, for purposes of §1.385-3, DS1 is treated as satisfying the DS1 Note with cash equal to the note's fair market value, followed by DS1's issuance of a new note for the same amount of cash immediately after DS1 Note ceases to be a consolidated group debt instrument. Under paragraph (d)(4)(i) of this section, the departing member, DS1 (and not the USS1 consolidated group) is treated as having distributed $10x to FS on Date A in Year 1 (a regarded distribution or acquisition) for purposes of applying §1.385-3(b)(3) after DS1 ceases to be a member of the USS1 consolidated group. Because DS1 Note is reissued by DS1 to USS1 within the per se period (as defined in §1.385-3(g)(19)) with respect to DS1's regarded distribution to FS, DS1 Note is treated as funding the distribution under §1.385-3(b)(3)(iii)(A) and, accordingly, is treated as stock under §1.385-3(b)(3). Under §1.385-3(d)(1)(i) and paragraph (c)(1)(i) of this section, DS1 Note is immediately deemed to be exchanged for stock of DS1 on Date B in Year 2. Under paragraph (c)(3) of this section, the deemed satisfaction and reissuance under §1.1502-13(g)(3)(ii) and the deemed issuance and exchange under paragraph (c)(1)(i) of this section are respected as separate steps and treated as separate transactions. Under §1.385-3(d)(7)(i), after DS1 Note is treated as stock held by USS1, DS1 Note is not treated as stock for purposes of determining whether DS1 is a member of the USS1 consolidated group.

Example 5. Treatment of consolidated group debt instrument and consolidated group's regarded distribution or acquisition. (i) Facts. On Date A in Year 1, DS1 issues DS1 Note to USS1. On Date B in Year 2, USS1 distributes $100x of cash to FP. On Date C in Year 3, USS1 sells all of its interest in DS1 to FS, resulting in DS1 ceasing to be a member of the USS1 consolidated group.

(ii) Analysis. Under paragraph (b)(1) of this section, the USS1 consolidated group is treated as one corporation for purposes of §1.385-3. Accordingly, when DS1

issues DS1 Note to USS1 in a distribution on Date A in Year 1, DS1 is not treated as issuing a debt instrument to a member of DS1's expanded group in a distribution for purposes of §1.385-3(b)(2)(i), and DS1 Note is not treated as stock under §1.385-3(b)(2)(i). DS1's issuance of DS1 Note to USS1 is also a disregarded distribution or acquisition, and under paragraph (d)(1) of this section, continues to be a disregarded distribution or acquisition when DS1 ceases to be a member of the USS1 consolidated group. The distribution of $100x cash by DS1 to USS1 on Date B in Year 2 is a regarded distribution or acquisition. When FS purchases all of the stock of DS1 from USS1 on Date C in Year 3 and DS1 ceases to be a member of the USS1 consolidated group, DS1 Note is deemed satisfied and reissued under §1.1502-13(g)(3)(ii), immediately before DS1 Note ceases to be an intercompany obligation. Under paragraph (c)(1)(i) of this section, for purposes of §1.385-3, DS1 is treated as satisfying DS1 Note with cash equal to the note's fair market value, followed by DS1's issuance of a new note for the same amount of cash immediately after DS1 Note ceases to be a consolidated group debt instrument. Under paragraph (d)(4)(ii) of this section, the USS1 consolidated group (and not DS1) is treated as having distributed $100x to FP on Date B in Year 2 (a regarded distribution or acquisition) for purposes of applying §1.385-3(b)(3) after DS1 ceases to be a member of the USS1 consolidated group. Because DS1 has not engaged in a regarded distribution or acquisition that would have been treated as funded by the reissued DS1 Note, the reissued DS1 Note is not treated as stock.

Example 6. Treatment of departing member's issuance of a covered debt instrument. (i) Facts. On Date A in Year 1, FS lends $100x of cash to DS1 in exchange for DS1 Note. On Date B in Year 2, USS1 distributes $30x of cash to FP. On Date C in Year 2, USS1 sells all of its DS1 stock to FP, resulting in DS1 ceasing to be a member of the USS1 consolidated group.

(ii) Analysis. Under paragraph (b)(1) of this section, the USS1 consolidated group is treated as one corporation for purposes of §1.385-3. Accordingly, on Date A in Year 1, the USS1 consolidated group is treated as issuing DS1 Note to FS, and on Date B in Year 2, the USS1 consolidated group is treated as distributing $30x of cash to FP. Because DS1 Note is issued by the USS1 consolidated group to FS within the per se period as defined in §1.385-3(g)(19) with respect to the distribution by the USS1consoldiated group of $30x cash to FP, $30x of DS1 Note is treated as funding the distribution under §1.385-3(b)(3)(iii)(A), and, accordingly, is treated as stock on Date B in Year 2 under §1.385-3(b)(3) and §1.385-3(d)(1)(ii). Under paragraph (d)(3) of this section, DS1 (and not the USS1 consolidated group) is treated as the issuer of the remaining portion of DS1 Note for purposes of applying §1.385-3(b)(3) after DS1 ceases to be a member of the USS1 consolidated group.

(g) Applicability date. This section applies to taxable years ending on or after

[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

(h) Expiration date. This section expires on **October 11, 2019**.

Par. 7. Section 1.752-2 is amended by adding paragraphs (c)(3) and (l)(4) to read as follows:

§1.752-2 Partner's share of recourse liabilities.

* * * * *

(c) * * *

(3) [Reserved]. For further guidance, see §1.752-2T(c)(3).

* * * * *

(l) * * *

(4) [Reserved]. For further guidance, see §1.752-2T(l)(4).

Par. 8. Section 1.752-2T is amended by revising paragraphs (c)(3) and (m) and adding (l)(4) to read as follows:

§1.752-2T Partner's share of recourse liabilities (temporary).

* * * * *

(c)***

(3) Allocation of debt deemed transferred to a partner pursuant to regulations under section 385. For a special rule regarding the allocation of a partnership liability that is a debt instrument with respect to which there is one or more deemed transferred receivables within the meaning of §1.385-3T(g)(8), see §1.385-3T(f)(4)(vi).

* * * * *

(l) * * *

(4) Paragraph (c)(3) of this section applies on or after [**INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER**].

(m) Expiration date--(1) Paragraphs (a) through (c)(2) and (d) through (l)(3) of this section expire on October 4, 2019.

(2) Paragraphs (c)(3) and (l)(4) of this section expire on **October 11, 2019**.

Par. 9. Section 1.1275-1 is amended by adding a sentence after the last sentence of paragraph (d) to read as follows:

§1.1275-1 Definitions.

* * * * *

(d) * * * See §1.385-2 for rules to determine whether certain instruments are treated as stock for federal tax purposes and §1.385-3 for rules that treat certain instruments that otherwise would be treated as indebtedness as stock for federal tax purposes.

* * * * *

John Dalrymple

Deputy Commissioner for Services and Enforcement.

Approved: October 11, 2016

Mark J. Mazur

Assistant Secretary of the Treasury (Tax Policy).

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