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July 7, 2016

Submitted electronically via: http://regulations.gov

CC:PA:LPD:PR
(REG-108060-15)
Internal Revenue Service
Room 5302
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Proposed Regulations under Section 385

Ladies and Gentlemen:

KPMG LLP appreciates the opportunity to comment on the proposed regulations under section 385[1] that were released on April 4, 2016, and published in the Federal Register on April 8, 2016 (the proposed regulations).[2]

KPMG LLP, the audit, tax and advisory firm, is the U.S. member firm of KPMG International Cooperative. KPMG is a global network of professional firms providing Audit, Tax and Advisory services. We operate in 155 countries and have more than 174,000 people working in member firms around the world. On a daily basis, KPMG LLP assists numerous clients by providing financial accounting audit and attestation services, business advisory services, general U.S. federal, state, local and international tax advice, and transactional planning.

Please note that while we anticipate the proposed regulations would materially affect many of our clients, our comments in this letter reflect the concerns of our organization, and the concerns of many of the tax professionals who practice within our organization (more than 25 of whom were contributors to this comment letter); we have not been engaged by a client to make these comments, nor do we write on behalf of any particular client.

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[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code"), or the applicable regulations promulgated pursuant to the Code (the "regulations") as of the date of this comment letter.

[2] Notice of Proposed Rulemaking, *Treatment of Certain Interests in Corporations as Stock or Indebtedness*, REG-108060-15, 81 Fed. Reg. 20912 (Apr. 8, 2016) (publishing Prop. Treas. Reg. §§ 1.385-1 through -4).

I. Introduction

We believe that the proposed regulations are extraordinary and unprecedented in scope and potential effect. The proposed regulations, if adopted in their current form, would have a virtually immediate and material impact on our clients that are subject to U.S. federal income tax laws, in ways that would have little relation to the proposed regulations' stated purpose. The impacts of the proposed regulations could extend well beyond the tax worlds, and result in adverse financial statement and credit rating impacts.

The proposed regulations potentially represent the single most consequential change in the laws of corporate taxation in a generation, rivaled only perhaps by the so-called "check the box" regulations under section 7701. The proposed regulations have been framed as comprising part of an effort to attack so-called inversion transactions,[3] and were released simultaneously with a series of guidance under section 7874 (the anti-inversion statute). We appreciate the significant policy concerns raised by inversion transactions. However, the proposed regulations are in no way limited in their application to inverted entities, and they would most heavily burden entities that have not inverted, do not intend to invert, and do not have the characteristics of an entity that is likely to invert.

We believe the proposed regulations are inconsistent with Congress' delegation of regulation-writing authority under section 385(a). Moreover, they raise numerous and important substantive issues, would impose an inappropriately large compliance burden on routine corporate transactions, and would cause far-reaching collateral consequences, many of which appear to have been unintended by the drafters, and some of which we no doubt remain unaware. In short, the proposed regulations are grossly overbroad, and would impose unnecessary collateral damage.

Finally, we seriously question whether the objectives that the Treasury Department intends to achieve through the proposed regulations are worth the costs they would impose on the Service itself in its role as a tax administrator, on taxpayers that seek in good faith to comply with our nation's tax laws, and on the integrity of the tax system itself through a new set of complex rules that potentially would result in numerous unadministrable situations.

II. Validity of the Recast Rules

1. Discussion

We believe the general, funding, and *per se* rules in Prop. Treas. Reg. § 1.385-3 exceed Treasury's regulatory authority under section 385.[4] Although section 385(a) grants Treasury authority to

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[3] *See* Press Release, The White House, Remarks of President on the Economy (Apr. 5, 2016, 12:15PM), https://www.whitehouse.gov/the-press-office/2016/04/05/remarks-president-economy-0; and Press Release, The White House, Press Briefing by Press Secretary Josh Earnest (Apr. 5, 2016, 12:30 PM) https://www.whitehouse.gov/the-press-office/2016/04/05/press-briefing-press-secretary-josh-earnest-452016.

[4] The documentation and substantiation rules of Prop. Treas. Reg. § 1.385-2, regardless of their propriety or advisability, generally appear consistent with a broad view of the regulatory authority in section 385(a). The proposed regulations avowedly seek to "discipline" taxpayers, a punitive motivation inconsistent with the Congressional purpose underlying section 385, which is to provide criteria by which to classify an instrument as debt or equity in a corporation. Nonetheless, documentation and substantiation historically have been viewed as important factors in a debt-equity analysis. While we have significant reservations regarding the propriety and the

prescribe regulations to determine whether an interest in a corporation is to be treated as stock or debt (in whole or in part), section 385(b) explicitly states that such regulations "shall set forth factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists."

Moreover, the legislative history makes clear that, in enacting section 385, Congress contemplated that any Treasury regulations issued under that section would set forth factors that are indicative of debtor-creditor or corporation-shareholder relationships in an attempt to resolve the ambiguities and uncertainties reflected in the abundance of case law regarding whether corporate arrangements in substance constitute debt or equity. In other words, the statute and the legislative history contemplate regulations that would improve upon the case authorities, drive more uniformity, and provide a series of generally applicable rules to distinguish indebtedness from equity.

More specifically, section 385 originated in the Senate Finance Committee's version of the Tax Reform Act of 1969. The Senate Finance Committee's report states:

> In view of the uncertainties and difficulties which the distinction between debt and equity has produced in numerous situations other than those involving corporate acquisitions, the committee further believes that it would be desirable to provide rules for distinguishing debt from equity in the variety of contexts in which this problem can arise. The differing circumstances which characterize these situations, however, would make it difficult for the committee to provide comprehensive and specific statutory rules of universal and equal applicability. In view of this, the committee believes it is appropriate to specifically authorize the Secretary of the Treasury to prescribe the appropriate rules for distinguishing debt from equity in these different situations.[5]

The Conference Committee accepted the Senate proposal, and section 385 was enacted into law.[6]

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drafting of the documentation and substantiation rules as proposed (and question the ability to write the rule as a *per se* rule that would *ipso facto* "equitize" debt instruments that fail to meet the requirements, without consideration of other factors), we acknowledge that the substance of these requirements could be articulated in a fashion that more closely aligns with the grant of regulatory authority. Thus, we view the documentation and substantiation rules (to the extent they relate to instruments issued by a corporation) as arguably thematically consistent with the broad regulatory grant in section 385(a), albeit significantly overbroad. Our comments regarding the invalidity of the proposed regulations are focused on the general, funding, and *per se* rules in Prop. Treas. Reg. § 1.385-3.

[5] S. Rep. No. 91-552, at 138 (1969). The House bill had included a more limited provision addressing certain corporate acquisition indebtedness, which was enacted as part of the bill and is now codified in section 279.

[6] The Conference Report simply noted that the conference substitute followed the Senate amendment. H.R. Conf. Rep. 91-782, at 308-309 (1969). Tax Reform Act of 1969, Pub. L. No. 91-172, § 415(a), 83 Stat. 487, 613-614. Section 385 has been amended three times. *See* Tax Reform Act of 1976, Pub. L. No. 94-455, § 1906(b)(13)(A), 90 Stat 1719, 1834 (a clerical amendment replacing "Secretary or his delegate" with "Secretary"); Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7208, 103 Stat. 2106, 2337 (inserting parenthetical language in section 385(a) to authorize prospective regulations to treat certain corporate interests as in part stock and in part indebtedness); and Energy Policy Act of 1992, Pub. L. No. 102-486, § 1936(a), 106 Stat. 2776, 3032 (adding section 385(c)).

We believe the proposed regulations exceed the regulatory authority granted by section 385 and go beyond Congressional intent. They do not seek to delineate a general debt-equity distinction or to clarify or rationalize debt-equity analysis. Instead, the proposed regulations would simply treat certain arrangements as equity in order to ensure that interest expense deductions are not available in the case of certain transactions. We believe that legislation would need to be enacted to allow Treasury to provide such treatment by regulation.

In addition, there is nothing in section 385 or its legislative history that suggests that Congress authorized regulations to determine the status of an interest in a non-corporate entity; rather, the legislative history suggests section 385(a) was intended to be limited to corporate issuers. The statutory provision is in subchapter C of Chapter 1 of the Code, the portion of the Code addressing corporate distributions and adjustments. Yet, the proposed regulations would recharacterize certain debt instruments issued by a partnership, either as equity in the partnership or as equity in the partner(s) of the partnership.

In the legislative history underlying the enactment of section 385, the Senate Finance Committee report states: "[a]lthough the problem of distinguishing debt from equity is a long-standing one in the tax laws, it has become even more significant in recent years because of the increased level of corporate merger activities and *the increasing use of debt for corporate acquisition purposes*."[7] As indicated in the passage cited above, the Senate Finance Committee report goes on to state:

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

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

in determining, with respect to a particular factual situation, whether a debtor-creditor relationship exists or whether a *corporation-shareholder* relationship exists.[8]

The above legislative history makes clear that the focus of Congress in enacting section 385 was the characterization of *corporate debt,* and thus the statute makes no reference to whether an interest in a *partnership* is to be treated as stock or indebtedness.

Similarly, the proposed regulations would recharacterize debt instruments issued by a disregarded entity either as equity in the issuing entity (which could result in the entity being treated as a partnership) or as equity in the owner of the entity (even though the debt instrument is not an interest in the owner). These proposed rules cannot be squared with the grant of regulatory authority regarding the debt-equity status of an interest in a corporation.

2. Recommendation

Therefore, we respectfully make the following recommendations:

- We urge the Treasury Department and the Internal Revenue Service to withdraw the proposed regulations, in their entirety.
- If the Treasury Department and Service do not withdraw the proposed regulations in their entirety, we recommend that they withdraw Prop. Treas. Reg. § 1.385-3.
- If the proposed regulations are not withdrawn, we recommend that the regulations, if and when finalized, should only apply to debt issued by corporations.

A more detailed discussion of the lack of statutory authority for the proposed regulations is set forth in a subsequent portion of this letter. We address the remainder of our comments to particular aspects of the proposed regulations.

III. The Expedited Timeframe for Finalizing the Proposed Regulations Raises Significant Tax Policy Concerns Given the Potential Collateral Consequences

1. Discussion

The effective dates of the proposed regulations and the expedited effort to finalize them, taken together or separately, raise significant tax policy concerns given the numerous uncertainties and collateral consequences that would result. We appreciate that there may be political considerations that are being brought to bear on the issue of inversions. Nonetheless, we believe the primary effect of the proposed regulations would be felt by business enterprises that have not inverted, and have no intention of inverting. In addition, we appreciate that the Treasury Department and this Administration have advanced legislative proposals to alter the applicable, substantive tax laws in relation to "leveraged distributions," "boot D reorganizations," section 304 transactions, and "earnings stripping." We believe that any "solution" in respect of these issues should be pursued exclusively in the legislative arena or through the renegotiation of income tax treaties.

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

As noted throughout our comments, the proposed regulations would have an extraordinary reach. The effect of recharacterizing debt instruments as equity—especially under the inadministrable funding and *per se* rules—will place significant additional pressure on many historic fault lines in corporate tax law and create new discontinuities. The Treasury Department has previously indicated significant concerns regarding the shifting of earnings and profits, the shifting of stock basis, and the issuance of upstream equity ownership ("hook equity"). We expect the proposed regulations would directly and substantially increase the occurrence of these issues, resulting in additional taxpayer disputes and considerable additional complexity. We expect the proposed regulations would lead to new uncertainties in determining control for purposes of the incorporation, reorganization, and liquidation provisions. In the context of troubled companies, we anticipate that there would be a number of inadvertent deconsolidations and other unexpected and unintended results, and the potential to substantially increase the use of "*Granite Trust*"[9] techniques, even without taxpayers intending to do so. Similarly, the unexpected and perhaps retroactive creation of non-voting equity by means of a debt's recharacterization could create taxable transactions (such as in a transfer of appreciated property to an otherwise controlled subsidiary). These would have the effect of upsetting Congress' tax policy choices underlying the non-recognition provisions as well as taxpayers' reasonable expectations about having an ability to predict their tax liabilities. Perhaps these would give taxpayers the opportunity retrospectively to claim an increase in the basis of transferred assets and the stock of the transferee corporation.

We are deeply concerned that extending the proposed regulations to cash pool and treasury center arrangements and the no affirmative use rules are invitations to sheer incoherence. The funding and *per se* rules are also particularly troubling, in that taxpayers do not have systems in place today to capture and track the information necessary for compliance. The Service cannot be in a much better position in terms of its ability to audit taxpayers' compliance with any of these rules, or to determine the consequences of noncompliance.

As a financial audit firm that is asked to certify the financial statements of large corporate enterprises and to attest to management's assessment of the company's internal controls over financial reporting, we are deeply troubled by these rules. How long will it take taxpayers to establish and implement systems to capture and track the information necessary properly to apply the unprecedented standards in the proposed rules? How difficult will it be to determine that management has adequately assessed the accuracy of its financial accounting for income taxes?

We understand that the Treasury Department and Service intend to finalize the proposed regulations quickly. This, notwithstanding that the regulations would be effective with respect to certain debt instruments issued on or after April 4, 2016, the date the proposed regulations were publicly released, and generally with respect to debt instruments issued the day the regulations are published as final.[10] The unprecedented breadth and scope of the proposed regulations and the many, many serious

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[9] *Granite Trust Co. v. United States*, 238 F.2d 670 (1st Cir. 1956).

[10] The effective dates in the proposed regulations are inconsistent with the requirement in section 553(d) of the Administrative Procedure Act (5 U.S.C. § 553(d)) that the required publication of a substantive rule be made not less than 30 days before its effective date. Certainly, there is no discussion in the preamble regarding any finding of good cause for an accelerated effective date, nor does good cause for an accelerated date exist because many of the transactions impacted by the rules have been well-known for decades. The current version of section 7805(b) does not authorize an earlier effective date with respect to regulations under section 385 because section 385

issues that they raise strongly counsel against hasty finalization. We believe that good tax policy demands that the process of finalizing this guidance deliberately take the time necessary to minimize the widespread, difficult, serious, collateral damage that the proposed regulations will engender if they were to be issued as final in their current form. A rush to meet an arbitrary deadline that might be construed as expedited for political considerations would represent a poor policy choice.[11]

A further consideration counsels for providing taxpayers with the time necessary to absorb and understand the rules in the proposed regulations—as they may be amended by final regulations—and to create and implement systems to properly comply with them. For obvious efficiency reasons that have nothing to do with tax planning, few large corporate groups currently employ systems that would satisfy the elaborate documentation and financial due diligence requirements demanded by the proposed regulations. Large corporate groups often use intercompany debt in lieu of bank debt in large part due to the significant non-tax cost savings and non-tax financial management benefits. Common practices among many large corporate groups may be found wanting in one or more respects under the proposal—after all, why would such taxpayers undertake the elaborate, expensive documentation often utilized in bank borrowings when such documentation has neither been required nor serves any useful function in the related-party context? Thus, large corporate groups will be required to design and implement changes to their current practices to support debt characterization under the proposed regulations. They reasonably can be expected to encounter numerous practical difficulties and questions as they design and effectuate their new systems.

We note that the effective dates for the Chapter 4 "FATCA" withholding tax regime and for withholding under section 871(m) have been repeatedly extended in acknowledgement of very similar concerns. Those experiences highlight the need for a more measured approach in this context.

Some changes are obvious and can be implemented in due course, such as new internal policies requiring generally that attorneys (either in-house counsel or outside counsel), paralegals or other professionals in a particular jurisdiction be consulted to prepare or review the necessary operative legal

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predates the effective date of section 7805(b). Taxpayer Bill of Rights 2, Pub. L. No. 104-168, § 1001(b), 110 Stat. 1452, 1468-1469 (1996).

[11] For comparison, the *General Utilities* doctrine was not repealed in a day, nor were comments limited to a 90-day period. Repeal had been debated as part of a political process, with an "unusually voluminous" literature, for years. Boris Bittker & James Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 8.20[3], n.288 7th ed. 2015). Professor Yin stated that the repeal process gained "important momentum" in 1982 – *four years before full repeal* – with the American Law Institute's publication of proposals to revise subchapter C, George K. Yin, *Taxing Corporate Liquidations (and Related Matters) After the Tax Reform Act of 1986*, 42 Tax L. Rev. 573, 579-580 (1987), and parts of the *General Utilities* doctrine were eliminated in the years preceding complete repeal. The absence of any comparable lead time is evidenced by the many issues and widespread collateral damage that the proposed regulations would create.

Also, for comparison, the original section 385 regulations were proposed to be effective more than nine months after the publication of the proposed regulations. Prop. Treas. Reg. § 1.385-1(a) (1980), 45 Fed. Reg. 18957, 18963 (Mar. 24, 1980) (proposing rules to be effective for instruments issued after December 31, 1980). The final regulations would have given an additional four-month grace period. Treas. Reg. § 1.385-1(a)(1) (1980); T.D. 7747, 45 Fed. Reg. 86438, 86445 (Dec. 31, 1980) (effective for instruments and loans issued after April 30, 1981). Ultimately, the effective dates were postponed and the regulations were withdrawn. *See* Joint Comm. on Tax'n, Report to the House Committee on Ways and Means on Present Law and Suggestions for Reform Submitted to the Tax Reform Working Groups, JCS-3-13, at 72-73 (May 6, 2013).

documentation. Some policies might take longer, such as those surrounding financial due diligence (which in many cases will be standardized across a large corporate group) and those involving third-party relationships (such as cash pooling operations that involve a bank). Other changes are more intractable, such as the need immediately to begin tracking all intercompany lending, as well as all actual and deemed inter-corporate distributions, acquisitions of expanded group (EG) member stock (including dividend equivalent "redemptions" of recharacterized debt instruments) and intercompany asset reorganizations by a borrowing entity—as well as these types of transactions that are engaged in by a borrowing entity's predecessors and successors—and systems to integrate the intercompany lending information with this other information. These requirements are particularly worrisome in the context of cash pooling and treasury center functions. Treasury Department and Service attorneys have made comments in panel discussions (and that were reported in the tax press) indicating that substantial changes will be considered with respect to these arrangements. However, *taxpayers do not know what those changes will be, what effect they might have, or what they will need to do to comply with whatever the modified new requirements might be*. We are particularly dismayed at the prospect that taxpayers might be expected to immediately comply with whatever rules are included in final regulations (in part based on transactions that have occurred after April 3, 2016), and without being given any time to design and implement new systems to comply with the regulations. To be sure, taxpayers are on notice now that new rules are coming and on the general direction that the new rules will take. *Taxpayers are not, however, on notice as to the specifics of the final rules*—especially as they relate to cash pooling and treasury functions—and they cannot reasonably be expected to create and implement expensive and disruptive new systems before knowing the details of what the final rules will require. We note that in other areas where compliance is reasonably expected to require extensive systems changes, the Treasury Department and Service have consistently crafted applicability dates to allow time for taxpayers to comply.[12] The proposed regulations create similar burdens but do not provide for necessary implementation time.

A further, practical point. Large domestic corporate taxpayers are subject to the laws of the states in which they operate. Many of the states have income tax rules that have significant features in common with the U.S. federal income tax rules, and there is considerable uncertainty as to the state tax effects of the proposed regulations.[13] In order to avoid the cost and other burdens of duplicative systems, taxpayers will want to design and implement systems that would facilitate both U.S. federal and state tax compliance. However, basic questions remain, and they remain for most large domestic corporate groups. While a consolidated group of corporations would be partially exempted from the ambit of the proposed regulations with respect to intercompany obligations due to the treatment of consolidated corporations as a single corporation (Prop. Treas. Reg. §§ 1.385-1(e), -2(c)(4)(i), -4(a)), some group members might file separate returns in one or more states, and the group might file unitary returns in one or more states. Some states which might otherwise adopt the rules of the proposed regulations need not adopt the single entity treatment principle, or apply it in the same manner. This presents the possibility that an intragroup debt instrument could be respected as indebtedness for U.S.

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[12] *See* Treas. Reg. §§ 1.1474-1(d)(4)(iii)(C) and 1.1474-1(i) (applicability dates regarding the implementation of FATCA); T.D. 9734, 80 Fed. Reg. 56866, 56878 (Sept. 18, 2015) ("The final and temporary regulations [regarding the implementation of section 871(m)] are generally effective on September 18, 2015. To ensure that brokers have adequate time to develop the systems needed to implement the regulations, however, the final and temporary regulations generally apply to transactions issued on or after January 1, 2017.").

[13] *See* Peter L. Faber, *SALT Implications of Proposed Section 385 Debt-Equity Regulations*, 80 State Tax Notes 931 (June 20, 2016); Amy Hamilton, *Roundup of State Commentary on Proposed IRS Debt-Equity Regs*, 2016 State Tax Today 117-1 (June 17, 2016).

federal income tax purposes under this single entity principle, yet at the same time the very same debt instrument could be treated as stock for State A and/or State B tax purposes. We recognize that state tax considerations are not typically given much attention by the Treasury Department when writing regulations. However, large domestic corporate groups cannot ignore these important considerations, which they must take into account in designing and implementing information collection and compliance systems. The Treasury Department should not be under the false impression that the single entity principle means that purely domestic consolidated groups are free to disregard how the rules could apply to intragroup debt instruments.[14]

The proposed regulations have been designated a "significant regulatory action" under section 3(f) of Executive Order 12866, and have been designated as "economically significant." The official *Regulatory Impact Analysis* filed with the proposed regulations at the regulations.gov website estimates the paperwork costs of compliance to be $13 million on an annualized basis (which we believe to be grossly understated), and estimates that the proposed regulations would impose an annual $843 million tax increase (on a discounted basis). These official designations and estimates acknowledge that the proposed regulations comprise important new rules, and will impose significant costs; there is also the implicit acknowledgement that many taxpayers will be required to adapt their policies and procedures and substantially adjust their behaviors in order to comply.[15] Notwithstanding, the Treasury Department and Service chose not to issue an advanced notice of proposed rulemaking, even though an ANPRM would appear to have been contemplated in section 2(c) of Executive Order 13563 issued by President Obama.[16]

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[14] In addition, large domestic corporate groups may have occasion to determine whether an intercompany obligation is an *exempt consolidated group debt instrument* or a *non-exempt consolidated group debt instrument* for purposes of Prop. Treas. Reg. § 1.385-4(b)(1). Such a determination will require access to information regarding the issuance of debt instruments, as well as all distributions, EG-member stock acquisitions and intercompany asset reorganizations during the relevant 72-month periods, including those that take place wholly within a consolidated group. The point is that every large corporate group – even those ostensibly covered by the "treat-all-members-of-a-consolidated-group-as-one-corporation" rule – will have to implement entirely new systems to enable them to comply with the proposed regulations.

[15] The Supreme Court recently stated that "[o]ne of the basic procedural requirements of administrative rulemaking is that an agency must give adequate reasons for its decisions. The agency must examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made." *Encino Motorcars, LLC v. Navarro*, No. 15-415, slip. op. at 9 (decided June 20, 2016) (quotation marks and citations omitted). We observe that the preamble to the proposed regulations contains little in the way of data or fact findings, and no real discussion relating to (or an acknowledgement of) the direct consequences of the proposed regulations.

[16] Section 2(c) of Executive Order 13563 states: "Before issuing a notice of proposed rulemaking, each agency, where feasible and appropriate, shall seek the views of those who are likely to be affected, including those who are likely to benefit from and those who are potentially subject to such rulemaking." The proposed regulations would have an extraordinary effect and would overturn decades of well-settled law, and are clearly intended to affect all large corporate groups regardless of their inversion status. Moreover, the bifurcation rule in Prop. Treas. Reg. § 1.385-1(d) could apply to numerous closely held corporations. Amy S. Elliott, *Debt-Equity Regs Could Apply to Millions of Closely Held Corps*, 2016 Tax Notes Today 113-2 (June 13, 2016) (reporting on the discussion of a panel that included a Treasury Department official, a senior attorney with the Service, and the former IRS Associate Chief Counsel (Corporate)). When would it ever be "feasible and appropriate" for tax regulations to adhere to this requirement, if these proposed regulations are excused?

Taxpayers who in good faith seek to comply with our nation's tax laws should be given a reasonable amount of time to establish operational information tracking and compliance systems. With all due respect, the debt-equity distinction has been around since the infancy of our income tax laws; it has been almost 50 years since Congress authorized regulations under section 385, and more than 30 years since the Treasury Department withdrew its prior effort at drafting regulations. The transactions targeted by the general, funding and *per se* rules were already tried and true (and approved of or accepted by trial and appellate courts) when section 385 was enacted in 1969. Those transactions rely on Code provisions and general tax principles that were black-letter law at that time, and that remain in the law notwithstanding repeated efforts to have Congress change the law. There is no reasonable tax policy argument for an accelerated due date for the proposed regulations, except—to take the Treasury Department at its word—in the context of anti-inversion efforts. And in that context, we do not believe there is a credible argument that justifies overturning decades of stable tax law in an effort to impose the rules in the proposed regulations on an accelerated basis to U.S. corporate groups that have not inverted, do not intend to invert, and are not candidates for an inversion.[17]

There is a further concern with the accelerated due dates. Many large corporate taxpayers that would be subject to these rules are required to file audited financial statements with the U.S. Securities and Exchange Commission, and to assess the effectiveness of their internal controls over financial reporting, in accordance with the standards established by the Public Company Accounting Oversight Board. An accelerated timeline for finalization of the proposed regulations could result in insufficient time to consider the numerous, substantive comments that the Treasury Department and Service have received and will receive, and insufficient time for companies to adapt to final regulations. In particular, we are concerned that if final regulations are issued on an accelerated schedule this fall with the currently proposed effective dates, the effect of the numerous uncertainties in the regulations and the relative lack of time for taxpayers to adapt to the final regulations could be reflected in companies' financial statements and could in certain circumstances needlessly complicate the ability to attest to companies' internal controls over their financial reporting, for purposes of the annual reports filed by companies with their Forms 10-K for years ending on Dec. 31, 2016.

We recommend that taxpayers be given no less than one year after finalization to comply with whatever new documentation requirements are imposed by final regulations. If the Treasury Department and Service are concerned that taxpayers might choose to "game the system" by rushing to issue poorly documented related-party debt instruments in the interim, a rule could be written to require reasonable documentation, including objective, contemporaneous evidence of an intent to create a debtor-creditor relationship (including appropriate journal entries) for the interim transition period.

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[17] Throughout the history of our nation's income tax laws, the Service had respected intercompany debt, and it issued elaborate rules addressing various aspects of intercompany debt. This is evidenced in regulations and proposed regulations that apply to indebtedness amongst related parties, such as regulations under Treas. Reg. § 1.1502-13(g), proposed regulations under section 163(j), and the section 301 regulations discussed in a later part of this letter; this is also consistent with the statutory provisions and legislative history discussed above. In our experience, the Service's enforcement policy has been to evaluate related-party debt under general tax principles, and taxpayers have relied on this policy for many decades. There is no discussion in the preamble why this policy must be so abruptly altered.

2. Recommendation

- Extend the time for comments for 90 additional days, through October 5, 2016, to allow other interested parties the time necessary to identify additional significant issues and submit comments.

- Given the significant changes that should be made to the proposed regulations and the potential scope of the changes, re-propose the regulations with necessary changes, to allow for additional comments and assessment of the potential for additional collateral damage.

- Revise the effective date provisions, so that the regulations would apply with respect to debt instruments issued on or after the day that is one year after temporary of final regulations are published in the Federal Register, and provide grandfather rule relief with respect to currently outstanding obligations.

IV. The Proposed Recast Regime Would Create Incentives Leading to Unintended Economic Results

1. Discussion

The proposed regulations are extraordinarily sweeping in their potential scope, and will have an inevitable and unfortunate effect on routine corporate transactions, thus providing a distortive difference in costs and uncertainties between U.S. corporations that would be subject to the rules and business entities that would not.

a. The proposed regulations favor ownership of U.S. corporations by individuals or entities not organized as corporations, which creates noneconomic incentives, because such non-corporate entities generally will not be a member of an expanded group. For example, consider a partnership formed by unrelated individual and corporate partners, none of which owns 80 percent or more of the partnership. U.S. corporations can issue debt to such non-expanded group persons, and deduct the interest on such obligations.[18]

b. The dual consolidated loss regime in section 1503(d) was motivated by a concern that foreign taxpayers' use of dually incorporated entities, which permitted the double use of interest deductions, provided an undue tax advantage to foreign acquirers that engaged in leveraged buyouts of U.S. companies.[19] The proposed regulations will likely have the perverse and opposite effect of *encouraging* leveraged buyouts of U.S. companies. This is because the proposed regulations would not apply to a "formation-based" injection of leverage into a U.S. holding company or acquisition company, yet would apply to later recapitalizations of existing businesses.

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[18] The Service has seen an "explosive growth" in partnership business structures, as noted in Michael J. Bologna, *IRS Attorney Forsees Continued Growth in Partnerships*, 81 BNA Daily Tax Rep. G-2, (Apr. 27, 2016). This is consistent with the data presented in Joint Committee on Taxation, Background on Business Tax Reform, JCX-35-16 (Apr. 22, 2016). *See also*, Ron DeCarlo & Nina Shumofsky, *Partnership Returns, 2012*, IRS Statistics of Income Bulletin (Winter 2015) (Table 1 reflects that Year 2013 partnership returns reflected $5.4 *trillion* in total income, $768 billion in total net income, and $24.1 *trillion* in total assets).

[19] *See* Joint Comm. on Tax'n, General Explanation of the Tax Reform Act of 1986, JCS-10-87, at 1063-1067 (1987) (explaining that the dual consolidated loss rules were intended to eliminate an undue tax advantage that favored certain foreign investors over U.S. investors in purchasing U.S. businesses).

Example. USP, a U.S. parent corporation, has a 3:1 external debt-equity ratio, which is standard in its industry. USP transfers $100 of assets to a newly organized, non-consolidated subsidiary in exchange for $75 of debt and $25 of equity. Two years later, the subsidiary has prospered and is worth $500, but has a sub-optimal debt-equity ratio.[20]

The proposed general rule would preclude the subsidiary from issuing and distributing a note to the parent, or from undergoing a recapitalization. However, the U.S. parent could sell the subsidiary to an unrelated foreign buyer, which could insert $375 of leverage into the subsidiary and thus re-establish the original debt-equity ratio without triggering the general rule.[21] In addition, the foreign buyer would be free to utilize an intercompany borrowing from a related foreign finance company to finance the purchase, without losing an interest deduction on that debt.[22] To be sure, the new leverage might be subject to recharacterization under the funding and *per se* rules if the purchased entity itself were to make a distribution, purchase related-party stock, or acquire assets in a related-party reorganization with boot within 36-months, but if the foreign acquirer is willing to wait for more than 36 months, the new acquisition-based leverage would not be recharacterized under the rules.[23]

c. By the same token, the proposed regulations would create incentives for U.S. corporations to sell their subsidiaries to foreign purchasers (and for foreign corporations to sell their U.S. businesses to other foreign buyers). In addition, when it comes to acquisitions of corporate business enterprises with no prior U.S. tax relevance, the complexity and likely effect of the proposed regulations combined with the failure to exclude such previously U.S-tax-irrelevant corporate business enterprises from their scope would impose on potential U.S. purchasers significant costs and uncertainties that rival foreign purchasers would not face.

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[20] *See* Jasper L. Cummings, Jr., *Can Treasury Bully Corporations into Shaping up their Debt?*, 151 Tax Notes 1647, 1649 (June 20, 2016) ("Evidently, Treasury has never talked to the CFOs who choose to impose fiscal discipline on profitable subsidiaries by making them carry the same debt load their competitors do."). We remind the Treasury Department and Service that Congress has recognized that taxpayers are free to choose to capitalize entities with a mix of stock and debt, even when the choice has tax considerations. Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act," JCX-18-10, at 152-153 (2010).

[21] $375 of debt could be inserted into a newly-formed U.S. holding corporation formed to effect the acquisition, or into the target company through a cash merger of a transitory domestic merger corporation into the target company. While that debt could be subject to the funding rule of Prop. Treas. Reg. § 1.385-3(b)(3), a patient foreign taxpayer could wait for 37 months before allowing (or causing) the funded member to engage in a transaction that might otherwise have triggered equity-recharacterization under the funding rule.

[22] The foreign acquiring corporation and the related foreign finance entity would not be subject to the U.S. income tax, and thus might not care whether the proposed regulations might restrict the interest deduction on the foreign-to-foreign intercompany borrowing. At the same time, the foreign acquiring corporation is likely to be able to deduct the interest on the intercompany borrowing under the rules applicable in its jurisdiction – an advantage the proposed regulations would deny to a U.S. acquiring corporation.

[23] While as a theoretical matter, the new leverage would be subject to equity recharacterization outside the 36-month post-acquisition period if the debt had been incurred with a principal purpose of funding a distribution, the principal purpose test cannot reasonably be interpreted to automatically turn *all* acquisition debt in leveraged buyouts into principal purpose debt.

d. While the proposed rules were said to be issued in connection with a desire to prevent departures from the U.S. tax system through inversions, the increased cost to comply with the rules in the proposed regulations and to manage the extraordinary complexities that will result from the general and funding rules (particularly in light of the *per se* rule) will have the perverse effect of further encouraging corporations to expatriate. In addition, the denial of interest deductions for inbound investment could simply disincentivize conducting operations in the United States, thereby adversely impacting the economy. We recognize that "earnings stripping" is not intended as a tax subsidy for foreign purchasers; however, a foreign corporation that seeks to use an optimal level of debt (perhaps mirroring the foreign acquirer's debt-equity ratio) will surely consider the additional U.S. income tax burden in losing an interest deduction and the cost of additional bank borrowings when determining whether to make additional investments in its existing U.S. entities. We expect this to be particularly acute in the financial sector.[24]

e. A number of the transactions targeted by the proposed regulations (such as so-called earnings stripping and leveraged distributions) will continue to work for taxpayers who employ borrowings from unrelated lenders. For obvious reasons, the proposed regulations do not target indebtedness held by unrelated lenders,[25] such as the bank borrowing employed in the very transaction at issue in *Falkoff.*[26] The proposed regulations would create an incentive for transactions to be undertaken in a manner that involves external rather than internal borrowing, thus creating unnecessary additional borrowing by large corporate groups, together with the attendant increased transaction costs, fees, and market risk. This would also be the case for routine intercompany borrowings that are effected for nontax reasons (such as reducing interest rates and transactions costs) by large corporate groups that channel their external borrowing through a central finance subsidiary or a corporate parent. Those corporate groups would be incentivized to restructure much of their routine intercompany debt as external borrowing, thereby incurring higher borrowing costs and other inefficiencies, and including increasing their external debt ratios (thus increasing risk in the U.S. corporate sector).

f. The proposed regulations would affect the amount of leverage reported on the financial statements of U.S. corporations subject to its regime. As discussed above, the substantiation and documentation requirements together with the general rule and funding rule will incentivize large corporate groups to substitute external borrowing from third-party lenders that are not members of the borrower's expanded group for internal financing. Under generally accepted accounting principles, internal borrowing often is eliminated on a corporation's

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[24] This issue could be particularly troublesome with respect to foreign-owned financial institutions when, for regulatory reasons, additional reserves and capital infusions might be advisable, or when liquidity could be affected. *See* Federal Reserve System, *Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations*, 79 Fed. Reg. 17240 (Mar. 27, 2014).

[25] We note that the anti-avoidance rule in Prop. Treas. Reg. § 1.385-3(b)(4) applies to debt instruments issued with a principal purpose of avoiding the application of the proposed regulations. Under a literal reading, this rule could apply to a debt instrument issued to an unrelated bank in lieu of an intercompany borrowing, a result that is absurd on its face.

[26] *Falkoff v. Commissioner*, T.C. Memo. 1977-93, *rev'd*, 604 F.2d 1045 (7th Cir. 1979) (*i.e.*, the loan from the First National Bank of Chicago to Henry Crown and Company).

consolidated financial statements. Conversely, generally accepted accounting principles do not allow external debt to be eliminated. If finalized, the proposed regulations would lead to an increase in the aggregate external debt-load on financial statements. This, in turn, would have an adverse impact on corporate debt-to-equity ratios and other financial indicators[27] that will negatively impact the credit ratings for U.S.-based corporations fully in the crosshairs of the proposed regulations. Foreign competitors will not suffer an equivalent burden.

g. The issuance of intercompany indebtedness is not subject to the general rule of Prop. Treas. Reg. § 1.385-3(b)(2) if incurred in the initial capital structure of a subsidiary corporation, but can be vulnerable to recharacterization if the subsidiary corporation issues an instrument with the identical terms thereafter in a recapitalization or distribution. This can be expected to lead to a greater amount of intercompany debt being issued upon corporate formations, including in the debt-pushdown context.

h. Certain tax rules operate on a counter-cyclical basis. For example, taxpayers undergoing financial stress often will pay less tax, and those that generate losses can carry the losses back to flusher taxable years. The current Administration and Congress have recognized this phenomenon in proposing and enacting a lengthened net operating loss carryback period during the so-called Great Recession.[28] In contrast the proposed regulations would operate on a pro-cyclical basis and punish corporations that are undergoing financial stress, by reducing access to internal borrowing, disallowing interest deductions for such borrowing, and increasing the likelihood of debt-to-equity conversions when debt is restructured.

The potential incentives that would be created if the proposed regulations were finalized in their current form can be expected to have macroeconomic effects and, as discussed below, would impose material costs, both monetary and nonmonetary, in terms of compliance, complexity, and uncertainty. Economic neutrality has long been a positive goal in terms of tax policy, yet the proposed regulations would seem to violate this goal.

The Treasury Department concedes that the proposed regulations constitute a "significant regulatory action" as that term is used in Executive Order 12866, and the *Regulatory Impact Analysis* acknowledges that the proposed regulations would result in approximately $1.0 billion in additional U.S. federal income taxes each year. However, the Treasury Department and Service did not issue an advanced notice of proposed rulemaking, as is contemplated in section 2(c) of Executive Order 13563, and have instead provided a comment period that seems rather truncated given the potential effect of the proposed changes. Nor, so far as we are aware, has there been any significant consideration given as to the most cost-effective manner of achieving the regulatory objectives or whether the regulatory

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[27] *See* Standard & Poor's Ratings Criteria, including its Definitions and Glossary of Common Business and Financial Terms, https://www.standardandpoors.com/en_US/web/guest/ratings/ratings-criteria/-/articles/criteria/corporates/filter/fundamentals (last visited June 23, 2016) (identifying the financial indicators used to analyze the risks and volatility associated with incremental leverage; ratios and indicators that would be affected by the proposed regulations include a corporation's debt leverage and financial leverage ratios).

[28] *See* Dep't of the Treasury, General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals, at 16 (2009); Worker, Homeownership, and Business Assistance Act of 2009, Pub. L. No. 111-92, § 13(a), 123 Stat. 2984, 2992-2994 (2009) (enacting the five-year NOL carryback rules of section 56(d)(1)(A)(ii) and former section 172(b)(1)(H)).

objectives could be satisfied with rules that would impose a lesser burden, at least apart from adding in a few exceptions designed to exclude taxpayers with relatively modest assets or revenues.

2. Recommendations

- Carefully consider the potential non-tax effects of the proposed regulations, and scale back the scope of the proposed rules to limit these effects.

- Refocus the proposed regulations on the characteristics of debt instruments and the key factors underlying debt-equity considerations, with the actual or deemed use of the proceeds no longer serving as a thinly-veiled surrogate to address perceived abuses that are unrelated to section 385.

- Consider alternative approaches (including renewed efforts to seek legislative changes on the underlying issues) that would not impose the severity of collateral effects that would result from the proposed regulations.

V. Collateral Damage under the Recast Rule, and Other Issues

The proposed regulations are unprecedented in their scope, and would effect the most significant change in corporate tax practice in a generation. While the proposed regulations may have been framed[29] as part of an effort to combat inversion transactions, their primary effect would be imposed upon entities that have neither inverted nor are candidates for an inversion. Treasury Department officials have acknowledged that the proposed regulations are intended to be "disruptive" and not "easy to sidestep."[30] One of our concerns is that the proposed regulations will cause an inappropriately large amount of collateral damage.

We realize that new rules inevitably create some degree of uncertainty; indeed, prior efforts to issue regulations under section 385 inspired Dean Manning to pick up his author's pen and coin the

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[29] *See* Press Release, The White House, Remarks by the President on the Economy (Apr. 5, 2016, 12:15 PM), https://www.whitehouse.gov/the-press-office/2016/04/05/remarks-president-economy-0 ("[T]hese new actions by the Treasury Department build on steps that we've already taken to make the system fairer. But I want to be clear: While the Treasury Department actions will make it more difficult and less lucrative for companies to exploit this particular corporate inversions loophole, only Congress can close it for good, and only Congress can make sure that all the other loopholes that are being taken advantage of are closed."); Press Release, The White House, Press Briefing by Press Secretary Josh Earnest (Apr. 5, 2016, 12:30 PM), https://www.whitehouse.gov/the-press-office/2016/04/05/press-briefing-press-secretary-josh-earnest-452016 ("And we have seen previous steps by the Treasury Department because the President has said Congress needs to act to close these loopholes and to definitively prevent these kinds of transactions. But short of that, the President vowed to use all of the executive authority that's vested in the executive branch to take a look at this. That authority is vested in the Treasury Department. And it's the Secretary of the Treasury, Jack Lew, who has been at the forefront of putting in place regulations that could limit the ability of large corporations to benefit from these unfair tax practices. And there have been a series of announcements over the last couple of years from the Treasury Department. This is just the latest one.").

[30] *See* Amy S. Elliott & Lee A. Sheppard, *Expanded Group Definition in Debt/Equity Regs May be Narrowed*, 2016 Tax Notes Today 90-1 (May 10, 2016) (citing remarks made at a bar panel discussion).

phrase "*hyperlexis*."[31] However, we believe that the proposed regulations would create uncertainty of a higher order of magnitude, due to the extraordinary breadth of the proposed rules, the fundamental nature of the debt-equity distinction, the range of issues that would be affected by the debt-equity classification, the potential tax costs and complexities inherent in a misclassification, the potential for duplicative, evergreen, and cascading (or "viral") consequences following an equity recharacterization of a debt instrument, and the complex "equity" ownership structures (and tangled legal entity organizational charts) that would result from debt recharacterizations.

We believe the proposed regulations to be *ultra vires* and inadvisable. However, recognizing that the Treasury Department and Service appear insistent on finalizing the proposed regulations notwithstanding these issues, we offer comments on certain ways in which the regulations could be made moderately less intrusive, burdensome and arbitrary. There are too many issues to discuss in detail. Some key points, below, warrant additional discussion. We attach an Appendix to our comments to illustrate a number of additional questions that the proposed regulations raise.

Please note that for purposes of the examples set forth below and in the Appendix, we use typical naming conventions; in addition, we assume that unless otherwise stated no exceptions apply, the relevant entities do not file consolidated returns, and the relevant foreign entities neither engage in a U.S. trade or business nor have a permanent establishment in the United States.[32]

A. Cash Pooling Arrangements and Treasury Center Functions[33]

1. Discussion

Perhaps the most significant negative impact would be caused by the failure of the proposed regulations to include administrable rules that reflect corporate business practices involving liquidity management functions. As business has become more globalized, the need to fund, manage cash, and hedge risk on a global scale has increased. Companies take different approaches to managing these global needs, but there has been a near-universal trend away from decentralized operations that serve only a single business line or geography, toward consolidated operations that need to function seamlessly on a regional or global basis. This trend has not been driven by tax considerations.

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[31] Bayless Manning, *Hyperlexis and the Law of the Conservation of Ambiguity: Thoughts on Section 385*, 36 Tax Law. 9 (1982).

[32] In other words, FP and FSub are foreign corporations, USP and S1 are domestic corporations, P is a parent corporation and S is a subsidiary corporation, and a CFC is a controlled foreign corporation within the meaning of section 957(a). Also, we assume that all debt instruments are properly characterized as debt under general tax principles and comply with all relevant requirements in Prop. Treas. Reg. § 1.385-2, and are issued by entities that exceed the applicable size limitations in Prop. Treas. Reg. § 1.385-2(a)(2)(i); further, we assume that the current year earnings and profits, threshold, and funded acquisitions of subsidiary stock by issuance exceptions in Prop. Treas. Reg. § 1.385-3(c) do not apply.

[33] It has been said that taxes are the lifeblood of government, their prompt and certain availability an imperious need, without which they perish. *Bull v. United States*, 295 U.S. 247, 259 (1935); *Eddy's Steam Bakery v. Rasmusson*, 47 F.2d 247, 248 (D. Mont. 1931), *rev'd*, 57 F.2d 27 (9th Cir. 1932). It is no less true that money and credit are the lifeblood of business, ultimately the lifeblood of jobs. *See* Herbert Hoover, Address at Des Moines, Iowa (Oct. 4, 1932) (from The Public Papers of the Presidents of the United States: Herbert Hoover, 1932-1933, at 467).

Treasury centralization is a product of increasing demands on treasury functions to reduce operating costs, strengthen governance, and position the organization for growth. Nuances in modern treasury structures are driven by its intended scope—from simple on-lending to fully integrated in-house banking, cash pooling, payment netting, etc.—and considering factors such as the locations of key business operations, banking relationships, and treasury talent, and limitations such as time zones and the ability to invest in new technology. The lack of any correlation between the complexity of a company's treasury operations and any intent to engage in a disfavored transaction is ignored under the proposed regulations, imposing an inordinate amount of the compliance burden and potential for unintended consequences on growth-motivated business transformation that is not justified in any way by an increase in actual abuse.

The Treasury Department and Service recently faced a similar realization through the comment process with respect to the regulations issued under section 1471, ultimately concluding that a treasury center managing a group's working capital, such as by pooling the cash balances of affiliates (including both positive and deficit cash balances), or by investing or trading in financial assets, or acting as a financing vehicle for the group should receive a specific exception to onerous compliance burdens as it did not pose a significant risk of tax abuse.[34]

Cash pooling is a feature of most modern centralized treasury operations. Pooling structures take various forms, but generally involve working with a banking partner to facilitate a variant of either physical (zero-balance) or notional pooling. Both structures allow for the automatic transfer of cash between affiliates' local operating accounts and accounts centralized at a branch of the pooling bank. In a physical pooling, the pooling accounts are owned by a single entity (often a treasury center) and those balances are then converted to a single currency and combined into a single account. With notional pooling, separate pooling accounts may be owned by a single or each respective affiliate and are not combined, but balances are treated as if they had been for interest calculation purposes.[35]

Cash pooling programs provide many important operational benefits, including that they:

- increase visibility into local entities' cash positions (and reduce the effort required to gain an overall understanding of the corporate group's cash position), often reducing overall minimum cash requirements and facilitating additional business growth;

- facilitate the optimal allocation of internal liquid funds, optimize cash flow management, coordinate varying cash flow cycles among local entities, and simplify liquidity management at the local entity level;

- reduce the corporate group's external borrowing and overdrafts, thus reducing the overall cost of funds and the corporate group's external debt-to-equity ratio;

- create economies of scale and bargaining power that can reduce the cost of external borrowing; and

[34] *See* Treas. Reg. § 1.1471-5T(e)(5)(i)(D)(1)(iv)-(v).

[35] As balances are not combined across pooling accounts, a combination of cross-guarantees, cross-pledges, and similar contractual terms are provided to protect the bank from exposure to gross overdrafts.

- create economies of scale—and a platform to integrate with central payment and risk management functions—that facilitate improved investment returns, and better and more efficient overall management of interest rate, currency, and other financial risks.

In short, the treasury function's goal with cash pooling is to ensure that the business operations have access to funds at the right time, in the proper location, and in the appropriate currency, while (a) minimizing its cost of funds, including with respect to interest and foreign currency exchange, and (b) maximizing the return on short-term surplus funds.

Pursuant to a cash pooling program, participating EG members might be considered for U.S. tax purposes to have borrowed from affiliates (that is, the "deposits" by positive balance members funding the "negative" balance members). In many cases, sweeps between local and pooling accounts occur on a daily basis. The high frequency of deposits and withdrawals, and lack of clear guidance generally, collides violently with the proposed regulations, such as the funding rules in Prop. Treas. Reg. § 1.385-3(b)(3) and the documentation rules of Prop. Treas. Reg. § 1.385-2. In particular, the proposed regulations do not contain any "short term" or "*de minimis*" loan exceptions to either the -2 or -3 regimes. The absence of these common-sense short term and *de minimis* materiality exceptions is all the more remarkable (if not inexplicable) given that the U.S. international tax system contains numerous examples of them in other regulations implementing "anti-abuse" rules.[36]

Centralized corporate cash management systems do not pose an inherent danger to the public fisc, nor are they inevitably a tax planning mechanism. We understand that the Treasury Department is concerned that the use of corporate cash management programs presents the potential for an "end-run" around the proposed regulations, to the extent they could be employed to effect long-term borrowings. Thus, while the Treasury Department and Service representatives have, to their credit, made public statements regarding a willingness to consider modifications to the proposed regulations to take cash pooling nuances into account—statements that we appreciate—the representatives have also made it clear that the proposed regulations, if and when finalized, will not exempt pooling transactions.

Taxpayers could adapt to the rules in the proposed regulations simply by discontinuing all of their present cash pooling arrangements. The trade off, however, is that the efficiency, cost, and management considerations discussed above would be forfeited. We would not expect most large corporate business groups to accept that trade-off and abandon a core component of their cash management systems due to the non-tax benefits the systems deliver; rather, we would expect these taxpayers would try to find ways to manage the tax consequences.[37]

We believe that it would be extremely imprudent to finalize the proposed regulations in their current form without seriously and comprehensively modifying the rules to accommodate cash

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[36] *See* Treas. Reg. § 1.482-2(a)(1)(iii)(B)-(E) (exceptions for which interest is not required to be charged on intercompany borrowings that arise in the ordinary course and are of short duration); Treas. Reg. § 1.956-2(b)(1)(v) (exception to U.S. property for debt arising from sales or processing of property which the obligations are ordinary and necessary); Temp. Treas. Reg. § 1.956-2T(d)(2)(ii)-(v) (similar treatment for payables debt arising from the provision of services, and also excluding entirely short-term loans that are outstanding for only a certain period and not more than a total number of days during the year). *See also* section 871(g)(1)(B) (exempting from withholding tax short-term obligations – any obligation payable 183 days or less from the date of original issue).

[37] We note that the proposed regulations would hobble U.S. taxpayers in their efforts to manage their cash pooling programs; foreign competitors would face no comparable restrictions.

management programs commonly used by large corporate groups today. The consequences of equity recharacterization of a cash pool balance would be extraordinary and draconian:

- Imagine a multinational cash pool for which the government asserts that a local overdraft should be treated as an exempt group instrument (EGI) and recharacterized as equity, but there was no one, clear counterparty to the balance. Would it then treat all cash pool participants with positive balances as holding some portion of the debt? The proposed regulations are silent as to methodologies. Would those "holder corporations" be treated as having acquired stock in an EG member? If so, then would those "holder corporations" be at risk of having some of their unrelated borrowings be recharacterized under the *per se* rule, either at the time of the cash pool reclassification or within three years thereafter? And if a "holder corporation" reduces its positive balance in the cash pool, would it be treated as selling EG member stock (*i.e.*, the recharacterized debt) to other cash pool members?

- Would the accrual of interest on every negative balance result in a deemed distribution of "stock" that would implicate the section 305(c) rules?[38] Whether on accrual or payment, would the interest be subject to recharacterization as a dividend distribution under section 301(c)(1) (or as a return of basis under section 301(c)(2)), or would it qualify as a tax-free stock distribution under section 305(a)? If the latter and if the balance is treated as preferred stock, will it be section 306 stock (implicating those consequences)? We would expect that in most situations, any underlying "equity" resulting from a cash pool balance would be nonvoting, thus causing significant impediments to foreign tax credit utilization.[39]

- Further complexities would be driven by the funding and *per se* rules, under which it is surprisingly irrelevant if a particular debt had been issued and repaid in the same year but prior to a disfavored distribution or acquisition and is no longer outstanding at the time of such other transaction. If a cash pooling arrangement utilizes daily sweeps and balances are recharacterized as stock, what would be the effect if a participant "goes negative" one day a month due to, say, payroll, with the negative balance restored in the following days from its business receipts?[40] A cash pool balance that went negative in January and was returned to positive in February and stayed positive throughout the remainder of the taxable year could be linked with a distribution in November, and retrospectively recharacterized as stock (absent a modification to the general timing rule of Prop. Treas. Reg. § 1.385-3(d)(1)(i) or exceptions for short-term and ordinary course transactions).

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[38] In most situations, a negative cash pool balance would automatically accrue an interest obligation under the relevant legal documentation. Compare stock, where dividends typically are not payable until such time as they are declared through board action.

[39] For example, as discussed below, payments on or repayment of a debt instrument that is recharacterized as nonvoting stock could be treated as dividend payments that do not bring (and in fact eliminate) foreign taxes, for failure to satisfy the voting stock requirement of section 902(a), and that fail to qualify for a reduced treaty rate for the same reason. Surely, the Treasury Department did not intend this result.

[40] As discussed in the Appendix, a borrowing that occurs on a day in January of Year 1 and that is repaid the following day can nonetheless result in the retroactive recharacterization of the borrowing under the funding rule based on a transaction that might occur any time during that taxable year, even after the borrowing has long since been repaid. Prop. Treas. Reg. § 1.385-3(d)(1)(i) (the general timing rule, which would cause a borrowing to be recharacterized as stock *ab initio* when the disfavored distribution or acquisition occurs in the same taxable year as the borrowing). The Prop. Treas. Reg. § 1.385-3(d)(1)(ii) exception to the general timing rule would only apply when the disfavored distribution or acquisition occurs in a taxable year *subsequent* to the borrowing.

- Additional complexities could result when a balance is reduced or paid down, which we assume is intended by the Treasury Department to be treated as a section 302(d) "dividend-equivalent" redemption.[41] Such a deemed redemption, we would note, not only could shift earnings and profits amongst various related corporate entities, but it would also result in a very large number of basis shifts—a scenario the Treasury Department and Service targeted in a 2009 basis proposal[42] and tried to eliminate in a 2002 basis proposal.[43]

- Finally, we anticipate that there would be a significant "cascading" or "viral" effect to the cash pool; as soon as one participant generates a balance that would be recharacterized as equity under the proposed regulations, the "holder" of such "stock"—however that might be determined—would be treated as having purchased EG member stock, with its "stock purchase" becoming vulnerable to linkage with its other borrowings under the funding and *per se* rules.

The complexities inherent in the issues discussed above are staggering. An extension of the general, funding and *per se* rules in the proposed regulations to the high-frequency intercompany borrowings arising from cash pooling and treasury center operations—operations that are overwhelmingly driven by non-tax business factors and through which the lifeblood of business flows—is an invitation to incoherence. A corporate taxpayer would want to accurately report its interest income and expense and its dividend income (and dividends received deduction, if applicable). In addition, going forward, a taxpayer will need to calculate earnings and profits, stock basis in other EG members (including any basis that might have been augmented through a basis shift), foreign taxes, and the like. At the same time, the Service with its increasingly limited resources must audit these issues and efficiently examine taxpayers. From our perspective, the proposed regulations would significantly complicate a large corporate group's financial accounting for income taxes determinations of its deferred tax assets and liabilities as of a particular date, and the income tax expense for a given period, for purposes of reporting such items on its financial statements.

2. Recommendations

Given that the cash management systems are not—and should not—be viewed as inherently suspect from a tax policy perspective, given their importance in managing business operations, and given the extraordinary consequences the proposed regulations would have, the Treasury Department and Service should make every effort to ensure that the rules in the proposed regulations do not hamstring corporate groups that seek to efficiently manage their treasury operations. Thus, the Treasury Department and Service should either (i) wholly exempt cash management systems from the ambit of the regulations until such time as the rules can accommodate such systems without imposing undue

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[41] Alternatively, if the negative cash pool balance recharacterized as equity is held by a subsidiary of the "issuer," the deemed redemption could qualify for sale or exchange treatment under section 302(a). *See* Rev. Rul. 74-605, 1974-2 C.B. 97; Treas. Reg. § 1.318-1(b)(1).

[42] Notice of Proposed Rulemaking, *The Allocation of Consideration and Allocation and Recovery of Basis in Transactions Involving Corporate Stock or Securities*, REG-143686-07, 74 Fed. Reg. 3509 (Jan. 21, 2009) (publishing Prop. Treas. Reg. § 1.302-5).

[43] Notice of Proposed Rulemaking, *Redemptions Taxable as Dividends*, REG-150313-01, 67 Fed. Reg. 64331 (Oct. 18, 2002) (publishing Prop. Treas. Reg. § 1.302-5) (subsequently withdrawn in Announcement 2006-30, 2006-1 C.B. 879, 71 Fed. Reg. 20044 (Apr. 19, 2006)).

damage or (ii) substantially modify the rules in the proposed regulations to limit unnecessary collateral damage.

There is no principled tax policy reason to subject routine, short-term deposits and withdrawals to the complexities associated with the funding and *per se* rules of Prop. Treas. Reg. § 1.385-3(b)(3). We therefore recommend limiting the rules' application to situations involving long-term negative balances that do not originate in the ordinary course of the borrower's business operations. In addition, the Treasury Department and Service should consider the effect the rules would have on taxpayers undergoing financial stress; a further proposal is added to prevent financially troubled entities from being penalized under the regulations.

- Wholly exempt cash pooling programs from the scope of the rules unless and until a workable set of rules can be drafted, commented upon, and amended as necessary. One possible way to accomplish this would be to leverage the definition of treasury center in the regulations under section 1471.

- Absent a complete exemption, at the very least provide that the *per se* rule of Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(B) does not apply to cash pooling arrangements. To the extent the cash pool balances lead to one group member being a long-term borrower from another for U.S. tax purposes generally, the general principal purpose rule in Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(A) could still apply. Thus, the proposed regulations would still have a mechanism that could address any particular negative cash pool balance that was created with a principal purpose contrary to whatever the final regulations deem problematic.

- If neither of the two foregoing recommendations are adopted, then the next best alternative would appear to be to add an ordinary course exception that would exclude cash pool balances that are incurred in the ordinary course of the taxpayer's financial and business operations. As a further example, an exemption could also be added for all balances that are outstanding for less than 365 days—a tenor common for revolvers used for routine liquidity management.

- If qualified short-term borrowings aren't entirely exempt, a separate excepted borrowing amount should be established based on a liquidity measure instead of an overall debt ratio; for example, a measure of average unrestricted current assets, relative to average current liabilities, as recorded on an entity's financial statements (including *pro forma* financial statements). Special rules should be provided for finance companies that are not required under applicable financial accounting standards to present classified balance sheets, and the excepted amount should be reset no more frequently than annually, absent an indication of abuse.

- Allow a borrower to net its positions on a monthly basis (or longer) in applying the above rules to avoid unnecessary burdens on routine fluctuations. In addition, determine a corporation's borrowing from a cash pool for a particular day (where relevant) with reference to the balance at the close of the day.[44]

[44] For example, assume a corporation commences a day with a positive balance of $100, during the day deposits $350 and withdraws $180, and ends with a positive balance of $270. If all of the draws occur prior to any of the deposits, the corporation could have a negative balance of $80 during a portion of the day, if the pool has intra-day sweeps. The ostensible tax policies underlying the proposed regulations would not be served by seizing on an intra-day negative balance to link it to some other transaction. For obvious practical concerns, a close-of-the-day approach would be preferable.

- Explicitly provide that a taxpayer should net across all of its accounts in a cash pool to determine its net position, including for example, where multiple accounts are maintained in different currencies, or where there are multiple branches, each with a separate account. Further, allow all members of a single consolidated group (and all of their controlled partnerships and disregarded entities) to net their balances *inter se*, to determine the relevant cash pool position.[45]

- Absent a complete exemption, and short of withdrawal of the proposed regulations, the Treasury Department and Service should consider limiting the scope of the proposed regulations to only cross-border situations in which U.S. tax concerns are most pronounced. One way of achieving that limitation would be to treat all EG members that are controlled foreign corporations and all EG members that are foreign corporations but are not controlled foreign corporations as each one person for purposes of the proposed regulations. This treatment mirrors that afforded to U.S. consolidated groups and would better focus the rules on situations in which the U.S. tax policy concerns appear to be most prevalent.

- Include a rule similar to Treas. Reg. § 1.1001-3(f)(7)(ii)(A) that would, for purposes of the substantiation rules in Prop. Treas. Reg. § 1.385-2, disregard a deterioration in the financial condition of a cash pool participant with a negative cash balance, when the deterioration arises subsequent to the time the participant joins the pooling arrangement and the balances are otherwise still exempted from the funding rule under an applicable exception.

- Provide specific guidance as to the application of authorities such as Rev. Rul. 76-192[46] to various notional pooling arrangements to clarify when the government will take the position that such arrangements create EGIs. Specifically, address which, if any, security provisions provided to the bank by pooling participants—pledges of deposits, cross-guarantees, overall guarantees, rights of offset, etc.—will cause a notional pooling program to be treated as subject to the final regulations under section 385.

- Explicitly provide rules that allow the application of the cash pooling exceptions to similar short-term lending arrangements that are operated with or without a third-party bank or in-house bank, and regardless of whether cash movements are executed automatically or manually.

- Absent a complete exemption, and in the case that our recommendations with respect to the effective dates are not adopted, allow a period of no less than one year from the finalization of the proposed regulations for companies to coordinate on a global basis and negotiate with third-party banks to restructure any balances in existing cash pooling arrangements that would not meet the

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[45] To illustrate, assume a foreign parent corporation owns US1 and US2, each a domestic corporation and a parent of its own consolidated group with numerous lower-tier subsidiaries. If both the US1 group and the US2 group join in a common domestic cash concentration pool and each group maintains a net positive balance overall, but one subsidiary of one group (say, US1 group) has a negative balance, would the US1 subsidiary be considered to be a borrower from each member of the US1 and US2 groups that has a positive balance? Presumably, any borrowing apportioned to other US1 group members would be disregarded under the single corporation rule of Prop. Treas. Reg. § 1.385-1(e), but how should the remaining "borrowing" be apportioned? Would the apportionment change every time the positive or negative balance of any pool member changes? How could the Service administer this rule? Is there any benefit in attempting to do so?

[46] Rev. Rul. 76-192, 1976-1 C.B. 205.

requirements of the limited cash pooling exemptions, without treating any resulting changes in the cash pool or corresponding extensions of other forms of debt as new issuances subject to the final regulations under section 385.

B. Acquisitions of Non-U.S.-Tax Relevant Groups

1. Discussion

The proposed regulations make no distinction as to their application on a territorial basis. Based on comments that have been made on various panels, the Treasury Department intends the proposed regulations to apply in the domestic-to-domestic and foreign-to-foreign contexts, in addition to the cross-border context. We also note that the proposed regulations could also apply to a foreign corporate group that has no connection whatsoever with the United States, and informal discussions with attorneys with the Treasury Department and Service confirm this.

First, as a matter of policy, the rules in the proposed regulations simply should not apply to a corporate group with no nexus to the U.S. federal income tax. The Treasury Department and Service acknowledge in the preamble to the proposed rules that they seek to "impose discipline" on taxpayers with the documentation and substantial requirements of Prop. Treas. Reg. § 1.385-2, and the requirements do have some relevance to certain aspects of a traditional debt-equity analysis. The general and funding rules in Prop. Treas. Reg. § 1.385-3 are clearly focused on the use of related-party debt instruments in distributions, section 304 transactions, and intercompany reorganizations. Without regard to the merits of the rules, there is no rational tax policy support to extend the proposed regulations to entities that entirely lack a nexus to the U.S. tax base. The debt-equity characterization of a debt instrument between such entities will have no bearing on any interest income, interest deduction, dividend income, or dividends received deduction reported on a U.S. federal income tax return. In short, there is no legitimate purpose to be served in extending the rules of the proposed regulations to corporate groups that completely lack a U.S. federal income tax connection. The Treasury Department and Service have previously recognized that rules of general applicability should be limited to entities that have relevance for U.S. federal income tax purposes (such as in the entity classification regulations[47]), and for similar reasons a special rule should be added to the proposed regulations.

Second, as a practical matter, extending the rules of the proposed regulations to corporate groups that completely lack a U.S.-tax connection would create a significant degree of uncertainty when the group is acquired by a U.S.-tax-relevant group.

> Example. USP, a U.S.-headquartered multinational corporate parent, acquires FP, a foreign corporation that owns multiple subsidiaries. At the time of the acquisition, neither FP nor any of its subsidiaries has or ever had a trade or business or a permanent establishment in the United States. At the time of its acquisition, FP and its subsidiaries have multiple related-party loans outstanding, participate in a common physical cash pooling arrangement, and had issued and repaid numerous related-party loans in the three years prior to the acquisition (we expect these assumptions would be true with respect to nearly all large foreign business enterprises).

[47] *See* Treas. Reg. § 301.7701-3(d).

FP would have had no reason to comply with any documentation requirements imposed under the tax regulations issued by the Treasury Department and Service, nor any reason to put in place bookkeeping systems or protocols to identify, track and potentially link related-party debt issuances or negative cash balances with distributions, related-party stock sales, and internal asset reorganizations. It is unlikely that any intercompany balances at or below the parent level would be "cleaned up" immediately prior to the acquisition. This raises a number of questions:

- How might USP go about determining whether a particular debt instrument issued by a member of the FP group and that is outstanding at the time of the acquisition should have been treated as stock upon its issuance or subsequent to its issuance under any of the rules in the proposed regulations? What about debt instruments issued in the past that are no longer outstanding? The FP group might not have generated or retained sufficient information upon which determinations under the documentation, general, funding, or *per se* rules could be made (even without taking into account the evergreen and cascading effects of the proposed regulations).

- If a debt instrument issued by a member of the FP group would have been characterized as stock under the proposed regulations prior to the acquisition, how can USP "clean-up" the debt instrument without causing unanticipated or unwarranted consequences? We observe that a competing foreign acquirer would not face similar uncertainties or costs.

- If USP wants to make a deemed asset sale election under section 338(g) with respect to FP and to "push down" the election to the FP subsidiaries, and if the proposed regulations would have recharacterized a significant amount of intercompany debt as hook equity, there might be some question as to whether the elections might be available at the lower tiers. For example, if FP owned F1, F1 owned F2, and F1 had issued a debt instrument to F2 that represented more than 20 percent of F1's value and that was subject to a "stock" recharacterization under the proposed regulations, would there be a qualified stock purchase of F1 or F2? If it were FP instead of F1 that had issued the debt instrument, would USP have effected a qualified stock purchase of FP?[48] Assuming a deemed asset sale election is effected under section 338(g), how might the aggregate deemed purchase price calculations be affected by the recharacterization of a debt instrument as stock?[49]

- If no section 338(g) elections are to be made, how might USP go about determining the earnings and profits and stock bases in FP and its subsidiaries, if the information necessary to determine how the proposed regulations might have applied to the FP group does not exist or was not maintained?

Similar complexities would arise with respect to the acquisition if FP had some U.S. subsidiaries, but had multiple foreign EG members either "above" the U.S. subsidiaries or in separate corporate chains in the organizational chart. How likely is it that FP and its foreign subsidiaries would have been in

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[48] A "qualified stock purchase" is defined in section 338(d)(3). Note that this issue is implicated when a debt instrument is reclassified as stock other than section 1504(a)(4) stock, and thus is not expected to apply in all circumstances.

[49] An election under sections 336(e), 338(g) or 338(h)(10) and the deemed transactions that would arise as a result of such an election would not cause intercompany debt (including recharacterized debt) amongst a target company and its subsidiary entities to disappear. Thus, these elections would not serve as a mechanism to simplify the target group's historic intercompany debt structure or otherwise moot section 385 considerations. Rather, additional questions would be raised, as noted in the Appendix.

compliance with U.S. Treasury regulations with respect to its non-U.S. businesses and entities? Why would we expect the FP group to alter its foreign intercompany lending or cash pooling practices to mitigate the effect of the proposed regulations, or to create and employ the tracking systems necessary to generate the information that would allow the funding and *per se* rules to be administered with respect to non-U.S. entities?

We recognize that a previously U.S.-tax irrelevant entity can become U.S.-relevant upon an acquisition. In this situation, due to the entity's lack of historic nexus to the U.S. tax base and absence of U.S. tax-planning activities, it would be appropriate to allow the entity some period of time to "clean up" the intercompany debt structure it has in place at the time of the acquisition and allow the acquiring group to transition the target to compliance with the rules through grandfather rules and transition relief.

We note that the Treasury Department years ago considered a very similar issue of "relevance" in the entity classification (or "check-the-box") regulations in Treas. Reg. § 301.7701-2 and -3. Under those rules, an entity's classification is not relevant—with the effect that it is effectively not considered a pre-existing entity—until its classification is relevant to the U.S. taxpayer's tax liability or information reporting obligations. Events that establish relevance include if the foreign entity receives a U.S.-source payment subject to U.S. withholding or the entity is owned in a sufficiently large amount by U.S. persons to trigger reporting under sections 6038, 6038A, etc.[50] The administrative and fairness considerations that led the Treasury Department to issue the relevance "exception" in the entity classification area apply with equal force to the proposed regulations.

We also note that similar issues can arise when a large corporate group acquires a smaller group that had not previously been subject to the rules in the proposed regulations, or when two smaller groups merge and as a result would become too large to qualify for the exclusions in the proposed regulations. Appropriate transition relief and grandfather rules should be provided in these circumstances as well.

2. Recommendations

- Exempt U.S.-tax irrelevant entities from the ambit of both the documentation requirements of Treas. Reg. § 1.385-2, as well as from the general, funding and *per se* rules of Treas. Reg. § 1.385-3. This would be a relatively simple matter to draft with respect to a foreign group that has no members with any trade or business or permanent establishment in the United States. Possibilities might be to exclude wholly irrelevant foreign entities from an expanded group, or exclude their debt instruments from the applicable instrument and debt instrument definitions. Drafting a rule with respect to foreign groups that have some U.S. subsidiary entities would be a more complex undertaking. For example, one of the "legs" of a "funding transaction" might have U.S. relevance while at the same time multiple other transactions within the foreign target group might not. The existing definition of relevance in Treas. Reg. § 301.7701-3(d)(1)(i) appears a useful analogy, as the debt instruments of a foreign entity would not be considered relevant (and thus would not be taken into account) unless held by a U.S. taxpayer or if the entity was owned by U.S. taxpayers in a sufficiently large amount for the instrument's characterization to implicate their information reporting and substantive tax obligations.

[50] *See* Treas. Reg. § 301.7701-3(d)(1)(i).

- Address how a previously U.S.-tax-irrelevant entity or debt instrument, and U.S. taxpayers that have historically been exempted from the section 385 rules due to their relatively small size, can transition into the section 385 rules. We would recommend that all debt instruments issued by a these entities be fully grandfathered from the rules in the proposed regulations, because it is unlikely that the debt instrument had been issued with a purpose to avoid U.S. federal income tax or to avoid the section 385 regulations. The grandfather rule should be written in a manner that allows such a debt instrument to be extended and repaid without affecting its characterization, and without triggering a deemed redemption.

- If the Treasury Department and Service are concerned about the possibility that an aggressive U.S.-tax-irrelevant target might seek to abuse the grandfather rule by issuing debt instruments on the cusp of an acquisition and did not want to solely rely on the no-affirmative use rule, the Treasury Department and Service could specifically provide a description of such a case as a context in which the anti-avoidance rule of Prop. Treas. Reg. § 1.385-3(b)(4) might apply.

C. Over-Expansive Definition of an EG – Attribution Rules

1. Discussion

One key term in the proposed regulations is expanded group (EG).[51] The EG definition was written with reference to the rules of section 1504(a), though without the exclusions of section 1504(b), and with regard to the expansive constructive stock ownership rules of section 318[52] (as modified by section 304(c)(3)). The proposed regulations would include the quirks of the underlying attribution rules, but would imbue them with far greater significance. For purposes of this comment, we assume that Prop. Treas. Reg. § 1.385-1(b)(3)(i)(B) would be expanded to substitute "directly or indirectly" in lieu of "directly" in section 1504(a)(1)(B)(ii) (the proposed regulations currently refer solely to section 1504(a)(1)(B)(i)).[53]

A few examples of how far these rules could extend:

- U.S. corporation X and foreign corporation Y, each a publicly traded corporation with multiple subsidiaries, engage in a joint venture through a 50-50 ownership of the stock in Z, a corporation. Under section 318(a)(2)(C), each of X and Y would be treated as owning 50 percent of Z and its subsidiaries. At the same time, under section 318(a)(3)(C), Z and its subsidiaries would be treated as owning 100 percent of the stock of all of the X subsidiaries and 100 percent of the stock of all of the Y subsidiaries.[54] The result—the X and Y subsidiaries would be part of an expanded group with Z as

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[51] *See* Prop. Treas. Reg. § 1.385-1(b)(3).

[52] *See Rickey v. United States*, 592 F.2d 1251, 1255 (5th Cir. 1979) (referring to the attribution rules in sections 318(a)(1), (a)(2), (a)(3) and (a)(4) as "four horror stories for taxpayers").

[53] We note that the Treasury Department and Service are on notice of this issue. *See* Amy S. Elliott, *Practitioners Question Application of Related-Party Debt Rules*, 2016 Tax Notes Today 76-2 (Apr. 20, 2016).

[54] The constructive ownership by an entity of stock actually owned by the entity's shareholders or partners is also referred to as "back attribution." Fred Ringel, Stanley Surrey & William Warren, *Attribution of Stock Ownership in the Internal Revenue Code*, 72 Harv. L. Rev. 209, 218 (1958); William Goldstein, *Attribution rules: undue multiplicity, complexity can create liabilities*, 15 Proc. Ann. Tul. Tax. Inst. 384, 389 (1965).

the parent corporation, and a debt instrument issued by an X subsidiary to a subsidiary of Y could be subject to recharacterization under the funding rule.[55] In addition, Z and its subsidiaries would be included in two "modified expanded groups," one with X as the parent corporation and the other with Y as the parent corporation.[56]

- X and Y from the prior example each own, say, a one percent interest in partnership PRS, with the other 98 percent of the interests held by unrelated persons. PRS directly owns the stock of corporation Z, and Z conducts substantial business operations directly and through multiple subsidiary corporations. Under section 318(a)(2)(A), X and Y are each treated as owning its proportionate share of the stock of Z corporation and its subsidiaries, an intuitive result that presents no unusual issues. However, under section 318(a)(3)(A) (which lacks a proportionality rule and a *de minimis* threshold), PRS is treated as owning 100 percent of the stock owned by each of X and Y, and Z is treated as owning 100 percent of this stock under section 318(a)(3)(C) (with reattribution under section 318(a)(5)(A)). While section 318(a)(5)(C) can preclude partner-to-partner reattribution of stock through a partnership, the provision does not apply to preclude reattribution to Z in this example. If X happened to be a financial institution, and Y happened to be a conglomerate that was a customer of X's, debt between X's subsidiaries and Y's subsidiaries would be subject to the funding and *per se* rules, because they all would be a part of the Z expanded group, even though to any impartial observer the X and Y subsidiaries would be in an arm's length relationship. This, solely because X and Y happened to hold relatively modest, non-controlling interests in the same partnership—interests to which the relevant loan officers and in-house treasury/finance personnel might give little weight, even if they were somehow to know about it.[57]

The fact patterns outlined above might seem absurd. However, dozens of U.S. and foreign multinational corporate groups have formed significant joint venture businesses with corporate and partnership formats. Some of these could be quite large, such as those in the energy industry (including co-ownership of oil and gas properties treated as partnerships for tax purposes). And some of them involve financial institutions, where the likelihood that a customary banking relationship could be picked up in the rules seems not at all remote. In addition, the expansive definition of a corporation for

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[55] This example exists in practice - a number of large publicly traded corporate enterprises, both domestic and foreign, have entered into 50-50 corporate joint venture arrangements. Note that if X had funded Z in part with debt capital, and if Z were itself a foreign entity, the reclassification of some of the Z-to-X debt could cause Z to become a controlled foreign corporation (CFC) within the meaning of section 957(a), even when there was no U.S. tax motivation to the debt capitalization, and even if in substance Z remained 50 percent foreign-owned and foreign-controlled. If thereafter Y were to fund Z with debt capital, the recharacterization of the Z-to-Y debt instrument could have the effect of "de-CFC'ing" Z, surely not what the Treasury Department or Service might have intended the proposed regulations to accomplish.

[56] In other contexts, "tie-breaker" rules are provided to prevent the complexities and absurdities that can occur when a corporation is part of two groups at the same time. *See* section 1563(b)(4); Treas. Reg. § 1.1563-1(c)(1); Prop. Treas. Reg. § 1.163(j)-5(a)(4). We recommend that a tie-breaker rule be added to the proposed regulations, for reasons similar to those underlying the other tie-breaker rules.

[57] Recently, the "May Co." regulations were retroactively *corrected* (the official terminology) to eliminate some problems that arise due to the extraordinary reach of the section 318 attribution rules in the partnership context. *See* Correcting Amendments to T.D. 9722, 80 Fed. Reg. 38940 (July 8, 2015) (correcting Temp. Treas. Reg. §§ 1.337(d)-3T(c)(2)(i) and -3T(f)(2)(ii) by providing that control is to be determined with reference to section 304(c), "except that section 318(a)(1) and (3) shall not apply"); Deanna Walton Harris, *Long Awaited Section 337(d) Regulations Leave Some Questions Unanswered*, 42 J. Corp. Tax'n., 37, 41 (Sept./Oct. 2015).

purposes of the EG definition potentially could include certain sovereign wealth funds (potentially, a foreign *per se* corporation under section 892(a)(3)), pension funds, exempt organizations, and numerous private equity investors. Many of these joint ventures will have some related-party debt in their structure. Also, in many of these ventures, either there will be co-venturers with potentially conflicting interests as to ownership (*e.g.*, a 50-50 corporate joint venture ownership arrangement), or the attributive link will run through a minority partnership interest that imparts no realistic possibility of controlling the joint venture's structure or financing. And in either of these contexts, there is no reasonable tax policy to be served by extending the reach of the proposed regulations, especially in light of the costs and complexities.

Moreover, in numerous circumstances, the proposed regulations could create "hook equity," which could in many fact patterns implicate latent ambiguities in the constructive ownership rules

> Example. USP owns 100 shares in CFC1 worth $100, and CFC1 owns 100 shares in CFC2 worth $80, and CFC2 owns a debt instrument issued by CFC1 that is worth $150 and that has been recharacterized as stock in CFC1.

USP's actual stock ownership in CFC1 would represent less than 50 percent of the value of the CFC1 "stock" when taking the CFC1 recharacterized debt instrument into account. It is not immediately apparent whether or to what extent USP would be treated as constructively owning the reclassified "stock" in CFC1 that CFC2 owns, or any of the actual stock in CFC2 that CFC1 owns.[58] Because of the "vote or value" rule in Prop. Treas. Reg. § 1.385-1(b)(3)(i)(C), we would expect that USP and CFC1 would be part of an EG[59] and that CFC1 and CFC2 would be part of an EG, but are not sure whether USP and CFC2 would be part of the same EG. These and similar attribution through hook equity issues are alluded to in the tax literature,[60] but currently do not arise often in practice. We would expect the proposed regulations to increase the frequency with which these issues occur, with their attendant complexity.

2. Recommendations

- Consider defining an expanded group through the prism of the section 1563(a) controlled group rules rather than the section 1504(a) affiliated group rules, in order to avoid back attribution and some of the other issues.

- In applying the proposed regulations, consider eliminating back attribution, perhaps through a rule similar to that in Temp. Treas. Reg. § 1.337(d)-3T(c)(2)(i). Alternatively, modify the back attribution rule of section 318(a)(3)(C) (the rule that treats a corporation as owning 100 percent of the stock owned by its shareholder, if the shareholder owns 50 percent or more of the stock in the corporation) to provide that the corporation owns a proportionate amount of the stock owned by

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[58] The constructive ownership rules that apply with respect to stock owned by or for a corporation -- sections 318(a)(2)(C) and 318(a)(3)(C) – are based on a shareholder owning 50 percent or more in *value* of the stock of a corporation. In the example, at first impression, USP would directly own less than 50 percent of the value of the stock in CFC1 ($100/$250).

[59] If the CFC1 debt instrument in nonvoting, USP would directly own stock representing 100 percent of the CFC1 voting power.

[60] *See* Stephen B. Land, *Strange Loops and Tangled Hierarchies*, 49 Tax L. Rev. 53 (1993); David F. Shores, *Section 304 and the Limits of Statutory Law*, 16 Va. Tax Rev. 455 (1997).

the shareholder. This is similar to the rule in section 304(c)(3)(B) with respect to shareholders who own between 5 percent and 50 percent of the corporation's stock.

- Similarly, in applying the proposed regulations, modify the back attribution rule of section 318(a)(3)(A) (the rule that treats a partnership as owning 100 percent of the stock owned by a partner) to provide that the partnership is to be treated as owning a proportionate amount of the stock owned by its partner.

- Alternatively, add an override rule that that would provide that notwithstanding the general constructive ownership rules, two entities will not be in the same expanded group unless one of the entities has a direct or indirect ownership of 80 percent or more in the other, applying proportionality principles.

- Provide guidance regarding the application of the rules of section 318 in the context of hook equity.

D. Over-Expansive Definition of EG – S Corporations and Other Entities

1. Discussion

The proposed regulations define an EG to include S corporations.[61] In our experience, S corporations can include large corporate enterprises, which is reflected in government statistics.[62] Also, in our experience, a number of large S corporations own stock in C corporations. The various dollar thresholds in the proposed regulations cannot be counted on to screen out all S corporations from the rules.

We are concerned that applying the rules in the proposed regulations could present an existential threat to the S corporation status of a large S corporation and could cause other collateral consequences. We cannot imagine that Congress intended such results in enacting section 385.

- Assume individual A owns stock in corporations X and P.[63] X is an S corporation, and P is a C corporation and the parent of an affiliated group of corporations. P (or one of its subsidiaries) loans funds to X in exchange for an exempt group instrument (EGI). If the EGI is recharacterized as stock (either under the documentation and substantiation rules or the general and funding rules), X's status as an S corporation will terminate. This is because P is not an eligible shareholder, thus violating section 1361(b)(1)(B). It may also be the case that the EGI would be treated as a second class of stock, thus violating section 1361(b)(1)(D) and potentially not qualifying for the "straight debt" safe harbor of section 1361(c)(5).

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[61] *See* Prop. Treas. Reg. § 1.385-1(b)(3)(i)(A), which references the definition of section 1504(a) without regard to S corporation exclusion in section 1504(b)(8).

[62] From tax returns filed for in 2012, more than 3,700 S corporations reported assets in excess of $100 million, and more than 15,000 reported revenues in excess of $50 million. Joint Comm. on Tax'n, Background on Business Tax Reform, JCX-35-16, at 24 tbl.4 (Apr. 22, 2016).

[63] We understand that the Treasury Department and Service intend to expand Prop. Treas. Reg. § 1.385-1(b)(3)(i)(B) so that it would substitute "directly or indirectly" in lieu of "directly" in section 1504(a)(1)(B)(ii).

- Assume X, an S corporation, owns all of the stock of a P, a C corporation, and P is the parent of an affiliated group of corporations. P (or one of its subsidiaries) loans funds to X in exchange for an EGI. If the EGI is recharacterized as stock, X's status as an S corporation will terminate (as noted in the example above). In addition, X would no longer be described in section 1504(b)(8), with the result that the P consolidated group would terminate (due to its acquisition by another C corporation, *i.e.*, X).

In the latter example, it is ironic that if X were to elect to file consolidated returns, the EGI that triggered the consequences would become a "disregarded" consolidated group debt instrument under Prop. Treas. Reg. § 1.385-4(c) and thus would no longer be treated as stock of X. As a result, X would no longer have an ineligible shareholder (or potentially a second class of stock). X could become eligible to make a new S corporation election, but if it did so the EGI would revert to stock status, and if so the cycle noted above would repeat.

In either situation, the effect would be to terminate the S corporation election for X. In the absence of a specific Congressional directive, we do not believe that the Treasury Department or Service intend to use, or that it is proper to use, "anti-inversion" regulations as a tool to attack the S corporation status of a large corporate enterprise. In addition, if the Treasury Department and Service believe that there is some abuse with debt instruments issued by S corporations, they should evaluate, make appropriate evidence-based findings, and articulate the findings and squarely address the rationale in the preamble. Similarly, we do not believe that tax-exempt corporations,[64] RICs, REITs, or other entities referenced in section 1504(b) should be included in the ambit of the rules. If the Treasury Department and Service disagree and decide to include these entities within the scope of the proposed regulations, then it is incumbent upon them to articulate the issue and articulate evidence-based findings in the preamble justifying the unusual application.[65] We recognize that, at the conceptual level, there might be some opportunity for base erosion with respect to some of these entities, and that for completeness such entities should be included in rules of general application. Nonetheless, the Treasury Department and Service should not lose sight of the practical; a conceptual purity must be weighed against the strong and longstanding tax policies inherent in the special, Congressionally-provided tax status of these entities. We do not believe that these entities should be at risk of losing their Congressionally-authorized tax status simply because of a debt instrument issued to a related-party, in the absence of compelling justifications. The debt-equity conundrum of section 385 does not present such a justification. Moreover, the Treasury Department and Service should consider a broader range of policy

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[64] We would note the potential, perhaps unlikely, that if a tax-exempt section 501(c)(3) organization were to issue a debt instrument to a related or subsidiary C corporation and the debt instrument were to be recharacterized as "stock" in the tax-exempt, there might be unfortunate complications under various rules, perhaps including the no-private-inurement rule. *See* John Woodhull & Erica Reiderbach, *Taxable Subsidiaries of Tax-Exempt Organizations*, 25 Tax'n Exempts 19 (Jan./Feb. 2014) ("Tax-exempt organizations have been creating taxable subsidiaries for as long as most practitioners can remember.").

[65] For example, the Treasury Department exempted S Corporations, RICS, and REITs from the dual consolidated loss rules when the section 1503(d) regulations were revised in the 2005-2007 timeframe. *See* Treas. Reg. § 1.1503(d)-1(b)(1). The reason for this exemption was that the entities were not generally subject to corporate level U.S. federal income tax. *See Dual Consolidated Loss Regulations*, T.D. 9315, 72 Fed. Reg. 12902, 12902-12903 (Mar. 19, 2007) (discussing RICs and REITs); *Dual Consolidated Loss Regulations*, REG-102144-04, 70 Fed. Reg. 29868, 29870 (May 24, 2005) (discussing S Corporations). The actual or effective pass-through nature of these entities similarly militates against subjecting such entities to rules whose ostensible purpose is to combat erosion of the corporate income tax base through "earnings stripping."

issues in determining whether the proposed regulations should apply to corporations that are instrumentalities of the government of a state or U.S. possession (and political subdivisions of such governments) the income of which is exempt under section 115, or to sovereign wealth funds.

2. Recommendations

- Exclude S corporations, as well as certain other entities, from the ambit of the proposed regulations (*i.e.*, revise Prop. Treas. Reg. § 1.385-1(b)(3)(i)(A) so that it only "turns off" paragraph (3) of section 1504(b)).

- Alternatively, issue regulations under section 1361(c)(5)(C) to provide that a debt instrument issued by an S corporation can qualify for the "straight debt safe harbor" of section 1361(c)(5), and if it so qualifies it will not be treated as stock for purposes of subchapter S, regardless of whether the debt instrument may have been recharacterized as stock under the general, funding, or *per se* rules of Prop. Treas. Reg. § 1.385-3(b).

- Undertake fact findings to determine whether there is an abuse potential that justifies subjecting tax-exempt and pass-through corporate entities to the burden of complying with the Prop. Treas. Reg. § 1.385-3 rules, and in particular with needing to closely guard against a potential loss of their special tax status, simply because the entity issues a debt instrument to a related-party and, within the 72-month window of the *per se* rule, acquires EG member stock.

E. Effect on Deemed Paid Foreign Tax Credits under Section 902

1. Discussion

Foreign tax credits have been allowed for almost 100 years, to reduce double taxation of income.[66] Under section 902(a), a domestic corporate taxpayer which owns 10 percent or more of the voting stock in a foreign corporation from which it receives dividends in a taxable year is deemed to have paid a proportion of the foreign corporation's foreign taxes. A problem arises under the proposed regulations if a debt instrument with traditional terms is recast as stock, when the holder does not otherwise own 10 percent of more of the voting stock of the issuer.

> Example. USP owns USS1 and CFC1 (as brother-sister corporations). CFC1 is an operating company that has significant earnings and profits and some amount of associated foreign taxes. CFC1 borrows funds from USS1 in an amount in excess of 10 percent of the equity value of CFC1 in exchange for a debt instrument with straightforward terms (and no voting rights), and in a later year the CFC1 debt instrument is reclassified as stock under the funding rule.

USS1 owns no stock in CFC1 apart from the CFC1 reclassified debt instrument, which confers no voting rights. When CFC1 pays interest on the debt instrument, it would be treated as making a dividend payment to USS1. When CFC1 retires the debt instrument, it would be treated as redeeming its stock in

[66] The foreign tax credit originated in sections 222(a) (as to individuals), 238(a) (as to domestic corporations), and 240(c) (the deemed paid credit) of the Revenue Act of 1918, ch. 18, 40 Stat. 1057, 1073, 1080, 1082 (1919). Its purpose has been described as "to mitigate the evil of double taxation" and facilitate the foreign enterprises of domestic corporations (*Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 7-8 (1932)) and "to obviate double taxation" (*American Chicle Co. v. United States*, 316 U.S. 450, 451 (1942)).

a dividend-equivalent redemption under section 302(d). However, USS1 did not and does not own 10 percent or more of the voting stock in CFC1, and USS1 is not allowed to aggregate its "stock" ownership with that of USP.[67] Thus, USS1 cannot qualify for a deemed paid credit under section 902.[68] Further, it seems clear that the foreign tax credits associated with the distribution disappear for U.S. tax purposes.[69]

Congress did not envision that regulations would be written under section 385 to preclude a taxpayer's ability to claim foreign tax credits that otherwise would have been available, simply because a foreign subsidiary had issued a straightforward debt instrument to a related-party. Similarly, there is no indication that Congress envisioned, when it enacted section 909, that regulations would be written under section 385 to *create* foreign tax credit splitting events.

There seem to be two obvious ways to mitigate the issue. First, treat the holder of the recharacterized debt instrument as a shareholder that is entitled to deemed paid credits, either through a stock aggregation rule (such as Treas. Reg. § 1.1502-34 or by means of the attribution allowed for foreign tax credit purposes in section 304 transactions[70]) that would apply for purposes of section 902 or through a rule that would treat a recharacterized debt instrument as voting stock for section 902 purposes. This result is not ideal, however, because it would have the effect of sprinkling foreign taxes across a range of related parties, substantially complicating foreign tax credit calculations (which are far from simple to begin with). In addition, treating a recharacterized debt instrument as voting stock (without providing the attribution allowed for foreign tax credit purposes in section 304 transactions) would not mitigate the issue if the value of the recharacterized debt instrument was less than ten percent stock ownership in the issuer.

We note there is administrative precedent for adopting an approach similar to this first alternative. In Rev. Rul. 91-5[71] and Rev. Rul. 92-86,[72] the Treasury Department and Service addressed whether section 902 credits should be available for deemed dividends arising from dividend equivalent section 304 stock sales, when selling shareholder of the issuing corporation did not directly own any stock in the acquiring foreign corporation. The rulings cite to legislative history of the 1984 amendments

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[67] For purposes of the section 902 deemed paid credit, USS1 would *not* be treated as owning the stock in CFC1 that is owned by USP, regardless of whether USP and USS1 consolidate. *See* Rev. Rul. 85-3, 1985-1 C.B. 222; *First Chicago Corp. v. Commissioner*, 96 T.C. 421 (1991), *aff'd*, 135 F.3d 457 (7th Cir. 1998). Moreover, the all-members-of-a-consolidated-group-as-one-corporation rule in Prop. Treas. Reg. § 1.385-1(e) would apply for purposes of the section 385 regulations, not for purposes of the deemed paid credit under section 902.

[68] Similarly, a deemed paid foreign tax credit might not be available to a CFC in an alternative fact pattern where debt between two CFCs is recharacterized as non-voting equity. Rev. Rul. 74-459, 1974-2 C.B. 207. Nevertheless, the CFC making distributions on a recharacterized debt instrument would continue to be required to reduce its foreign tax credit pool by the amount of taxes attributable to the dividend thereby preserving its effective tax rate. Treas. Reg. § 1.902-1(a)(8). *See* Kevin M. Cunningham, *The New Section 385 Proposed Regulations: No More Alice in Wonderland*, 43 J. Corp. Tax'n 4 (July/Aug. 2016).

[69] *See* Treas. Reg. § 1.902-1(a)(8).

[70] See Rev. Rul. 91-5, 1991-1 C.B. 114; Rev. Rul. 92-86, 1992-2 C.B. 199.

[71] Rev. Rul. 91-5, 1991-1 C.B. 111.

[72] Rev. Rul. 92-86, 1992-2 C.B. 149.

to section 304[73] to support the result that the selling shareholder is entitled to a section 902 credit to the same extent. Unlike the cases in those rulings, there is no oddity regarding that the dividend is considered to come directly from the redeeming affiliate. Thus, the policy consideration that motivated the issuance of those rulings—*viz*., that the "relatedness" that caused dividend treatment despite the lack of actual stock ownership ought to in fairness be imputed for purposes of section 902—is even stronger in this case.

A second way to address the issue that is also not ideal but better than a loss of credits would be to disregard the recharacterized debt instrument for purposes of section 902. This would retain the foreign taxes at the issuer level for use by its actual stockholders, though it would at best have the effect of potentially accelerating U.S. income taxation and deferring the use of foreign taxes.

In this latter regard, we note that the preamble to the proposed regulations specifically requests comments on the treatment of recharacterized debt as "U.S. equity hybrid instrument" splitter arrangements under Treas. Reg. § 1.909-2(b)(3)(ii).[74] The tone of the request suggests that the Treasury Department and Service fully expect that such instruments will be subject to the section 909 rules, despite acknowledging the potential "proliferation" of such creatures. We do not believe that instruments recharacterized under section 385 are the types of events or transactions that section 909 was intended to address (*i.e.*, those that were intentionally structured to "separate away" the underlying income and earnings and profits from the associated foreign tax credits). Subjecting recharacterized debt instruments to the section 909 regime would be unduly burdensome for taxpayers to comply with, even more difficult for the Service to monitor and audit, and would further no principled tax policy objective. We therefore recommend that the Treasury Department instead use its authority under section 909(e) to exempt from section 909 splitter status all hybrid instruments arising from the government's own recharacterization mechanism in the proposed regulations.

2. Recommendation

- Revise the proposed regulations to ensure that foreign tax credits that would have been available but for the application of the proposed regulations will continue to be available, without accelerating U.S. income taxes or causing double taxation of foreign source income. The revisions also should address foreign tax pool dilution issues.

F. Effect of Recharacterized Debt Instruments on Various Control Requirements

1. Discussion

Numerous provisions of the Internal Revenue Code are premised upon a transferor or an issuer owning stock that possesses a certain quantum of voting rights and value in a corporation, or upon an acquirer acquiring such a quantum of stock. For example, a person who transfers appreciated property to a corporation in exchange for stock in the corporation can qualify for non-recognition treatment under section 351 if the transferor is in control of the transferee corporation. For this purpose, control is

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[73] The legislative history indicates that Congress intended foreign tax credits to be available "to the same extent as if the distribution had been made directly by the corporation that is treated as having made the distribution [under section 304(a)]." H.R. Conf. Rep. No. 98-861, at 1223 (1984).

[74] 81 Fed. Reg. 20912, 20929-20930 (Apr. 8, 2016).

defined in section 368(c) as ownership of stock that possesses at least 80 percent of the total combined voting power of all classes of voting stock and the ownership of at least 80 percent of the total number of shares of each class of outstanding non-voting stock.[75] Similarly, a corporation can acquire the stock or property of an unrelated corporation in a tax-free reorganization under section 368(a)(1) using stock of its parent corporation, provided the parent corporation is in control of the acquiring corporation.[76] For this purpose, the same section 368(c) control definition applies. In addition, to acquire the stock of a target corporation in a tax-free reorganization, the acquiring corporation must either acquire control of the target corporation[77] or acquire an amount of stock in the target corporation that constitutes control in exchange for parent voting stock.[78] The section 368(c) control definition is also relevant for purposes of a tax-free spin-off, split-off, and split-up under section 355.[79] Under any of these provisions, the presence of a single recharacterized debt instrument that does not confer voting rights can defeat "control," and thus can result in a taxable transaction. To be clear, the control requirement applies to reorganizations involving previously unrelated target corporations as well as transactions amongst commonly controlled entities. It is difficult to imagine what rational tax policy could, on balance, mandate a taxable transaction result in the face of the Congressional purposes underlying the incorporation and reorganization provisions.[80] Ironic, perhaps, that while the proposed regulations would treat debt as stock, the current Administration is asking Congress to repeal rules that treat stock as debt, due to a concern that taxpayers can structure into taxable transactions.[81]

Similar concerns occur with respect to provisions that contemplate ownership of stock that satisfies the requirements of section 1504(a)(2). For example, a tax-free subsidiary liquidation requires

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[75] Rev. Rul. 59-259, 1959-2 C.B. 115.

[76] This can apply in the context of a forward triangular merger under section 368(a)(1)(A) by reason of section 368(a)(2)(D), a reverse subsidiary merger under section 368(a)(1)(A) by reason of section 368(a)(2)(E), a triangular stock acquisition under section 368(a)(1)(B), and a triangular asset acquisition under section 368(a)(1)(C).

[77] Section 368(a)(1)(B).

[78] Section 368(a)(2)(E)(ii).

[79] Section 368(c) is also referred to in sections 108(e)(7)(C), 367(a)(5), 1202(h)(4)(D), and 1361(f)(2)(B).

[80] *See Hempt Bros., Inc. v. Commissioner*, 490 F.2d 1172, 1177 (3d. Cir. 1974) ("Section 351 has been described as a deliberate attempt by Congress to facilitate the incorporation of ongoing businesses and to eliminate any technical constructions which are economically unsound."). *See also* Rev. Rul. 2003-51, 2003-1 C.B. 938, Rev. Rul. 2015-9, 2015-21 I.R.B. 972 and Rev. Rul. 2015-10, 2015-21 I.R.B. 973, in which the Service seems to have taken pains to ensure that certain transactions could qualify for section 351 treatment notwithstanding the step-transaction doctrine. In addition, the non-recognition provisions, in many instances, serve an anti-avoidance function as well, as is evidenced by the numerous liquidation-reincorporation cases decided in the context of the tax-free reorganization definition of section 368(a)(1)(D) (where the Service argued there had been a reorganization – in the face of taxpayer arguments that the transactions involved taxable corporate liquidations). This latter point is also evidenced by the history of the Revenue Act of 1934, when a Congressional subcommittee proposed repealing the tax-free reorganizations, only to have the provisions retained at the behest of the Treasury Department. *See* Statement of the Acting Secretary of the Treasury Regarding the Preliminary Report of a Subcommittee of the Committee on Ways and Means, 9-10 (1933); H.R. Rep. No. 704, 73d Cong., 2d Sess., at 12-13 (1934); S. Rep. No. 558, 73d Cong., 2d Sess., at 16-17 (1934). The point is that there are significant and multifaceted tax policy rationales underlying the non-recognition provisions in subchapter C, which will be upset in many situations if the proposed regulations were to be finalized in their current form.

[81] *See* Dep't of the Treasury, *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals*, at 239 (2016) (proposal to repeal the nonqualified preferred stock provisions).

the parent corporation to directly own such stock in a liquidating subsidiary,[82] a section 336(e) qualified stock disposition and a section 338 qualified stock purchase trigger off the section 1504(a)(2) standard, and of course the standard is key to determining the composition of an affiliated (and thus a consolidated) group.[83] In cases of "straight debt" debt instruments that bear adequate stated interest and have no voting rights, an equity recharacterization might not present an issue in the section 1504 context because the "plain vanilla stock" rules in section 1504(a)(4) could exclude such debt from the section 1504(a)(2) test. However, in certain circumstances, the exclusion would not be available.

> Example. Foreign parent corporation FP owns USP, a domestic corporation. USP owns S1, and S1 borrows funds from USP in exchange for a debt instrument. If USP distributed the S1 debt instrument to FP and if it were to be recharacterized as "stock" under the documentation and substantiation rules, it might qualify as "plain vanilla preferred" equity and the USP-S1 consolidated group would not terminate.

However, if S1 was in some financial distress, the S1 debt instrument might be worth less than its face amount, creating is a risk that the recharacterized debt instrument[84] would be viewed as having a redemption or liquidation right that exceeded a reasonable premium, and thus would not qualify for the "plain vanilla preferred" exclusion. The result might very well be to terminate the USP-S1 consolidated group, and to prevent S1 from being able to liquidate tax-free into USP.

We are deeply troubled that taxpayers that are planning a transaction might not be able to accurately determine section 368(c) control at the time of the transaction if the relevant entity has issued a related-party debt instrument, because the debt instrument could be recharacterized as equity with retroactive effect.[85] For example, if FP owned all of the stock of FS1 and US1, US1 had issued a debt instrument to FS1 in January, and the entities were calendar-year taxpayers, the US1 debt instrument could be recharacterized as stock at the time of its issuance under the funding rule if the disfavored transaction that triggered the funding rule occurred in the same year (even if not until December).[86] As should be evident by now, the potential for retroactive adverse tax results under this provision is a recurring source of uncertainty and a matter that urgently requires correction, if the proposed regulations are to be finalized.

> Example. FP owns all of the stock of FS1 and US1. US1 is a holding company that is the parent corporation of a consolidated group, and it owns all of the stock of US2, a subsidiary member of its group. US2 owns multiple lower-tier consolidated subsidiaries. On January 1 of Year 2, US2

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[82] Section 332(b)(1).

[83] Numerous provisions of the Code refer to section 1504(a), including in sections that apply to inversions (sections 4985(e)(4) and 7874(c)(1)).

[84] This accrues because the recharacterized debt instrument would have gone through the deemed satisfaction and reissuance rules of Treas. Reg. § 1.1502-13(g), and would have been treated as having been reissued at its fair market value, reflecting a discount to the debt instrument's stated redemption price at maturity.

[85] We believe that "control" will be inappropriately affected in many situations when sophisticated taxpayers would be cognizant and able to accurately evaluate the current status of a recharacterized debt instrument. However, we understand that the Treasury Department and Service are unsympathetic to this issue, and believe that a debt instrument that is recharacterized under the rules should be treated as stock for all purposes. Thus, this comment is focused on the fundamental unfairness of a retroactive recharacterization of a debt instrument.

[86] Prop. Treas. Reg. § 1.385-3(d)(1)(i).

issues a $100 debt instrument to FS1. The debt instrument is properly documented, and confers no voting rights. On December 31 of Year 2, when US1 estimates that it will have $30 in current year earnings and profits, US1 distributes $25 to FP as a dividend in reliance on the current year earnings and profits exception in Prop. Treas. Reg. § 1.385-1(c)(1). In September of Year 2, US1 transfers a group of appreciated and loss properties to US2, in an exchange it believes will qualify for nonrecognition treatment under section 351. In Year 4, after an IRS audit, a $40 deduction claimed for Year 1 by a lower-tier subsidiary below US2 is disallowed for that year, and instead is allowed for Year 2. The earnings and profits adjustment tiers up through US2 to US1, and as a result, US1's Year 2 earnings and profits are retrospectively eliminated under Treas. Reg. § 1.1502-33.

In the example, neither US1 nor US2 would have had any current year earnings and profits after the audit adjustment; thus $25 of the US2 debt instrument would be recharacterized as stock (presumably, as stock in US2) under the funding rule, *effective as of the time of its issuance on January 1 of Year 2*. Prop. Treas. Reg. § 1.385-3(d)(1)(i). After the issuance of the US2 "non-voting stock," US1 would not possess section 368(c) control of US2, and its transfer of properties to US2 in September of Year 2 would not qualify for non-recognition treatment.

Alternatively, if two years after the issuance of a debt instrument the Service were to determine that the documentation requirements had not been fully satisfied, perhaps due to a failure to undertake and memorialize a sufficiently robust financial due diligence (or perhaps through the type of inadvertent error that would normally justify section 9100 relief but that could not qualify under the narrowly drafted reasonable cause exception of Prop. Treas. Reg. § 1.385-2), the debt instrument could be recharacterized as stock upon its issuance.[87]

Example. T, a domestic target corporation, owns CFC. T also has 100 shares of stock outstanding, all owned by individual A. In Year 1, T issued a debt instrument to CFC. It is unclear whether the T debt instrument, which does not provide for voting rights, could be treated as stock under the documentation requirements of Prop. Treas. Reg. § 1.385-2. USP, which is not related to T or A, seeks to acquire T in a tax-free reorganization. To effect the acquisition, USP forms a merger corporation, which merges into T in Year 3. As a result of the merger, A receives solely shares of USP voting stock, and USP owns all 100 shares of T stock.

On its face, the transaction appears to qualify as a parenthetical or triangular section 368(a)(1)(B) reorganization, and as a reverse subsidiary merger qualifying for tax-free reorganization treatment under section 368(a)(1)(A) by reason of section 368(a)(2)(E). Each of these provisions, however, requires USP to acquire an amount of stock in T that satisfies the control definition in section 368(c), meaning stock possessing 80 percent or more of the vote and 80 percent or more of each class of nonvoting stock. If, upon audit, the T-CFC debt instrument is recharacterized as stock under the documentation rule, the recharacterization would be effective as of the Year 1 date of issuance. The result is to call into question whether in Year 3 USP acquired control of T—even though USP acquired all 100 shares of T's outstanding stock, and indirectly acquired ownership of the T-CFC debt instrument.[88]

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[87] Prop. Treas. Reg. § 1.385-2(c)(3)(i).

[88] Under Prop. Treas. Reg. § 1.385-2(a)(3), once T characterizes the debt instrument as indebtedness, T, CFC, and "any other person relying on the characterization of [the T-CFC debt instrument] as indebtedness for federal tax

The proposed regulations are likely to upset the reasonable expectations of corporate groups planning certain transactions—including transactions with unrelated parties—all due to the potential for a retroactive recharacterization of a debt instrument.[89] This result is certainly not compelled by the policies underlying the proposed regulations, and it cannot be squared with the longstanding policies underlying subchapter C's non-recognition provisions.[90]

2. Recommendations

- Provide that for purposes of the various control requirements, debt instruments recharacterized as stock under the proposed regulations would not be treated as stock and would be respected as debt, provided the debt instruments would qualify as indebtedness under general debt-equity principles.[91]

- Alternatively, provide that a debt instrument will not be retroactively recharacterized as stock, for purposes of making a control determination.

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purposes" must treat the T-CFC debt instrument as debt. This appears to bind USP, even if it has some doubt as to whether the debt instrument, for example, had been supported by a sufficiently robust financial due diligence.

[89] In certain limited circumstances, a tax-free transaction that no longer qualified as such due to a retroactive recharacterization of a debt instrument under the documentation rule, might have been consummated in a taxable year closed to assessment under the statute of limitations. The Treasury Department and Service have previously encountered this phenomena. *See* Karen C. Burke, *The Story of* Hendler*: From Pyrrhic Victory to Modern Section 357*, *in* Business Tax Stories (Steven A. Bank and Kirk J. Stark, eds. 2005) (Foundation Press).

[90] A number of tax rules outside of the subchapter C/consolidated returns context hinge on membership in the same affiliated group or that otherwise are based on section 1504(a) control, and these rules could be affected by stock recharacterizations of debt instruments under the proposed regulations. As one perhaps obscure example, section 6715A imposes a penalty for the tampering with a mechanical dye injection system used to indelibly dye fuels for purposes of the section 4802 exemption from the excises on diesel fuels and kerosene. We understand that there has been an historic concern with respect to the evasion of diesel fuels taxes by various individuals and organized crime elements, and that the diesel dyeing system is an important component of law enforcement efforts. Section 6715A(c)(2) imposes joint and several liability on the parent corporation of an affiliated group, if a member of the group is liable for a monetary penalty for tampering. *See* Joint Comm. on Tax'n, General Explanation of Tax Legislation Enacted in the 108th Congress, JCS-5-05, at 436-439 (2005). Section 1504(a) is also referred to in other provisions outside of subchapter C, such as the corporate equity reduction transactions rules (section 172(g)(3)(E)(i)), the LIFO inventory rules (section 472(g)(2)(A)), the worldwide interest apportionment election in section 864 sourcing rules (section 864(f)(1)(C)), the rules addressing sales of stock to an employee stock ownership plan or cooperative (section 1042(b)(2)(A)), the section 1092 straddle rules (section 1092(d)(3)(B)), and special rules relating to the definition of price for purposes of the manufacturers tax (section 4216(b)(3)(A) and (b)(4)(A)).

[91] *Cf.* Treas. Reg. § 1.1361-5(b)(1) ("For purposes of determining the application of section 351 with respect to this transaction, instruments, obligations, or other arrangements that are not treated as stock of the QSub under § 1.1361-2(b) are disregarded in determining control for purposes of section 368(c) even if they are equity under general principles of tax law.").

G. Intercompany Payables or Distributions Arising Due to Tax Adjustments

1. Discussion

Large multinational corporate groups routinely face transfer pricing and audit adjustments, some favorable, some unfavorable. Often, transfer pricing adjustments are made, which give rise to correlative adjustments. The proposed regulations should contain special rules to address how these correlative adjustments relate to the funding rule.

> Example. USP owns USS, which owns CFC1, CFC2, and CFC3. In Year 1, CFC1 transfers $100 to USS in exchange for goods, services, or the use of intangible property. In Year 3, CFC1 issues a $250 debt instrument to CFC2 in exchange for $250 in local currency, and USS issues a $75 debt instrument to CFC3. In Year 4, the taxpayer and the Service agree (or it is determined in IRS Appeals or in litigation) that the proper transfer price was $90. As a correlative adjustment, the parties might agree that CFC1 made a $10 distribution to USS, or that USS has a $10 payable to CFC1.[92]

Would CFC1's $10 deemed distribution cause $10 of its Year 3 debt instrument to be recharacterized as stock under the funding and *per se* rules? If so, would this be effective as of the issuance of the Year 3 debt instrument, or at the time of the audit adjustment in Year 4? If the account payable route were chosen, could it be recharacterized as hook equity under the funding and *per se* rules? Would it be treated as arising in Year 1 when the underpayment was made, or in Year 4 at the time of the audit adjustment?[93] Would it be treated as stock under the documentation rules of Prop. Treas. Reg. § 1.385-2, due to the failure timely and properly to document the overpayment as a loan (or, more absurdly, for failure to conduct a financial due diligence, *ab initio*)?

> Example. The facts are the same as in the previous example, except that the proper transfer price was $110. The parties agree that as a correlative adjustment, USS made a contribution of $10 to CFC1, or CFC1 has a $10 payable to USS.

If CFC1 had paid too little for the goods, services or use of intangibles, might there be some deemed contribution of property from USS to CFC1? If so, is USS treated as having made a funded acquisition of $10 of CFC1 stock within the meaning of Prop. Treas. Reg. § 1.385-3(c)(3), with CFC1 as the successor to USP for purposes of the funding rule (and if so, when)?[94]

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[92] Treas. Reg. § 1.482-2(g)(3)(i); Rev. Proc. 99-32, 1999-2 C.B. 296.

[93] We note that the Fifth Circuit Court of Appeals in *BMC Software, Inc. v. Commissioner*, 780 F.3d 669 (5th Cir. 2015), squarely rejected the government's contentions that account payables arising under Rev. Proc. 99-32 could be considered to be in existence retroactively for purposes of section 965 vis-à-vis the years implicated by the adjustment. The Court's reasoning would apply with equal force to provide in this hypothetical that the account payable should not be treated as in existence until Year 4, to the extent it is even treated as "indebtedness" at all for federal tax purposes.

[94] We observe that while the proposed regulations assume that a capital contribution should be treated the same as an actual issuance of stock (Prop. Treas. Reg. § 1.385-3(g)(3), *Example 11(i)*), the proposed regulations contain no operative rule that would provide for this result. *Cf.* section 367(c)(2) (creating a deemed issuance of stock in certain capital contributions made to a foreign corporation); Treas. Reg. § 1.368-2(l)(2)(i) (deeming a nominal share of stock to have been issued in the context of a stockless reorganization under section 368(a)(1)(D)).

Similar issues can arise outside of the transfer pricing area. For example, if on audit it is determined that there has been a constructive distribution or contribution, might these constructive transactions implicate the funding, *per se*, and successor rules? For example, if in the example above, CFC1 had transferred some of its property directly to CFC2 without payment, CFC1 might be viewed under general tax principles as having made a constructive distribution to USS, which then made a constructive contribution to CFC2, equal to the value of the use of the property.

2. Recommendations

- Exempt any deemed contribution or distribution arising as a correlative adjustment from the ambit of the funding rule. This could be achieved through a specific exception to the definition of "debt instrument" in Prop. Treas. Reg. § 1.385-3(f) or, more broadly, through a global short-term (*e.g.*, 90 day) indebtedness exception, which taxpayers using Rev. Proc. 99-32 could avail themselves of if they repay the accounts within 90 days of the closing agreement,[95] as is required by the Revenue Procedure and on the basis that the indebtedness does not exist, if at all, until the closing agreement takes effect.

- Provide similar rules with respect to other retroactive adjustments that could have the effect of triggering the application of the rules, such as an audit adjustment that finds a constructive contribution or distribution to have occurred.

H. Repayment of Intercompany Balances – Determination of Dividend Equivalency

1. Discussion

The complexity of the proposed regulations is on display when one considers the many potential consequences of the repayment of a reclassified debt instrument. Some of this is discussed above in connection with cash pooling and treasury center arrangements, and below in connection with the duplication, cascading and evergreen effects. We make the following, additional observations.

- Due to the broad constructive ownership rules that apply for purposes of testing under section 302, it is anticipated that in most circumstances, the repayment of a debt instrument that has been recharacterized as stock would be treated as a dividend-equivalent redemption by reason of section 302(d) or section 306(a)(2). We understand this to be consistent with the Treasury Department's intent. In this context, the holder's "stock basis" in the recharacterized debt instrument should not disappear,[96] but rather should in effect be transferred to and included in an actual shareholder's stock basis in the issuer, pursuant to Treas. Reg. § 1.302-2(c).[97] This would result in the very basis

[95] *See* Rev. Proc. 99-32, § 5.01(4)(e).

[96] The premise underlying dividend-equivalent redemptions is that the cancellation of some number of shares does not fundamentally alter the redeemed shareholder's economic investment in the distributing/redeeming corporation. Thus, the shareholder's basis in the distributing/redeeming corporation, which measures the shareholder's investment, should be preserved.

[97] The "all boot D" basis regulations specifically instruct the shareholder to designate the particular share to which unrecovered basis attaches. Treas. Reg. § 1.358-2(a)(2)(iii)(B). A similar rule here could provide some clarity, especially when the redeeming corporation might have issued multiple debt instruments to disparate EG members that are potentially subject to recharacterization as stock. Alternatively, a rule could provide that when the holder of the recharacterized debt instrument does not actually own stock in the issuer, the holder's "stock basis"

shift that the Treasury Department and Service targeted in the 2009 "big basis" proposed regulations package,[98] and tried to eliminate in the 2002 stock basis proposals,[99] yet stock basis shifts would occur with much greater frequency as a direct result of the proposed regulations.

- Some redemptions might not be dividend equivalent, however, because of a limited rule that precludes a corporation from being treated as owning its own stock. For example, assume USP owns CFC1, CFC1 owns CFC2, and a debt instrument issued by CFC1 to CFC2 is recharacterized as stock in CFC1 under the funding rule. When CFC1 repays its recharacterized debt instrument, it is redeeming hook equity owned by its shareholder CFC2. CFC2 does not actually own any stock in CFC1, nor does it constructively own any of the stock in CFC1 that is actually owned by USP;[100] thus, because CFC2 would be treated as having all of its stock in CFC1 redeemed, the redemption would be treated as a sale or exchange from the perspective of CFC2 by reason of section 302(a), and no dividend consequences would result.

- Some redemptions might be effected through an offset of reciprocal positions.[101]

  Example. USP owns CFC1 and CFC2, CFC2 owns CFC3. CFC1 had issued a debt instrument to CFC2 that had been recharacterized as stock in CFC1, and CFC3 had issued a debt instrument to CFC1 that had been recharacterized as stock in CFC3. To "clean up" the intercompany debts, CFC2 contributes the recharacterized CFC1 debt instrument to CFC3. Thereafter, the two debt instruments are offset under local law.[102]

The tax characterization of the offset transaction is not free from doubt. In the example above, each corporate entity involved in the offset would be simultaneously acting both in its capacity as a corporation redeeming its stock held by a shareholder, and in its capacity as a shareholder having the stock it owns redeemed by the issuing corporation. The Service has not issued any guidance on concurrent section 302(d) redemptions in 35 years, and the limited pre-*General Utilities* repeal guidance

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attaches to the particular actual shareholder that furnished the requisite attributive link implicating section 302(d). *See* Rev. Rul. 71-563, 1971-2 C.B 175 (generally providing this result in the context of a section 304 sale of less than 100% of the Issuing corporation stock, where the selling shareholder did not actually own any stock of the constructively related acquiring corporation).

[98] Notice of Proposed Rulemaking, *The Allocation of Consideration and Allocation and Recovery of Basis in Transactions Involving Corporate Stock or Securities*, REG-143686-07, 74 Fed. Reg. 3509 (Jan. 21, 2009) (publishing Prop. Treas. Reg. § 1.302-5).

[99] Notice of Proposed Rulemaking, *Redemptions Taxable as Dividends*, REG-150313-01, 67 Fed. Reg. 64331 (Oct. 18, 2002) (publishing Prop. Treas. Reg. § 1.302-5) (subsequently withdrawn in Announcement 2006-30, 2006-1 C.B. 879, 71 Fed. Reg. 20044 (Apr. 19, 2006)).

[100] *See* Rev. Rul. 74-605, 1974-2 C.B. 97; Treas. Reg. § 1.318-1(b)(1).

[101] Similar issues might arise where two entities repay borrowed funds from each other at various points during the same taxable year. For example, assume on Jan. 15 of Year 2, CFC1 repaid a recharacterized debt instrument it had issued to CFC2 in Year 1, on June 1 of Year 2 CFC2 issued a new debt instrument to CFC1 in a general rule transaction, and on Nov. 30 of Year 2 CFC2 repaid its debt instrument. During the Year 2, CFC1 and CFC2 would each have redeemed a recharacterized debt instrument from the other. The issue might arise more frequently where multiple entities participate in a common cash pool or treasury center arrangement, or when a U.S. acquirer purchases a foreign corporate group and seeks to "clean up" the foreign target's intercompany debts.

[102] The offset could also arise in other ways, such as if CFC3 were to liquidate into CFC2.

was *obsoleted* more than a decade ago.[103] In this fact pattern, would any gain or loss be recognized by a redeeming corporation under section 311? What would happen to the "stock" basis each entity had in the "stock" of the other? What would happen to the earnings and profits of each entity, as well as foreign taxes associated with those earnings and profits? If the two debt instruments each had a value of $100, CFC1 had $5 of earnings and profits, and CFC2 had no earnings and profits, would the transaction result in an iterative earnings and profits calculation, such that both CFC1 and CFC2 would each have $100 in current earnings and profits at the end of the taxable year?[104]

2. Recommendations

- Add rules that would provide guidance relating to the movement and location of earnings and profits (and associated foreign taxes) in situations when reciprocal recharacterized debt instruments are redeemed in the same taxable year or are offset.

- Provide an example to confirm a holder's basis in a recharacterized debt instrument that is redeemed in a dividend-equivalent redemption under section 302(d) or section 306(a)(2) will augment basis of actual stock (and recharacterized debt instruments) in the issuer. The proposed regulations should also provide a methodology to address the situation when the issuer has multiple EG-member shareholders, and perhaps also cover the situation when there are multiple classes of stock (including one or more recharacterized debt instruments).

I. Repayment of Intercompany Balances – Duplication, Cascading and Evergreen Issues

1. Discussion

We would expect the repayment of a recharacterized debt instrument, in most circumstances, to be treated as a section 302(d) redemption or a section 306(a)(2) redemption, and thus as a section 301 distribution. There is nothing in the *per se* rule, however, that would exclude or "turn off" the original transaction that caused the recharacterization of the debt instrument from continuing to cause

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[103] The Service addressed a reciprocal redemption fact pattern prior to *General Utilities* repeal in Rev. Rul. 79-314, 1979-2 C.B. 132 (nonliquidating distributions in a section 302(a) cross-redemption context), and in Rev. Rul. 80-181, 1980-1 C.B. 70 (liquidating distributions). These rulings were obsoleted in Rev. Rul. 2003-99, 2003-2 C.B. 388. Perhaps the Service has considered variations of this issue when issuing regulations in the *May Company* context. *See* T.D. 9722, 80 Fed. Reg. 33402 (June 12, 2015) (adding Treas. Reg. § 1.337(d)-3T) (where a partner is acting in its partner capacity as receiving a distribution from a partnership, and it its capacity as a corporation that is transferring a partnership interest to its shareholder to redeem its stock). Note that if one corporation were to transfer a recharacterized debt instrument issued to it by an EG member to retire a recharacterized debt instrument it had previously issued to a different EG member, the retirement itself could be viewed as a section 304(a)(1) transaction leading to a simultaneous, cross-section 304(d) redemption fact pattern (and itself potentially setting up further complexities under the *per se* rule).

[104] Earnings and profits for a taxable year are computed at the close of the year, without diminution by reason of distributions made during the year. Section 316(a)(2). In the example, CFC1's $5 of earnings and profit would be treated as having been distributed to CFC2, thus creating $5 in earnings and profits for CFC2 for the year, which could then be treated as having been received by CFC1 in the CFC2-to-CFC1 distribution, which would give CFC1 $10 ($5 plus $5) in current earnings and profits, and so on. Clearly this type of duplication is absurd, yet it appears mandated by a literal application of the mechanical rules in section 316.

mischief, presenting the potential for duplication.[105] In addition, the recharacterization of a debt instrument as stock is viewed as though the lender had acquired stock in the EG member that issued the debt, creating risk for the lender's own debt instruments to be recharacterized as stock under a cascading application of the funding and *per se* rules. Finally, payments of interest and principal on a recharacterized debt instrument themselves are characterized as distributions, each of which is vulnerable to being linked with another debt instrument under the *per se* rule, creating an evergreen effect.

> Example. Assume FP owns FS1 and FS2, FS1 owns US1, and FS2 owns US2. In Year 1, US1 borrows $100 from FS1 and issues a debt instrument to FS1. In Year 2, US1 pays an $80 dividend to FS1 out of its accumulated earnings and profits. In Year 3, US1 transfers $100 to FS1 in satisfaction of the Year 1 debt instrument. In Year 4, US1 borrows $175 from US2 and issues a debt instrument to US2. All of the loans are properly documented, and no exceptions from the proposed regulations apply.

In Year 2, when the $80 dividend distribution is made, the distribution is linked to the $100 Year 1 debt instrument under the *per se* rule in Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(B)(*1*). The result is that (i) $80 of the $100 Year 1 debt instrument would become treated as stock under the funding rule in Prop. Treas. Reg. § 1.385-3(b)(3)(i), and (ii) for purposes of the *per se* and funding rules, FS1 has now acquired EG member stock. This latter result could have a *cascading effect* given the extraordinary reach of the funding and *per se* rules, and could cause debt instruments issued by FS1 to be subject to recharacterization under the funding and *per se* rules.

In Year 3, when the Year 1 debt instrument is repaid, $80 of the repayment would be treated as a redemption of the "stock" portion and $20 as satisfaction of the "debt" portion. The $80 redemption would be treated as a dividend equivalent redemption under section 302(d) or section 306(a)(2), and thus as a distribution for purposes of section 301 and the proposed regulations. This creates an *evergreen effect*, as each payment of interest and principal effectively triggers a new 72-month, *per se* rule period. In the example, the $80 "redemption" would cause a portion of the Year 4 debt instrument to be recharacterized as equity. If that was a 10-year debt instrument, its repayment in Year 14 would be a further distribution, placing US1 debt instruments issued in Years 11-17 at risk of stock recharacterization. In this manner, a single $80 distribution in Year 2 could cause successive US1 debt instruments to face recharacterization in years to come.

When US1 issues a new $175 debt instrument in Year 4, the *per se* and funding rules would apply to recharacterize it as stock in whole or in part. It is unclear whether a recharacterization would be triggered by reason of the Year 2 dividend distribution, or by reason of the Year 3 dividend-equivalent redemption that occurred when the Year 1 debt instrument was repaid, or by both. Both distributions are within the 36 months preceding the issuance of the Year 4 debt instrument, and there is nothing in the *per se* rule or any other rule that tells us to disregard either the Year 2 distribution or the Year 3 dividend-equivalent redemption for this purpose.

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[105] The rule in Prop. Treas. Reg. § 1.385-3(b)(3)(iii) appears to be focused on a situation where a specific distribution or acquisition is picked up in more than one of the triggers of Prop. Treas. Reg. § 1.385-3(b)(3)(ii) (*i.e.*, overlap situations), and not on the situation where a particular distribution or acquisition could serially taint successive debt instruments.

In particular, we note that the entire Year 2 distribution of $80 was already fully "linked" to the Year 1 loan of $100 and this linkage served as the basis for recharacterizing $80 of the Year 1 debt instrument. The premise for this result is that under the *per se* rule, $80 of the Year 1 loan was issued with a principal purpose of funding the Year 2 distribution. Having reached this conclusion, how can *any* of the Year 4 debt *also* be considered to have been issued with a principal purpose of funding the same Year 2 distribution, *when all $80 of the Year 2 distribution was already considered to have been funded by the Year 1 debt.* Read literally, however, there is no "coordination" rule that prevents the Year 2 distribution from serving "double duty" of multiple linkages under the *per se* rule and funding rules in this context.[106] The result is particularly arbitrary because if the Year 1 loan had *not* been repaid at the time of the Year 4 borrowing, such that there was not a new deemed distribution in Year 3, Prop. Treas. Reg. § 1.385-3(b)(iv)(B)(3) would provide that the Year 2 distribution was linked only to the Year 1 loan and was not "free" to also be linked at the same time to the Year 4 loan. Although a post-Year 4 repayment of the Year 1 loan would create a new distribution at that time that could be linked to the Year 4 loan, no rule authorizes (or precludes) a "re-testing" of the Year 4 loan vis-à-vis the Year 2 distribution upon the repayment of the previously linked principal purpose debt instrument from Year 1.[107]

Perhaps more than any other aspect of the proposed regulations, the foregoing results would represent an egregious overstepping of the government's discretion and authority in interpreting and issuing guidance under section 385. Even if one concedes (which we do not) that it is valid for debt to be characterized as equity under the funding rule, the idea that multiple debt instruments could each be recharacterized on the premise of having had a principal purpose of (fully) funding the *same* funding rule transaction *prima facie* defies logic, to say nothing of any principled tax policy objective. Moreover, FS1 would have $160 in dividend income, even though the "substance" involves a single $80 distribution. This is because the $80 Year 2 distribution would retain its character as a dividend, as provided in Prop. Treas. Reg. § 1.385-3(b)(3)(vi) (providing that the acquisition or distribution treated as funded with a debt instrument under the funding rule is itself not recharacterized as a result of the treatment of the debt instrument as stock).

Returning to the example, the ordering rule in Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(B)(*4*) specifically provides that if a debt instrument can be treated as funding two or more distributions, it is treated as funding distributions and acquisitions based on the order in which they occurred; however, because the issue price of the Year 4 debt instrument exceeds both the amount of the Year 2 distribution and the Year 3 dividend-equivalent redemption, it would not preclude a duplication. If both distributions, notwithstanding the forgoing, are to be taken into account (given that both occurred within the 36 months preceding the issuance of the Year 4 debt instrument), then $80 of the $175 Year 4 debt instrument would be recharacterized as stock by reason of the Year 2 distribution, and an additional $80 of the $175 Year 4 debt instrument would be recharacterized as stock by reason of the $80 Year 3 dividend-equivalent redemption. The result is that a single $80 distribution (or equity reduction) has now tainted $160 of the Year 4 related-party debt—a *duplication effect*. And this after the Year 2 distribution *already* recharacterized $80 of the Year 1 debt, such that the single $80 Year 2

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[106] The multiple interests rule in Prop. Treas. Reg. § 1.385-3(d)(3)(iv)(B)(*3*) does not appear to apply, because in Year 4, the Year 1 debt instrument has been retired and is no longer treated as having funded the Year 2 distribution.

[107] *Cf.* Prop. Treas. Reg. § 1.385-3(d)(2) (expressly authorizing re-testing when a recharacterized debt instrument leaves the EG).

distribution ultimately resulted in $240 of recast debt! While we would argue for an interpretation of the rules that does not permit arbitrary and unprincipled duplication results of this type, duplication is improper and it would be far preferable for the final rules to explicitly confirm this result.

An additional duplication issue is discussed in the Appendix.

2. Recommendations

- Provide an anti-duplication rule. It might be possible to accomplish this by clarifying that the multiple interests rule in Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(B)(*3*) that associates a distribution with respect to the first available debt instrument continues to apply even after the first instrument is retired, such that it does not thereafter also taint another debt instrument. Moreover, consider the cascading and evergreen issues, and whether a rule or a mechanism could be devised to minimize disruptions these issues could cause.

J. Repayment of Intercompany Balances – Other Issues

1. Discussion

The proposed rules facilitate the sideways movement of earnings and profits (including when favorable to taxpayers) by mechanically requiring the movement of such earnings and profits upon repayment of most recharacterized debt instruments. This could have results similar to those intended to be prevented by the fast pay regulations.[108] While the fast-pay regulations do not apply when the arrangement was not structured with the objective of moving earnings and profits through repayments of debt,[109] the ubiquity of such cross-chain equity instruments would automatically maximize the movement of such earnings and profits, regardless of intent.

The no affirmative use rules create unmanageable uncertainty. As one of many possible examples:

> Example. USP owns USS1 and CFC1, and USS1 owns CFC2. During Year 1, CFC1 issues a $150 debt instrument to CFC2 that is recharacterized as stock in CFC1. Assume that at the time CFC1 issued its debt instrument to CFC2, USP and CFC1 employees were aware that the CFC1 debt instrument could be recharacterized as stock, and that USP would subsequently seek one or more distributions from CFC1 and/or CFC2 (the latter, *via* USS1). In Year 5, when CFC1 has $100 of earnings and profits and CFC2 has no earnings and profits, CFC1 transfers $150 to CFC2 to repay its debt instrument.

It is unclear whether either CFC can make a distribution of its own cash without triggering a dividend. If the USP corporate group tax department was aware of the possibility that the CFC1 debt instrument could be recharacterized as stock under the proposed regulations, and if there might be

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[108] Treas. Reg. § 1.7701(l)-3.

[109] Treas. Reg. § 1.7701(l)-3(b)(2)(ii) (providing that "stock is not fast-pay stock solely because a redemption is treated as a dividend as a result of section 302(d) unless there is a principal purpose of achieving the same economic and tax effect as a fast-pay arrangement."). Our recommendation addressing the interaction of the proposed regulations and the fast-pay stock rules is contained in the Appendix.

some attendant tax savings (such as a return-of-capital distribution from one of the CFCs *vs.* a dividend distribution from the other CFC), can the tax department have confidence that the proposed regulations would apply? For purposes of the no affirmative use rule, how are the tax benefit to be measured? The no affirmative use rule in Prop. Treas. Reg. § 1.385-2(d) looks to the federal tax liability of any EG member or members (or that of "any other person relying on the characterization of an EGI as indebtedness for federal tax purposes"), but what if the aggregate U.S. federal income tax liabilities of the EG as a whole in each taxable increases as a result? Or if there is a decrease in Year 1, but an equal or a larger increase in Year 2, such that there is no net reduction or even a net increase? The no affirmative use rule in Prop. Treas. Reg. § 1.385-3(e) looks to the federal tax liability of any EG member, again without any reference to the aggregate tax liability of the EG in any particular table year or the net tax liability for the EG over a term of years.

If the proposed regulations were to apply in the example above, the mechanical rules would treat CFC1's retirement of its debt instrument as a $100 dividend distribution to CFC2 under sections 302(d) and 301(c)(1) (and as a $50 return-of-capital distribution under section 301(c)(2)), with the result that CFC2 would have the $100 of earnings and profits formerly held by CFC1. However, under the affirmative use rule, CFC1 might have retained its earnings and profits notwithstanding the dividend-equivalent "redemption" of its debt instrument. Should USP create a series of tax projections for all of the EG members, including the potential for the application of the PTI rules, section 1248 and section 964(e), the ability to use foreign tax credits, etc.? Or is it enough that the movement of earnings and profits from CFC1 to CFC2 would create the opportunity for a return-of-capital distribution from CFC1 to USP (without considering whether that should be offset by any increase in USS1's tax liability with respect to any distribution from CFC2)? Taxpayers would be hard pressed to gauge their tax position.

2. Recommendations

- Eliminate the no affirmative use rules.

- Provide rules that clarify the application of the earnings and profits rules. Given the significant complexities of the proposed regulations, it is difficult to make recommendations that could address all of the potential fact patterns. However, at a minimum, it should be made clear that the aggregate amount of earnings and profits within an EG should not be increased as a result of cross-redemptions.

- In addition, a rule should be provided that taxpayers who make good faith estimates as to the location of earnings and profits will not be penalized if their estimates turn out to be incorrect.

- Clarify that the fast-pay rules would not apply to a debt instrument that is recharacterized as stock under the proposed regulations.

K. Current Year Earnings and Profits Exception[110]

1. Discussion

[110] We have added to the Appendix additional comments and recommendations regarding the current year earnings and profits exception, to address the exception's application in the context of consolidated groups.

We commend the Treasury Department and Service for including a few exceptions partially to ameliorate the general, funding and *per se* rules, such as the current year earnings and profits (CYEP) exception in Prop. Treas. Reg. § 1.385-3(c)(1). We recommend a few modifications to the CYEP rule to allow it to serve a more useful function.

The principal difficulty with the rule is that the amount of a corporation's earnings and profits for a particular year might not be determinable with any degree of certainty for some period of time after the close of the taxable year. For example, a calendar-year corporation that seeks to make a distribution in, say, March of a year cannot know for sure what its business results (let alone its net income) will be for the year. Given the effect of the ordering rule in the second sentence of Prop. Treas. Reg. § 1.385-3(c)(1), a corporation might choose to defer making distributions until the end of the taxable year, to avoid limiting its ability to use the CYEP exception. (Additionally, the corporation will remain vulnerable to adjustments that occur after the close of the year, such as adjustments that arise due to an audit adjustment.) Moreover, as discussed elsewhere in our comments, a corporation might have issued and repaid a debt instrument in a particular year, only to have the note retroactively recharacterized later in the same year as stock (due to a subsequent distribution, acquisition of EG member stock, or other transaction), with the result that repayment of the debt instrument is retroactively characterized as a distribution (thus absorbing earnings and profits for purposes of the CYEP exception).

In other contexts, Congress has enacted rules that contemplate that certain entities will distribute most or all of their current earnings and profits. Examples include the REIT and RIC regimes. In addition, Congress has enacted certain penalty rules when a corporation that accumulates too much earning and profits will face a penalty tax unless it makes a distribution. In these situations, Congress has enacted rules to provide a grace period, allowing the affected entities the opportunity to make their distributions within, say, 75 days after the close of the taxable year. Such a rule enhances administrability and certainty. If the CYEP exception is not expanded in accord with our recommendation below, we would recommend a similar 75-day grace period be added to the rules to make the CYEP exception more "workable" for taxpayers. However, we recognize that coordinating rules might need to be added with respect to a distribution made during the period.

> Example. CFC1 has earnings and profits of $100 in each of Years 1 and 2. CFC1 makes $75 of distributions during Year 1, and $120 of distributions during Year 2, of which $30 occurs in January of Year 2.

Overall, the $195 of distributions in Years 1 and 2 are less than the $200 of earnings and profits generated in those years. The $75 in Year 1 distributions should qualify for the CYEP exception in Prop. Treas. Reg. § 1.385-3(c)(1). The $120 in Year 2 distributions exceed the Year 2 earnings and profits. A rule could be written to allow the first $25 of the $30 distribution in January of Year 2 to qualify for the CYEP exception for Year 1. Coordination rules would then be advisable to address distributions made during the early part of a table year, so that it is clear to which year or years the distributions relate.

As a more limited and less preferable alternative, it would be simpler to provide corporations an election to use CYEP or prior year earnings and profits, to exempt distributions made in a year to the extent of CYEP or the current year's earnings and profits for the immediately preceding year. This would not require any special coordination rules to address the potential for a particular distribution to be matched to earnings and profits of more than one year.

2. Recommendations

- Modify the CYEP exception to allow taxpayers to elect to use CYEP or an entity's earnings and profits of the immediately preceding year. We note that since April 4, some taxpayers may have relied on the proposed regulations to determine the consequences of applying the -3 recharacterization rules. Such taxpayers should be allowed to rely on the proposed regulations' description of the CYEP exception. Accordingly, the Treasury Department and Service should expressly allow taxpayers to apply the proposed regulations' rules for taxable years beginning before the finalization of the -3 rules.

L. Dividends Received Deduction

1. Discussion

A payment of interest on a debt instrument that has been recharacterized as stock under the proposed regulations would be treated as a dividend, to the extent the issuer has current or accumulated earnings and profits. Similarly, most redemptions of a recharacterized debt instrument are expected qualify as a dividend-equivalent redemption under section 302(d) or section 306(a)(2).

In general, a corporation that receives a dividend and that is otherwise subject to tax on its receipt of the dividend is entitled to claim a dividends received deduction under section 243. The U.S. generally employs a classical double taxation system with respect to corporate profits, when corporate income is taxed to the corporation when earned,[111] and is subject to a second tax when distributed to a shareholder.[112] Intercorporate holdings present the possibility that income might be subject to three or more levels of tax; to mitigate, section 243 provides a dividends received deduction.[113] The dividends received deduction is subject to certain minimum holding period requirements and, in measuring this requirements, periods for which the shareholder has a "diminished risk of loss" with respect to the stock are not taken into account.[114] By cross-reference, the holding period rules and restriction for periods of diminished risk of loss also apply in section 901(k) *vis-à-vis* claiming a foreign tax credit for foreign withholding taxes paid on dividends.

In 1994, the Service issued Rev. Rul. 94-28,[115] which would appear to deny taxpayers a dividends received deduction with respect to dividends received on mandatorily redeemable stock when the holder has the rights of a creditor and the instrument is not stock for corporate law purposes but is stock for U.S. federal income tax purposes apparently on the theory that such investment carried a

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[111] Section 11(a).

[112] Section 61(a)(7).

[113] Corporations generally have been permitted to deduct dividends received from other corporations beginning with the enactment of a dividends received deduction. Payne-Aldrich Tariff Act of 1909, ch. 6, § 38, 36 Stat. 11, 112 (1909). *See* Daniel C. Schaffer, *The Income Tax on Intercorporate Dividends*, 30 Tax Law. 161, 163 (1979); Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 5.05 (7th ed. 2000 & Supp. 2015-03).

[114] Section 246(c).

[115] Rev. Rul. 94-28, 1994-1 C.B. 86. *See* Jasper L. Cummings, Jr., *Dividends and Sales of Privately Held Stock – Avoiding the Limitations of Section 246(c)*, 108 J. Tax'n 156 (2008).

"diminished risk of loss." The ruling appears to have been issued with respect to certain types of transactions; the ruling should not be viewed as establishing a general rule nor should it be extended to debt instruments that are recharacterized as stock under the proposed regulations. Whatever tax policy the proposed regulations are intended to achieve would not be furthered by subjecting income earned by an expanded group member to triple taxation, or by denying a foreign tax credit with respect to foreign taxes associated with dividends; similarly, whatever tax policy Rev. Rul. 94-28 was intended to achieve would not be furthered by creating triple taxation or denying foreign tax credits due to a debt instrument's recharacterization as stock.

2. Recommendations

- Expressly provide that ownership of a recharacterized debt instrument is deemed to satisfy section 246(c), such that payment of a dividend can qualify for a dividends received deduction and for foreign tax credits , notwithstanding Rev. Rul. 94-28, and include an example that illustrates this point.

M. Consolidated Groups – Subgrouping Rules

1. Discussion

The proposed regulations that address the interactions with consolidated groups do not contain any subgrouping rules. For example, assume the parent of one consolidated group acquires all of the stock of the parent of another consolidated group, and the target group had multiple intercompany obligations that were disregarded by reason of the consolidated group rules in the proposed regulations. As a result of the acquisition, the target group would terminate, and the intercompany obligations amongst the target group's members would no longer be debt instruments between members of "the" target group, as that term is used in Prop. Treas. Reg. § 1.385-4(b)(1). However, the target group's intercompany obligations would continue to be intercompany obligations, and should continue to be exempted from the proposed regulations. Similar issues could arise when two or more corporations from one group join an acquiring group. The consolidated return regulations that apply to intercompany obligations contain subgrouping rules;[116] the section 385 rules should have similar rules, for similar reasons.

2. Recommendations

- Provide subgroup rules similar to those contained in Treas. Reg. § 1.1502-13(g) that would apply when an issuer and a holder that are part of a consolidated group leave "the" consolidated group and join a different consolidated group, provided the two entities remain in a consolidated group relationship with each other.

N. Documentation, Substantiation, Diligence, and Behavioral Requirements

1. Discussion

[116] Treas. Reg. § 1.1502-13(g)(3)(i)(B)(*8*) (outbound subgroup exception); Treas. Reg. § 1.1502-13(g)(5)(i)(b)(*2*) (inbound subgroup exception).

We have observed a number of issues with respect to the documentation and related requirements, and include additional comments in the Appendix. Overall, we believe that these requirements are overbroad, and would serve little purpose other than to significantly increase costs and legal fees, and encourage external borrowing (which itself would drive up costs and increase economic risks). These requirements illustrate the aphorism that the perfect should not be the enemy of the good.

The appropriate objective seemingly to be achieved by these requirements—clear identification of certain items as indebtedness or as objectively identifying when a debtor-creditor relationship exists as to a particular flow of funds—is largely satisfied today by contemporaneous journal entries. Large corporate taxpayers might not employ perfect documentation, but in almost all cases their actual documentation is practical and sufficient. The reported cases litigated in recent years that involve large corporate enterprises do not involve a complete lack of documentation.[117] Rather, a lack of documentation and other informal conduct inconsistent with debtor-creditor status is largely seen as the hallmark of small taxpayers in the closely held corporation setting,[118] the very ones excused from the scope of the documentation, substantiation, financial diligence, maintenance and behavioral requirements.

The proposed regulations leave the unmistakable impression that certain transactions and related-party debt are simply disfavored. The Treasury Department and Service seemingly are not responding to genuine problems in the documentation and substantiation area with large taxpayers, but rather are seeking to take advantage of an opportunity to discourage certain transactions by imposing as many obstacles and costs as can be justified by any means. In this regard, we note that there is little discussion in the preamble that validates the Treasury Department's and the Service's professed desire to "impose discipline" on taxpayers. There are no evidence-based discussions or findings that justify the imposition of these requirements on large corporate taxpayers, let alone that would tend to establish that the anticipated costs of compliance (and costs of the attendant taxpayer disputes) are justified by the desired tax policy or administrative benefits. We would also note that we expect the costs of compliance to far exceed the estimate published in the *Regulatory Impact Analysis*.[119]

In the related-party context, there is little need to undertake all of the documentary formalities that accompany a bank borrowing, often because the very nature of the related-party relationship provides the creditor with safeguards and remedies that are not available in the unrelated-party context. For example, a bank cannot force its borrowers to undertake certain actions absent contractual requirements or economic compulsion. In the related-party context, a creditor can seek recourse to

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[117] *See Schering Plough v. United States*, 651 F.Supp.2d 219 (D. N.J. 2009), *aff'd sub nom. Merck & Co. Inc. v. United States*, 542 F.3d 475 (3d. Cir. 2011); *Hewlett-Packard Co. v. Commissioner*, T.C. Memo. 2012-135; *NA General Partnership v. Commissioner (Scottish Power)*, T.C. Memo. 2012-172; *PepsiCo Puerto Rico, Inc. v. Commissioner*, T.C. Memo. 2012-269.

[118] *See DF Systems, Inc. v. Commissioner*, 548 Fed. Appx. 247 (5th Cir. 2013) (unpublished); *Ramig v. Commissioner*, T.C. Memo. 2011-147, *aff'd*, 496 Fed. Appx. 756 (9th Cir. 2012) (unpublished); *Hubert Enterprises, Inc. v. Commissioner*, 125 T.C. 72 (2007), *aff'd in part, vacated in part*, 230 Fed. Appx. 526 (6th Cir. 2007) (unpublished).

[119] We note that other commenters have written that the estimate of the compliance costs woefully understates the actual costs that the documentation and substantiation requirements of the proposed regulations would impose. See the comment letters from the Business Roundtable (June 7, 2016) and the United States Council for International Business (June 7, 2016).

management to force actions by the debtor. Additionally, in the unrelated borrowing context, long, detailed, and complex documentation often is put in place to cover a wide swath of potential yet quite remote contingencies, to ensure that no possible course of action or occurrence is left unaddressed by contractual provisions. The calculus is quite different in the related-party context. For obvious reasons, related-party lending transactions are not often accompanied with long-form documentation addressing all known contingencies. Such documentation would serve little if any purpose other than to drive up internal costs and complexities without any corresponding benefit, and cost savings is one of the key drivers for routine internal borrowing within a large corporate group.

The requirement to document financial metrics and capacity to pay every time there are drawdowns of facilities and incurrences of indebtedness pursuant to pooling and treasury functions is administratively excessive, and should be changed. This is not done in the context of bank borrowing facilities, nor in the context of letters of credit with unrelated lenders. This is also not done each time the holder of a credit card incurs a charge. In those contexts, the financial diligence is performed up front. Why is this heightened requirement suddenly reasonable or appropriate in the related-party context?

The requirement to document action in the capacity of a creditor in the event of default goes beyond documentation and creates significant substantive problems. While it is true that qualification as intercompany debt requires the intent to create a bona fide creditor relationship, it is also obvious that intercompany creditors will take broader interests into account in deciding whether and how to pursue creditor remedies in the event of default, given their overlapping equity interests. In addition, the requirement to act with the same judgment that an unrelated creditor would have could cause intercompany creditors to exercise remedies that could trigger cross-defaults with respect to outside lending, and drive corporations into bankruptcy.

As the U.S. Court of Appeals for the Second Circuit has stated:

> [I]t is one thing to say that transactions between affiliates should be carefully scrutinized and sham transactions disregarded, and quite a different thing to say that a genuine transaction affecting legal relations should be disregarded for tax purposes merely because it is a transaction between affiliated corporations. We think that to strike down a genuine transaction because of the parent-subsidiary relation would violate the scheme of the statute and depart from the rules of law heretofore governing intercompany transactions.[120]

What the court said 60 years ago is equally perspicuous and proper today. When the parties have a genuine intent to enter into a debtor-creditor arrangement, memorialize the arrangement with reasonable and objective manner, and engage in conduct that is reasonable under the particular circumstances, the debt characterization of the underlying instrument should not be upset. The standard in the proposed regulations as to the parties' conduct should be articulated with reference to what is reasonable under the circumstances. Stated differently, the documentation standard should not be to emulate the behavior of an unrelated creditor, but rather to act with the diligence and judgment of a creditor in similar circumstances.

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[120] *Kraft Foods Co. v. Commissioner*, 232 F.2d 118, 124 (2d. Cir. 1956).

2. Recommendations

- Eliminate the requirement to document actions taken as a creditor in the event of a default attributable to financial distress. As noted above, given related-party status, such an expectation is not realistic and any documentation is likely to be inadequate or mendacious.

- We have made a number of additional recommendations in the Appendix.

O. Controlled Partnerships and the Aggregate Rule

1. Discussion

Prop. Treas. Reg. § 1.385-3(d)(5) provides that a controlled partnership within the meaning of Prop. Treas. Reg. § 1.385-1(b)(1) is treated as an aggregate of its partners for purposes of Prop. Treas. Reg. § 1.385-3. Further, each EG partner within the meaning of Prop. Treas. Reg. § 1.385-3(f)(7) of a controlled partnership is treated as holding its "proportionate share" of the controlled partnership's assets and issuing its "proportionate share" of any debt instrument issued by the controlled partnership. The proposed regulations would determine an EG partner's proportionate share for these purposes "in accordance with [the EG partner's] share of partnership profits."[121]

The proposed regulations do not define "partnership profits" or provide any guidance on how to determine an EG partner's share of partnership profits. A partner's share of partnership profits is a vague measurement standard with no single answer, except perhaps in a "straight up" partnership where all items of income, gain, loss and deduction are allocated strictly in accordance with capital percentages. Without additional guidance, any deviation from the simplest partnership sharing arrangement would cause uncertainty in the application of the proposed regulations. For example, if a partnership agreement contains special allocations of particular items or a preferred return, there would be multiple potential computations of a partner's share of the partnership's overall profits.[122]

We also note that the proposed regulations do not provide guidance with respect to <u>when</u> a partner's "proportionate share" is to be determined. A partner's share of partnership profits or capital can vary dramatically over the life of a partnership and raises another significant area of uncertainty with regard to the application of these rules to an EG.

As noted previously in this comment letter, because the application of the proposed regulations to an EG would cause significant and far reaching adverse tax consequences and financial reporting concerns, it is imperative that the triggers for application of these rules be absolutely clear.

We also recommend that the final regulations clarify the extent of the application of the funding rule under Prop. Treas. Reg. § 1.385-3(b)(3) when an EG partner issues an applicable instrument to a controlled partnership or holds an applicable instrument issued by a controlled partnership that may be subject to recharacterization under Prop. Treas. Reg. § 1.385-3. To the extent the aggregate treatment

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[121] Prop. Treas. Reg. § 1.385-3(d)(5)(i).

[122] A well-known article on this topic concludes that there are up to 25 different ways to calculate a partner's share of profits. *See* Sheldon I. Banoff, *Identifying Partners' Interests in Profits and Capital: Uncertainties, Opportunities and Traps*, 85 Taxes 197, 209 (2007).

of controlled partnerships results in a partner that is both the deemed lender and issuer of an applicable instrument, we believe the applicable instrument should not be subject to the proposed regulations.

> Example. X and Y are corporations that are members of an EG and each owns a 50 percent interest in PRS, a partnership for U.S. tax purposes. Assume that X's and Y's proportionate share of the PRS is 50 percent for purposes of Prop. Treas. Reg. § 1.385-3. X issues an applicable instrument to PRS, and X makes a distribution to its corporate parent within 36 months of issuing the applicable instrument.

Under the aggregate rule of the proposed regulations, each of X and Y are treated as holding 50% of the applicable instrument issued by X. Accordingly, with respect to 50% of the applicable instrument, X is both the issuer and the holder. Under these facts, 50% of the applicable instrument should be disregarded as a single person cannot be the holder and issuer of the same debt instrument; at the very least, 50% of the applicable instrument should not be subject to recast as equity under Prop. Treas. Reg. § 1.385-3. Similarly, if PRS issues an applicable instrument to X, to the extent the aggregate treatment of PRS results in X being both the holder and issuer of 50 percent of the applicable instrument, the proposed regulations should not apply to recast that portion of the applicable instrument.

One further observation. At the "35,000 foot level," the aggregate rule would overlay one *counter-factual* abstraction on top of a second *counter-factual* abstraction—the partnership is a legal entity that is engaged in particular transactions (which would be attributed to the partners in some manner), and a debt instrument that is recharacterized under the general or funding rules will be a debt instrument that satisfies the documentation rules, and thus has terms typical of debt instruments (rather than equity-like terms). We explore some additional issues regarding the aggregate rule in the attached Appendix.

2. Recommendation

- As noted above, we recommend that the regulations, if and when finalized, apply solely to debt instruments issued by corporations, and that debt instruments issued by partnerships be wholly exempt.

- The final regulations should provide a specific method for determining a partner's share of partnership profits for purposes of Prop. Treas. Reg. § 1.385-3; or allow taxpayers to apply an alternative measurement (such as a partner's "proportionate share" in the partnership's capital).

- For purposes of Prop. Treas. Reg. § 1.385-3, a partner's "proportionate share" should be determined at the time a controlled partnership issues an applicable instrument to an EG member or an EG member issues an applicable instrument to a controlled partnership. If the Treasury Department and Service are concerned that partnership interests might be changed shortly before or after a debt instrument is issued (*i.e.*, within one year) with a principal purpose to manipulate the section 385 rules, an anti-abuse rule could be written. Such a rule should allow taxpayers to establish, where warranted under the facts, that change was not motivated with such a principal purpose.

- The final regulations should clarify that, to the extent the aggregate treatment of a partnership results in a partner being deemed to be both the issuer and holder of an applicable instrument, the applicable instrument should not be subject to recharacterization as equity.

P. The Bifurcation Rule

1. Discussion

The intended scope of the bifurcation rule is unclear. The only example in the proposal is one in which there is an expectation that 60 percent of a debt can be repaid, and that the other 40 percent won't be repaid. In such a case, existing authorities would entirely deny treatment as debt. The proposed rule seemingly allows the government to treat the instrument as debt in part, but because the rule can only be asserted by the government, it is difficult to conceive of when such favorable treatment would occur.

Apart from the circumstance where it is expected that only a portion of the debt can be repaid, it is questionable that the rule would ever be relevant, unless the government proposes to alter the longstanding treatment of instruments like convertible debt. If such alteration is desired, the rule should be narrowly tailored to such instruments. Finalization of the current proposal would simply create irreducible, inherent uncertainty as to the characterization of financial instruments other than straight nonconvertible debt.

The ongoing treatment of instruments bifurcated by either the bifurcation rule or the recast rule would be unmanageable. Either, it would be unclear whether repayments are treated as payments on the debt or equity components, or an ordering rule would create the need for extensive additional rules to prevent circumvention of the ordering rule. These issues are discussed in the Appendix.

Because an individual can be a member of a modified expanded group, the rules could in theory require treatment of debt as equity in individuals—clearly an absurd result. Moreover, the result of treating natural persons as modified expanded group members combined with the invocation of the section 318 constructive ownership rules could result in applying the bifurcation rule to a debt instrument issued by one natural person and held by a related natural person. All that would be required is that one person be treated as a member of a modified expanded group, after which all natural persons related to the first person under section 318 themselves could become members of the modified expanded group.[123]

In addition, there are certain statutory rules—like section 636(a) - that require instruments to be treated as debt. The bifurcation rule, as well as other rules in the package, would create reams of similarly unanswerable collateral questions and distortions, hardly a proper policy to implant into a rule that might potentially apply to a large number of taxpayers. [124]

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[123] If individual A directly or indirectly owns 50 percent or more of the stock in two or more corporations, A is a member of the modified expanded group that includes both corporations, as is A's spouse, children, grandchildren, and parents (each of whom would be treated as owning the stock owned by A, by reason of section 318(a)(1)(A)). We observe that section 318(a)(5)(B) provides a limited exception to the section 318(a)(5)(A) reattribution rule, so that stock constructively owned by a member of A's family under would not be further reattributed to other members of A's family; thus, a spouse of one of A's children would not be included in the modified expanded group.

[124] Amy S. Elliott, *Debt-Equity Regs Could Apply to Millions of Closely Held Corps*, 2016 Tax Notes Today 113-2 (June 13, 2016).

2. Recommendation

- Withdraw the bifurcation rule. Alternatively, the rule should be modified consistent with our comments in the Appendix.

Q. Bilateral Tax Treaties

1. Discussion

The proposed regulations would cause collateral effects with respect to international agreements memorialized in bilateral tax treaties. Some of these issues are the subject of the comments of a recent Treasury Department official.[125]

First, we observe that the statutory language of section 385(a) provides for the treatment of an instrument as stock or debt for purposes of the Code ("this title," *i.e.*, Title 26 of the United States Code). The language does not expressly authorize or contemplate regulations that could affect the treatment of a debt instrument for purposes of bilateral tax treaties between the U.S. and certain of our trading partners. Second, we observe that the term "stock" generally is left undefined in U.S. tax treaties, and the U.S. tax characterization of a debt instrument as stock generally can determine the application of treaties to income from U.S. sources.

We would expect the proposed regulations to result in collateral consequences in the treaty area in two ways—qualification for treaty benefits (*i.e.*, does an entity qualify for a benefit under the treaty), and which treaty benefits are implicated (*i.e.*, the applicable withholding rate).

A recharacterized debt instrument could affect whether a treaty resident meets an ownership requirement under an applicable limitation on benefits ("LOB") provision, particularly under future treaties that follow the recently proposed U.S. model treaty (the "Proposed Model Treaty"). Most current U.S. income tax treaties contain LOB articles with provisions requiring various levels of stock ownership to be satisfied with respect to corporate residents. Broadly, the "publicly traded subsidiary" tests generally require that qualifying ownership exist at each intermediate owner level but "derivative benefits" and "ownership/base erosion" tests generally do not.[126] The tests that look at "qualified" intermediate ownership are more likely to be affected by the proposed regulations. The Proposed Model Treaty would require intermediate owners to be "qualifying intermediate owners" for purposes of the subsidiary of a publicly traded test, the ownership / base erosion test, and the derivative benefits test.

Example. UKCo, a publicly traded UK corporation, owns all of the stock of UKSub1 and FSub, a Cayman corporation; UKSub has for more than 12 months owned all of the stock of USP, a

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[125] Robert H. Dilworth, *U.K. Treaty Conflict: Unintended (?) Consequences of the U.S. Debt-Equity Regulations*, 82 Tax Notes Int'l 975 (June 6, 2016).

[126] *Compare, e.g.,* U.S.-U.K. Income Tax Treaty, art. 23(2)(c)(ii) (requiring that at least 50 percent of the aggregate vote and value of the shares in the company be owned directly or indirectly by five or fewer companies that are qualified residents because they are publicly traded and, in the case of indirect ownership, requiring *each intermediary company* to be a resident of either the U.S. or the U.K.), *with* U.S.-U.K. Income Tax Treaty, art. 23(2)(f) (ownership / base erosion test). Examples of other U.S. treaties that require intermediate owners to be "qualified" under the publicly traded test: Australia, Canada, France, Germany, and the Netherlands.

domestic corporation. In Year 4, UKSub1 issues a debt instrument to FSub, and uses the borrowed funds for corporate purposes (perhaps to fund growth organically or through acquisitions). The UKSub debt instrument is a meticulously documented, 10-year instrument with customary debt provisions, and its value exceeds the value of UKSub1's actual stock. During Years 1 and 2, however, UKSub had made distributions to UKCo (or had purchased stock of UKCo subsidiaries), and as a result the funding rule would operate to recharacterize the UKSub debt instrument as stock upon its issuance. In Year 10, while the UKSub-FSub debt instrument remains outstanding, USP distributes money to UKSub as a dividend distribution. Assume that USP has not issued any related-party debt instruments.

The USP dividend distribution does not implicate any of the concerns underlying the proposed regulations—it is a straightforward, un-"funded" distribution of money—and the proposed regulations would have no direct application to the distribution. The UKSub debt instrument does not implicate any of the concerns underlying the proposed regulations, because it is a wholly-intra-UK transaction that has no direct U.S. tax effects. However, the proposed regulations would have a collateral effect on the distribution; the funding rule would recharacterize the UKSub debt instrument, with the result that UKSub would be treated as majority-owned by FSub—not UKCo. The consequence of this is that the USP dividend would be subject to the 30% statutory rate under section 881(a), because UKSub might not be treated as a qualified UK resident and might be ineligible for a treaty benefit.[127]

The proposed regulations also would potentially affect the treaty rate applicable to a payment of interest on a recharacterized debt instrument.

Example. UKCo, a publicly traded UK corporation, owns UKSub and USP. In Year 1, USP issues a debt instrument to UKSub in exchange for funds used by USP for corporate purposes (perhaps to expand USP's business organically or through the acquisition of a U.S. target corporation). The USP debt instrument has customary debt terms, confers no voting rights, and satisfies the relevant documentation requirements. USP business prospers and UKCo requires money for its business operations, and UKCo causes USP to make a dividend distribution to it in Year 3 in an amount in excess of USP's current year earnings and profits. As a result, the USP debt instrument issued to UKSub is recharacterized as stock under the funding rule. USP timely pays all interest and principal due on the recharacterized debt instrument, which is retired in Year 6.

UKCo should be entitled to claim a zero treaty rate benefit for the Year 3 dividend distribution, because it owns all of the USP stock that has been issued (including 100% of the voting power), and it has owned the stock for more than 12 months at the time of the Year 3 USP distribution.[128] But what rate would apply when USP transfers money to UKSub to pay interest[129] and principal on the

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[127] Generally, treaties would allow a subsidiary such as UKSub to be a qualified resident if a recharacterized debt instrument does not represent 50% or more of the subsidiary's value. However, a class of stock owned by a non-qualifying intermediate owner (such as FSub) appears to disqualify UKSub from qualifying as a subsidiary of a publicly traded corporation even if the recharacterized debt instrument represents less than 50% of UKSub's value. *See* Dep't of the Treasury, Technical Explanation of the U.S.-U.K. Income Tax Treaty, art. 23 (Mar. 5, 2003) (the subsidiary of a publicly traded entity test requires that 50% of *each class of stock* be owned by qualifying owners).

[128] U.S.-U.K. Income Tax Treaty, art. 10(1).

[129] The treaty defines "interest" as "income from debt-claims of every kind…." U.S.-U.K. Income Tax Treaty, art. 11(2). The proposed regulations would appear to effectively override this definition.

recharacterized debt instrument, which the proposed regulations would treat as dividends (including as a dividend equivalent redemption)? The 15% treaty rate would appear applicable, because UKSub does not own any voting stock in USP (a prerequisite for the 5% rate).

The foregoing discussion has focused on the treatment of payments of interest on debt instruments, where the debt instruments have been recharacterized as equity. Next, consider that the repayment of the principal on a recharacterized debt instrument, perhaps in most cases, would be treated as a dividend-equivalent redemption, even where the debt instrument is in form a straightforward promissory note with no equity-like terms or features. This invokes the prospect of imposing a withholding tax on a remittance of principal amounts, surely not what our trading partners might have contemplated when negotiating a treaty with our nation's negotiators.

We do not believe that the results in these examples are appropriate, or are even necessary to achieve the policies underlying the proposed regulations. However, we recognize that there are competing considerations, which upon further reflection illustrate the lack of wisdom underlying the proposed regulations. If the Treasury Department and Service revise the proposed regulations so that the debt instruments in the examples above retain their debt characterization for treaty purposes, the result would be to exacerbate the favoritism that the rules in the proposed regulations show toward inbound investment (over domestic investors). These issues demand greater consideration, and the Treasury Department should ensure that its policy decisions are well articulated in the preamble so that taxpayers can understand the decisions that are being made, and why the Treasury Department believes those decisions are appropriate.

2. Recommendations

- We recommend that the proposed regulations not apply to recharacterize the debt status of any debt instrument, unless and until the Treasury Department and Service thoroughly study the issue and come to some informed determination as to the wisdom of such an approach (and the implications for our treaty network). If the Treasury Department and Service intend to override the tax treaties and to have debt instruments be recharacterized as stock for treaty purposes (and not only for purposes of the Code), the preamble should clarify the intent, should articulate what tax policy choices mandate such a result, and should discuss why it is appropriate for the proposed regulations to override the policies underlying tax treaties. If the Treasury Department and Service intend to exempt inbound debt instruments, the preamble should similarly clarify the intent, articulate what tax policy choices mandate such a result, and discuss why it is appropriate to exempt debt instruments issued in the inbound investment context but not extend a similar exemption for domestic investors.

R. Validity of the Recast Rules

1. Discussion

In our view, the proposed regulations exceed the boundaries of the Congressional grant of regulatory authority in section 385. The proposed regulations do not seek to delineate a general debt-equity distinction or to clarify or rationalize debt-equity analysis; rather, the proposed regulations were issued with the specific intent to *alter* current substantive law and to deter certain specific transactions that are otherwise clearly permitted under current law and that have been approved by courts.

Congress, in articulating the grant of regulatory authority in section 385, specifically referred to "factors" to be "taken into account"; not "conditions" that are "determinative." However, the approach taken in the proposed regulations would *legislate* a series of *ipso facto* rules to disallow debt characterization to a related-party debt instrument.

Section 385 originated in the Senate Finance Committee's version of the Tax Reform Act of 1969. The Senate Finance Committee's report states:

> In view of the uncertainties and difficulties which the distinction between debt and equity has produced in numerous situations other than those involving corporate acquisitions, the committee further believes that it would be desirable to provide rules for distinguishing debt from equity in the variety of contexts in which this problem can arise. The differing circumstances which characterize these situations, however, would make it difficult for the committee to provide comprehensive and specific statutory rules of universal and equal applicability. In view of this, the committee believes it is appropriate to specifically authorize the Secretary of the Treasury to prescribe the appropriate rules for distinguishing debt from equity in these different situations.[130]

The Senate Finance Committee thus included a provision to grant specific statutory authority to promulgate regulatory guidelines for determining whether a corporate obligation constitutes stock or indebtedness. The Senate Finance Committee report explained:

> The provision specifies that these guidelines are to set forth factors to be taken into account in determining, with respect to a particular factual situation, whether a debtor-creditor relationship exists or whether a corporation-shareholder relationship exists.[131]

The Conference Committee accepted the Senate proposal, and section 385 was enacted into law.[132]

The text of section 385(a) authorizes Treasury Department to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated as indebtedness or equity. Section 385(b), enacted at the same time as section 385(a), provides:

> The regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists.

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[130] S. Rep. No. 91-552, at 138 (1969). The House bill had included a more limited provision addressing certain corporate acquisition indebtedness, which was enacted as part of the bill and is now codified in section 279.

[131] *Id*. The Conference Report simply noted that the conference substitute followed the Senate amendment. H.R. Conf. Rep. 91-782, at 308-309 (1969).

[132] Tax Reform Act of 1969, Pub. L. No. 91-172, § 415(a), 83 Stat. 487, 613-614. Section 385 has been amended three times. *See* Tax Reform Act of 1976, Pub. L. No. 94-455, § 1906(b)(13)(A), 90 Stat 1719, 1834 (a clerical amendment replacing "Secretary or his delegate" with "Secretary"); Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7208, 103 Stat. 2106, 2337 (inserting parenthetical language in section 385(a) to authorize prospective regulations to treat certain corporate interests as in part stock and in part indebtedness); and Energy Policy Act of 1992, Pub. L. No. 102-486, § 1936(a), 106 Stat. 2776, 3032 (adding section 385(c)).

Not surprisingly, this statutory language closely mirrors the Senate Finance Committee's instructions in its report. Similarly, the Joint Committee on Taxation's "Bluebook" explanation of the provision also mirrors this factor-centric approach, stating that the provision provides Treasury Department:

> . . . with specific statutory authority to promulgate regulatory guidelines, to the extent necessary or appropriate, for determining whether a corporate obligation constitutes stock or indebtedness for all purposes of the Internal Revenue Code. These guidelines are to set forth factors to be taken into account in determining in a particular factual situation whether a debtor-creditor relationship exists or whether a corporation-shareholder relationship exists.[133]

The Section 385 regulatory grant of authority refers to "regulations [that] shall set forth factors to be taken into account" (emphasis added). The statutory language, Senate Finance Committee report, and Joint Committee on Taxation Explanation are quite consistent. Collectively, they contemplate regulations that would improve upon the case authorities, drive more uniformity, and provide a series of generally applicable rules to distinguish indebtedness from equity.

This language does not grant the Treasury Department the ability to combat perceived tax abuse that might involve a debt instrument or related-party indebtedness. Nor does it allow Treasury to legislate a series of *per se* rules with respect to certain underlying transactions. Likewise, it does not authorize Treasury to "equitize" what is, in substance, a debt instrument simply because the instrument was issued to a related-party and that related-party happened to have implemented a disfavored transaction within a six-year period surrounding the issuance of the debt instrument (or because a taxpayer happened to distribute a debt instrument rather than – as in the *Falkoff* case –borrow funds from a bank and distribute those funds).[134] The Treasury Department's decision that a related-party debt instrument is equity raises even more concerns in that (i) it completely disregards whether the debt instrument would unambiguously qualify as indebtedness under historic and current law, (ii) a debt instrument issued to an unrelated-party on the same day with identical terms could be respected as debt, and (iii) the rules do not even consider whether the instrument has a factual nexus with the disfavored transaction.

Once an issuer would have satisfied the documentation and substantiation requirements of Prop. Treas. Reg. § 1.385-2, the general and funding rules of Prop. Treas. Reg. § 1.385-3 would come into play, including the *per se* rule's "irrebuttable presumption." These rules do not list factors, nor articulate how various factors are to weighted, analyzed, or ultimately balanced. These rules do not purport to distinguish indebtedness from equity based on any intent to repay, any ability to repay, or any other characteristic that historically has been relevant in the debt-equity case law (apart from being issued in a related-party context). In fact, in the related-party context only the proposed regulations ignore the factors typically relevant to a good-faith debt-equity determination. Rather, two points would control – is the debt instrument held by a related-party, and has there been some disfavored transaction at some point during a 72-month period (a distribution, a related-party reorganization or related-party stock sale, etc.), regardless of any factual or other connection between the debt issuance and the disfavored

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[133] Joint Comm. on Internal Revenue Tax'n, *General Explanation of the Tax Reform Act of 1969*, *JCS-16-70,* at 123 (1970).

[134] *Falkoff v. Commissioner*, 604 F.2d 1045 (7th Cir. 1979).

transaction. Under these rules, the credit quality of a debt instrument or its issuer is simply not relevant, nor is the intent or conduct of any of the parties. The proposed regulations could, in the related-party context, for example, disregard one hundred pages of documentation and a perfected purchase-money security interest that over-collateralizes a debt. The proposed regulations ignore the connection, or lack thereof, between the debt and the disfavored transaction and prohibit any attempt to trace the debt proceeds to a specific use.[135] The Congress that enacted section 385 in 1969 intended to provide a broad grant of regulatory authority to address the debt-equity conundrum. However, it did not contemplate regulations that would disregard the debt-equity conundrum in its entirety and instead be used as a tool to attack particular transactions – many of which were already "old hat" at that time.[136]

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[135] As to the latter point, we note that similar "no-tracing" methodologies are used in narrow contexts, for compelling reasons, and only when the no-tracing rules would have a quite limited effect. For example, a no-tracing rule is used in the corporate equity reduction transaction (or CERT) context. However, that rule was adopted per Congress' specific direction that in computing a corporate equity reduction interest loss, a strict avoided cost methodology would apply. Section 172(g)(2)(B). In addition, the CERT rules have a narrow application, only serving to preclude taxpayers from carrying back certain interest-deduction-fueled net operating losses to prior taxable years (taxpayers remain able to use those deductions currently and to carry over interest deduction-fueled losses to offset income in future taxable years). Similarly, an approach that rejects tracing was promulgated as part of the current Unified Loss Rule (ULR), Treas. Reg. § 1.1502-36. However, the ULR regime is a rule with limited application, in that it applies on a loss limitation model, and only seeks to (i) disallow losses that result from noneconomic basis adjustments otherwise enabled by the consolidated return regulations, and (ii) prevent the duplication or multiplication of a single economic loss. Neither the CERT rule nor the ULR rule has the potential to apply to nearly as many taxpayers or as many transactions as would the proposed regulations.

[136] For example, in the "leveraged distribution" context, the corporation in *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946) issued and distributed its debt instruments in 1937, the corporation in *Bazley v. Commissioner*, 331 U.S. 737 (1947) issued and distributed its debt instruments in 1939, and the taxpayer in *Kraft Foods Co. v. Commissioner*, 232 F.2d 118 (2d. Cir. 1956) issued and distributed its debt instruments beginning in 1934. Note or "open account" distributions were at issue in the income and excess profits cases of *Logan-Gregg Hardware Co. v. Heiner*, 26 F.2d 131 (W.D. Pa. 1928) (note distributions made in 1918) and *Weed & Bro. v. United States*, 38 F.2d 935 (Ct. Cl. 1930) (distributions were credited in 1919 to the accounts of shareholders, who were free to draw upon at accounts at any time). In each of these cases, the underlying debt instruments (or journal entries) were issued – and the cases were decided – years before the 1969 enactment of section 385. As for tax planning around the timing of a distribution and the particular pool of earnings and profits from which a distribution is made, multiple statutory amendments and Supreme Court cases from the 1910s and 1920s evidence that Congress was exquisitely aware of the issue during the infancy of the income tax laws, as can be seen from the discussion in *Edwards v. Douglas*, 269 U.S. 204 (1925). For example, the combined income, surtax and excess profits tax rates applicable to dividends ranged from 0% (for distributions of pre-1913 earnings and profits) to 67% (for distributions of earnings and profits generated in 1917).

Congress was aware that taxpayers might seek to time corporate distributions to take advantage of a temporary absence of earnings and profits, when it enacted section 312(i) in response to the decision in *Commissioner v. Gross*, 236 F.2d 612 (2d. Cir. 1956). At the time Congress codified the *General Utilities* doctrine in 1954, it was well-understood that a corporation with no earnings and profits could distribute appreciated assets without recognizing gain, without generating earnings and profits, and without having the shareholder receiving the distribution be liable for a dividend tax. Randolph E. Paul, *Ascertainment of 'Earnings or Profits' for the Purpose of Determining Taxability of Corporate Distributions*, 51 Harv.L.Rev. 40, 51-61 (1937); Leonard Raum, *Dividends in Kind: Their Tax Aspects*, 63 Harv.L.Rev. 593 (1950); *Commissioner v. Timkin*, 141 F.2d 625, 630 (6th Cir. 1944); *Gross*, 236 F.2d at 616 (describing the issue as "familiar"). Nothing in the legislative history suggests Congress had these issues in mind when it enacted section 385. To the contrary, it is fair to infer that Congress knows precisely how to amend substantive tax law (which it did in enacting section 312(i)) when it does not like the substantive results from tax planning, and the fact that Congress has not done so – especially given the Treasury Department's energetic insistence in multiple proposals – is not some implicit authorization for the Treasury Department to bypass

In fact, the legislative history underlying the 2010 codification of the economic substance doctrine shows Congressional awareness with customary debt-equity tax planning. The Joint Committee on Taxation, in explaining the provision that was enacted as section 7701(o), stated:

> The provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Among these basic transactions are (1) the choice between capitalizing a business enterprise with debt or equity; (2) a person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and (4) the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied.[137]

This – in the very context of codification of the economic substance doctrine – is further evidence that Congress has been well aware of – and has been comfortable with – taxpayers capitalizing subsidiaries with a mix of debt and equity, and using related-party indebtedness.

The proposed regulations do not attempt generally to distinguish debt from equity based on any characterization other than the relationship of the borrowing and lender. Rather, the proposed regulations address transactions that do not raise issues with respect to whether arrangements in substance are debt or equity, which is the focus of section 385. It is clear that the Treasury Department has concerns with taxpayers' efforts to rely upon the statutorily prescribed rules in section 356(a)(2), or in section 304(a)(1), depending on which provision might yield better results. Thus, the Treasury Department has repeatedly proposed legislative changes that seek to harmonize the two sets of rules.[138] Similarly, the Treasury Department has concerns with taxpayers' use of the bedrock annual accounting period of U.S. federal income tax law[139] to time distributions so as to qualify for return-of-basis

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Congressional inaction. In this regard, we observe that as discussed elsewhere in our comments, Congress specifically amended the Code to address the effect of a corporation's distribution of its own discounted debt instruments. *See* sections 312(a)(2) and 1275(a)(4). Congress is aware that corporations can distribute their debt instruments, and it has never decided to outlaw this practice. The Treasury Department cannot credibly claim that its proscribing note distributions in the proposed regulations would faithfully further the purposes of the Congress that enacted section 385.

[137] Joint Comm. on Tax'n, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act," JCX-18-10, at 152-153 (Mar. 21, 2010) (citations omitted) (emphasis added).

[138] *See* Dep't of the Treasury, General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals, 114-116 (2016). The section 356(a)(2) issue is well known, and has even given rise to an exhaustive treatment in the tax literature. *See* Michael L. Schler, *Rebooting Section 356: Part 1 – The Statute*, 128 Tax Notes 285 (July 19, 2010). This hardly is some new-found awareness – the House of Representatives proposed repealing it in 1954, and it was repeatedly the subject of proposals to Congress including proposals by the Staff of the Senate Finance Committee and the Joint Committee on Taxation. *Id.* at 289; Jasper L. Cummings, Jr., *Form vs. Substance in the Treatment of Taxable Corporate Distributions*, 85 Taxes 119, 155 n.123 (2007). *See also* Walter J. Blum, *The Earning and Profits Limitation on Dividend Income: A Reappraisal*, 53 Taxes 68, 80 n.17 (1975).

[139] *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931).

treatment (*i.e.*, so-called *Falkoff*[140] planning),[141] or "earnings-stripping" (or "debt-pushdown") transactions by foreign-parented U.S. corporations. Thus, the Treasury Department has proposed legislative changes addressing these kinds of transactions.[142] In this same vein, Congress repeatedly has been urged to "tighten" the earnings stripping rules of section 163(j),[143] to repeal the "boot within gain" limitation of section 356(a)(2), and to remove selling corporations from the ambit of section 304.[144] These proposals have been made by Republican and Democratic Administrations alike. Yet, multiple Congresses – Democratic, Republican, and split – have chosen not to enact such legislation. Similarly, it is clear that the Treasury Department has concerns with inversions (and has issued multiple rounds of guidance designed to discourage these transactions and implement the rules of section 7874 and other

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[140] *Falkoff v. Commissioner*, 604 F.2d 1045 (7th Cir. 1979). *See also Kraft Foods Co. v. Commissioner*, 232 F.2d 118 (2nd Cir. 1956).

[141] As early as 1956, Professor Andrews concluded that "[t]he requirement that a distribution, to be taxed as ordinary income, must be out of earnings and profits has outlived its usefulness" William D. Andrews, *"Out of its Earnings and Profits": Some Reflections on the Taxation of Dividends*, 69 Harv. L. Rev. 1403, 1438 (1956). Professor Andrews was neither the first nor the last person to call for repealing the earnings and profits limitation on dividends; however, the limitation endures, notwithstanding multiple suggestions that Congress repeal it. As noted by the Seventh Circuit in *Falkoff*, 604 F.2d at 1051-1052:

> The Commissioner, of course, has argued that to reverse the Tax Court's judgment would permit taxpayers to determine for themselves the time and manner of taxation, in frustration of Congressional directive and with prejudice to the federal fisc. We think our decision here will have no such dire consequence. Congress in enacting the revenue code adopted the annual accounting concept and permitted the wholly-owned corporation to be treated as an entity separate from the shareholder. We believe the taxpayers here did no more than use these characteristics of the tax system to their best advantage. The situation here is an unusual one a corporation without accrued or current earnings and profits but with substantial assets against which it can borrow to make a cash distribution to its shareholders. Yet, even here the effect is only to delay, not escape, taxation. A distribution reduces a shareholder's basis in his shares and thereby increases taxable gain upon disposition of the stock. The Corporation's future earnings and profits will be taxed as dividends when distributed.

[142] *See* Dep't of the Treasury, General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals, 2-4, 114-116 (2016); Dep't of the Treasury, Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties (Nov. 2007).

[143] *See* Department of the Treasury, General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals, 104-106 (2003). Similar proposals have been included in a number of subsequent budget proposals under Presidents Bush and Obama.

[144] *See* David H. Brockway, *Section 304 is Very Strange*, Tax Forum No. 517, *reprinted in* 76 Tax Notes 189 (July 14, 1997). *See also* Boris Bittker & James Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 9.09[1] (7th ed. 2015) ("[S]ection 304 itself rests on a fiction and in turn employs other fictions and minutiae. . ., a fantasia surprising even for the fiction-happy tax law. Like other dividend-versus-sale rules, it has generally been used by corporations to obtain dividend treatment and avoided by individuals seeking capital gains. What started out as a modest anti–dividend avoidance rule has grown into a considerable monster."); Tax Section, N.Y. State Bar Ass'n, Report No. 716, Report on Section 304(b)(4), at 3 (1992) ("Viewed with the modern eye, the concerns that section 304 addresses seem to some degree exaggerated, and the statute itself a kind of antique musketry, as likely to backfire on the fisc as to hit any intended taxpayer target."); *id*. at 5 ("If the anti-bailout policies of section 304 have elements of anachronism as applied to individual shareholders, the statute's application to a selling corporate shareholder has been a puzzle since its enactment…. For corporate shareholders, section 304 has thus commonly served not as a sanction but as a planning tool, throwing the taxpayer into a briar patch of dividend treatment.").

provisions[145]), yet Congress has chosen not to act in the manner the Treasury Department has recommended. Substantive rules like those at issue here fall within the purview of Congress, which is the proper forum for promulgation of rules like those included in the proposed regulations. This is particularly so in light of their scope, the underlying legislative provisions and their histories, and the importance of the tax policies involved.

The Treasury Department's concerns with certain transactions do not justify or sanction the results-oriented approach employed by, or the extraordinary scope of, the proposed regulations. Congress, in delegating regulation-writing authority to the Treasury Department to provide for factors, clearly intended a factor-based approach which would have built upon and hopefully improved the long-standing problem in the tax law of drawing an appropriate distinction between debt and equity.

The debt-equity distinction is a fundamental one that predates our Nation's modern income tax law.[146] For many years, taxpayers have carefully structured their arrangements in ways to qualify as indebtedness,[147] and the courts have often – though not always – upheld the taxpayers' characterizations.[148] The courts have also recognized that corporations that engage in business activity have a tax identity separate from their shareholders.[149] Congress too recognizes this principle, which is bedrock upon which the direct taxation of corporate income rests.[150] As the Second Circuit Court of Appeals has stated:

> [I]t is one thing to say that transactions between affiliates should be carefully scrutinized and sham transactions disregarded, and quite a different thing to say that a genuine transaction affecting legal relations should be disregarded for tax purposes merely because it is a transaction between affiliated corporations. We think that to strike down a genuine transaction

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[145] While we have reservations concerning the Treasury Department's guidance under sections 367 and 7874 that were targeted at inversions, our comments in this letter are not intended to address the Treasury Department's authority to issue regulations that are in fact focused on inversion transactions.

[146] By 1946, the Supreme Court noted that the terms "interest" and "dividends" were "well understood words as used in the tax statutes." *John Kelley Co. v. Commissioner*, 326 U.S. 521, 530 (1946). The debt-equity distinction in the income tax existed as early as the Wilson-Gorman Tariff Act, ch. 349, § 32, 28 Stat. 509, 556 (1894) (the income tax bill invalidated by *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601 (1895)), and it was continued in the Tariff Act of 1909, ch. 6, § 38(3), 36 Stat. 11, 114 (1909) even though there was no U.S. federal individual income tax in effect in 1909 (the 1909 act was upheld in *Flint v. Stone Tracy Co*., 220 U.S. 107 (1911)), with the result that individual bondholders were not subject to a federal income tax on their receipt of interest issued by corporations even though corporations could deduct interest payments. *See* Steven A. Bank, *Historical Perspective on the Corporate Interest Deduction*, 18 Chapman L. Rev. 29 (2014). *See also* Jonathan Talisman, *Do No Harm: Keep Corporate Interest Fully Deductible*, 141 Tax Notes 211 (Oct. 14, 2013).

[147] For example, the subject instruments in *Kraft Foods Co. v. Commissioner*, 232 F.2d 118 (2nd Cir. 1956) had been issued in 1934.

[148] For example, the Supreme Court upheld the John Kelley Co.'s interest deductions on notes issued in 1937 and distributed to its shareholder, while simultaneously disallowing the Talbot Mills corporation's interest deductions in a companion case on debt which had quite different terms. *John Kelley*, 326 U.S. 521.

[149] *Moline Properties v. Commissioner*, 319 U.S. 436 (1943).

[150] *See* section 11(a).

because of the parent-subsidiary relation would violate the scheme of the statute and depart from the rules of law heretofore governing intercompany transactions.[151]

In looking over almost one hundred years of case law in the debt-equity arena, what is remarkably consistent is that taxpayers that seek to issue debt in lieu of equity – whether with tax or non-tax motivations – that are financially able to support a debt characterization, that unambiguously document and substantiate the debtor-creditor relationship, and that act consistently with the documentation, will have their debt characterization sustained by the courts, regardless of their tax motivations in selecting debt in lieu of equity and related-party debt in lieu of bank borrowings. The ability to create a valid debtor-creditor relationship between shareholder and corporation had become black letter law long before the time Congress enacted section 385(a) in the Tax Reform Act 1969, and was the black letter law context in which section 385 was written.[152] To be sure, taxpayers lost cases when their substantiation and conduct were ambiguous or the terms of the debt departed from the norm, but as a general tax principle, financially sound taxpayers were free to choose to issue either debt or equity, and debt characterization was accepted provided the parties intended to create a debtor-creditor relationship and they acted in a manner that generally was consistently with that relationship. Had Congress intended to provide the Treasury Department with authority to negate years of well-settled general tax principles or overturn black-letter law, it would have expressed its intent in unmistakable terms. However, Congress did not do this - rather, it gave the Treasury Department a more limited mandate as described above in respect of identifying factors.

Moreover, it is clear that Congress is aware that corporations can be indebted to their shareholders, and can even distribute debt instruments to their shareholders,[153] and that Congress has consented to this situation, because Congress has enacted Code provisions that explicitly address this

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[151] *Kraft Foods*, 232 F.2d at 124.

[152] The proposed regulations state the premise that there is little or no non-tax relevance to the debt-versus-equity classification of a corporate instrument held by a shareholder. In fact, debt or equity characterization of an instrument has material non-tax relevance in determining the adequacy of equity capitalization of corporate entities under state and non-U.S. corporate, commercial, bankruptcy, and regulatory laws, which relevance pre-dates the income tax relevance of the debt-versus-equity classification of an instrument held by a shareholder.

[153] The Treasury Department and Service also have long recognized that corporation can distribute its own debt instrument to its shareholders. For example, current regulations contain provisions expressly addressing a corporation's distribution of its own debt instrument to its shareholder. Treas. Reg. § 1.301-1(d)(1)(ii). The substance of the relevant language in this regulation is not new – it was present in the version published in 1955 T.D. 6152, 20 Fed. Reg. 8875, 8877 (Dec. 3, 1955), 1955-2 C.B. 61 ("… If the property distributed consists of the obligations of the distributing corporation, or stock of the distributing corporation treated as property under section 305(b), or rights to acquire such stock treated as property under section 305(b), the amount of such distribution shall be an amount equal to the fair market value of such obligations, stock, or rights….")) and in the version published in 1960 (T.D. 6500, 25 Fed. Reg. 11402, 11607 (Nov. 26, 1960) (the relevant language was identical to that in T.D. 6152)). This language was expressly preserved and restated in the 1964 changes to the regulations (T.D. 6752, 29 Fed. Reg. 12701 (Sept. 9, 1964); 1964-2 C.B. 84), the 1971 changes to the regulations (T.D. 7084, 36 Fed. Reg. 266 (Jan. 8, 1971), 1971-1 C.B. 230); and the 1972 changes to the regulations (T.D. 7209, 37 Fed. Reg. 20800 (Oct. 4, 1972), 1972-2 C.B. 204). Subsequently, the particular provision was reorganized, and the provision continued without substantive change. T.D. 7587, 44 Fed. Reg. 1376 (Jan. 5, 1979), 1979-1 C.B. 126. Treas. Reg. § 1.301-1(d)(1) was amended again in 1995, albeit in a non-substantive manner. T.D. 8586, 60 Fed. Reg. 2497, 2500 (Jan. 10, 1995), 1995-1 C.B. 147. With this history, it is hard to conceive that the Treasury Department or the Service were unaware that corporations could – as a matter of black-letter law – distribute debt instruments to their shareholders.

situation.[154] In 1984, Congress enacted sections 312(a)(2) and 1275(a)(4), which explicitly deal with a corporation's section 301 distribution of a debt instrument to its shareholder, to address the situation where the debt instrument is a discount obligation (*i.e.*, bears original issue discount).[155] In their description of the present law context in which these provisions were enacted, the Congressional tax-writing committees wrote that "a corporation can distribute as a dividend its own debt obligations," a phrase that appears in the reports of the House Ways and Means Committee, the Senate Finance Committee, and the conference committee.[156] Can the general rule of the proposed regulations apply to treat a debt instrument as stock, when the debt instrument is a discount obligation and is "four-square" within these statutory provisions? These statutory provisions were enacted after section 385; perhaps they should be read to have implicitly restricted the grant of regulatory authority.[157]

Additionally, even if the Treasury Department possessed the authority the proposed regulations imply, using it as it has here create bizarre results, which Congress cannot reasonably have intended to permit. Under the proposed regulations, identical debt instruments issued under identical financial circumstances and documented with the same legal formalities could be subject to disparate characterization based solely on whether the holder is a related corporation, and whether the issuer happened to have engaged in some other potentially unrelated transaction at some point within a 72-month period surrounding the issuance. If a financially successful corporation were to distribute a dividend in the form of notes to its shareholders, the notes' debt-equity characterization could differ under the proposed regulations based solely on whether the shareholder-recipient was a controlling corporation or an individual.[158] Alternatively, the characterization of a debt instrument could differ

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[154] There is a long history of note dividends to which Congress is surely aware. *See Jos. Schlitz Brewing Co. v. Commissioner*, 134 F.2d 165 (7th Cir. 1943) (involving the distribution of notes in 1937 for which a "dividend paid credit" was claimed); *Logan-Gregg Hardware Co. v. Heiner*, 26 F.2d 131 (W.D. Pa. 1928) (involving the distribution of notes in 1918).

[155] Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 61(c), 98 Stat. 494, 581-582 (1984).

[156] H.R. Rep. No. 98-432, at 1203 (1984); S. Prt. No. 98-169, at 188 (1984); H.R. Conf. Rep. No. 98-861, at 843 (1984). The sentence also appears in the Joint Committee Bluebook, though the word "can" (which signifies ability) was replaced with the word "may" (which signifies permissiveness and electivity). Joint Comm. on Tax'n, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (JCS-41-84), at p. 185 (1984).

[157] In 1989, Congress enacted the earnings stripping rules of section 163(j) to limit the deductibility of interest paid on certain related-party debt, another implicit recognition that one corporation could be indebted to a related corporation. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7210, 103 Stat. 2106, 2339-2342 (1989). That very bill also amended section 385(a) to add the parenthetical part-debt, part-stock language. The portion of the relevant House committee report that addresses section 163(j) explicitly acknowledges that a corporation may deduct interest paid to related persons, and notes that section 385(a) authorizes regulations to set forth various factors. H.R. Rep. No. 101-247, at 1240 (1989). Congress likely would have said something in the legislative history, or written different rules in section 163(j) or section 385(a), had it believed or intended the Treasury Department and Service to possess the authority to issue regulations to outlaw a large swath of related-party debt solely based on transactions the borrower might have undertaken three years before or after a borrowing. Similarly, the Congressional acknowledgement in the section 7701(o) legislative history that a shareholder is free to select between debt and equity capitalization of a subsidiary based on tax considerations can be read as an implicit limitation of the scope of section 385(a).

[158] For example, assume individual A owns all of the stock of corporation P, P owns 80 percent of corporation S, and A owns the remaining 20 percent of S. If S were to declare a dividend distribution to its shareholders and payable in the form of debt instruments, the debt instruments issued to P would be subject to recharacterization

depending upon whether a note was part of an original capital structure, or if it was issued in a recapitalization undertaken to modify the capital structure or in a distribution intended to modify the corporation's capital structure and leverage ratio.[159] What tax policy consideration relative to the debt-equity distinction is implicated by the issuance of a note in a recapitalization or distribution, as opposed to a corporate formation? [160] Similarly, if a corporation chooses to borrow funds from a commonly controlled corporation to finance, say, a business expansion, and within the six-year period surrounding the borrowing also happens to have engaged in an otherwise separate reorganization with a related-party (or had distributed accumulated earnings and profits), the corporation's borrowing would be treated differently than if it had waited to engage in the reorganization or earnings and profits distribution for 37 months (or had waited to borrow for that period of time). The proposed regulations do not require any factual connection between the borrowing and the intercompany reorganization or distribution, and in fact *actual proof that no linkage is present* is expressly made irrelevant.[161] These proposed rules are not justified. The claim that such a rule is made necessary due to the fungible nature of cash has little to do with the debt-equity considerations central to section 385(a), and cannot mask the fundamentally arbitrary nature of the way these rules would operate. There is no clear tax policy underpinning for the distinctions the proposed regulations would make that relates to the concerns that motivated Congress to enact section 385.

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as stock under the general rule, and the debt instruments issued to A would not, even if the debt instruments were identical in all respects save for the name of the payee.

[159] For example, assume corporation P forms corporation S1, and transfers $100 to S1 in exchange for $25 of S1 stock and $75 of S1 debt. Assume further that P had formed corporation S2, and transferred $100 to S2 in exchange for $100 of S2 stock, and subsequently either recapitalized S2 (exchanging $100 of S2's original stock for $25 of new S2 stock and $75 of S2 debt) or caused S2 to distribute a $75 debt instrument. The S1 debt would retain its debt characterization (assuming no recharacterization under the funding and *per se* rules), whereas the S2 debt would be recharacterized as stock upon its issuance under the general rule, even though the economics and the issuer's ability to repay are identical.

[160] The Supreme Court, in *Bazley v. Commissioner,* 331 U.S. 737 (1947), and *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946), dealt with debentures that had been issued in tax-motivated recapitalizations, and respected the debt characterization of the debentures. The key focus in *Bazley* was whether the taxpayer received the debt instrument as a taxable dividend distribution, and in *John Kelley* was whether the corporation could deduct the interest payments on the distributed debentures. In neither case did the transaction in which the debts were issued seem to matter at all to the debt-equity characterization. The *John Kelley* court upheld interest deductions as to the John Kelley Co.'s debentures, and denied deductions in the *Talbot Mills* companion case expressly based upon the terms of the Talbot Mills debentures (the "characteristics of the obligations") rather than the relationship of the parties. *John Kelley*, 326 U.S. at 526.

[161] The Treasury Department may provide an *irrebuttable* presumption that a debt instrument is a *principal purpose debt instrument*, implicitly issued with some evil motive, but such a presumption cannot establish the fact of that motive – the presumption merely means that the particular rule applies categorically, regardless of actual motivations, and notwithstanding the complete absence of any direct factual linkage between the borrowing and some other use of money or property.

As discussed elsewhere in our comments, a debt instrument could be retroactively characterized as stock under the *per se* rule *after it had been issued and repaid*, based on an unrelated distribution or acquisition that occurs later in the same taxable year, due to the manner in which the timing rule would operate. Such a debt instrument cannot possibly have funded a distribution or acquisition that occurs after it had been repaid. The *per se* rule is based on the concept that money is fungible, but money is not *that* fungible.

Would the Treasury Department contend that section 385 gives it the authority to deny interest deductions to (or impose dividend treatment on) taxpayers who engage in other transactions it might disfavor at some future date? What if a taxpayer borrowed funds and issued a debt instrument to a related-party, and within some "irrebuttable presumption" period of time the taxpayer also engaged in an otherwise unrelated listed transaction, or reported a lower effective tax rate, or contested an IRS transfer pricing determination? Why is it permissible to use section 385(a) to attack taxpayers who effect a repatriation (including one that would, in the absence of the proposed regulations, be respected as a dividend and upon which a U.S. federal income tax would be paid or that represents previously taxed income), a "debt-pushdown" to "earnings strip," a return-of-capital distribution to manage the timing of the recognition of earnings and profits, or some other transaction, when the taxpayers employ general and longstanding tax principles to do so, and the transaction is consistent with the longstanding terms of the Internal Revenue Code and generally applicable judicial doctrines? The Treasury Department should be wary of creating the precedent of writing regulations untethered from the policy that motivated Congress to enact the underlying law.

The Treasury Department's real concern appears to have nothing to do with the historic debt-equity conundrum. The Treasury Department's concern appears to be with taxpayers' use of other, long-standing, general tax principles to achieve results with which it has concerns and on which Congress has not acted. Congress is the proper governmental instrumentality to act to combat these perceived tax abuses. The Treasury Department has proposed legislative changes, and the solution to these perceived problems is, in short, legislation if Congress decides to act. Bypassing Congress and using a grant of regulatory authority issued to provide debt-equity guidance for an unrelated purpose exceeds the Treasury Department's authority under section 385.

Finally, as discussed in the text of our comments, section 385(a) provides, "[t]he Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether *an interest in a corporation* is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness)" (emphasis added). There is nothing in section 385 or its legislative history that suggests that Congress authorized regulations to determine the status of an interest in a non-corporate entity; rather, the legislative history suggests section 385(a) was intended to be limited to corporate issuers. The statutory provision is in subchapter C of Chapter 1 of the Code, the portion of the Code addressing corporate distributions and adjustments. Yet, the proposed regulations would recharacterize certain debt instruments issued by a partnership, either as equity in the partnership or as equity in the partner(s) of the partnership.

In the legislative history underlying the enactment of section 385, the Senate Finance Committee report states, "[a]lthough the problem of distinguishing debt from equity is a long-standing one in the tax laws, it has become even more significant in recent years because of the increased level of corporate merger activities and *the increasing use of debt for corporate acquisition purposes*."[162] The Senate Finance Committee report goes on to state:

> In view of the increasing use of debt for corporate acquisition purposes and the fact that the substitution of debt for equity is most easily accomplished in this situation, the committee also agrees with the House that it is appropriate to take action in this bill to provide rules for resolving, *in a limited context,* the ambiguities and uncertainties which

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

> have long existed in our tax law in distinguishing between a debt interest and an equity interest in a *corporation*. . .
>
> In view of the uncertainties and difficulties which the distinction between debt and equity has produced in numerous situations other than those involving corporate acquisitions, the committee further believes that it would be desirable to provide rules for distinguishing debt from equity in the variety of contexts in which this problem can arise. The differing circumstances which characterize these situations, however, would make it difficult for the committee to provide comprehensive and specific statutory rules of universal and equal applicability. . . .
>
> In view of this, the committee believes it is appropriate to specifically authorize the Secretary of the Treasury to prescribe the appropriate rules for distinguishing debt from equity in these different situations . . . . For the above reasons, the committee has added a provision to the House bill which gives the Secretary of the Treasury or his delegate specific statutory authority to promulgate regulatory guidelines, to the extent necessary or appropriate, for determining whether a *corporate* obligation constitutes stock or indebtedness. The provision specifies that these guidelines are to set forth factors to be taken into account in determining, with respect to a particular factual situation, whether a debtor-creditor relationship exists or whether a *corporation-shareholder* relationship exists.[163]

The above legislative history makes clear that the focus of Congress in enacting section 385 was the characterization of *corporate* debt and thus the statute makes no reference to whether an interest in a partnership is to be treated as stock or indebtedness.

Similarly, the proposed regulations would recharacterize debt instruments issued by a disregarded entity either as equity in the issuing entity (which could result in the entity being treated as a partnership) or as equity in the owner of the entity (even though the debt instrument is not an interest in the owner). These proposed rules cannot be squared with the grant of regulatory authority regarding the debt-equity status of an interest in a corporation.

2. Recommendations

As noted at the beginning of this letter, we make the following recommendations:

- We urge the Treasury Department and the Internal Revenue Service to withdraw the proposed regulations, in their entirety.
- If the Treasury Department and Service do not withdraw the proposed regulations in their entirety, we recommend that they withdraw Prop. Treas. Reg. § 1.385-3.
- If the proposed regulations are not withdrawn, we recommend that the regulations, if and when finalized, should only apply to debt issued by corporations.

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

VI. Additional Complexities and Taxpayer Disputes

1. Discussion

The rules in the proposed regulations can be expected to spawn multiple new taxpayer disputes. As discussed throughout our comments, we expect there will be significant complexities and opportunities for disputes in determining how to apply these rules, particularly in light of the reach of the *per se* rule and the potential for cascading effects. Additionally, the proposed regulations will result in new and significant (and unfortunate) uncertainties in the calculation of a corporation's earnings and profits, and in the basis in a corporation's stock (including the basis in debt instruments recharacterized as stock). New opportunities for taxpayer disputes will arise in the context of merger and acquisition activities, when an acquiring corporation will be required to try to determine a target group's potential exposures under these new rules, to "clean up" the target's intercompany debt structure, and to integrate the target's treasury function into its own. None of these issues are so much as referenced in the preamble, nor do we have any sense that they factored into the Treasury Department's and Service's regulatory decision-making or costs and benefits determinations.

2. Recommendations

- Eliminate the funding and *per se* rules.
- Expand the reasonable cause exception in Treas. Reg. § 1.385-2(c)(1), and allow for "section 9100"-type relief.

VII. Additional Tax Planning Opportunities

1. Discussion

The extraordinary breadth and reach of the proposed regulations, and the numerous changes and collateral consequences that they would impose, will inevitably open up significant new planning opportunities. Our comments in prior sections of this letter have focused on a number of complexities that could create problems for taxpayers. However, it has been our experience that in many situations, creating a non-economic, counter-factual situation leads to interesting discontinuities, thus creating opportunities for subsequent mischief.[164] To coin a phrase, discontinuities fertilize the soil from which future tax avoidance can sprout.

For example, the proposed regulations will result in numerous "issuances" of hook equity. Up to this point it has been our experience that the Treasury Department and Service have looked askance on

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[164] Martin D. Ginsburg, *The National Office Mission,* 27 Tax Notes 99, 100 (Apr. 1, 1985) ("When you grab a technical nicety and sharpen it to spear a legitimate transaction, and no impelling tax policy or unavoidable statutory mandate requires that result, you court disaster. You have assumed the risk of Moses -- nee Aaron's -- Rod, the Murphy's Law of the tax field. As I never tire of repeating, it reminds us that every stick crafted to beat on the head of a taxpayer will, sooner or later, metamorphose into a large green snake and bite the Commissioner on the hind part. Nothing, you see, works one way in the tax field. Those folk out there are exceedingly ingenious. If, in aid of particular mayhem, you espouse an interpretation too narrow or too broad or just plain skewed, before you can turn around the tax bar will do you in.").

the use of hook equity.[165] If the proposed regulations are finalized in their current form, the result would be hook stock in many foreseeable situations, and likely in many unforeseen situations where the complexities of the *per se* rule become apparent only with hindsight. Similarly, the proposed regulations would create numerous instances of hybrid instruments that are "straight debt" under a traditional debt-equity analysis, but that would be recharacterized as equity under the general, funding, or *per se* rules.

We find it unfortunate that the proposed regulations are written as a "one way street" to recharacterize debt instruments as stock, notwithstanding that the Service repeatedly has sought the opposite—to treat equity interests as indebtedness—in a variety of contexts. For example, in a number of structured finance cases, the Service sought to establish that a financial institution was a secured lender rather than an equity holder in a partnership,[166] or that an equity interest was in substance indebtedness that could not support a foreign tax credit.[167] As a thought experiment, what might have happened in those cases if the proposed regulations were final, and if those taxpayers had structured the deal in a manner that brought the issuer and holder into the same EG by invoking the option or partnership attribution rules? Would the government have been willing to argue in court that the equity-in-form interests at issue in those cases should be treated as indebtedness? How would the government respond when it is pointed out that those very same interests—if they had been labelled as debt—would have been vulnerable to equity recharacterization under the rules of the proposed regulations? (Literally, the no affirmative use and anti-avoidance rules would not apply to an instrument that is in form an equity interest.)

As discussed above, the repayment of a debt instrument that is recharacterized as stock is likely to be treated as a section 302(d) or section 306(a)(2) dividend-equivalent redemption. Again, this is likely the intended result of the proposed regulations, but it will substantially increase opportunities for taxpayers—inadvertently or otherwise—to shift stock basis and earnings and profits amongst commonly controlled corporate entities. To be sure, there would be new anti-avoidance and no affirmative use rules, but those rules can have only limited application when the direct, inevitable, and intended consequences of repaying a recharacterized debt instrument lead to movements in stock basis and earnings and profits. In addition, those rules might be heeded by well-advised, risk-adverse taxpayers, but cannot be expected to halt aggressive taxpayers who stretch certain rules to their fullest to gain every conceivable tax advantage. This is a further caution, because the rules would incentivize and reward aggressive taxpayers who play a tax lottery while punishing compliant taxpayers.

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[165] *See* Notice 89-37, 1989-1 C.B. 679 (the "May Company" notice); Notice of Proposed Rulemaking, *Partnership Transactions Involving Equity Interests of a Partner*, 57 Fed. Reg. 59324 (Dec. 15, 1992) (Prop. Treas. Reg. § 1.337(d)-3); T.D. 9722, 80 Fed. Reg. 33402 (June 12, 2015) (publishing Temp. Treas. Reg. §§ 1.337(d)-3T and 1.732-1T); Notice 94-93, 1994-2 C.B. 563 (addressing the effect of an inversion on certain *General Utilities* gain); S Rev. Proc. 2016-3, Section 4.02(11), 2016-1 I.R.B. 126, 138 (the hook equity "no-rule" policy).

[166] For example, the Castle Harbor cases - *TIFD III-E Inc. v. United States*, 342 F. Supp. 2d 94 (D. Conn. 2004), *rev'd*, 459 F.3d 220 (2d. Cir. 2006), *remanded to*, 660 F. Supp. 2d 367 (D. Conn. 2009), *rev'd*, 666 F.3d 836 (2d. Cir. 2012), *remanded to*, 8 F. Supp. 3d 142 (D. Conn. 2014), *rev'd*, 604 Fed. Appx. 69 (2d. Cir. 2015), *cert. denied*, 136 S. Ct. 796 (2016). *See also ASA Investerings Partnership v. Commissioner*, T.C. Memo. 1998-305, *aff'd*, 201 F.3d 505 (D.C. Cir. 2000); *Saba Partnership v. Commissioner*, T.C. Memo. 1999-359, *vacated and remanded*, 273 F.3d 1135 (D.C. Cir. 2001); *Boca Investerings Partnership v. United States*, 167 F. Supp. 2d 298 (D.D.C. 2001), *rev'd*, 314 F.3d 625 (D.C. Cir. 2003). *See also Chemtech Royalty Assocs., L.P. v. United States*, 2013-1 U.S.T.C. (CCH) ¶ 50,204; 111 A.F.T.R.2d (RIA) 953 (M.D. La. 2013), *aff'd*, 766 F.3d 453 (5th Cir. 2014).

[167] *See Hewlett-Packard Co. v. Commissioner*, T.C. Memo. 2012-135.

We surely cannot predict all of the ways in which the rules in the proposed regulations could be used to create tax planning opportunities, at the time of the issuance of a debt instrument. However, we are confident that the discontinuities that the proposed regulations would create will lead to new tax planning opportunities, some of which will become apparent only after a debt instrument has been issued and recharacterized (the no affirmative use and anti-avoidance rules cannot police post-issuance planning when awareness of a tax benefit was not present at the time of a debt instrument's issuance). We are in some ways reminded of the experience with nonqualified preferred stock, which was enacted in 1997 as an anti-avoidance revenue raising measure and is currently proposed to be repealed for the very same reason.

2. Recommendation

- The proposed regulations should be withdrawn. Alternatively, if the proposed regulations are not withdrawn, the Service's current no-rule policy for "the treatment or effects of hook equity" in section 4.02(11) of Rev. Proc. 2016-3 should be repealed.

VIII. Opportunity Costs

The Service has been operating under severe and perhaps historic budgetary constraints. It has had to curtail much-desirable activities and programs, and has been unable to timely complete many of the items that have appeared on recent Priority Guidance Plans. The Treasury Department and Service might have productively devoted resources to finalizing regulations under section 163(j) that had been proposed in 1991, or to finalizing the earnings and profits rules in Prop. Treas. Reg. § 1.367(b)-8, that had been proposed in 2000, or to finalizing basis regulations that were initially proposed in 2002 and were re-proposed in 2009 (which, in part, also would update the section 304 regulations to reflect statutory changes to section 304 made in 1982 and in subsequent years). Each of those projects could have had an impact on the type of tax planning targeted in the proposed regulations, and would also have provided much needed guidance to a large group of taxpayers. The Treasury Department and Service could have deployed executive and staff hours to other guidance projects that might not affect inverted companies, but that nonetheless are important projects that would affect a large number of taxpayers, such as updating regulations under section 351(e) to reflect statutory changes made in 1997, or finalizing the "no net value" regulations that were proposed in 2005, or finalizing the proposed regulations issued in 2006 that would update the historic section 959 and 961 regulations to reflect statutory changes made in years subsequent to 1983, or finalizing the regulations that were proposed in 2007 to update the section 355 active trade or business regulations and reflect statutory changes made in 2005. All of the projects referred to above have appeared on the Priority Guidance Plan.

In producing the proposed regulations, the Treasury Department and Service have clearly expended significant executive and staff hours, enough to reflect a conscious management and policy decision to forego work on other projects. If the Treasury Department and Service intend to finalize the proposed regulations, it is essential that they devote significant additional resources to consider the numerous technical and other changes to the proposed regulations that have been suggested by us and by other commenters—it would be unwise to do otherwise.

As a final point, we also note that debt instruments recharacterized under the proposed regulations may be considered hybrid instruments for cross-border tax purposes, and the issuer's local-country expense disallowed if that country has adopted rules similar to those recommended in the

OECD BEPS Project's Action 2 Hybrid Mismatch report. The Treasury Department was an active participant in the BEPS process and spent significant resources in doing so. It is strange and seemingly counter-productive for the Treasury Department, having worked to curtail cross-border hybrid instruments presumably out of concern regarding their vitality as a matter of sound tax policy, to now unilaterally take actions that, in its own words, may cause a "proliferation" of hybrid instruments.[168] A readily foreseeable effect is that when the earnings of affected issuers are eventually subject to U.S. tax, the U.S. fisc will earn less revenue because the U.S. owner will be entitled to greater foreign tax credits. More broadly, this only further underscores our concerns about the Treasury Department's and the Service's decision to commit the resources they have to the proposed regulations.

IX. Conclusion

In addition to being in large part invalid, the proposed regulations would create large-scale noneconomic incentives that would dis-incentivize investment in the United States and distort investment and ownership decisions when investment is made. The proposed regulations would give rise to far-reaching collateral consequences ranging from the disappearance of tax attributes such as foreign tax credits, the routine shifting of earnings and profits and stock basis in potentially distortive directions, the inability to comply with and understand the tax consequences of routine transactions given the dichotomy between the mechanical rules and the "affirmative use" turn-offs (as well as the potential "de-controlling" effect of the retroactive recharacterization of a debt instrument), and the unparalleled documentation and compliance burdens, all of which will lead to further taxpayer disputes. Additionally, we anticipate that the proposed regulations would provide additional tax tools, and create new planning opportunities, while imposing huge costs in terms of tax administration and taxpayer compliance, casting further doubt on the underlying wisdom of the approach and scope of the proposed regulations. The proposed regulations should be withdrawn in their entirety.

We welcome the opportunity to discuss our comments further with any interested personnel at the Treasury Department and the Internal Revenue Service. Please feel free to contact Joe Pari at 202-533-4444, Steven Lainoff at 202-533-3158, Ron Dabrowski at 202-533-4274, Seth Green at 202-533-3022, Mark Hoffenberg at 202-533-4058, or Maury Passman at 202-533-3775.

Very truly yours,

KPMG LLP

cc:

The Honorable Mark J. Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury

The Honorable John Koskinen
Commissioner
Internal Revenue Service

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[168] *See* 81 Fed. Reg. 20912, 20930 (Apr. 8, 2016) ("Given that these section 385 regulations may give rise to a proliferation of U.S. hybrid equity splitter arrangements…").

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Appendix – Additional Issues and Comments

Prop. Treas. Reg. § 1.385-1

1. Definition of an expanded group. If the Treasury Department and Service do not accept our recommendation to substitute the controlled group rules of section 1563, the definition of an expanded group in Prop. Treas. Reg. § 1.385-1(b)(3)(ii) should be revised to provide that in applying the rules of section 304(c)(3) (and so much of section 318 as relates thereto), a corporation will be treated as owning stock held by its shareholders, in that proportion to which the value of the stock which the shareholder owns in the corporation bears to the value of all of the stock in the corporation (this language is derived from section 318(a)(2)(C)). In other words, corporate back attribution should be limited by a proportionality rule.

2. Definition of an expanded group. If the Treasury Department and Service do not accept our recommendation to substitute the controlled group rules of section 1563, the definition of an expanded group in Prop. Treas. Reg. § 1.385-1(b)(3)(ii) should be revised to provide that in applying the rules of section 304(c)(3) (and so much of section 318 as relates thereto), a partnership will be treated as owning stock held by its partners, in that proportion to which the value of the partnership interest which the partner owns in the partnership bears to the value of all of the partnership interests in the partnership (this language is derived from section 318(a)(2)(C)). In other words, partnership back attribution should be limited by a proportionality rule.

3. Definition of an expanded group. For purposes of determining indirect ownership, the proposed regulations would pick up the rules of section 304(c)(3) (Prop. Treas. Reg. § 1.385-1(b)(3)(ii)) or the principles of such rules (Prop. Treas. Reg. § 1.385-1(b)(1) (second sentence). If the Treasury Department and Service substitute the controlled group rules of section 1563, the rules of section 1563(e)(2) and Treas. Reg. § 1.1563-3(b)(2) would apply. In applying any of these rules (or principles of these rules), there may be an issue as to how to determine a partner's proportionate ownership in a partnership, or in the capital and profits of a partnership. In the context of a complex partnership agreement, it is not clear whether the determination should be based on relative liquidation values, relative fair market values, or other metrics. We have recommended that final rules should provide a method for determining a partner's share of partnership profits for purposes of the aggregate rule in Prop. Treas. Reg. § 1.385-3(d)(5). Similarly, we recommend that final rules should provide a safe harbor methodology for determining a partner's share of partnership profits and capital for purposes of the constructive ownership rules or, in the absence of a safe harbor, that the preamble to the regulations, if and when finalized, clarify that in making these determinations for purposes of the section 385 rules, taxpayers may utilize any reasonable method, consistently applied.

4. Definition of an expanded group. Provide guidance that would clarify how hook equity is to be taken into account when determining the composition of an expanded group within the meaning of Prop. Treas. Reg. § 1.385-1(b)(3) (and in applying the rules of section 304(c)(3), and so much of section 318 as relates thereto), especially when the hook equity represents more than 50 percent of the entity's value.

5. Definition of a modified expanded group (MEG). Modify the MEG definition so that it incorporates the 80% threshold that applies to the definition of an EG (in other words, provide that the bifurcation rule can be applied to debt instruments issued by corporations and held by individuals

and controlled partnerships, provided the holders directly or indirectly own 80% or more of the stock in the issuing corporation). A less than 80% interest does not represent the commonality of interests that justifies affiliation (and the consequences of affiliation) or the potential application of the bifurcation rule. Alternatively, modify the MEG definition to incorporate a "greater than 50 percent" threshold in Prop. Treas. Reg. § 1.385-1(b)(5) (*i.e.*, substitute "greater than 50 percent" in lieu of "at least 80 percent" in sections 1504(a)(2)(A) and (B)). As discussed in the attached letter, there are circumstances where a 50% interest does not confer control (especially where there is a competing 50% co-venturer), and the proposed regulations are overbroad to the extent they would apply in that context.

6. Definition of a modified expanded group. As discussed in the attached letter, we observe that the modified expanded group rule could include multiple individuals, potentially subjecting a debt instrument between two individuals to the bifurcation rule.

   Example. Individual A owns all of the stock of X corporation and B (A's spouse) owns all of the stock of corporation Y. A and B have a minor child, C. A and B lend $10 to C in exchange for the issuance of a debt instrument. There is no reasonable expectation that C will satisfy more than $1 of the debt instrument.

   By reason of the attribution rules each of A, B and C are treated as owning the stock owned by the other. For example, A is treated as owning the Y stock actually owned by B and for the same reason B is treated as owning the X stock actually owned by A. Section 318(a)(1)(A)(i). Meanwhile, C is treated as owning both the X stock actually owned by A and the Y stock actually owned by B. Section 318(a)(1)(A)(ii). In addition, the re-attribution rule provides that stock constructively owned by a person generally is considered to be owned by that person for purposes of further applying the constructive ownership rules. Section 318(a)(5)(A). Moreover, the corporate "back attribution" rule provides that a corporation is treated as owning all of the stock owned by its shareholder, where the shareholder owns 50% or more of the stock of the corporation. Section 318(a)(3)(C). The result is that X is treated as owning the stock owned by A, and thus the Y stock that A constructively owns. Similarly, Y is treated as owning the X stock constructively owned by B. Fortunately, the section 318(a)(5)(B) rule that limits family reattribution does not allow an attributive link to run through C.[169]

   The modified expanded group definition treats individuals who own (or who are treated as owning) the requisite amount of stock in an entity as a member of the modified expanded group. Prop. Treas. Reg. § 1.385-1(b)(5) (third sentence). In the example, because each of A, B and C are treated as owning all of the stock in X and Y, A, B, and C are members of the same modified expanded group. Thus, the debt instrument issued by C in the example to C's parents runs between MEG members, and would be subject to the bifurcation rule. We observe that there is no *de minimis* exception or an applicable dollar threshold that would exempt small debt instruments from the ambit of the bifurcation rule.

[169] For purposes of this example, we assume that Prop. Treas. Reg. § 1.385-1(b)(3)(i)(B) would be expanded to substitute "directly or indirectly" in lieu of "directly" in section 1504(a)(1)(B)(ii) (the proposed regulations currently refer solely to section 1504(a)(1)(B)(i), and that Prop. Treas. Reg. § 1.385-1(d)(ii) would be modified to apply to debt instruments running between two MEG members.

This is an absurd result, and we cannot imagine that the Treasury Department or the Service would seek to use regulations under section 385 as a means of attacking intra-family loans. Moreover, as we point out in the attached letter, section 385(a) does not authorize regulations other than with respect to interests in corporations, and thus the proposed regulations should not apply to non-corporate issuers. It also is unfathomable to recharacterize a debt instrument issued by an individual as "stock" in the issuer. However, unless the proposed rules are modified, the literal application of the proposed rules could lead in the example's direction. If the Treasury Department and Service do not accept our recommendation to limit the rules to debt instruments issued by corporations, we recommend the addition of a provision to make it clear that the proposed regulations do not apply to debt instruments issued by individuals.

7. Treatment of deemed exchange. We commend the Treasury Department and Service for including a rule to minimize some of the potential initial tax consequences of a retroactive debt reclassification. It would be helpful to clarify that the treatment to be provided in Prop. Treas. Reg. § 1.385-1(c) applies notwithstanding section 108(e)(8).

   Example. FP owns all of the stock of US1 and US2. In Year 1, US1 borrows $100 from US2, and issues a 10-year debt instrument to memorialize its obligation to repay US2. In Year 3, when interest rates have increased substantially (or US1's credit rating changes), US1 makes a distribution of $40 to FP. Assume that no exceptions to the proposed regulations apply.

   As a result of the Year 3 distribution, a $40 portion of the Year 1 debt instrument is recharacterized as stock under the funding and *per se* rules. Under the timing rule of Prop. Treas. Reg. § 1.385-3(d)(1)(ii), because the Year 1 debt instrument is treated as funding a distribution in a subsequent taxable year, the Year 1 debt instrument is treated as exchanged for stock when the Year 3 distribution is made. This deemed stock-for-debt exchange appears intended to not result in any immediate tax consequences, because the rules would provide that US2 is treated as having realized an amount equal to its adjusted basis in that portion of the Year 1 debt instrument as of the date of the deemed exchange. Similarly, the issuer is treated as having retired that portion of the Year 1 debt instrument for an amount equal to its adjusted issue price. Prop. Treas. Reg. § 1.385-1(c). This latter rule on its face appears difficult to reconcile with section 108(e)(8). The statutory provision provides that a corporation that repays a debt obligation with stock is treated as having satisfied the debt for an amount equal to the fair market value of the stock. If, in the example above, a $40 tranche of the Year 1 debt instrument is worth, say, $35 due to a change in the market interest rates or the issuer's credit rating, section 108(e)(8) would appear to create $5 in cancellation of indebtedness income (CODI) consequences. Conversely, if the tranche is worth $44 due to a marked decrease in rates, would US1 have a $4 deductible redemption premium under Treas. Reg. § 1.163-7(c)?

   We appreciate that the proposed regulations would tend to mitigate potential CODI consequences. We recommend that language be added in the preamble to confirm that the language of Prop. Treas. Reg. § 1.385-1(c) applies notwithstanding section 108(e)(8).

8. Treatment of deemed exchange. Clarify that when a debt instrument that relies on the section 482 applicable federal rate (AFR) safe harbor in Treas. Reg. § 1.482-2(2)(iii)(A)B)(*1*) is recharacterized as stock, the AFR safe harbor continues to apply to the recast debt for purposes of applying section 482 and associated provisions.

9. Bifurcation rule. Add *de minimis* and "*de maximus*" rules, for obvious simplification reasons. These rules might provide that if 20 percent or less of a debt instrument would be bifurcated into a stock portion, the entire debt instrument would be treated as debt; conversely, if 80 percent or more of the debt instrument would be stock, the entire debt instrument is recharacterized as stock.

10. Bifurcation rule. The bifurcation rule of Prop. Treas. Reg. § 1.385-1(d), as written, could apply to debt instruments issued by individuals, because an individual can be a member of a MEG. I However, the non-debt portion of a debt instrument issued by individuals cannot properly be viewed as stock in the individual. Thus, if the Treasury Department declines to accept our recommendation that the rules be limited to debt instruments issued by corporations, we recommend that the bifurcation rule not apply to debt instruments issued by individuals.

11. Bifurcation rule. Add a statement in Prop. Treas. Reg. § 1.385-1(d) that recognizes that a holder of a debt instrument that has been bifurcated into part-debt, part-stock, can claim a worthless stock deduction under section 165(g) with respect to the stock portion, to the extent a deduction would be available had the bifurcated portion of the debt instrument been issued in form as stock, and that the bifurcation will have no adverse effect on the ability of a holder to claim a worthless or partially worthless debt deduction under section 166 with respect to the debt portion.

12. Bifurcation rule. How are determinations under Prop. Treas. Reg. § 1.385-1(d)(1) to be made, who will make the determinations? National Office coordination of bifurcation determinations should be considered; regional enforcement variations should be discouraged.

13. Bifurcation rule. Provide guidance to clarify the consequences of a bifurcation of a debt instrument (or a modified expanded group version of an EGI). The preamble to the proposed regulations contains an example where a $5 million debt instrument is bifurcated into part debt ($3 million) and part stock ($2 million), due to no reasonable expectation that $2 million of the debt instrument would be repaid. There is no explicit timing rule with respect to the bifurcation rule (unlike the other rules), which raises a question as to when would a bifurcation be effective. It appears that the proposed regulations contemplate that the determination would be effective upon the issuance of an EGI (or the MEG-equivalent of an EGI). However, as discussed in the attached letter, in a number of circumstances (such as those involving various control requirements) a retroactive bifurcation determination could result in unfortunate and fundamentally unfair consequences, which present competing policy concerns that should be explicitly addressed. For example, elsewhere in the regulations there are rules that would address the effect that the recharacterization of a debt instrument would have on the transaction in which the underlying instrument is issued (Prop. Treas. Reg. § 1.385-3(b)(vi)). We believe the Treasury Department and Service should give significant additional consideration to the practicalities and procedures involving bifurcation.

14. Bifurcation rule. How should post-bifurcation payments be treated, and what methodologies might apply?

    Example. A corporation issues a $5 million debt instrument, which is bifurcated into part debt ($3 million) and part stock ($2 million), due to the lack of a reasonable expectation that $2 million of the debt instrument would be repaid (*i.e.*, the debt instrument discussed in the example from the preamble to the proposed regulations). Assume that the instrument bore a stated interest rate of 5 percent, the instrument was issued on January 1 of Year 1, the issuer actually paid $250,000 of stated interest on December 31 of Year 1, and the instrument was

bifurcated by the Service in Year 4 based on a determination resulting from an exam of the issuing corporation's return for Year 1, retroactive to the date of issuance.

How would the recharacterization affect the payments made on the debt instrument? Should all of the $250,000 payment be characterized as interest? If so, should $100,000 of the payment (40 percent of the $250,000) be treated as a prepayment on the $3 million debt portion? Should it be treated in its entirety as interest on the $3 million debt portion, thus implicitly creating a "grossed up" interest rate? Alternatively, should proportional amounts of the payment be allocated to each part of the bifurcated instrument, perhaps treated as $150,000 of interest and a $100,000 section 301(c) distribution? And if so, what is the rationale for allocating any payment of interest to the "stock" portion of the bifurcated debt instrument, when the very reason for the bifurcation is the lack of a reasonable repayment expectation?

Could the taxpayer specifically designate the allocation (which might be retroactive, and what effect of the penultimate sentence of Prop. Treas. Reg. § 1.385-1(d)(1), which requires the taxpayer to treat the debt instrument as debt)? What about repayments of principal? The better default rule might be to allocate all principal repayments to the debt portion of the bifurcated debt instrument, especially given the underlying premise that at the time of issuance there was no reasonable likelihood that the stock portion of the debt instrument would be repaid. However, given the myriad of situations in which bifurcation might arise (especially given the broad definition of an EG), we believe it would be appropriate to allow the taxpayer the discretion to elect how to allocate actual payments of interest on the instrument, between the "debt" portion and the "stock" portion.

15. Bifurcation rule. The penultimate sentence of Prop. Treas. Reg. § 1.385-1(d)(1)(i) would require the issuer and holder of an expanded group instrument, as well as any other person relying on the characterization of the EGI as indebtedness for U.S. federal income tax purposes, to treat the EGI consistent with the issuer's initial determination. The statutory rule in section 385(c)(2) that allows a taxpayer to take a different position, provided the fact of inconsistent treatment is disclosed on the tax return, is turned off. This "you're-stuck-with-the-initial-characterization rule" is improper; there will be occasions when it is more appropriate to treat an item in a manner inconsistent with the issuer's original characterization, provided tax return disclosure is made, as Congress recognized when it enacted section 385(c)(2). It is also pernicious, in that a taxpayer may be asked to file a tax return with a position that the individual signing the return believes may be incorrect.

    Example. USP purchases all of the stock of FP, a previously unrelated foreign target corporation. No elections are made under sections 336(e) or 338. FP and its foreign subsidiaries have issued various intercompany debt instruments that were initially characterized as indebtedness, consistent with general U.S. tax principles. However, FP and its foreign subsidiaries were not subject to U.S. tax and did not comply with the rules in the proposed regulations, and it appears that some of the FP group's intercompany debt instruments would have been recharacterized as stock under the proposed regulations.

Is USP required to treat the instruments as indebtedness for purposes of its Forms 5471 (and its Form 1120)? Regardless of whether the proposed regulations are modified (as we suggest) to exempt foreign targets from the rules, the identical issue is presented in the context of domestic target corporations.

Example. USP purchases all of the stock of UST, a previously unrelated domestic target corporation. No elections are made under sections 336(e) or 338. UST and its foreign and domestic subsidiaries have issued various intercompany debt instruments that were initially characterized as indebtedness. UST took the position that the UST group's intercompany debt instruments were properly respected at indebtedness. USP and its tax advisors believe that some of the UST intercompany debt instruments are better characterized as stock under the proposed regulations.

The same issue arises—is USP required to treat the UST group's debt instruments as debt, even if it believes that the indebtedness characterization isn't sustainable under the facts? Similarly, what if UST had treated a debt instrument as stock, based on a good faith but erroneous application of the rules in the proposed regulations, and that the erroneous treatment came to light in the tax due diligence process? The wiser choice would seem to be to allow USP to treat the debt instruments of the FP group (in the first example) and the UST group (in the second) consistent with its best, good faith estimates as to the proper characterizations, with a requirement that any inconsistent characterization be properly and clearly disclosed on the relevant tax returns. In addition, mistakes are not confined to one scenario, such as acquisitions. What if USP had made an error with respect to the characterization of a USP group debt instrument that came to light in a taxable year after its issuance?

A corporation's Form 1120 (which would include Forms 5471 for acquired CFCs) is required to be submitted with a statement made under penalties of perjury, to the effect that the signor has examined the return and that "to the best of my knowledge and belief, it is true, correct, and complete." Why require a corporate taxpayer to sign and file an incorrect or untrue Form 1120 return reporting items relating to debt instruments that the person signing the return has reason to believe may have been mischaracterized?

Moreover, if the proposed regulations are intended to combat base erosion, where is the wisdom in providing taxpayers who believe that a debt instrument should be treated as stock under the proposed regulations with the ability to "hide behind the skirts" of the "you're-stuck-with-the-initial-characterization rule," and continue to claim the benefit of an interest deduction?

Section 385(c)(2) provides that holders are bound by the issuer's initial characterization. The reason for this is simple—to prevent the whipsaw of inconsistent reporting by issuer and holder.[170] We have seen nothing in the legislative history of section 385(c) to suggest that there was some punitive or other purpose. In addition, we see no attempt in the preamble to justify this "you're-stuck-with-the-initial-characterization rule," or to articulate a rationale that would support this rule. Rather, we see whipsaw avoidance as the only relevant rationale, and allowing taxpayers to take a different position provided there is proper tax return disclosure is both the better policy as well as the rule that would better facilitate tax administration.

16. Bifurcation rule. The penultimate sentence of Prop. Treas. Reg. § 1.385-1(d)(1)(i) would require the issuer and holder of an expanded group instrument, as well as any other person relying on the characterization of the EGI as indebtedness for U.S. federal income tax purposes, to treat the EGI

[170] H.R. Rep. No. 102-716, at 3-4 (1992). This passage is noted in the preamble to the proposed regulations. 81 Fed. Reg. 20912, 20913 (Apr. 8, 2016).

consistent with the issuer's initial determination. While it appears from the context of the preamble and regulatory language that this rule is intended to be confined to the bifurcation rule (we note the waiver of section 385(c) in Prop. Treas. Reg. § 1.385-3(d)(3)), there is no explicit indication of this. The rule, if it is to be retained (notwithstanding our recommendation to withdraw it), should be clarified by expressly limiting it to the bifurcation rule context. In other words, to the extent retained in final regulations, the "you're-stuck-with-the-initial-characterization rule" should not preclude a taxpayer from reporting a debt instrument as stock if, based on subsequent events, the debt instrument is recharacterized as stock under the documentation rules.

17. Bifurcation rule. The bifurcation rule appears to be the only operative rule that is intended to apply amongst members of a modified expanded group (MEG) that are not also members of an expanded group. However, the operative rule in Prop. Treas. Reg. § 1.385-1(d)(1) specifically applies to exempt group instruments (EGIs), and the definition in Prop. Treas. Reg. § 1.385-1(d)(2) specifically presupposes that the subject instrument is an EGI. A debt instrument that is issued by one MEG member to another MEG member is not an EGI, unless the issuer and holder are both members of the same expanded group. While the intent of the provision seems to be to authorize bifurcation of a debt instrument in the MEG context, if the rule is to be retained a technical clarification is advisable. Perhaps the rule should be revised to authorize an instrument that would be an EGI but for the fact that the instrument is held by members of a modified expanded group rather than an expanded group.

18. A new exemption. Add a rule that wholly exempts short-term borrowings from the regulations. For example, if one EG member borrows from another EG member with the intent to repay the loan in one year or less, and in fact repays the loan, there is little justification for subjecting the loan to bifurcation under Prop. Treas. Reg. § 1.385-1(d), or to the documentation requirements of Prop. Treas. Reg. § 1.385-2, or to the general, funding and *per se* rules under Prop. Treas. Reg. § 1.385-3. Would the same rules otherwise respect as stock an instrument that is mandatorily redeemable in one year or less, which is in fact so redeemed?

    Taxpayers that have a short-term liquidity need and that are concerned that they may have engaged in a disfavored distribution or acquisition within the 72-month *per se* rule period might instead resort to bank credit. However, why should tax rules be written to encourage this? There is little to be gained by forcing taxpayers to incur the costs of short-term bank debt in lieu of related-party debt. At the same time, there is much to be gained in avoiding the issues and complexities discussed in these comments, such as the potential retroactive recharacterization of paid-off, same-year loans under the funding rule, the administrability concerns, the "evergreen" and "cascading" problems, the shifting of stock basis and earnings and profits, the potential loss of foreign tax credits and resulting double taxation of income, and the other complexities inherent in the proposed regulations, with respect to short-term borrowings.

19. A new exemption. Add a rule that wholly exempts borrowings from the regulations where the issuer or the holder leaves the EG shortly after the borrowing is made, or as part of the same series of transactions that includes the borrowing. Similarly, add a rule that provides that the acquisition of stock in this context will not cause the funding or *per se* rules to apply.

    <u>Example</u>. USP seeks to dispose of a line of business in an initial stock offering. As part of the plan, USP organizes a new corporation and contributes a business (including a subsidiary corporation) and working capital funds (or short-term seed money) to Newco in exchange for 20

shares of Newco stock and a Newco debt instrument. Less than 90 days later, Newco sells 80 shares of its stock in a public offering and repays its debt to USP with IPO proceeds. In an unrelated transaction two years prior to Newco's IPO, USP had issued a debt instrument to CFC1 (a member of USP's EG), and the debt instrument remains outstanding at the time of Newco's IPO.

There is little justification for subjecting the Newco loan in the example to bifurcation under Prop. Treas. Reg. § 1.385-1(d), to the documentation rules of Prop. Treas. Reg. § 1.385-2, or to the general, funding and *per se* rules under Prop. Treas. Reg. § 1.385-3. The example does not implicate the concerns that appear to have motivated the proposed regulations. Moreover, if the Newco loan were recharacterized as stock, its retirement in all likelihood would not be dividend-equivalent but rather would qualify for sale or exchange treatment under section 302(a) under the "firm and fixed" plan test of *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954) and *Merrill Lynch & Co., Inc. v. Commissioner*, 120 T.C. 12 (2003), *aff'd*, 386 F.3d 464 (2d. Cir. 2008). In this example, subjecting the Newco loan to the requirements of the proposed regulations would increase costs to the parties (and encourage the use of external debt), without advancing the underlying policies.

Similarly, there would be little point in subjecting the Newco debt instrument to an equity recharacterization when, as part of the same plan, Newco departs the EG while the debt instrument remains outstanding. In this scenario, the EGI status of the debt instrument is transitory; why invoke the complications inherent in the various rules of the proposed regulations?

In addition, in the example above the debt instrument USP had issued to CFC1 should not be recharacterized as stock under the funding and *per se* rules simply because USP had organized Newco as an IPO vehicle and had given it working capital or seed money, and Newco was temporarily a member of the same EG.[171] Newco's EG-member status is transitory; the entire transaction wholly lacks the base erosion or *Falkoff* planning aspects that the Treasury Department finds objectionable. In addition, there is no diminution in any entity's capital structure on account of these transactions, and the USP-CFC1 debt instrument completely lacks a factual relation to Newco's funding and its IPO. In short, the proposed regulations are unnecessarily overbroad to the extent they would trigger any debt recharacterization in the example above. We recommend that for purposes of applying the funding and *per se* rules a corporation in the position of USP in the example above should not be treated as having acquired EG member stock where, as part of the same plan, the transferee corporation leaves the EG.

20. A new exemption. Add a rule that wholly exempts from the proposed regulations intercompany debt that arises in the ordinary course. An example would be trade receivables that are indebtedness in form. There is little tax policy justification for imposing significant additional compliance and systems costs plus the risk of equity recharacterization with respect to related-party debt where the debt arises in the ordinary course of business and there is a level of contemporaneous, objective evidence that supports debt characterization under general tax principles. For this purpose, ordinary course ought also cover short-term deposits made with an internal finance company. The current ordinary course exception in Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(B)(*1*) is drafted far too narrowly, and in any event would only apply for purposes of the *per se* rule.

[171] The exception in Prop. Treas. Reg. § 1.385-3(c)(3) for funded acquisitions of subsidiary stock by issuance would not apply – USP's ownership of Newco's stock would drop below the 50 percent threshold during the 36-month period immediately following Newco's issuance of stock to USP.

21. A new exemption. Add a rule that wholly exempts from the regulations certain interests that are treated as indebtedness by statute or by other applicable regulations. Examples of this are in section 636(a) (production payments carved out of mineral property), section 860B(a) (regular interests in a REMIC), and section 1286 (certain coupon stripping transactions). We do not believe that the Treasury Department has the authority under section 385(a) to override the congressionally-directed status of these interests, and the proposed regulations should include appropriate cross-references to avoid any confusion. Similarly, the regulations should be coordinated with other rules in regulations (and the policies underlying those other regulations) that confer debt status. Examples include Temp. Treas. Reg. § 1.446-3T(g)(4)(i) (a swap with significant nonperiodic payments) and Treas. Reg. § 1.467-4 (prepaid or deferred rentals under certain leases). See also Rev. Proc. 99-32, 1999-2 C.B. 196 (allowing the creation of an interest bearing receivable or payable upon a section 482 adjustment).

22. A new exemption. Add a rule that wholly exempts from the proposed regulations all indebtedness that does not exceed a particular dollar threshold (such as $10 million) or that does not exceed a certain percentage of the issuer's total assets (such as 10 percent). This exemption would operate as a type of *de minimis* rule, which would go a long way towards eliminating significant complications under the proposed regulations with respect to relatively small amounts of debt. This rule could be paired with an anti-avoidance rule that would aggregate all debt instruments that are issued as part of the same plan, if there is a principal purpose of seeking inappropriately to exploit this exception (*i.e.*, an "anti-structuring" rule).

<u>Prop. Treas. Reg. § 1.385-2</u>

23. Documentation rules. To the extent a complete exemption is not provided, add an exception (or allow for less stringent requirements) to the rules of Prop. Treas. Reg. § 1.385-2 for debt instruments issued in the ordinary course. An example would be trade receivables that are indebtedness in form. Alternatively, allow for a relaxed documentation and substantiation requirement for ordinary course indebtedness. There is little tax policy justification for imposing significant additional compliance and systems costs plus the risk of equity recharacterization with respect to related-party debt where the debt arises in the ordinary course of business and there is a level of contemporaneous, objective evidence that supports debt characterization under general tax principles.

24. Documentation rules. The documentations rules do not apply to certain groups where no member has issued stock that is publicly traded, and where the expanded group has $100 million or less of total assets and $50 million or less of annual total revenue on the date a particular debt instrument is issued. Prop. Treas. Reg. § 1.385-2(a)(2)(i). There are situations where a debt instrument is "re-tested" at a later date, in particular when the issuer's and holder's actions are evaluated to determine if they are sufficiently robust and evidence a debtor-creditor relationship. Prop. Treas. Reg. § 1.385-2(b)(2)(iv). Such later activities might take place at a time when the relevant expanded group no longer exceeds the relevant dollar thresholds; after all, fortunes changes, and a corporate group could substantially shrink through business activities and dispositions. It would be appropriate to add a rule that exempts an expanded group from the proposed regulations if it no longer exceeds the relevant dollar thresholds (or, say, 85% of such thresholds).

25. Documentation rules. The rules would apply to an expanded group instrument (EGI), which is defined as an applicable instrument between members of an expanded group. For this purpose, an applicable instrument is defined in Prop. Treas. Reg.§ 1.385-2(a)(4)(i)(A) as "any interest issued or deemed issued that is in form a debt instrument." The preamble (part III.A., at 81 Fed. Reg. 20912, 20920) confirms that the definition of an applicable instrument excludes (and thus the documentation rules would not apply to) interests that are not debt in form. We commend the Treasury Department and Service for reserving on rules for debt that is not in-form debt.

    We can foresee circumstances when, on exam, disputes could arise as to the meaning of "in-form debt" for purposes of this rule, and believe that additional guidance would be helpful not only for taxpayers but also for I.R.S. personnel. It would be helpful to include examples of some of the more common types of interests that are excluded under this rule.

26. Documentation rules. The language in Prop. Treas. Reg. § 1.385-2(b)(2)(i) utilizes the term "sum certain." This terms has been used throughout the debt-equity case law, and is used in section 385(a). Presumably, the term as used in the proposed regulations is employed in a generic sense (as is the case in the case law), and is not intended as a term of art invoking the restrictive meaning historically applied to the term in the context of the law of negotiable instruments,[172] nor was it intended to impose a substantive requirement that a non-negotiable debt instrument could never satisfy the documentation requirement (such a rule would be overbroad, and arbitrary in effect). It would be helpful to clarify that the term is used in a generic sense, and is intended to impose a requirement that the amount that the amount that must be repaid must be reasonably determinable from objective evidence such as the totality of the documents used to satisfy the documentation requirements, including draw requests, receipts, confirmations of electronic funds transfers, cancelled checks, and the like. Such a requirement would adhere to the purposes underlying the documentation rules, without arbitrarily excluding many instruments that conform to general commercial terms.

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[172] Black's Law Dictionary defines a "sum certain" as "any amount that is fixed, settled, or exact, . . . a sum that is agreed on in the instrument or a sum that can be ascertained from the document." Garner, Black's Law Dictionary (10th ed. 2014). The relevance of the term is that an instrument without an unconditional obligation to pay a sum certain in money could not be a "negotiable instrument," and thus there could be no "holder in due course." To qualify as a sum certain, the principal amount must be clearly determinable from the face of the instrument (with any necessary computation), without reference to an outside source. *Branch Banking & Trust Co. v. Creasy*, 269 S.E.2d 117, 121-122 (N.C. 1980). Words such as "$2 million, or so much thereof as may be advanced from time to time under the terms of a loan agreement" have been held to be insufficient to establish a sum certain, because a holder must look to sources outside the face of the instrument to determine how much of the $2 million had been advanced. *Resolution Trust Corp. v. Oaks Apartments Joint Venture*, 966 F.2d 995, 1001-1002 (5th Cir. 1992); *Cobb Bank & Trust Co. v. American Mfrs. Mut. Ins. Co.*, 459 F. Supp. 328, 333-334 (N.D. Ga. 1978). Similarly, a note or document that promises to pay "any and all liabilities" or "all amounts that may be owing" or that includes an allowance for future advances does not reference a sum certain. *King v. Industrial Bank of Washington*, 474 A.2d 151, 155 (D.C. App. 1984); *Farmers Production Credit Ass'n v. Arena*, 481 A.2d 1064, 1065 (Vt. 1984). The 1990 revisions to Article 3 of the Uniform Commercial Code moved away from the sum certain requirement (to a "readily ascertainable amount of money, with or without interest or other charges described in the promise or order," with variable rates of interest allowed). It appears that 49 states have adopted some form of the 1990 revision, while as of April 2016, New York's version of UCC section 3-104(1)(b) continues to impose a sum certain requirement.

27. Documentation rules. The language in Prop. Treas. Reg. § 1.385-2(b)(2)(i) requires that there must be an "unconditional" repayment obligation. Presumably, the intent is that the repayment obligation be fixed, and determinable by objective, written documentation, as discussed in the preceding comment. At the same time, we presume that there was no intent to impose a substantive prohibition against contingent payment obligations that qualify as indebtedness under current rules, through imposition of a documentation requirement that could never be satisfied. While the use of a contingent payment instrument among related parties must surely be rare, nonetheless it would be helpful to confirm that related-party contingent payment instruments are not automatically precluded from debt characterization, but rather the rule is intended to impose a requirement that the amount that must be repaid must be reasonably determinable from objective evidence such as the totality of the documents used to satisfy the documentation requirements, and financial indices published by unrelated persons.

28. Documentation rules. The language in Prop. Treas. Reg. § 1.385-2(b)(2)(ii) requires the written documentation to establish certain creditors' rights. As a matter of drafting and semantics, many of the underlying creditors' rights are created through the common law and courts' equity jurisdiction, local property laws and creditors' rights statutes (such as a state's counterpart to Article 9 of the Uniform Commercial Code), and the U.S. Bankruptcy Code, which give meaning to contractual commitments and allow for their enforcement. In addition, due to the prevalent use of cross-default provisions or no other default negative covenants in unrelated-party borrowings, there are times when specific creditors' rights provisions might not be advisable in a related-party debt instrument; paperwork-oriented rules should not preclude debt characterization in these fact patterns where there is more than enough contemporaneous, objective documentation that unambiguously establish creditor status under local law. Traditionally, there has been little reason in the context of related-party borrowings for creditors to regurgitate voluminous, detailed, and intrusive language across multiple pages of legal-sized paper dealing with every conceivable contingency; such documentation is unnecessary where the creditor has some degree of control over the affairs of the borrower due to the common control relationship, and such additional verbiage would serve little purpose. In this latter regard, nothing has changed, and there is little to be achieved by requiring the same degree of documentation that one might expect in a multi-million dollar secured bank loan where the parties deal at arm's length with interests that are not particularly aligned. Perhaps a better articulation might be to require that the holders possess or have access to a reasonable quantum of creditors' rights with respect to the particular debt instrument, without imposing a requirement that a particular remedy must be articulated in the written instrument.

29. Documentation rules. If the above recommendation is not accepted, the regulations should incorporate special rules indicating how cash pool participants can adequately document creditors' rights inter se, given the restrictions unique to a cash pooling arrangement. For instance, the creditors' rights documentation requirement would need to account for common restrictions on establishing competing interests in the subject balances, to which each cash pool participant has already agreed; in all cases participants' interest may need to be subordinated to the creditor interests of the pooling bank.

30. Documentation rules. The language in Prop. Treas. Reg. § 1.385-2(b)(2)(ii) states that the rights of a creditor must include a superior right to that of a shareholder to share in the assets of the issuer in case of dissolution. It would be helpful to clarify (perhaps in the preamble) that this requirement would not be violated by the potential availability of equitable subordination under case law or the

U.S. Bankruptcy Code.[173] And there are other rare cases (*e.g.*, debt could be equity if issued after a company's financial condition declines, even if it is *pari passu* with older debt).

31. Documentation rules. The language in Prop. Treas. Reg. § 1.385-2(b)(2)(ii) states that the rights of a creditor must include a superior right to that of a shareholder to share in the assets of the issuer in case of dissolution. This rule should be clarified that a holder of debt that is recharacterized as stock under the section 385 regulations is not a "shareholder" for purposes of this documentation requirement.

    Example. FP owns all of the stock of US1 and US2, and all of the stock of FS, its foreign internal finance corporation. US1 issues a debt instrument to US2 in Year 1. In Year 2, US1 issues a new debt instrument to FS. The Year 2 debt instrument is subordinated to the Year 1 debt instrument. In Year 3, the Year 1 debt instrument is recharacterized as stock under the funding and *per se* rules when US1 makes a distribution to FP.

    The fact that the Year 2 debt instrument is subordinated to the Year 1 debt instrument should not cause the former to be *ipso facto* recharacterized as stock simply because the latter has become recharacterized as stock, regardless of whether the Year 1 debt instrument is recharacterized as stock prior to or after the issuance of the Year 2 debt instrument. Similarly, recharacterization under the documentation rules would be inappropriate if the two debt instruments rank *pari passu* with each other. In the context of a recharacterized debt instrument, there is no reasonable policy justification that would countenance debt recharacterization of every EGI issued by a particular issuer simply because one of the issuer's EGIs is recharacterized as stock under one of the rules in the proposed regulations.

32. Documentation rules. The financial due diligence requirements in Prop. Treas. Reg. § 1.385-2(b)(2)(iii) should be limited to the time of the issuance of a debt instrument. In the context of revolving loan arrangements and facilities and cash pool arrangements, the cost of requiring new financial diligence with respect to each draw would far outweigh any reasonable tax policy objective, and would go beyond what is encountered in a bank borrowing context. For example, banks and other third-party creditors do not typically require new credit checks each time a borrower seeks to draw on a revolving loan facility, or charge a credit card, or withdraw funds against an overdraft protection facility, or when facing a demand against a letter of credit. Financial due diligence should not be required for these types of facilities more often than commercially reasonable. Similarly, a new financial due diligence should not be required after the time a debt instrument was issued.

    Example. USP owns 75% of the stock of CFC1; the remaining CFC1 stock is owned by an otherwise unrelated joint venture partner. In Year 1, USP transfers $100 to CFC1 in exchange for

[173] Equitable subordination can occur under the Bankruptcy Code (11 U.S.C. § 510(c)) as well as under the common law. *Pepper v. Litton*, 308 U.S. 295 (1939); *Nerox Power Sys. V. M-B Contracting Co.*, 54 P.3d 791, 794-795 (Alaska 2002); *Hilo Crane Service, Inc. v. Ho*, 693 P.2d 412, 420 (Haw. Ct. App. 1984). Under common law, a shareholder who was also a creditor has had its creditor rights effectively subordinated to the rights of preferred shareholders. *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307 (1939) (a common law case, decided under the 1898 Bankruptcy Act). *Compare In Re WiInstar Communications, Inc.*, 554 F.3d 382, 414 (3d. Cir. 2009) (the Bankruptcy Code provision does not authorize equitable subordination of a creditor's claim to a shareholder's interest), *with Matter of Lifschultz Fast Freight*, 132 F.3d 339 (7th Cir. 1997).

a new debt instrument, to finance CFC1's business operations. In Year 3, USP purchases all of the remaining stock in CFC1, and the latter joins USP's EG.

While not entirely clear, it appears that the documentation requirements in Prop. Treas. Reg. § 1.385-2 would apply to the Year 1 CFC1 debt instrument immediately after the time in Year 3 when CFC1 joins the USP EG, and that these requirements might include the need to undertake a new financial diligence. Prop. Treas. Reg. § 1.385-3(c)(2)(i). With all due respect, such a requirement as applied to the facts of this example would serve no objective tax policy.

Moreover, what would happen if an EG member's financial prospects decline? The proposed regulations would act as a pro-cyclical economic hammer, cutting off the entity's access to intercompany borrowings during the bottom of an economic or business cycle, increasing the possibility of converting its debt into equity and thus curtailing legitimate interest deductions (as well as potentially triggering a series of other complications that are discussed throughout these comments).

33. Documentation rules. The financial due diligence requirements in Prop. Treas. Reg. § 1.385-2(b)(2)(iii) should not be imposed each and every time there is a modification of an instrument (regardless of whether the modification is significant under Treas. Reg. § 1.1001-3), when a debt instrument enters an expanded group (Prop. Treas. Reg. § 1.385-2(c)(2)(i), as noted in the prior comment), or when a debt instrument is treated as having been reissued for other purposes (such as when a consolidated group debt instrument leaves a consolidated group and becomes an EGI, as contemplated in Prop. Treas. Reg. § 1.385-2(c)(4)(ii)). At best, a new financial diligence and retesting will impose costs that have nothing to do with the original issuance of the debt instrument or its intended status;[174] at worse, requiring a new financial diligence will have a disproportionately negative effect on financially troubled entities without furthering a reasonable tax policy purpose. Specific rules were put in place in Treas. Reg. § 1.1001-3(f)(7)(ii) to provide that the financial deterioration of an issuer is to be disregarded when testing to determine whether an alternation or modification of a debt instrument results in an instrument that is not debt, and in Treas. Reg. § 1.1502-13(g)(3)(ii)(B) to provide that a deemed satisfaction and reissuance will not alter the debt characterization of an intercompany instrument. There is no reasonable tax policy justification for placing such a non-neutral rule into the proposed regulations, either through an ostensibly paperwork-oriented provision or otherwise. For reasons similar to why rules were put in place in those other regulations to disregard post-issuance financial deterioration, similar rules should apply for purposes of the proposed regulations. Alternatively, to the extent the Treasury Department and Service persist in a belief that financially troubled entities should have to undergo the financial diligence procedures each and every time a debt instrument is modified, the preamble to final regulations should expressly address the policies to be achieved, address why their policies conflict with the policies of the rules mentioned above regarding financial deterioration, weigh the perceived benefits against the likely costs that would be imposed and the distortions that would be created, and include regulatory language to make this result explicit.

[174] There is a certain pointlessness in requiring a fresh financial diligence potentially years after a debt instrument's issuance. What is to be determined? The loan will have been funded, it is not as if the underlying debt instrument could be rescinded if the financial diligence shows that the issuer's financial strength is insufficiently robust.

34. Documentation rules. It should be made clear that the financial due diligence requirements in Prop. Treas. Reg. § 1.385-2(b)(2)(iii) should be applied in a flexible manner, so as to not impose unwarranted costs and complexity out of proportion to the tax policies sought to be achieved. It would be helpful to include a couple of examples to illustrate how this requirement will be interpreted and applied, and to discuss in the preamble how this requirement will be administered. In addition, some taxpayers might find it more administrable to perform regularly scheduled, periodic financial diligence (through internal finance departments, or perhaps using third party service providers), rather than diligence on an *ad hoc* basis each time a loan is made.

    In addition, we can foresee the likelihood that some number of in-house tax functions in large corporate group may not learn of every potential intercompany borrowing prior to the borrowing, notwithstanding reasonably strong protocols designed to ensure compliance with the proposed regulations, and thus periodic post-borrowing diligences as well as general pre-borrowing diligences may be reasonable in numerous circumstances. Thus, we would recommend that the rules allow the financial due diligence to be performed a reasonable time before or after the issuance of an EGI.

35. Documentation rules. The rule in Prop. Treas. Reg. § 1.385-2(b)(2)(iv)(B) requires a holder, in the event of a default on an EGI, to document the reasonable exercise of the diligence and judgment of a creditor, which may include evidence of the parties' efforts to renegotiate the EGI. In the context of a bank borrowing, there would be no concern that a renegotiation of the terms of a debt instrument would lead to a recharacterization of the debt instrument as equity. Treas. Reg. § 1.1001-3(f)(7)(ii). However, the proposed regulations would set up a different dynamic with respect to an EGI. In this latter context, the creditor might not want to renegotiate the terms of an EGI for fear that the issuer's financial deterioration could cause a modified EGI to be recharacterized as equity under the financial due diligence requirements of Prop. Treas. Reg. § 1.385-2(b)(2)(iii). At the same time, if the circumstances are such that an unrelated creditor would renegotiate a debt instrument's terms, the failure to do so would itself create a risk of recharacterization. In either event, the proposed regulations would create a heavy bias in favor of stock recharacterization of a financially troubled EG member's EGIs, a non-neutral result which could operate to "punish" such an issuer when the issuer is already in a difficult position. We recommend that a rule similar to Treas. Reg. §§ 1.1001-3(f)(7)(ii) and 1.150213(g)(3)(ii)(B) be added to the proposed regulations, to remove an inappropriate bias towards stock characterization resulting from an issuer's financial deterioration.

36. Documentation rules. The rule in Prop. Treas. Reg. § 1.385-2(b)(2)(iii) states that if protection or privilege is asserted with respect to a report or analysis in support of a borrower's ability to repay, 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. Valid intercompany debt is often used to fund strategic business expansion. Details of such plans that support future repayment is extremely sensitive information. Specific limitations should be established regarding the Service's ability to request, review, and maintain such information.

37. Documentation rules. The rule in Prop. Treas. Reg. § 1.385-2(b)(4) would require a taxpayer to maintain the required documentation "for all taxable years that the EGI is outstanding and until the period of limitations expires for any return with respect to which the treatment of the EGI is relevant." This is a potentially indefinite period. For example, assume an EGI is issued in year 1, the issuer deducts the interest paid in that year, and the issuer had a net operating loss for that year. The interest deduction (which is dependent on the EGI's being characterized as debt and not as

stock) can be relevant for all years to which the net operating loss is carried, a potentially 20-year period. Alternatively, assume the interest deduction is "disqualified interest" within the meaning of section 163(j), and is carried forward to a subsequent taxable year. Interest deductions deferred under section 163(j) can continue to carry forward indefinitely (unlike loss carryovers, there is no time cut-off for deferred interest deductions under section 163(j)). Further, assume the EGI is repaid in year 5. If the EGI were "stock" under the section 385 regulations, the redemption likely was a dividend equivalent redemption under section 302(d) or 306(a)(2), with the result that the issuer's earnings and profits would shift to the holder and the basis in some other stock in the issuer would be adjusted to include the holder's "stock" basis in the EGI, under Treas. Reg. § 1.302-2(c). The earnings and profits and stock basis consequences might not be relevant for many years to come.

Currently, in circumstances where a shareholder might not have retained sufficient information (such as cancelled checks, wire transfer confirmations, bank statements) to support its stock basis in a corporation the stock of which it has held for decades, a shareholder might seek other forms of substantiation, such as journal entries. However, if there is no corroborating support, the consequence is that unproven stock basis will not receive much credence—a simple failure of proof. Similarly, taxpayers that have been in existence since the Payne-Aldrich Tariff Act of 1909 (or who are the section 381(a) successors to such a corporation) need not have maintained all of their income tax and financial records for each and every post-1908 taxable year in order to be allowed to calculate earnings and profits; rather, reasonable estimates based on corroborating evidence are permitted in practice. These are practical issues, and the Service in its role as the tax administrator generally has adopted a reasonable approach. We note that the Service itself has adopted various formal document retention policies, and similar policies in the corporate world are nearly universal.) In contrast, under the proposed regulations, the consequence might be to cause a retrospective recharacterization of a debt instrument, perhaps a considerable amount of time after its issuance and satisfaction. And what burden might the taxpayer face—trying to prove a negative, that a debt instrument and the taxpayer's own behavior around the debt instrument did not fail to satisfy the documentation requirements? At some point, a revenue agent might apply a rule of reason as a matter of administrative grace, but none is unequivocally available under the proposed regulations. This leaves open the possibility—perhaps more theoretical than practical, but a possibility nonetheless—that a failure to maintain complete documentation about a particular debt instrument potentially for multiple decades after a debt instrument was issued and repaid could cause some future mischief.

38. Documentation rules. The reasonable cause rule in Prop. Treas. Reg. § 1.385-2(c)(1) simply states that appropriate modifications in the documentation requirements "may be made." By whom? Who is to determine the circumstances under which an exception might be made? The proposed regulations include a reasonable cause exception that states that the principles of Treas. Reg. § 301.6724-1 apply in interpreting whether reasonable cause exists in any particular case. Those rules, however, were not written with the documentation requirements of the proposed regulations in mind.

39. Documentation rules – reasonable cause exception. We can foresee situations when despite the best of intentions, the exercise of reasonable diligence, and the implementation of an exemplary corporate borrowing policy, taxpayers will fail to comply with the documentation requirements through inadvertent error. Corporate taxpayers must act through human agents, and that implies occasional imperfection. Documents can be mis-filed, inadvertently discarded, or disappear in a computer glitch. Non-tax personnel might fail to appreciate the need to maintain robust

documentation or to perform financial diligence prior to funding a related-party loan, or might on occasion disregard corporate policy regarding such loans, and a tax department might not learn of this until after the time periods set forth in Prop. Treas. Reg. § 1.385-2(b)(3). Scrivener's errors and other mistakes can appear in written documents. Imagine a large corporate group that may have multiple thousands of intercompany debts arising as ordinary course receivables for intercompany purchases of inventory, goods and services, and as routine draws and deposits in a cash management program—even if 99.9% of the intercompany receivables fully comply with the documentation requirements (corresponding to an error rate of one-in-a-thousand), numerous documentation rule issues can be expected to arise every year. The Service operates a program whereby it issues private letter rulings granting "section 9100" relief in certain circumstances where there has been an inadvertent failure to effect a regulatory election, and the taxpayer is able to establish that it acted reasonably and in good faith. Treas. Reg. §§ 301.9100-1, *et seq.* The reasons underlying that program are understandable, and the ability to grant such relief is appropriate. The proposed regulations should include some similar mechanism; the reasonable cause exception in Prop. Treas. Reg. § 1.385-2(c)(1) (which invokes the principles of Treas. Reg. § 301.6724-1) is too narrowly drafted, is not directed towards understandable situations that can be predicted to arise under the proposed regulations with respect to taxpayers who act in good faith, and does not provide sufficient flexibility for relief from inadvertent error. Moreover, if and when the proposed regulations are finalized, the accompanying preamble to the Treasury Decision should unequivocally state that the reasonable cause exception is intended to be administered by the Service in a flexible manner, and is intended to not penalize taxpayers that encounter issues through inadvertent error.

40. Inbound EGIs. Prop. Treas. Reg. § 1.385-2(c)(2)(i) provides that the section applies at the time an applicable instrument that was not an EGI when issued becomes an EGI. It is not clear what this provision is intended to do. Presumably, a non-EGI debt instrument can become an EGI either because (i) an EG member acquired the holder's position or assumes/novates the issuer's position, (ii) the issuer or holder joins the EG, or (iii) the issuer, holder, or debt instrument are no longer in the same consolidated group. In each situation, the full panoply of documentation and substantiation requirements should not apply. For example, where the debt instrument continues to have the same holder and issuer, there is no reason to require a new round of financial due diligence. Whatever concern that might underlie this requirement—such as a borrowing issued through a "friendly" party that is intended to subsequently become an EGI—is adequately addressed in the anti-avoidance rule of Prop. Treas. Reg. § 1.385-2(e). Thus, create an exception to the financial diligence requirements where the debt instrument continues to be issued by and held by the same parties at the time the instrument becomes an EGI.

41. Applicable instrument issued and held by members of consolidated groups. Prop. Treas. Reg. § 1.385-2(c)(4)(i) confirms the rule in Prop. Treas. Reg. § 1.385-1(e) that all members of a consolidated group are to be treated as a single corporation for purposes of the proposed regulations. If the Treasury Department does not accept our recommendation to remove non-corporate issuers from the ambit of the rules, it would be advisable to clarify that where all of the interests in a partnership are wholly-owned by members of the same consolidated group, the rules of Prop. Treas. Reg. § 1.385-2 do not apply to debt instruments issued by the partnership to a member of the consolidated group, or issued by a member of the consolidated group and held by the partnership. Such debt instruments are excepted from the rules of Prop. Treas. Reg. § 1.385-3, by reason of treating the debt instrument as having been issued by or held by the partners under the aggregate rule in Prop. Treas. Reg. § 1.385-3(d)(5)(i). As the preamble notes in Section VI of the Background, "the proposed regulations should not apply to issuances of interests and related transactions among members of a

consolidated group because the concerns addressed in the proposed regulations generally are not present when the issuer's deduction for interest expense and the holder's corresponding interest income offset on the group's consolidated federal income tax return." This policy applies equally in the context of Prop. Treas. Reg. § 1.385-2. In addition, this would have the salutary effect of preventing inadvertent deconsolidations, when a debt instrument is issued to a partnership wholly - owned within the consolidated group by a disregarded entity wholly-owned by a higher-tier member of the group, where the debt instrument would otherwise fail to satisfy the documentation and substantiation requirements of Prop. Treas. Reg. § 1.385-2.

> Example. USP owns S1 and DRE (a disregarded entity), DRE owns S2, and S1 and S2 collectively own all of the interests in domestic partnership PRS. DRE issued a debt instrument to PRS that is properly respected as debt under general tax principles. If the DRE debt instrument is recharacterized as stock under Prop. Treas. Reg. § 1.385-2, DRE could be treated as a partnership. The result would be to disaffiliate (and thus deconsolidate) S2 from the USP group.

We understand that if DRE were to issue an instrument that was in-form debt, but that was more properly treated as equity under general tax principles, the same result might apply. However, we posit a situation where the DRE instrument would be debt under general tax principles, but would be treated as equity under the documentation rules (*i.e.*, a situation which would not occur under current law). In this situation, the principles of the proposed regulations surely would not demand let alone counsel for a deconsolidating result. The specific reasons why the proposed regulations generally exempt a debt instrument wholly within a consolidated group strongly suggest disregarding the DRE debt instrument in the example, a result that is further supported by the policies that encourage the filing of consolidated returns.

42. Applicable instrument ceases to be an intercompany obligation. The proposed regulations should contain specific rules that better integrate with the rules of Treas. Reg. § 1.1502-13(g). One example of this is in Prop. Treas. Reg. § 1.385-2(c)(4)(ii), which states that the provision does not affect the application of the rules under Treas. Reg. § 1.1502-13(g). One of the -13(g) rules provides that a deemed satisfaction and reissuance of an intercompany obligation that leaves the consolidated group will not result in an equity recharacterization of the obligation; however, it appears that the intent is to subject such a debt instrument to the rules of the proposed regulations (including the financial due diligence requirement), which presents a risk of equity recharacterization for a financially troubled issuer. The rules should be better coordinated, and the timing of deemed transactions should be clarified, so that the intended results are clear and unambiguous.

43. Treatment of disregarded entities.[175] Prop. Treas. Reg. § 1.385-2(c)(5) provides that an EGI that is recharacterized as debt under the documentation and substantiation rules and that was issued by a disregarded entity will be treated as stock in the disregarded entity. In contrast, the rule's counterpart in Prop. Treas. Reg. § 1.385-3(d)(6) provides that a debt instrument recharacterized under the general, funding or *per se* rules of that section would be treated as stock in the disregarded entity's owner. The reason for disparate treatment is not immediately clear from the

[175] The term "disregarded entity" is defined in the proposed regulations by reference to the entity classification regulations. Prop. Treas. Reg. § 1.385-1(b)(2). We note that the issues discussed in this Appendix also generally apply to entities that are disregarded by reason of statutory directive, such as a qualified REIT subsidiary and a qualified subchapter S subsidiary. Sections 856(i)(2) and 1361(b)(3)(B). The proposed regulations do not appear to contemplate these latter types of entities.

preamble. Moreover, we see little justification in the documentation and substantiation rule for using the issuance of an EGI to convert a disregarded entity into a partnership in a situation when the subject EGI would be respected as indebtedness under general tax principles. As noted elsewhere, we have recommended that debt instruments issued by non-corporate issuers should be exempted from the regulations. However, if this recommendation is not accepted, we would recommend conforming the -2(c)(5) rule with the -3(d)(6) rule, or at the least providing that in circumstances where the underlying EGI is respected as indebtedness under general tax principles, the disregarded entity's owner would be treated as the issuer of the EGI.

Alternatively, if the intent is to treat a debt instrument issued by a disregarded entity as equity in the entity, the regulations should clarify whether the disregarded entity should be treated *per se* as a partnership, and provide guidance on the application of the doctrine of *Commissioner v. Culbertson*, 337 U.S. 722 (1949) and *Commissioner v. Tower*, 327 U.S. 280 (1946) to such an entity, especially where the lender would not satisfy the factors in *Luna v. Commissioner*, 42 T.C. 1067 (1964) because the lender is, in substance, a lender acting in a financial capacity and is not an equity holder or a co-venturer in a business. In addition, the guidance should address whether payments made pursuant to a recharacterized debt instrument qualify as guaranteed payments within the meaning of section 707(c) and Treas. Reg. § 1.707-1(c) or are in substance distributions by the issuing partnership subject to section 731, and whether the holder of such an interest is a partner in a partnership if it is the only interest in the issuing partnership owned by the holder.[176] Moreover, the guidance should address the so-called "*Castle Harbor*" and similar case authorities that have treated certain partnerships as "shams" where a purported partner is in substance a lender.[177] It would be quite the Catch-22 situation, indeed, if tax regulations would create a "partnership" through recharacterization of a debt instrument issued by a disregarded entity, which partnership might be viewed as a "sham" under case law authorities because the underlying debt instrument is merely a debt instrument, and because the holder has no intent to share in the risks and rewards of the issuer's business or to be a co-owner of the issuer's business.

44. Treatment of disregarded entities. Prop. Treas. Reg. § 1.385-2(c)(5) provides that an EGI that is recharacterized as debt under the documentation and substantiation rules and that was issued by a disregarded entity will be treated as stock in the disregarded entity. If the disregarded entity is a domestic entity that is engaged in the conduct of a trade or business in the United States and the EGI holder is foreign, the foreign lender could be treated as a partner in a domestic partnership, potentially receiving a share of the domestic partnership's profits (rather than interest on a debt instrument). In addition, the foreign lender could be deemed to be engaged in the conduct of a U.S. business through the resulting partnership by reason of section 875(1), and could be subjected to U.S. income taxation as a result—with respect to the interest payments and the "dividend-equivalent redemption" retirement payment, and potentially also with respect to other U.S. source income under the limited force-of-attraction rule in section 864(c)(3).

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[176] This guidance should also address whether an issuing entity is properly treated as a partnership for U.S. federal income tax purposes, if the holder of a recharacterized debt instrument issued by the entity is only entitled to a guaranteed payment (and no share of partnership profits), and the entity has a single owner (apart from the holder of a recharacterized debt instrument).

[177] *See* cases cited *supra* note 166.

A debt instrument issued by a domestic disregarded entity that is recharacterized as stock under the documentation rules would, in many circumstances, be treated as an equity interest in the entity, *ab initio.* This could raise a number of issues.

> Example. FP owns USP and FS. USP owns LLC, a domestic limited liability company that is disregarded, and thus treated as a branch or division of USP. LLC is actively engaged in a business in the U.S. During Year 1, in order to finance the needs of its business, LLC borrows funds from FS. (FS is not engaged in a U.S. trade or business, and has no U.S. transactions apart from the loan.) USP had adopted protocols to comply with the proposed regulations; USP's tax department believes that USP was the borrower, is told that the internal intercompany debt protocols have been followed, and reports all items related to the borrowing as though USP was the issuer. However, in Year 4, when LLC repays the borrowing, the USP tax department discovers that the borrower was LLC (not USP), and recognizes that as a result the documentation requirements have not been satisfied timely with respect to the Year 1 borrowing, and the Year 1 borrowing might have been recharacterized as an equity interest in LLC from the date of the borrowing.

In many cases, it is foreseeable that through inadvertence, a corporate group's tax department (or its external tax advisors) might not realize that a disregarded entity such as LLC has issued an EGI, or that the EGI failed to comply with all of the requirements under the documentation rules. This, in turn, could result in a situation where LLC is treated as having more than one equity owner, and might be viewed as a partnership for U.S. federal income tax purposes. In this type of situation, the relevant tax advisors might not know to file a Form 1065 (U.S. Return of Partnership Income) for LLC; instead, all of LLC's items might be reported on the actual owner's Form 1120 (U.S. Corporation Income Tax Return). A failure to file a partnership return for LLC could implicate various penalties, and could fail to commence the running of a statute of limitations. Moreover, there could be an issue as to whether FS might be subject to U.S. income tax under section 881, and whether FS may claim normal trade or business deductions associated with its "share" of LLC's income when it has not timely filed a Form 1120-F (U.S. Income Tax Return of a Foreign Corporation)—even if USP has reported all of LLC's items on its Form 1120.[178]

As noted elsewhere, we recommend that the proposed regulations be limited to debt instrument issued by corporations, and that indebtedness of partnerships and disregarded entities not be subject to recharacterization under the proposed regulations. We have also recommended an expansion of the reasonable cause exception. If these recommendations are not accepted, we recommend that the Treasury Department and Service provide that the holder of a recharacterized debt instrument in the circumstances of the example not be treated as engaging in a U.S. trade or business solely due to holding a recharacterized debt instrument.

46. Treatment of partnerships. A debt instrument issued by a controlled partnership that fails to meet the requirements of the documentation rules would result in a recharacterization of the debt instrument, and the EG member that holds the debt instrument might be treated as a partner in the issuer under Prop. Treas. Reg. § 1.385-2(c)(6)(ii). A series of unintended and collateral tax consequences creating additional complexities could result.

[178] *Swallows Holding, Ltd. v. Commissioner*, 515 F.3d 162 (3d. Cir. 2008); Treas. Reg. § 1.882-4(a)(3)(i).

Example. FP owns US1, US2, and FS. US1 and US2 each own 50% of the interests in PRS, a controlled partnership. In Year 1, FS transfers $100 to PRS in exchange for a debt instrument; however, the debt instrument memorializing the loan is untimely, and fails to satisfy the documentation requirements of Prop. Treas. Reg. § 1.385-2(b)(3).

In the example above, the $100 loan would be recharacterized as equity of PRS. As a result, FS might become a partner in PRS, despite owning an interest in a partnership that entitles it to receive a guaranteed payment and nothing more. (As noted above, consideration should be given to whether it is appropriate to treat FS as a partner and how this treatment reconciles with established partnership taxation principles.) To the extent FS would be treated as a partner, questions might arise as to the extent to which PRS's debts are allocable to FS under the rules of section 752 at the time FS becomes a partner in PRS, and whether changes in the allocable amount of debts should be viewed as contributions from FS to PRS or as distributions from PRS to US1 and US2, when looking to the funding rule and applying the aggregate rule of Prop. Treas. Reg. § 1.385-3(d)(5)(i) (which applies for purposes of -3). In addition, the addition of a new partner would give rise to additional filing obligations (*e.g.*, Schedule K-1). As noted above, there is a question as to whether FS would be deemed to be engaged in the conduct of a U.S. business through PRS under section 875(a).

If our recommendation to exclude debt instruments issued by non-corporate issuers is not accepted we recommend harmonizing the treatment of partnerships under Prop. Treas. Reg. § 1.385-2(c)(6)(ii) with the treatment of controlled partnerships under Prop. Treas. Reg. § 1.385-3(d)(5), which, in contrast, uses an aggregate approach to treat a recast debt instrument as an equity interest in the partners (rather than the partnership). The preamble should discuss whichever rubric is adopted, and the rationale for adopting the particular rule.

45. Treatment of disregarded entities and partnerships. Prop. Treas. Reg. § 1.385-2(c)(5) and -2(c)(6)(ii), respectively, provide that an EGI that is issued by a disregarded entity or a partnership and that is recharacterized under the documentation and substantiation rules is treated as equity in the disregarded entity or partnership. The bifurcation rule of Prop. Treas. Reg. § 1.385-1(d) also can partially recharacterize into equity debt issued by a "modified controlled partnership." Whether the bifurcation rule applies to debt issued by a disregarded entity is less clear, given that such entities are treated as issuers under Prop. Treas. Reg. § 1.385-2(a)(4)(iii) but are not generally treated as "persons" under section 7701(a)(1), as is contemplated by the modified expanded group definition in Prop. Treas. Reg. § 1.385-1(b)(5). These recharacterizations of the pass-through entity's equity holders, which might not occur until years after the initial issuance of the debt instrument, may give rise to "triggering events" for purposes of the dual consolidated loss rules in section 1503(d) and Treas. Reg. § 1.1503(d)-1 through 8. In particular the dilution of a domestic owner's interest in a separate unit created by the addition of a foreign equity owner may give rise to a "foreign use" triggering event, unless the dilution does not exceed the *de minimis* standard.[179] Furthermore, if debt issued by a separate unit is recast into stock and represents the majority of the separate unit's value, a "disposition"-based triggering event could occur.[180] Application of the *de minimis* standard and disposition triggering events in the context of combined separate units is already fraught with uncertainty and the recast rule, if not changed, is likely to create additional uncertainty in this

[179] *See generally* Treas. Reg. §§ 1.1503(d)-3(a) and (c)(4)-(5); 1.1503(d)-7(c), Ex. 13; and IRS Advice Memo 2008-007.

[180] *See* Treas. Reg. § 1.1503(d)-6(e)(1)(iv)-(v).

complex area. From a policy perspective, debt issued by a separate unit that is expected by the issuer to be treated as debt cannot be considered to have been issued with any purpose of enabling the losses or expenses of the separate unit to be "double dipped" by the holder. A recasting of that instrument as a result of section 385 policies, which are wholly unrelated to the dual consolidated regime's underpinnings, is not an appropriate occasion to trigger application of the dual consolidated loss recapture regime. We therefore request that Treasury and the IRS ameliorate this harsh and presumably unintended consequence by adding: (i) a new exception in Treas. Reg. § 1.1503(d)-3(c) that prevents the ownership of a separate unit arising because of the Prop. Treas. Reg. §§ 1.385-1 or 2 rules from giving rise to a foreign use under Treas. Reg. § 1.1503(d)-3, and (ii) a new exception in Treas. Reg. § 1.1503(d)-6(f) that excludes an equity ownership change arising from a recast under Prop. Treas. Reg. §§ 1.385-1 or -2 from being taken into account as a disposition of the separate unit's assets or of the domestic owner's interest in the separate unit for purposes of Treas. Reg. § 1.1503(d)-6(e)(1)(iv) and (iv).

46. No affirmative use. It is not clear what purpose is to be served by the no affirmative use rule of Prop. Treas. Reg. § 1.385-2(d). When viewed at the time of the issuance of a debt instrument, a taxpayer that intentionally fails to satisfy the documentation and substantiation requirement with the evil motive of securing some advantage inherent in equity treatment of the debt instrument could far more easily arrange to use an equity instrument in lieu of the debt instrument, such as non-qualified preferred stock, or some other instrument that would be treated as stock under general tax principles. At the same time, the presence of such a rule adds inherent uncertainty and risk to all EGI issuers. If the intent is to prevent taxpayers from retroactively electing into equity treatment some time after issuance by failing to comply with an information request or by destroying documents, sufficient tax procedural rules are currently in place to address such an abuse. Nonetheless, if this is the intent, we recommend that the no affirmative use rule be re-written to focus on post-issuance conduct by referring to "the requirements of paragraph (b)(2)(iv)(B) or paragraph (b)(4)" of 1.385-2.

47. Effective date. As discussed in the attached letter, taxpayers should be given a reasonable amount of time to evaluate final rules and to design and implement protocols and systems to comply with the rules. An immediate effective date is fundamentally unfair. Moreover, given the potential consequences of failing to fully comply with the rules, the cascading and evergreen effects, and the cliff effect of the threshold exception in Prop. Treas. Reg. § 1.385-3(c)(2), the unfairness of an immediate effective date could be compounded. Thus, provide an applicability date in Prop. Treas. Reg. § 1.385-2(f) that is at least one year after the date final regulations are published in the Federal Register, and in no event prior to June 1, 2017.

48. Effective date and transition rules. As discussed in the attached letter, corporate groups that are not subject to the rules (due to size thresholds or lack of a U.S.-tax nexus) will be brought into the rules in subsequent years due to growth, or due to mergers and acquisitions activity, or due to being acquired by a U.S. acquirer. For example, if a large U.S. corporate group acquires a large foreign corporate group that previously had no U.S. trade or business, permanent establishment or subsidiary, the foreign target group could have substantial amounts of intercompany debt instruments that had been issued subsequent to the issuance of regulations and yet would have had no reason to comply with the rules. Similarly, if a large domestic corporate group were to acquire a modest sized domestic target group, the target group might have had no reason to comply with the regulations due to the applicable dollar thresholds. Where the parent of such a target group is acquired, there might not be any occasion to "clean-up" the target group's intercompany indebtedness. Moreover, in our experience, target groups are reluctant to undertake the trouble

and expense of "cleaning-up" an intercompany debt structure prior to the closing of an acquisition—after all, why incur the effort and expense, when the closing might be delayed or might not occur? Similar issues could arise where two modest-sized corporate groups merge and create a single group that is too large to satisfy the dollar-threshold requirements of the exception in Prop. Treas. Reg. § 1.385-2(a)(2)(i). Moreover, in all of these circumstances, the target group might have relied upon its foreign status or its relatively modest size as an way around having to comply with the proposed regulations, and thus refrained from employing protocols and systems to capture historic information that might be necessary to determine whether its intercompany debt instruments could be immediately subject to recharacterization.

In these situations, there is no policy justification for immediately subjecting a target group's intercompany debt instruments to the documentation and substantiation rules, which would in effect present a retroactive application of the rules to instruments that had been issued at a time when the target group was not subject to the regulations.

The effective date rule in Prop. Treas. Reg. § 1.385-2(f) should be modified so that it does not apply to a debt instrument that was issued at a time when the issuer was either not subject to the documentation rules due to the exceptions in those rules, or was not U.S.-tax relevant. Moreover, that rule should not be undermined by some deemed reissuance of a previously issued debt instrument, and should provide there is no deemed issuance of such a debt instrument upon joining an acquiring expanded group, either, notwithstanding the rule in Prop. Treas. Reg. § 1.385-2(c)(2), -2(c)(4), or some other rule. Finally, a transition period of 90 days should be added to allow a broad range of ordinary course transactions (including cash management systems) to not run afoul of these rules, to give the acquiring corporate group the time necessary to integrate the acquired group into its Prop. Treas. Reg. § 1.385-2 documentation compliance systems.

<u>Prop. Treas. Reg. § 1.385-3</u>

49. General and funding rules. One of the apparent policy goals underlying the general rule is that the issuance of a debt without a corresponding equity investment "lacks meaningful non-tax significance, such that respecting the distributed instrument as indebtedness for federal tax purposes produces inappropriate results." 81 Fed. Reg. at p. 20917. We disagree with this statement. First, as discussed in the body of the letter, Congress has the exclusive province to declare the appropriateness of the results, especially given that debt distribution transactions have been addressed by the U.S. Supreme Court and various U.S. Courts of Appeals years before Congress enacted section 385, and yet there is nothing in the text of section 385 or the legislative history that authorizes regulations that would categorically preclude the distribution of indebtedness. In addition, in subsequent legislation that remains in the Code in sections 312(a)(2) and 1275(a)(4), Congress itself specifically recognized and thus implicitly acquiesced in note distributions.

    Second, it has long been recognized that there is a very real sense no economic significance in any corporate distribution, be it a distribution of money, indebtedness, or other property. As noted years ago:

> A dividend does *not* confer an economic benefit on its recipient. The distribution leaves the shareholder no richer, since his directly-owned assets increase only by the same amount that the beneficial ownership of those assets represented by his stock interest diminishes.[181]

This observation is most apt where the shareholder that receives a distribution is itself a parent corporation that owns all of the stock of the distributing subsidiary corporation. In this context, it is largely immaterial as a matter of economics whether the parent corporation owns the distributed property directly or indirectly. Moreover, the parent corporation can acquire direct ownership of the distributed property by causing the subsidiary corporation to liquidate or reorganize into it, or by reorganizing itself into the subsidiary, and such a transaction would qualify for non-recognition treatment in most cases.[182] This is true not only with respect to a distribution of money, but also with respect to the distribution of other property, whether the other property is the proverbial truck (*i.e.*, a generic asset, as opposed to stock in a subsidiary) or debt. The differences are not based in economics; rather they are based in tax, which treats a shareholder as having recognized income when it receives a dividend and imposes recognition treatment on a distributing corporation when it distributes appreciated property (at least, as to the latter, since the 1986 repeal of the *General Utilities* doctrine), and in law and legal entitlements, where the shareholder's legal rights with respect to an asset will differ based upon whether the shareholder owns the asset outright or through corporate solution. We observe that Congress respects the law-based difference, which is what triggers dividend income in the hands of the shareholder under section 61(a)(7).[183]

From the same flawed policy underlying the general rule as to the distribution of a debt come a series of additional rules. First, the general rule of Prop. Treas. Reg. § 1.385-3(b)(2) is extended to recharacterize as stock related-party debt issued to acquire stock in an EG member. The Treasury Department and Service claim that this transaction "is similar in many respects to a distribution of a debt instrument and implicates similar policy considerations," 81 Fed. Reg. at p. 20917.[184] Next, the

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[181] Charles I. Kingson, *The Deep Structure of Taxation: Dividend Distributions*, 85 Yale L.J. 861, 863-864 (1976) ("A dividend therefore is included in gross income not because it affects the shareholder's net worth (which is increased even by undistributed corporate profits), but because the distributed property no longer is in corporate solution. It can be argued that obtaining control over the distributed property-being able to use or dispose of it as the shareholder wants-benefits the shareholder in a tangible way. The corollary, however, must be that the original conversion of money from personal to investment use through the purchase of stock worsened his economic position.").

[182] Rev. Rul. 70-223, 1970-1 C.B. 79. Special rules could apply to certain cross-border transactions, such as an inbound or outbound reorganization.

[183] The legal entitlement to assets of the corporation is key, as is seen in *Eisner v. Macomber*, 252 U.S. 189, 194-5 (1920) ("The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit"), and in *Kraft Foods Co. v. Commissioner*, 232 F.2d at 124 ("[I]t is one thing to say that transactions between affiliates should be carefully scrutinized and sham transactions disregarded, and quite a different thing to say that a genuine transaction affecting legal relations should be disregarded for tax purposes merely because it is a transaction between affiliated corporations.").

[184] We would observe that this rule would extend categorically to all acquisitions of EG-member stock, regardless of whether the particular transaction has the effect of a distribution (with one modest exception). The preamble seeks to justify this extension by reference to the policies underlying section 304, which was enacted "to prevent taxpayers from acquiring affiliate stock to convert what otherwise would be a taxable dividend into a sale or exchange transaction." 81 Fed. Reg. 20912, 20917 (Apr. 8, 2016) (citation omitted). The preamble then notes that if this rule were not in place, taxpayers could readily avoid the debt distribution rule by acquisitions of EG member

Treasury Department and Service would extend the general rule to recharacterize debt instruments issued as boot in an intercompany asset reorganization, because "internal asset reorganizations can operate in a similar manner" to acquisitions of EG-member stock. From the flawed policy at the heart of the general rule, the funding rule follows, because without it, a taxpayer that otherwise would have issued a debt instrument in a one-step transaction could use a multi-step transaction to avoid the application of the general rule. 81 Fed. Reg. at p. 20918. Finally, the Treasury Department and Service wrote the *per se* rule "because money is fungible and because it is difficult for the IRS to establish the principal purposes of internal transactions." 81 Fed. Reg. at p. 20923.

All of these operative rules appear to follow from the basic policy determination that the issuance of a debt instrument without a concomitant infusion of equity can no longer be tolerated.

The obvious follow on to these rules is that taxpayers should be given credit for equity infusions.

Condemning taxpayers for issuing debt instruments without giving credit for new equity investment is unbalanced, is not supported by the policy choices the Treasury Department and Service have articulated in the preamble, and is unnecessarily punitive.

We recommend that issuances of debt instruments should be netted against new capital investments (in the form of capital contributions and equity investments), prior to applying the rules in the proposed regulations. If the *per se* rule is to be retained, the same time period for the rule should be relevant for purposes of netting new capital investments, and if a taxpayer is not permitted to rebut the presumption under the *per se* rule then there should be a balancing *irrebuttable* presumption in favor of capital and equity infusions.

50. General and funding rules. One of the triggers for the application of the general and funding rules is the acquisition of EG-member stock. Certain restructuring transactions that are undertaken in connection with the sale or distribution of a business line might be effectuated with related-party debt, in transactions that result in the acquirer and seller no longer being related. Some of these transactions involve short-term debt instruments that will be "cleaned-up" prior to the separation, which we recommend should be excluded under a general exception for short-term indebtedness. We also recommend that an acquisition of EG-member stock not be treated as a general rule triggering transaction if the acquirer, seller, and target are not members of the same expanded group at the end of the transaction or series of transactions that are part of the same integrated plan. Similar language appears in Treas. Reg. § 1.338-3(b)(3)(ii)(C), to set forth the time to test relationships for the purpose of determining whether there has been a qualified stock purchase (which cannot be effected from a related-party). In this context, there is little reason to impose an equity recharacterization of a debt instrument, followed shortly thereafter by a further recharacterization when one of the parties leaves the EG (with the likely result that a deemed redemption of the recharacterized debt instrument in exchange for a re-recharacterized debt

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stock that would have the effect of a distribution. However, we observe that the general rule does not exclude acquisitions of EG-member stock that would not have the effect of a distribution and are not covered by section 304, such as taxable stock acquisitions (including those that are excused from section 304 because the selling entity does not control the target corporation after the transaction – which we discuss in a comment) and acquisitions that are without section 304 due to the lack of control (*see* Rev. Rul. 74-605). In addition, the general rule does have a limited exception for the acquisition of EG-member stock in a section 351 exchange, but that exception is complex and unnecessarily limited.

instrument would be treated as a sale or exchange redemption under section 302(a)) or when the debt instrument leaves the EG.

51. General and funding rules. The acquisition by a subsidiary of stock in a corporate parent (or in a higher-tier entity) that is made in connection with equity compensation or a taxable purchase of assets from an unrelated seller does not implicate the concerns underlying the proposed regulations. However, such acquisitions appears to be covered by the general and funding rules. Prop. Treas. Reg. § 1.385-3(b)(b)(ii) and Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(B). While the rules would exempt acquisitions of EG member stock in an "exempt exchange," that term is defined too narrowly. For example, consider the transaction described in Treas. Reg. § 1.1032-3(e), *Example 1*:

    Example. *X,* a corporation, owns all of the stock of *Y* corporation. *Y* reaches an agreement with *C,* an individual, to acquire a truck from *C* in exchange for 10 shares of *X* stock with a fair market value of $100. To effectuate *Y*'s agreement with *C, X* transfers to *Y* the *X* stock in a transaction in which, but for [Treas. Reg. § 1.1032-3], the basis of the *X* stock in the hands of *Y* would be determined with respect to *X*'s basis in the *X* stock under section 362(a). *Y* immediately transfers the *X* stock to *C* to acquire the truck.

    The example concludes that no gain or loss is recognized on the disposition of the *X* stock by *Y*, and it states that under Treas. Reg. § 1.1032-3(b)(1), immediately before *Y*'s disposition of the *X* stock, *Y* is treated as purchasing the *X* stock from *X* for $100 of cash contributed to *Y* by *X*, with the result that under section 358, *X*'s basis in its *Y* stock is increased by $100.

    A similar result, for the same reasons, is presented in *Example 4* of Treas. Reg. § 1.1032-3(e), only in that example the stock is issued to an employee of the subsidiary for services provided to the subsidiary.

    In neither of these examples is there a net decrease in the equity or gross assets of the subsidiary; rather, the subsidiary is engaging in value-for-value exchanges with otherwise unrelated persons to acquire an asset or services, with the purchase price implicitly funded by the parent corporation. Yet, each of these examples involves a deemed purchase by a subsidiary of stock in its parent, which implicates the general, funding and *per se* rules, because the parent and the subsidiary necessarily share an EG-relationship. These deemed EG stock purchases have nothing to do with the policies underlying the proposed regulations. The "exempt exchange" definition in Prop. Treas. Reg. § 1.385-3(f)(5) references section 1032, but only where the transferor and transferee are parties to a reorganization.

    We recommend adding a rule that would exempt deemed purchases of EG member stock that are described in Treas. Reg. § 1.1032-3, as well as actual purchases of EG member stock in comparable scenarios. This exemption can be limited to an amount of stock that is not excessive by reference to the services performed or assets acquired, and 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.

    If the Treasury Department and Service believe that such an exception would exempt transactions that resemble reorganizations from the ambit of the proposed regulations, an exception to this exception could be added to apply the rules to EG member stock acquired in a transaction where the

subsidiary entity acquires either substantially all of the stock of a target corporation, or an amount of stock in the target corporation that constitutes control (within the meaning of section 368(c)).

52. General and funding rules. Clarify the interaction between the recently finalized regulations regarding reorganizations under section 368(a)(1)(F) and the proposed regulations.

    Treas. Reg. § 1.368-2(m)(3)(iii) provides that a transaction may qualify as an F reorganization even though a holder of stock in the transferor corporation receives a distribution of a 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 receipt of such a distribution is treated as an unrelated, separate transaction from the reorganizations, whether or not connected in a formal sense.

    > Example. FP owns US1, and seeks to change its state of incorporation. To effectuate the change, US1 forms US2 and merges into US2. In the merger, FP receives US2 stock and a US2 debt instrument in exchange for its US1 stock.

    The merger could qualify as an F reorganization and the US2 debt instrument would be treated as distributed in an unrelated, separate transaction. This would seem to set the stage for applying the general rule to treat the US2 debt instrument as stock as of its issuance. This presents a chicken-and-egg issue, because if the US2 debt instrument were stock *ab initio*, the distribution rule of Treas. Reg. § 1.368-2(m)(3)(iii) would not apply, the underlying debt instrument would not have been issued in a distribution, and as a result there would not be a distribution that would trigger the general rule of Prop. Treas. Reg.§ 1.385-3(b)(2)(i). A coordinating rule should be added to clarify the application of the proposed regulations to the issuance of a debt instrument under this and similar circumstances.

53. General and funding rules. The presence of a recharacterized debt instrument can affect the determination of whether one corporation owns or has acquired an amount of stock in another corporation that constitutes control within the meaning of section 368(c). This issue is discussed in the attached letter. A further issue is whether a recharacterized debt instrument can disqualify a reorganization and defeat nonrecognition treatment, due to a failure to satisfy the continuity of interest requirement in Treas. Reg. § 1.368-1(e).

    > Example. P corporation owns all of the stock of T corporation, which is worth $100. P also holds a $40 debt instrument issued by T, which was recharacterized as stock under the funding and *per se* rules. Corporation A seeks to acquire T's assets, and an agreement is reached whereby T will use its excess cash (or will borrow from a bank) to repay the debt instrument held by P, followed by T's merger into A in exchange for $50 in A stock and $50 in cash. Assume that but for the section 385 regulations, the merger would qualify as a tax-free reorganization within the meaning of section 368(a)(1)(A), with P recognizing gain in its T stock to the extent of the $50 boot.

    In form, the transaction is a simple repayment of outstanding indebtedness followed by a tax-free reorganization. One of the qualifying reorganization requirements is that a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization. Treas. Reg. § 1.368-1(e)(1)(i). A proprietary interest in the target corporation is preserved if, in a potential reorganization, it is exchanged for a proprietary interest in the acquiring corporation. What this

means in practice is that at least 40% of the value of the stock in the target corporation must be exchanged for stock in the acquiring corporation.

In the example, based on the form of the transaction P has received $50 of A stock in exchange for its $100 of T stock, which appears to satisfy the continuity requirements. *See* Treas. Reg. § 1.368-1(e)(2)(v), *Example 1*. However, the appearance may be deceiving; because the recharacterized debt instrument is recharacterized as stock and it was redeemed in the transaction, P has received $50 of A stock in exchange for $140 of T stock. In order to be confident that the merger can satisfy the continuity requirement and qualify for tax-free reorganization treatment, P will have to receive $56 worth of A stock. We recommend that this issue be considered in connection with the determination of control issues discussed in the attached letter. The policies underlying the non-recognition rules are the same ones implicated by this example.

54. General and funding rules. If a portion of a debt instrument is recharacterized as stock, and a portion remains respected as indebtedness, taxpayers should be allowed to determine how to allocate actual payments of interest between the stock and debt portions. This issue is presented in any circumstance in which a portion of a debt instrument is recharacterized as stock, regardless of whether as a result of the bifurcation rule, the documentation rules, or the general and funding rules.

55. Funding rules. The funding rule could have an unexpected application where a particular corporation is a member of one EG at the time of a note issuance, and a different EG at the time of a disfavored distribution or acquisition. This appears to be a drafting issue, where clarification would be helpful.

    Example. USP owns CFC1. FP owns FSub. In Year 1, FSub makes a distribution of $100 to FP. In Year 2, CFC1 purchases FSub from FP in exchange for cash. In Year 3, FSub borrows $250 from USP or from CFC1, and issues a debt instrument in exchange.

    The question that arises is whether FSub's Year 1 distribution to FP would taint $100 of the $250 Year 3 debt instrument under the funding and *per se* rules. As currently drafted, the rules refer to a distribution by FSub to a member of FSub's EG. Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(A). At the time of the distribution in Year 1, FP and FSub were members of the same EG, even though they are no longer in an EG-relationship in Year 3 when issues a debt instrument. The rules should be clarified to require the distributee (or seller, in the case of an acquisition) to be a member of the issuer's EG at the time of the issuance.

    The same issue might be implicated if the facts are reversed:

    Example. USP owns CFC1. FP owns FSub. In Year 1, FSub borrows $100 from FP, and issues a debt instrument in exchange. In Year 2, CFC1 purchases FSub from FP in exchange for cash. In Year 3, FSub distributes $100 to CFC1, and issues a debt instrument in exchange.

    In this example, contrary to typical commercial practice, the target corporation remains indebted to the seller. In Year 2, when a distribution is made to an EG member, the debt instrument continues to be held by FP, which is not a member of FSub's EG at that time. However, the language of the funding and *per se* rules key off the *issuance* of a debt instrument to a member of the issuer's EG (which FP was at the time of the issuance) and the *distribution* to (or *acquisition* from) a member of the issuer's EG (which CFC1 is at the time of the distribution). These rules seem only to contemplate

that the counterparty to the issuance, distribution, or acquisition be a member of the issuer's EG at the time of the issuance, distribution or acquisition, respectively—but not that all counterparties be a member of the issuer's EG simultaneously. There is a rule in Prop. Treas. Reg. § 1.385-3(d)(2) that addresses what happens when a recharacterized debt instrument that is treated as stock leaves the EG, but that rule does not appear to prevent a recharacterization of the debt instrument when, as in the example, the debt instrument was not recharacterized as stock at the time it left the EG .

We recommend that the operative rules be modified to provide that the distribution (or acquisition) and the debt issuance must be made to members of the same EG (*i.e.*, both the distribution/acquisition and funding "legs" occur within the *same* EG). A recharacterization of the FSub debt instrument in either example as stock would not serve the policies underlying the proposed regulations.

We recognize that there are complexities that such a rule could entail:

> Example. USP owns CFC1 and CFC2; CFC2 owns CFC3. In Year 1, CFC1 purchases the stock of CFC3 from CFC2 in exchange for a debt instrument. In Year 3, CFC2 distributes the CFC1 debt instrument to USP, and USP sells the stock of CFC2 to an unrelated purchaser.

In this example, the issuer (CFC1) and the seller in the stock acquisition (CFC2) do not remain in an EG relationship with each other. However, the CFC1 debt instrument remains in the issuer's EG. While we disagree with the policies underlying the proposed regulations, we recognize that the Treasury Department and Service would perceive their policy choices to be violated by exempting the CFC1 debt instrument from the proposed regulations.

Perhaps a better way to avoid an inappropriate debt recharacterization, without undermining the policy choices embedded in the proposed regulations, would be to "de-link" the issuance of a debt instrument from a distribution or acquisition where the issuer (the "funded member") leaves the EG. Alternatively, perhaps a rule could be written (paralleling Prop. Treas. Reg. § 1.385-2(d)(2)) to provide that a debt instrument that has left the EG-relationship will not be recharacterized as stock under the funding or *per se* rules, based on a transaction that occurs after the debt instrument has left.

We observe that further complications can be expected in the context of the rules applicable to predecessors and successors, within the meaning of Prop. Treas. Reg. §§ 1.385-3(f)(9) and -3(f)(11), and we have made recommendations elsewhere in this Appendix regarding these rules. We recommend that the issuance of a debt instrument should be "de-linked" from acquisitions and distributions made by predecessors and successors, where the "funding" entity and the distributee (or seller in an acquisition) are not members of the same EG.

We appreciate that the rules in the proposed regulations are complex and could lead to results that we cannot fully comprehend at this point—something that we hope the Treasury Department and Service also appreciate. If the Treasury Department and Service are concerned that there could be some circumstances in which the modifications we recommend in this comment could lead to mischief, our recommended modifications could be limited to the *per se* rule of Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(B). This would leave the underlying debt instruments subject to the principal purpose rule of Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(A).

56. Funding rule. The funding and *per se* rules should be revised to clarify that a particular debt instrument that has been repaid prior to a particular distribution, stock acquisition or asset reorganization cannot be recharacterized under the rules as a result of the post-retirement transaction, even if the subsequent distribution were to occur in the same taxable year. No tax policy rationale supports linking a debt that has been repaid to a transaction that occurs after the debt was repaid. Such a debt cannot be considered to have funded the later transaction, and the policies underlying the proposed regulations cannot properly justify the consequences of a retroactive recharacterization of a debt instrument subsequent to its repayment.

57. Funding rule. The complete liquidation of a subsidiary should not be considered a distribution of property for purposes of Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(A), and it should not trigger a recharacterization. For example, If USP owns CFC1 and CFC2, and CFC2 owns CFC3, a loan from CFC1 to CFC3 should not be recharacterized as equity if CFC3 were to completely liquidate into CFC2. Instead, the successor rule would treat CFC2 as a successor to CFC3 for purposes of the funding rule, which is a more appropriate rule. A similar rule should apply with respect to any situation where all or substantially all of the assets of a funded corporation are transferred to another corporation that is a successor to the transferor under Prop. Treas. Reg. § 1.385-3(f)(11)(i), such as to another corporation pursuant to a plan of reorganization. The ability to characterize the transferee as a successor to the transferor justifies a deferral of any potential debt recharacterization, because the rules can continue to operate if, as and when the successor/transferee engages in some disfavored acquisition or distribution within the timeframe of the *per se* rule.

58. Funding Rule. The acquisition of EG member stock for a debt instrument (to the extent within the current year earnings and profits exception in Prop. Treas. Reg. § 1.385-3(c)(1)) should not be considered the issuance of a note in exchange for property for purposes of further applying Prop. Treas. Reg. § 1.385-3(b)(3)(ii). That is, that excepted acquisition should not be considered to "fund" the issuing corporation. Throughout the -3 regulations, EG member stock is not viewed as property contributing to the assets of an acquiring company. That treatment should apply for purposes of the Funding Rule as well. (We make a similar recommendation below regarding distributions, in our comments to the current year earnings and profits rule.)

59. Funding Rule. The Funding Rule should be clarified to make clear that the issuance of cash boot in a reorganization cannot cause the recast of debt at both the acquiring corporation and the target corporation in the reorganization. That is, both Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(A) and (C) should not be allowed to apply to the same reorganization.

    <u>Example</u>. FP owns FS, US1 and US2. In Year 1, US1 and US2 each borrowed funds from FS, and each issued a debt instrument to FS in exchange. In Year 3, FP causes US2 to merge into US1 in a reorganization within the meaning of sections 368(a)(1)(A) and 368(a)(1)(D). US2 is worth $100; P receives $90 of US1 stock and $10 in cash in the merger.

    This example involves an asset reorganization, within the meaning of Prop. Treas. Reg. § 1.385-3(f)(1). US1 and US2 are each "funded" members, because each has issued a debt instrument to FS. US1 is US2's "successor," and US2 is US1's predecessor, within the meaning of Prop. Treas. Reg. §§ 1.385-3(f)(9)(i) and -3(f)(11)(i).

    The reorganization involves $10 in cash boot; we question whether this $10 would result in the recharacterization of $20 of debt instruments under the funding rule.

From US1's perspective, it acquires property (US2's assets) in an asset reorganization, and FP—a member of the same EG immediately before the reorganization—receives money within the meaning of section 356 with respect to its stock in US2. US1 is also a "funded" member, given its issuance of a note in Year 1 to FS. This implies that $10 of the US1-to-FS debt instrument would be recharacterized as stock under Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(C) and -3(b)(3)(iv)(B). As applied to US2, it is treated as having received the $10 from US1 in an exchange described in section 361(b), and as having distributed the $10 to FP pursuant to section 361(c). This might be viewed as a distribution of property (defined in Prop. Treas. Reg. § 1.385-3(f)(10) by reference to section 317(a), thus inclusive of money), to FP (a member of US2's EG). The $10 would be treated as other property or money for purposes of section 356, thus the exclusion in Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(A) does not apply. US2 is a "funded" member, given its issuance of a note in Year 1 to FS. This implies that $10 of the US2-to-FS debt instrument would be recharacterized as stock under Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(A) and -3(b)(3)(iv)(B).

There is an overlap rule in Prop. Treas. Reg. § 1.385-3(b)(iii) that provides that "to the extent all or a portion of a distribution or acquisition by a funded member is described in more than one paragraphs (b)(3)(ii)(A) through (C) of this section, the funded member is treated as engaging in only a single distribution or acquisition described in paragraph (b)(3)(ii) of this section." This overlap rule does not appear to apply, because US1 and US2 are separate members of the EG, and each one is making only a single distribution or acquisition. The problem is that the $10 cash boot is viewed as funding US1's acquisition, and US2's distribution, which does not easily fit into the overlap rule as drafted.

We recommend that the overlap rule in Prop. Treas. Reg. § 1.385-3(b)(3)(iii) be revised to ensure that the issuance of boot in an asset reorganization does not lead to duplicative debt instrument recharacterizations.

60. Funding, *per se* and timing rules. There is a further duplication issue that warrants a correction:

> Example. FP owns USP and FSub. In Year 1, FSub lends $100 to USP in exchange for a 5-year debt instrument, and USP uses the proceeds to expand its business. The debt instrument is properly documented. In Year 3, when USP's business has increased in value, USP makes a $20 dividend distribution to FP out of its accumulated earnings and profits, and later in Year 3 USP transfers $100 to FSub to prepay and retire the Year 1 loan.

The USP debt instrument is respected as indebtedness when it is issued in Year 1. In Year 3, as a result of USP's distribution to FP, $20 of the Year 1 debt instrument is recharacterized as stock under the funding and *per se* rules. This results in a $20 dividend-equivalent redemption later in Year 3, when FP prepays the debt instrument—which is itself an additional $20 distribution within the *per se* rule's 3 year period. The timing rule of Prop. Treas. Reg. § 1.385-3(d)(1)(ii) provides that when a debt instrument is recharacterized as stock under the funding rule by reason of a distribution that occurs in a taxable year subsequent to the taxable year in which the debt instrument was issued, the debt instrument is deemed to be exchanged for stock when the distribution occurs. This could be read to indicate that a second $20 portion of the Year 1 debt instrument is recharacterized as stock at the moment it is repaid, resulting in $40 of distributions. If the facts are altered such that in Year 3 USP prepays $50 of the $100 debt instrument, and prepays the remaining $50 in Year 4, the duplication issue is more problematic (and can no longer be resolved with a simple fix to the timing rule of Prop.

Treas. Reg. § 1.385-3(d)(1)(ii)). Rather, the duplication issue in this alternative example should be addressed by a more general anti-duplication rule,[185] or perhaps by some sort of overall cap rule that looks to the net diminution of paid-in capital or retained earnings. In either version of this example, there is a single, net $20 distribution from USP to FP. The rules should not operate to recharacterize more than $20 of USP's debt instrument as stock.

61. Ordinary course exception. The funding rule facially appears intended to apply to related-party debt instruments that are issued with a principal purpose to fund a distribution, an acquisition of EG-member stock, or an acquisition of assets in an asset reorganization in exchange for boot. The *per se* rule applies as a type of force-of-attraction rule to say that regardless of the purpose of a particular borrowing, the issuance of a debt instrument will be irrebuttably linked with such a disfavored transaction if the transaction and the borrowing occur within 36 months of each other.

    The ordinary course exception in Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(B)(*1*) seems intended to operate as a limit to the *per se* rule, and would provide that the issuance of a debt instrument will not be linked to a distribution, acquisition of EG-member stock, or acquisition of assets in an asset reorganization in exchange for boot, provided the debt instrument was issued in certain narrow circumstances. The underlying concept—that the issuance of a debt instrument has no factual relationship to some other disfavored transaction—has the same strength outside of the narrow confines of the ordinary course exception, and the exception should be expanded to cover additional circumstances. For example, why should the exception be limited to the amounts that are currently deductible under section 162 (or capitalized into inventory or cost of goods sold)? The reason for this exception is equally applicable with respect to amounts that are deductible under section 164 (such as where one entity implicitly borrows from a nonconsolidated affiliate to pay state taxes in a unified filing state, or perhaps where one CFC borrows from a related same-country CFC to pay local taxes, or where one entity pays the taxes of another with concomitant balancing journal entries creating intercompany debt).[186] Similarly, debt issued to fund purchases of section 1231 property (property used in a trade or business) should qualify for an ordinary course exception. For example, if a CFC purchases equipment from its US parent corporation on credit at the beginning of a year, and immediately places the equipment in service as part of its manufacturing or production operations, the CFC would be entitled to depreciation deductions on the equipment for the current year, some of which would be capitalized into the inventory it produced in that year, and some into its cost of goods sold for that year, under cost accounting principles and the UNICAP rules of section 263A. Those portions of the purchase price should qualify for the ordinary course exception of Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(B)(*3*) as it is currently articulated; however, the remaining portion of the equipment's purchase price would be capitalized and would reside in CFC's basis in the equipment. Thus, a debt instrument issued to fund that portion of the purchase price could not qualify for the exception. What rational tax policy demands this distinction?

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[185] We have made a number of comments regarding the potential for duplicative recharacterizations. Perhaps, in addition to the anti-duplication modifications we recommend, a general anti-duplication rule would be warranted. *See* Treas. Reg. § 1.1502-80(a)(2).

[186] This can happen where one domestic entity pays the taxes of a related nonconsolidated entity, where both join in a unitary state tax filing, or where one CFC pays the taxes of a related, same-country CFC, and the payments are booked with contemporaneous journal entries to set up intercompany payables/receivables. A similar phenomenon is implicitly recognized in the consolidated context in Treas. Reg. § 1.1502-33(d)(6), *Example 1(c)*.

62. Current year earnings and profits exception. See the body of the letter for a discussion of the CYEP exception, and a recommendation that it refer to the current earnings and profits of the immediately preceding year.

63. Current year earnings and profits exception. As we read the CYEP exception, it applies as measurement device for purposes of determining the amount of distributions and acquisitions that are within an exception to the funding and *per se* rules, and is not an operative rule that designates the particular pool of earnings and profits from which a distribution is made. It would be helpful to clarify this point, and to clarify the relationship between the CYEP exception and the section 959(a) rules regarding the distribution of previously taxed income.

64. Current year earnings and profits exception. As we read the CYEP exception, it could except a debt instrument issued to fund an acquisition from the operation of the general rule, but the same debt instrument could be caught under a subsequent application of the funding and *per se* rules.

    Example. USP owns CFC1 and CFC2. In Year 1, CFC1 generates $100 of current earnings and profits. On December 31 of Year 1, CFC1 issues a $75 debt instrument to USP to purchase the stock of CFC2 (and during Year 1 CFC1 has made no other distributions, or has not acquired any other EG member stock, and has not participated in an asset reorganization). USP recognizes and takes into account $75 in dividend income for the year under sections 61(a)(7), 304(a)(2), 302(d) and 301(c)(1). In Year 2, CFC1 generates no current earnings and profits, though it distributes $10 to USP as a dividend from its Year 1 earnings and profits.

    In Year 1, when the CFC1 debt instrument is issued, it is respected as indebtedness notwithstanding the general rule in Prop. Treas. Reg. § 1.385-3(b)(2)(i) because it qualifies for the CYEP exception in Prop. Treas. Reg. § 1.385-3(c)(1).

    It is not clear whether, in Year 2, CFC1's $10 dividend distribution causes $10 of the $75 Year 1 debt instrument to be recharacterized as stock. In Year 1, the presence of $100 in current year earnings and profits means that the $75 EG member stock acquisition is reduced to zero.[187] In Year 2, there are no current year earnings and profits, and thus the $10 distribution appears eligible to be linked under the *per se* rule with the Year 1 $75 debt instrument.

    Example. The facts are the same as in the prior Example, except that in Year 1, CFC1 has no current earnings and profits and it distributes $10 to USP, and in Year 2 CFC1 generates $100 in current earnings and profits and it issues a $75 debt instrument to USP in exchange for the stock of CFC2.

    In this alternative example, it is similarly unclear whether the $10 Year 1 distribution might cause a portion of the $75 Year 2 debt instrument to be recharacterized as stock. The language of the CYEP exception starts with the phrase "For purposes of applying [the general and funding rules] to a member of an expanded group with respect to a taxable year…." The focus on the application of the CYEP rule with respect to a particular taxable year, combined with its operative language that focuses on a reduction in the aggregate amount of distributions or acquisitions, implies that after

[187] The proposed language states that distributions and acquisitions for a particular year are reduced by the amount of the current year earnings and profits. We assume that the reduction is not intended to reduce the amount of distributions to an amount below zero.

application of the CYEP exception, the aggregate amount of Year 2 distributions or acquisitions is zero—but the CYEP rule does not seem to disregard the $10 distribution in Year 1, and nothing appears to prevent the linkage of that Year 1 $10 distribution with the Year 2 debt instrument.

If this is the proper interpretation, we would observe that the proposed regulations are unnecessarily overbroad and would apply in an arbitrary manner, with no reasonable tax policy support. In both fact examples, there was a total of $100 of earnings and profits and only $85 of acquisitions and distributions, and the debt instrument was issued in a year in which there were more than enough current year earnings and profits to justify the debt instrument's issuance. This interpretation also serves to illustrate that the CYEP exception can operate as a trap for the unwary.

We recommend that a debt instrument that is issued in a manner that qualifies for the CYEP exception for the year of its issuance be exempted from the subsequent applications of the funding and *per se* rules. (We make a similar recommendation above in connection with a comment on the funding rule.)

65. Current year earnings and profits exception. The ordering rules in Prop. Treas. Reg. § 1.385-3(b)(3)(iv) should be amended to allow taxpayers to designate which distributions and acquisitions are claimed under the exception. This could be effected pursuant to a statement included with a tax return. The potential for retroactive applications of the proposed regulations, for various tax adjustments including constructive distributions, and retrospective adjustments to estimates of earnings and profits, adds uncertainty to the CYEP rule's application. The ability to designate a specific intended ordering would allow taxpayers to mitigate some of the uncertainty, and potentially reduce taxpayer disputes.

66. Current year earnings and profits exception. See the comment below regarding the CYEP exception in the context of a consolidated group.

67. Threshold exception. The threshold exception in Prop. Treas. Reg. § 1.385-3(c)(2) would apply with respect to a debt instrument if *immediately after its issuance*, the aggregate issue price of relevant debt instruments is below the threshold. However, the manner in which the rule is written appears severely to limit its potential usefulness as a simplifying rule.

    Example. USP owns CFC1 and CFC2, and CFC2 owns CFC3. At the beginning of Year 1, the USP EG has related-party debt instruments outstanding with an aggregate adjusted issue price of $42 million that would be recharacterized as stock under the proposed regulations, but for the threshold exception. In Year 2, CFC1 issues a 10-year debt instrument to CFC2 with an issue price of $10 million in exchange for the stock of CFC3 in a group restructuring.

    The Year 2 debt instrument would be recharacterized as stock under the general rule, and together with the previously outstanding $42 million in debt instruments exempted under the threshold exception, would exceed the $50 million threshold. As a result, *all* $52 million of these debt instruments (including the previously outstanding $42 million) would be recharacterized as stock.

    First, the exception would be unavailable for so long as any debt instrument issued by an EG member that was previously issued under the exception remains outstanding, as is illustrated in Prop. Treas. Reg. § 1.385-3(g), *Example 17(ii)(D)*. What this means in the example above is that the USP EG would not be eligible to utilize the threshold exemption for any debt for so long as any of the

$52 million in recharacterized debt instruments remains outstanding, even if the USP group significantly reduces the total amount of outstanding related-party debt instruments (including ones that have been recharacterized as debt instruments) to, say, less than $10 million. What is the policy justification for this indelible taint? If the policy underlying the threshold exception is based on simplification and administrability, to have it function as a type of *de minimis* exception, would this policy be advanced or undermined by the consequences that would occur when a corporate group reduces all outstanding related-party debt instruments to fit within the $50 million threshold? Second, the rule would have an acknowledged cliff effect, which is both harsh and inappropriate with respect to taxpayers who would historically operate within the exception and who might exceed the exception's dollar threshold due to non-abusive factors.

68. Threshold exception. The threshold exception in Prop. Treas. Reg. § 1.385-3(c)(2) would apply with respect to a debt instrument if *immediately after its issuance*, the aggregate issue price of relevant debt instruments is below the threshold. This presents difficult issues in the context of foreign-parented groups.

    Example. FP owns two foreign holding companies (FSub 1 and FSub 2) and a foreign finance company (FSub 3). FSub 1 owns USP, and FSub2 directly and indirectly owns multiple foreign corporations. USP borrows $30 million from FSub 3 in exchange for the issuance of a $30 million debt instrument (which is properly documented).

    This example presents a different aspect of issues that arise as a result of transactions amongst the non-U.S.-tax relevant entities. USP will want to be able to determine (and the service will want to be able to confirm) whether USP's $30 million debt instrument qualifies for the threshold exception of Prop. Treas. Reg. § 1.385-3(c)(2). That provision provides that a debt instrument is not subject to the general or funding rules if the aggregate issue price of debt instruments held within the EG that would be recharacterized under those rules does not exceed $50 million. This issue appears relatively straightforward, but what incentive does FP have to carefully evaluate all of the related-party debt instruments (and cash pooling arrangements) amongst its foreign subsidiaries, and all distributions, acquisitions of EG stock, and intercompany asset reorganizations among the issuers of such debt instruments (and their predecessors and successors—including section 351 transferees—under the broad definitions in Prop. Treas. Reg. §§ 1.385-3(f)(9) and -3(f)(11))? How might the Service obtain and evaluate the relevant information? Even with the best of intentions, USP's tax department might not be able to obtain all relevant information itself, especially considering the costs of obtaining and implementing the systems necessary to capture the necessary data, and its inability to control its foreign parent corporation. Would the Service be in any better position to accurately determine the relevant information, even with subpoena power, if the foreign parent corporation had not implemented a system that captured the information? We have noted in the attached letter that the proposed regulations would have an incentivizing effect that would favor foreign corporate ownership. This aspect of the threshold exception illustrates an additional way in which this effect can be felt.

69. Funded Acquisitions of Subsidiary Stock Exception. The exception in Prop. Treas. Reg. § 1.385-3(c)(3)would be "turned off" if the funded member that is the transferor corporation no longer directly or indirectly owns the transferee corporation during the 36-month period following a transfer of property to the transferee corporation. However, if the transferee corporation is sold for cash in the 36-month window, it is not clear why the "de-investment" by the funded member should

trigger a recast of its debt, or how such a rule would further the policies ostensibly to be served by the rule.

The preamble does not appear to discuss the rationale for this exception. One possible rationale is that it would be an over-reach to treat every section 351(a) exchange and capital contribution as an acquisition that could trigger a recharacterization of the transferor's debt instruments. Such a rule could not credibly be defended, would undermine the strong Congressional policies underlying section 351,[188] and an exception for section 351(a) exchanges and capital contributions is essential. In addition, the preamble does not appear to discuss why the exception would no longer be available if the transferor and transferee are no longer in a more-than-50% control relationship. A possible reason is that this exception has some degree of inter-relatedness with the predecessor and successor rules, and absent these rules, the purposes of the proposed regulations could be avoided through a transferor corporation's funneling borrowed funds through a subsidiary transferee corporation in order to effectuate certain acquisitions. If this is the policy, there should be an exception (*i.e.*, the exception for funded acquisitions of subsidiary stock by issuance should continue to apply) where the transferor sells or exchanges the stock of the transferee in a value-for-value exchange, and where the transferor's interest dips below the 50% control threshold by reason of transactions that have nothing to do with the transferor.

> Example. USP owns CFC1, and CFC1 owns CFC2. In Year 1, CFC1 borrows $100 from USP, and issues a debt instrument in exchange. In Year 3, in an otherwise unrelated transaction, CFC1 transfers $30 of property to CFC2 in exchange for additional shares of CFC2 stock, in a non-recognition exchange described in section 351(a). In an unrelated transaction during Year 4, CFC1 sells the stock of CFC2 to X (an unrelated purchaser) for cash.

CFC1's acquisition of the additional shares of CFC2 stock in the Year 3 section 351(a) exchange is covered under the Prop. Treas. Reg. § 1.385-3(c)(3) exception. However, in Year 4, CFC1 ceases to own more than 50% of the stock of CFC2, and the threshold exception no longer applies. As a result, on the date in Year 4 when CFC1 no longer owns the CFC2 stock, the exception for funded acquisitions of subsidiary stock by issuance would no longer apply, the consequence being that CFC1 would be treated as issuing some amount of its stock (here, 30% of the Year 1 debt instrument) to USP in exchange for the Year 1 debt instrument.

The first thing we observe is that CFC1 should receive additional sales proceeds from X for its CFC2 stock on account of having made the Year 3 contribution to CFC2. When viewed from the perspective of the $30 of debt proceeds CFC1 is deemed to have received from USP and contributed to CFC2, CFC1 would have been "made whole" by receiving $30 of CFC2 stock in exchange, and subsequently by receiving $30 of extra sales proceeds from X. There should be no net diminution in CFC1's net assets or net equity as a result of any of these transactions, and the $30 that it contributed to CFC2 would have come back to it.[189] What, then, is the purpose behind recharacterizing CFC1's Year 1 debt instrument as stock under the general or funding rules?

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[188] Just last year, the Service implicitly recognized these policies in issuing Rev. Rul. 2015-9, 2015-21 I.R.B. 972, and Rev. Rul. 2015-10, 2015-21 I.R.B. 973. *See also* Rev. Rul. 2003-51, 2003-1 C.B. 938; *Hempt Bros., Inc. v. United States*, 490 F.2d 1172 (3d. Cir. 1974); *Portland Oil Co. v. Commissioner*, 109 F.2d 479 (1st Cir. 1940).

[189] We recognize that the $30 of CFC2 stock received in the Year 3 exchange might be worth more, or less, than $30 at the time in Year 4 when it is sold to X. However, the change in value would result from market forces, representing a true economic loss (or gain). Such might well have happened in any event if CFC1 had invested the

Example. USP owns CFC1, and CFC1 owns CFC2. In Year 1, CFC1 borrows $100 from USP, and issues a debt instrument in exchange. In Year 3, in an otherwise unrelated transaction, CFC1 transfers $30 of property to CFC2 in exchange for additional shares of CFC2 stock, in a non-recognition exchange described in section 351(a). In an unrelated transaction during Year 4, unrelated domestic corporation X transfers $200 in cash to CFC2 in exchange for $200 of CFC2's stock, and immediately afterwards X owns 60% of CFC2's only class of stock.

In this example, because CFC1's ownership in CFC2 dips below the more-than 50% threshold within 36 months of transferring the $30 to CFC2, the exception for funded acquisitions of subsidiary stock by issuance would no longer apply, and the consequence would be that CFC1 would be treated as issuing some amount of its stock (here, 30% of the Year 1 debt instrument) to USP in exchange for the Year 1 debt instrument. In this example, if the X-CFC2 transactions are undertaken for fair value (likely in the example due to the arm's length relationship between SP and X) the value of the stock that CFC1 owns in CFC2 should not change. CFC1's net assets and net equity have not changed. There is no *Falkoff/Kraft* planning going on in the example, no subtle repatriation, and we would contend no occasion to recharacterize the CFC1 debt instrument.

Example. FP owns US1, and US1 owns US2 (the latter two do not consolidate). In Year 1, US1 borrows $100 from FP, and issues a debt instrument in exchange. In Year 3, in an otherwise unrelated transaction, US1 transfers $30 of property to US2 in exchange for additional shares of US2 stock, in a non-recognition exchange described in section 351(a). In an unrelated transaction during Year 4, unrelated domestic corporation X transfers $200 in cash to US2 in exchange for $200 of US2's stock, and immediately afterwards X owns 60% of US2's only class of stock.

This example posits the same facts as the preceding example, but presented in the inbound context. And, in this context, there is no base erosion concern present because US1's net assets and net equity remain the same, whether the $100 debt proceeds are held by US1 in the form of cash, in the form of US2 stock, in the form of sales proceeds for the US2 stock, or in some combination of these forms.

Similarly, we question whether such a rule would apply if the transferee corporation's stock becomes wholly worthless within the 36-month period (and if so, why?).

This discussion leads us to question whether there is a legitimate need for a rule that would discontinue the exception, and invoke a recharacterization of the transferor's debt instruments, where the transferor no longer owns a more-than 50% interest in the transferee. We can see why the Treasury Department and Service might perceive a need for a rule to address a situation where the transferee corporation (US2 or CFC2 in the examples above) transfers money or the property to an EG member in a section 304 transaction, or as boot in an intercompany reorganization. But we discern no credible need for a rule where the transferee corporation's stock is sold to an unrelated

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debt proceeds in its own business operations. In any event, the proposed regulations should not be trigged by an economic loss (especially when recharacterizing the underlying debt instrument as stock under the general and funding rules has no relation to traditional debt-equity considerations) than the loss duplication factor of the old "loss disallowance rule" regulations. *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. App. 2001).

person for value, or the percentage ownership is diluted through real contributions from an otherwise unrelated person, or where the transferee becomes wholly worthless, etc.

Given the limited situations in which the 36-month limitation would appear to advance a legitimate policy goal, the limitation should be removed. Alternatively, the exception for funded acquisitions of subsidiary stock by issuance should continue to apply where the stock is transferred to an unrelated person, or is retained (even though diluted in terms of percentage ownership), or becomes wholly worthless.

70. Funded Acquisitions of Subsidiary Stock Exception. The exception in Prop. Treas. Reg. § 1.385-3(c)(3) makes reference to the direct and indirect ownership of stock in the transferee corporation, such that if the requisite quantum of stock is no longer owned within a 36-month period, the exception would no longer apply. For purposes of determining indirect ownership, the rule invokes the limited rules in section 958(a), in lieu of using the broad constructive ownership rules that would apply for the other purposes of the proposed regulations, such as the EG and controlled partnership determinations. The reason for such a constrained rule is neither discussed nor referenced in the preamble, nor is it immediately apparent why it is appropriate to create the complexity inherent in employing different constructive ownership rules in the same set of regulations. We recommend that whatever indirect stock ownership rule is to apply for purposes of Prop. Treas. Reg.§ 1.385-1(b)(1) and -1(b)(3) should also apply for purposes of this exception. Alternatively, it would be helpful to have a discussion in the preamble to the regulations, if and when finalized, as to why the section 958(a) rule should apply in this indirect stock ownership rule context, as opposed to the section 304(c)(3) rule that applies to the other indirect stock ownership questions in the proposed regulations.

71. Funded Acquisitions of Subsidiary Stock Exception. Prop. Treas. Reg. § 1.385-3(c)(3) should be clarified expressly to allow the transferee of a funded member itself to acquire subsidiary stock by issuance without such acquisition being treated as an acquisition of EG member stock. That is, Prop. Treas. Reg. § 1.385-3(c)(3) should expressly contemplate cascading section 351 (and section 721) transactions. The definition of "successor" in Prop. Treas. Reg. § 1.385-3(f)(11) should be amended accordingly.

72. Predecessors and Successors. Clarify that predecessor and successor status (as defined in Prop. Treas. Reg. § 1.385-3(f)(9) and (11), respectively), ends when the predecessor and successor are no longer members of the same EG. This situation could arise in any number of reorganizations or divisive transactions.

73. Treatment of partnerships. The intended consequences of the rule that provides for treatment of partnerships as an aggregate of their partners should be illustrated, to provide some guidance as to what is intended and how the rule should be applied.

    Example. Individual A, a high net worth taxpayer, owns all of the stock of corporations X and Y. A also owns 50% of the interests in partnership PRS. A's spouse and children own the remaining 50% of the interests in PRS. PRS issues a debt instrument to X to memorialize a loan of $100; the PRS debt instrument complies with all of the requirements of Prop. Treas. Reg.§ 1.385-2.

In this example, PRS is a controlled partnership, because each of X and Y would be treated as owning 100% of the interests in each other and in PRS.[190] Under Prop. Treas. Reg. § 1.385-3(d)(5)(i), PRS is treated as an aggregate of its partners. This would appear to suggest that each of the PRS partners is to be treated as issuing his or her proportionate share of the PRS debt instrument. If so, the PRS debt instrument is not subject to the rules of Prop. Treas. Reg. § 1.385-3, because each deemed issuer is an individual, and an individual cannot be an EG member.

Here, we would interpret the rules of the proposed regulations to respect A, A's spouse, and A's children—the actual partners in PRS—as PRS's partners for purposes of the aggregate rule (and, conversely, we do not look at X or Y as PRS partners where their ownership is constructive rather than actual). Thus, the PRS debt instrument in the example would not be subject to the general or funding rules, because it would be treated as having been issued by individuals, who are not members of the X-Y EG. An example would be helpful, to confirm this point.

> Example. Individual A, a high net worth taxpayer, owns all of the stock of corporations X, Y and Z. X and Y each own 50% of the interests in partnership PRS. PRS issues a debt instrument to X to memorialize a loan of $100; the PRS debt instrument complies with all of the requirements of Prop. Treas. Reg.§ 1.385-2.

In this example, each of X and Y owns a 50% interest in PRS, and constructively owns the remaining 50% interest, for a total overlapping ownership of the same 100% of the PRS interests; similarly, Z constructively owns all 100% of the PRS interests. First, partnerships require two or more owners, yet the interests actually and constructively owned by each of X, Y and Z comprise all 100% of the PRS interests. Does this suggest that PRS might be disregarded in its entirety for purposes of the section 385 regulations? Second, if the aggregate rule is intended to apply in the example above to treat X as issuing a $50 debt instrument to itself (a nonsensical situation), and to treat Y as issuing a $50 debt instrument to X, interesting questions arise that require guidance.

As noted in the attached letter, the aggregate rule would overlay one *counter-factual* abstraction on top of another, surely not a recipe for clarity. More likely, it is an invitation for significant taxpayer disputes. This can be expected to result in some degree of confusion in a situation where the partnership is a simple one with static ownership. This would become far more complex where a partnership has (a) varying interests, waterfalls and special allocations, (c) different profits and capital interests, (c) transfers of partnership interests amongst partners, and (d) incoming and departing partners through contributions and redemptive distributions.

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[190] X is treated as owning the stock owned by its shareholder A, by reason of section 318(a)(3)(C). For purposes of the controlled partnership definition in Prop. Treas. Reg. § 1.385-1(b)(1), indirect ownership of a partnership interests is determined by using the "principles" of Prop. Treas. Reg. § 1.385-1(b)(3)(ii), which provides that indirect stock ownership is determined by applying the rules of section 304(c)(3). That latter provision invokes the constructive ownership rules of section 318 with certain modifications. A actually owns 50% of PRS, and applying the constructive ownership "principles" A is treated as owning the remaining 50% of the PRS interests held by A's spouse (section 318(a)(1)(A)) and children (section 318(a)(1)(B)). Thus, A owns 100% of PRS, and under section 318(a)(3)(C) (and the reattribution rule of section 318(a)(5)(A)) X is treated as owning 100% of PRS. The result is that PRS is a controlled partnership within the meaning of Prop. Treas. Reg. §§ 1.385-1(b)(1) and -3(f)(2). For identical reasons and with the identical attributive linkage, Y also would be treated as owning the same 100% of PRS that X owns.

For example, what adjustments are to be made on account of payments that are made on the instrument, in the event the PRS debt instrument is recharacterized as stock? If PRS prepays $20 of the instrument, can PRS allocate the prepayment to a particular portion of the debt instrument? If the debt instrument is recharacterized as stock under the funding rule in a later year, the aggregate rule would treat X as owning a $50 interest in Y, when in fact X owns no such interest. Would section 1032 apply to the deemed issuance of stock in Y to X, and if so, how? Should Y be treated as issuing its fictional stock (*i.e.*, a $50 portion of the PRS debt instrument) directly to X in exchange for $50 of cash, or as contributing its stock to PRS, with PRS acquiring cash from X with the fictional Y stock? Would X be entitled to claim a dividends received deduction with respect to PRS's payments of interest (and on the repayment), and if so, to what extent might section 1059 apply? Would a portion of each payment of interest be treated as a distribution from Y to X, thus potentially tainting other debt instruments actually issued by Y to another EG member?

What treatment if PRS itself sold some of its assets and distributed the proceeds to X and Y (or used the proceeds to pay down bank debt, which could be treated as a distribution to X and Y under section 752(b)); is this to be treated in part as a distribution from Y to X and from X to Y? If it is to be treated as a distribution for purposes of the section 385 regulations, might this taint other debt instruments issued by X or Y to other EG members, or could the distributions be netted to zero, at least where, under facts such as those in the example, the X-to-Y and Y-to-X distributions offset in timing and amount? May X and Y rely on the netting rule in Treas. Reg. § 1.752-1(f), to net contributions and distributions that occur as part of a single transaction? Alternatively, would a distribution by PRS to X and Y not qualify as a "distribution" by X or Y within the meaning of Prop. Treas. Reg. § 1.385-3(f)(4), because it is not in fact a distribution by either X or Y to a shareholder with respect to its stock?

The aggregate rule imposes one *counter-factual* over another— (i) the partnership is an actual legal entity that actually engages in a particular transaction (the relevant actual rights and obligations involve the partnership and its counterparties, not the partners), and (ii) a recharacterized debt instrument in many circumstances will be a debt instrument with terms typical to debt instruments, and that necessarily has satisfied the documentation rules before being tested under the general and funding rules. This can be expected to result in an inordinate degree of confusion.

As noted in the attached letter, we do not believe that regulations under section 385(a) can validly apply to debt instruments issued by a partnership. We understand why the Treasury Department and Service might want to include partnership rules, to prevent taxpayers from seeking to avoid the application of the section 385 regulations through use of partnerships. We question, however, whether the complexities and absurdities inherent in the aggregate rule are worth the trouble.

If our recommendation to exclude debt instruments issued by noncorporate issuers is not accepted, we recommend that clarifying guidance be issued to illustrate that the actual, direct partners of a partnership are respected as partners (*i.e.*, no partners by attribution) and treat them as issuers (or holders) to the extent of their proportionate shares of PRS, and to look through partners only to the extent the actual, direct partner is itself a partnership. As noted elsewhere, we recommend that guidance be provided to help determine a partner's proportionate interest in the partnership. Second, we recommend that consideration be given to replacing the aggregate rule with an anti-avoidance rule, that would apply in some manner where a debt instrument is issued by a partnership with a principal purpose of avoiding the purposes of the general or funding rules; however, we strongly recommend that any such anti-avoidance rule be limited in scope and application, lest it

present the same problems and confounding complexities to the same group of transactions that are presented by the aggregate rule. Moreover, if the aggregate rule is to be retained, we recommend that a series of examples be included to illustrate the basic operation of the aggregate rule in a number of commonly occurring and easily anticipatable circumstances.

74. Treatment of partnerships. The preamble to the proposed regulations states that the Treasury Department and Service are considering rules that would treat preferred equity in a controlled partnership as equity in the expanded group partners.[191] In addition, the anti-abuse rule in Prop. Treas. Reg. § 1.385-3 provides that an interest that is not a debt instrument for purposes of Prop. Treas. Reg. § 1.385-3 or § 1.385-4 (for example, a contract to which section 483 applies or a nonperiodic swap payment) will be treated as stock if issued with a principal purpose of avoiding the application of Prop. Treas. Reg. § 1.385-3 or § 1.385-4. The proposed regulations offer no guidance as to how to interpret the phrase "an interest that is not a debt instrument" and presumably it can be read to include a preferred partnership interest.

    We view the recharacterization of a preferred partnership interest as improper and unnecessary, as the issuance of preferred equity is already subject to a comprehensive regulatory regime under sections 704 and 707, which contain rules to limit abusive transactions. Furthermore, the literal language of the anti-abuse rule could theoretically encompass *almost any* instrument or interest. We therefore recommend that the final regulations narrow the scope of the anti-abuse rule by providing (1) guidance as to what interests are included in the term "interest that is not a debt instrument," and (2) examples of situations that are or are not abusive. We also recommend that the final regulations provide that the issuance of preferred partnership equity is not subject to the section 385 regulations.

75. Treatment of partnerships. The proposed regulations could be read to apply to the distribution by a partnership of its own note to a partner. In such a case, under Prop. Treas. Reg. § 1.385-3, the note could potentially be recast as an equity interest of the distributee partner in the other partners in the partnership. We question this treatment. Under Treas. Reg. § 1.704-1(b)(2)(iv)(e)(2), if a promissory note (that is not readily tradable) is distributed to a partner by a partnership that is the maker of such note, for capital account purposes, such distribution is disregarded until there is a taxable disposition of such note by the partner, or when the partnership makes principal payments on the note. As such, we believe that for purposes of the proposed regulations, such distribution should also be treated as a "tax nothing" and thus should not trigger the application of the proposed

[191] The preamble states that the issuance of preferred equity by a controlled partnership to an EG member may give rise to similar concerns as debt instruments of a controlled partnership. 81 Fed. Reg. at p. 20929. This is rather ironic. The proposed regulations would operate to treat debt as equity under a series of *ipso facto* rules. So, why a concern that a real partnership might choose to structure an interest in it as equity rather than debt, in an effort to avoid having to worry about whether the very same interest (if issued as debt) might be recharacterized as equity under the documentation rules, or the general and funding rules? If the real concern is that it would be equity in a partnership as opposed to its partners, general tax principles recognize that taxpayers have considerable latitude to structure an interest as debt or equity, to choose the type of entity (foreign or domestic, "C" corporation or "S" corporation or partnership, etc.), and to choose which entity to invest in. This is acknowledged in the legislative history to the economic substance doctrine. *See* Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," As Amended, in Combination with the "Patient Protection and Affordable Care Act"* (JCX-18-10), at pp. 152-153 (2010) (citations omitted).

regulations. We therefore recommend that that the final regulations clarify that the distribution of a partnership's own note to its partners is not subject to the section 385 regulations.

78. Treatment of partnerships. If a debt instrument issued by a controlled partnership is recharacterized as equity under Prop. Treas. Reg. § 1.385-3, the proposed regulations provide that the holder of the debt instrument would be treated as holding stock in the EG members that are partners of the controlled partnership, and that appropriate conforming adjustments be made. Prop. Treas. Reg. § 1.385-3(d)(5). Although unclear and needing additional guidance, it appears the nature of the adjustment will depend upon whether the holder is an existing partner or an EG member that does not already own an interest in the partnership.

    Example. FP owns US1, US2, and FS. US1 and US2 each own 50% of the interests in PRS, a controlled partnership. In Year 1, US1 and US2 respectively distribute $30 and $90 to FP out of accumulated earnings and profits. In Year 2, FS transfers $100 to PRS in exchange for a debt instrument. The debt instrument is recharacterized as stock under Prop. Treas. Reg. § 1.385-3(b)(3) to the extent it is treated as having funded the distributions by US1 and US2.[192]

    In the example above, when testing distributions for purposes of the funding rule in Prop. Treas. Reg. § 1.385-3(b)(3), the aggregate approach in the proposed regulations appears to require imputation of a debt instrument's issuance to the partners as an initial step, followed by an application of the funding and *per se* rules by looking to the disfavored distributions and acquisitions made by EG member partners.[193] This is the method employed in Prop. Treas. Reg. § 1.385-3(g), *Example 14(ii)(A)*. Under this approach, US1 is treated as issuing a $50 debt instrument to FS, of which $30 is recharacterized as stock in US1 *ab initio* under the funding rule due to US1's having distributed $30 to FP in Year 1. Similarly, US2 is treated as having issued a $50 debt instrument to FS, all of which is recharacterized as stock in US2 *ab initio* under the funding rule due to US2's distribution to FP in Year 1. This would ordinarily create an inside/outside basis discrepancy, because PRS would have an additional $100 of cash, yet US1 and US2 would not be able to increase their bases in their PRS interests under section 752(a) to reflect their share of PRS' economic, actual liability to repay the underlying debt instrument. To avoid this disparity, Prop. Treas. Reg. § 1.385-3(d)(5)(ii) provides that PRS, US1 and US2 must make conforming adjustments to reflect the treatment of the recharacterized debt instrument as stock in US1 and US2. Any adjustments, the proposed regulations state, must be consistent with the purposes of the proposed regulations and must be made in a manner that avoids the creation of, or increase in, an aggregate inside/outside disparity.[194]

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[192] It is not at all clear whether when applying Prop. Treas. Reg. § 1.385-3, a deemed distribution under section 752(b) should be treated as a "distribution" (within the meaning of Prop. Treas. Reg. § 1.385-3(f)(10)) from one partner to another, or conversely, whether a deemed contribution under section 752(a) should be treated as an acquisition by one EG-member partner of the stock of the other EG-member partners.

[193] Under the facts of this example, $10 of the $100 debt instrument continues to be respected as debt. We assume that the proposed regulations intend that all $10 of this amount would be allocable to US1, and that the aggregate rule not apply in an iterative manner to cause the reattribution of $5 of the non-recharacterized amount to US2.

[194] This rule appears in the portion of the aggregate rule that provides that a debt instrument issued by a partnership and recharacterized under the general or funding rules is treated as stock in its partners. Prop. Treas. Reg. § 1.385-3(d)(5)(ii). We assume this rule is also intended to authorize adjustments to be made with respect to

Prop. Treas. Reg. § 1.385-3(g), *Example 14*, illustrates some of the anticipated adjustments. The methodology in the example from the proposed regulations would seem to support treating FS as paying $50 to each of US1 and US2 in exchange for their issuance of $20 of US1 debt, $30 of US1 stock, and $50 of US2 stock, followed by the respective deemed contributions by US1 and US2 to PRS of $50 in exchange for partnership interests. This approach generally works well to restore the aggregate inside/outside "basis parity," as well as each partner's outside basis provided each partner's debt share equals its share of partnership profits.[195] This approach, however, will not restore each partner's outside basis where the partners' allocable share of partnership debt differs from the partners' allocable share of partnership profits. Moreover, there could easily be an aggregate disparity in this latter situation, if there is a minority, non-EG partner in the controlled partnership.

> Example. FP owns US1, US2, and FS. US1 and US2 each own 50% of the interests in PRS, a controlled partnership. In Year 1, FS transfers $100 to PRS in exchange for a debt instrument. In Year 2, US1 and US2 respectively distribute $80 and $90 to FP out of accumulated earnings and profits. As a result of the Year 2 distributions, the Year 1 debt instrument is recharacterized as stock under Prop. Treas. Reg. § 1.385-3(b)(3) to the extent it is treated as having funded the distributions by US1 and US2. Assume that the partnership agreement allocates 40% of partnership debts to US1, and 60% to US2.

Prior to the recharacterization of the Year 1 debt instrument, US1's outside basis would increase by $40 and US2's outside basis would increase by $60, on account of their respective shares of PRS's liability on the debt instrument. When the debt instrument is recharacterized as stock in the partners in year 2, the appropriate adjustments referenced in the proposed regulations are determined by reference to the partners' allocable share of partnership profits (*i.e.*, 50-50%). Here, it appears that US1 and US2 would each be deemed to issue their debt and stock to FS for $50 and contributing the cash to PRS. It follows then that US1's basis is decreased by $40 (its share of the Year 1 debt instrument) and increased by $50 (its deemed contribution), for a net increase of $10. Conversely, and for the same reasons, US2's basis would decrease by $60 and increase by $50, for a net decrease of $10. The net effect is a basis shift between the partners.

The proposed regulations focus on avoiding the creation of, or increase in, an aggregate inside/outside disparity amongst all of the partners, and does not say anything about the partners, and it is not clear why creating shifts in outside basis among the partners represents good tax policy. Moreover, if there is a minority partner in the partnership that is not a member of the same EG, and each partner's profits interests is not fully congruent with its share of the partnership liabilities under the partnership agreement, we can foresee aggregate inside/outside basis disparities.

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debt instruments issued by a controlled partnership that is respected as indebtedness, for purposes of applying the -3 rules.

[195] We have noted elsewhere in these comments that the determination of a partner's proportionate share of partnership profits – the factor that determines how to allocate partnership assets and debts amongst the partners for purposes of the aggregate rule – can have its own uncertainties. The uncertainty might be exacerbated in the presence of debt instruments recharacterized under the documentation rules of Prop. Treas. Reg. § 1.385-2.

What methodology might avoid this? The aggregate and funding rules already create inter-related *counter-factual* scenarios; must taxpayers concoct additional artificial explanations to justify adjustments to avoid the very inside/outside basis disparities the fictions of the proposed regulations would otherwise create? Or must the partners live with basis disparities, including potential aggregate disparities?

The treatment of interest payments by PRS to FS on the recharacterized debt instrument is also unclear. Perhaps the appropriate adjustment would be to deem PRS to distribute cash to US1 and US2 in an amount equal to their "proportionate shares" of the interest payment. Should this fictional payment be deemed to have been made with a 40/60 ratio or 50/50 ratio? Alternatively, perhaps PRS should be treated as making a guaranteed payment in the same amount to US1 and US2. In each alternative, the cash received by US1 and US2 presumably would be deemed transferred to FS in what would be a section 301 distribution. In the first alternative, each partner's respective basis in PRS would be reduced by the amount of the deemed distribution from PRS to it. In the second alternative, US1 and US2 would receive a guaranteed payment that would be offset by its share of guaranteed payment deductions resulting in no gain or loss. It would be helpful if the final regulations offered more explicit guidance on the treatment of interest payments by the partnership. Similarly, there are questions as to what adjustments might be made when PRS transfers $100 to FS to retire its obligations under the debt instrument, or if US1 and US2 are called upon to satisfy the debt instrument, which they would do in a 40/60 ratio.

The deemed adjustments are similarly complex where the holder of the recast debt instrument is an existing partner.

> Example. FP owns US1, US2, and FS. US1 and US2 each own 50% of the interests in PRS, a controlled partnership. In Year 1, US1 and US2 respectively distribute $30 and $90 to FP out of accumulated earnings and profits. In Year 2, US1 transfers $100 to PRS in exchange for a debt instrument. The debt instrument is recharacterized as stock at the time of its issuance under Prop. Treas. Reg. § 1.385-3(b)(3) to the extent it is treated as having funded the distributions by US1 and US2.

A literal application of the proposed regulations leads to a conundrum. Would it treat US1 as issuing a $50 debt instrument to itself (a strange result) and US2 issuing a $50 debt instrument to US1? If so, should the $50 debt instrument US1 is treated as issuing to itself result in treasury stock, to the extent it is linked under the *per se* rule to the $30 that US1 distributed to FP in Year 1? The $50 debt instrument deemed issued by US2 would be recharacterized as stock in US2, due to the *per se* rule's linkage of the deemed US2 debt instrument with US2's actual distribution to FP in Year 1. As PRS makes actual interest payments to US1, and when it pays $100 to US1 to satisfy and retire its obligation under the actual debt instrument, what are the deemed transactions? As with a number of items in the partnership context, the proposed regulations offer no guidance on these issues.

If our recommendation to exclude debt instruments issued by non-corporate issuers is not accepted and the aggregate approach is retained, we recommend that a series of examples be included to illustrate the basic operation of the aggregate rule in a number of commonly occurring and easily anticipatable circumstances involving a controlled partnership. Examples could consider the U.S federal income tax treatment of debt recharacterized under Prop. Treas. Reg. § 1.385-3 where (1) a partnership issues a debt instrument to an EG member that is not a partner, (2) a partnership issues a debt instrument to an EG member that is an existing partner in the partnership, (3) a partnership

has a minority partner that is a related person but not an EG member,[196] (4) a partnership has a minority partner that is otherwise unrelated to the EG members,[197] (5) the partnership is the holder of a debt instrument issued by an EG member that is not an existing partner, (6) the partnership is the holder of a debt instrument issued by an EG member that is an existing partner, (7) the partnership issues a debt instrument to an EG member that holds a debt instrument issued by the partnership that was recharacterized as stock under the documentation rules, and (8) the partnership issues a debt instrument to an EG member, where the EG member partners of the partnership hold recharacterized debt instruments that run between the partners. Additional examples should also set forth the go-forward treatment and tax consequences to the partners and the partnership in enough of the alternatives so as to provide meaningful guidance on these issues (*i.e.*, specify how interest payments are treated going forward, etc.).

Prop. Treas. Reg. § 1.385-4

79. Subgrouping. As noted in the attached comment letter, subgrouping rules should be added to the consolidated return portion of the proposed regulations.

80. Examples. The examples in Prop. Treas. Reg. § 1.385-4 make reference in certain situations to a consolidated group rather than to a particular member of the group. For instance, the third sentence of *Example 1(ii)* states that "… the USS1 consolidated group is treated as issuing a debt instrument…." Yet, the same *Example 1(ii)* concludes that the particular debt instrument is recharacterized as the stock of DS1 (as opposed to stock in the "USS group" in its one corporation capacity). Similar language appears in the other examples. All members of the USS1 group are treated as one corporation by reason of Prop. Treas. Reg. § 1.385-1(e); there is no operative rule that provides us that the debt instrument should be treated as stock in any particular member of the USS1 group. Perhaps the debt should be treated as stock in the USS1? This would be more consistent with the one corporation rule, and it would also be consistent with the rule in Prop. Treas. Reg. § 1.385-3(d)(6) (treating a recharacterized debt instrument issued by a disregarded entity as stock in the entity's owner). However, because members of a group can have minority interests, it is not clear whether such a rule would be appropriate in all circumstances. In any event, if the intent is to write a rule that leads to the answer given in *Example 1(ii)*, we recommend that a specific rule be added to provide that a debt instrument issued by a member of a consolidated group, if recharacterized as stock, is treated as stock in the particular member that issued the debt instrument. If the intent is to apply a stricter one-corporation rule, then a rule should be added to treat a recharacterized debt instrument issued by a member of a consolidated group (or by a disregarded entity or partnership held within the group) as stock in the parent. Either way, clarification would be helpful. Moreover, it would be helpful to employ terminology and concepts that are consistent with those utilized throughout the consolidated return regulations (*i.e.*, a debt instrument is not issued by a consolidated group, it is issued by a member of the group).

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[196] For example, if individual A owns corporations W, X, Y and Z, each of them directly owns a 20% interest in partnership PRS, and PRS issues a debt instrument to, say, W (or holds a debt instrument issued by W).

[197] For example, if P and S each directly owns a 40% interest in partnership PRS, and unrelated corporation X owns the remaining 20% of the PRS interests, and PRS issues a debt instrument to, say, W (or holds a debt instrument issued by W).

81. Current year earnings and profits. The general and funding rules in the proposed regulations contain an exception in Prop. Treas. Reg. § 1.385-3(c)(1) for current year earnings and profits. It stands to reason that the general consolidated-group-as-one-corporation rule in Prop. Treas. Reg. § 1.385-1(e) generally should apply when considering this exception.

    Example. FP owns USP, the parent of a consolidated group. USP owns S1 and S2, each a subsidiary member of the USP group. S1 issues a debt instrument to USP, and USP distributes the S1 debt instrument to FP.

    The S1 debt instrument in the hands of USP would not be subject to the regulations (see *Example 1(ii)* in Prop. Treas. Reg. § 1.385-4(d)(3)). When USP distributes the S1 note to FP, the determination of whether the current year earnings and profits exception applies should be made with reference to the earnings and profits of USP. This follows from the consolidated-group-as-one-corporation rule, from the notion of the exception's focus on the "current year" (which implies that the relevant year is the year of the members of the consolidated group, which is derived from the taxable year of the parent corporation by reason of Treas. Reg. § 1.1502-76(a)), from the principles of Treas. Reg. § 1.1502-33, under which the earnings and profits of members of the group tier up to the parent, and from the notion that there is no such thing as "consolidated earnings and profits." But what if the same S1 debt instrument had been issued by S1 directly to FP in exchange for, say, an acquisition of EG-member stock, and thus potentially subject to stock recharacterization under the general rule? At first blush, it might seem odd that in looking at an S1 obligation the current year's earnings and profits of USP should be considered. However, for the same reasons USP's earnings and profits provides the proper measure in the example above, it should provide the proper measure for a direct issuance by a subsidiary member.

    The issue is less clear when attempting to determine whether a recharacterized debt instrument that had been a consolidated group debt instrument (CGDI) is an "exempt" CGDI or a "non-exempt" CGDI. If the distinction between exempt and non-exempt CGDIs is to be maintained, different considerations could come into play, requiring a balancing of the complexity of adding in an exception that would look to a particular issuing member's earnings and profits against the policy gains to be achieved. If the answer is to look to the particular issuing member's earnings and profits, should such earnings and profits include the earnings and profits of lower-tier group members? For consistency with the notion apparently underlying the "exempt" CDGI rule, should adjustments be made to determine what earnings and profits would have tiered-up if all "exempt" CDGIs were stock rather than debt? We recommend that a rule be added to provide clarity on the issue.

82. In the situation where a member leaves a consolidated group and as a result an intercompany obligation no longer qualifies for an exception from the proposed regulations, the rules of Prop. Treas. Reg. § 1.385-4(b)(1) would make a distinction between whether the debt instrument is an *exempt consolidated group debt instrument* or a *non-exempt consolidated group debt instrument*. This distinction is not relevant when the debt instrument is transferred by the holder to an EG member that is not part of the same consolidated group. Prop. Treas. Reg. § 1.385-4(b)(2). The distinction is based on whether the particular intercompany obligation was exempted from the ambit of the proposed regulations solely because of its status as an intercompany obligation, or whether the debt instrument was not subject to the proposed regulations for other, additional reasons (such as the CYEP or threshold exceptions, or for not having been issued in a manner that would have triggered the general rule, or through not being "linkable" to a disfavored transaction through the *per se* rule). We observe that the need to make this distinction invokes all of the

inherent complexities in the proposed regulations,[198] as well as the need to design and implement information systems necessary to track data relating to intercompany debt issuances, intercompany distributions, intercompany stock acquisitions, and the like. Most large domestic corporate groups will already be required to collect and maintain much of this information due to the need to comply with the state and local tax rules that adopt all or part of the U.S. federal rules, with local variations. However, there would be some additional complexity because the particular intercompany obligation could be linked to a distribution or other disfavored transaction with a need to make the determination using U.S. federal tax information (such as earnings and profits), which often differs from the corresponding state and local tax information (which may be calculated using different bases, rules and methods). We recommend that this distinction be eliminated (and the disparate rules of Prop. Treas. Reg. §§ 1.385-4(b)(1) and -4(b)(2) be harmonized, unless supported by compelling policy justifications, and if there are compelling policy justifications, the justifications should be articulated in the preamble to help taxpayers and their advisors better understand the "why" of these rules (which should greatly aid interpretation and ultimately lead to better compliance).

83. Section 1503(f) imposes a limit on the ability of a member of a consolidated group to use the group's losses or credits to offset its taxable income or tax liability, where the member distributes dividends on its "plain vanilla preferred" stock that is held outside the group. This provision would be implicated where a subsidiary member of a consolidated group issues a debt instrument to a non-consolidated EG member, and the debt instrument is recharacterized as preferred stock. This consequence hardly seems compelled by the policies underlying the proposed regulations. We recommend that the Treasury Department and Service exercise regulatory authority under section 1503(f)(4) to provide that recharacterized debt instruments do not constitute "applicable preferred stock" for purposes of section 1503(f)(3)(D).

84. Section 1504(a)(5)(C) and (D) provide that the Service shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 1504(a), including regulations that allow taxpayers to rely on good faith estimates of the value for purposes of the section 1504(a) 80% value requirement, and to disregard the inadvertent cessation of meeting the 80 percent value requirement due to fluctuations in the relative values of different classes of stock. To date, no regulations have been issued; however, the Service issued Notice 2004-37,[199] in which it announced circumstances in which the failure to satisfy the value requirement of section 1504(a)(2)(B) of the Code would be disregarded under section 1504(a)(5)(C) and (D) in determining whether a corporation is treated as a member of an affiliated group. The guidance in the Notice does not apply, however, if certain events occur, including (1) the issuance of new stock by the issuing corporation to a non-group member, (2) the redemption of its stock by the issuing corporation from a member of the group, (3) certain section 301(c) distributions of money or other property made by the issuing corporation, and (4) a recapitalization of the issuing corporation within the meaning of section 368(a)(1)(E). Any of these enumerated events could be implicated by a recharacterization of a debt

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[198] We also note that additional complexities would be presented in the consolidated context, when making the exempt CGDI *vs*. non-exempt CGDI distinction. For example, how should deemed contributions and distributions under Treas. Reg. § 1.1502-33(d) with respect to federal income tax liabilities be taken into account? Should departing members be apportioned some amount of internal distributions or contributions (or could incoming members import some taint)?

[199] Notice 2004-37, 2004-1 C.B. 947.

instrument issued to a nonconsolidated EG member. This consequence hardly seems compelled by the policies underlying the proposed regulations, or by the policies underlying Notice 2004-37. We recommend that the Treasury Department and Service exercise regulatory authority under section 1504(a)(5) to provide that the issuance of a recharacterized debt instrument, and payments of interest and principal on such instruments, do not constitute "designated events" within the meaning of section 3.04 of Notice 2004-37.

85. The rules of Prop. Treas. Reg. § 1.385-4(b) distinguish between situations where a member leaves a consolidated group, and where the consolidated group debt instrument leaves the group. If the rules are not harmonized, which rules would apply to a transaction in which a member of a consolidated group is a party to a reorganization with a non-member, and the surviving entity is an EG member but not a consolidated group member?

    Example. USP owns US1 and US2, and the entities join in filing a consolidated return. USP also owns CFC1. USP engages in business operations in foreign jurisdictions through CFC1, and also through US2's foreign branches. For valid business reasons, USP seeks to reorganize US2 as a foreign corporation. Pursuant to this plan, USP organizes a new foreign corporation (CFC2), and transfers all of the US2 stock to CFC2 in exchange for CFC2 stock. Thereafter and as part of the same plan, US2 dissolves, and transfers its assets to CFC2 in liquidation. At the time of the transaction, US2 held a debt instrument issued by US1 that would have been recharacterized as stock in US1 but for the rule in Prop. Treas. Reg. § 1.385-1(e).

    The reorganization transaction should qualify as an "outbound" tax-free reorganization within the meaning of section 368(a)(1)(F) and as a "mere change" for purposes of Treas. Reg. § 1.368-2(m). By reason of Treas. Reg. § 1.367(a)-1(f), US2 is treated as transferring its assets (including the US1 debt instrument) to CFC2 in exchange for CFC2 stock, followed by its transfer of the CFC2 stock to USP in exchange for and cancellation of the stock USP owned in US2. This is the same treatment that generally applies in the context of acquisitive tax-free reorganizations. Under the proposed regulations, CFC2 is a "successor" to US2. Prop. Treas. Reg. § 1.385-3(f)(11)(i).

    In this example, which rule would apply? Is it viewed as though US2 has departed the USP consolidated group? We observe that in general, "it is appropriate to treat the Resulting Corporation in an F reorganization as the functional equivalent of the Transferor Corporation."[200] Alternatively, should it be viewed as though the US1 debt instrument was transferred outside of the group, consistent with the transactions deemed to occur by reason of the section 367(a) regulation? If the former, the issue becomes elective, because a very similar transaction could be implemented by using CFC1 as the acquisition vehicle, or by having CFC1 or US1 purchase a modest amount of CFC2 stock from CFC2 within the "potential F reorganization" (as that term is defined in Treas. Reg. § 1.368-2(m)(1)) and thereby fail to satisfy the requirements of an F reorganization. Treas. Reg. § 1.368-2(m)(1)(i) and -2(m)(1)(ii)). The result of these alternative structures would be a tax-free reorganization within the meaning of section 368(a)(1)(D) instead of section 368(a)(1)(F), which would appear to invoke Prop. Treas. Reg. § 1.385-4(b)(2) rather than Prop. Treas. Reg. § 1.385-4(b)(1).

[200] T.D. 9738, 80 Fed. Reg. 56904, 56907 (Sept. 21, 2015). The quoted language appears in the preamble to the final regulations under section 368(a)(1)(F) – the same regulations package that finalized Treas. Reg. § 1.367(a)-1(f).

Additional Issues

86. Interaction with section 305(c). In the context of actual stock, a corporation typically is not subject to an enforceable obligation to pay a dividend unless and until the corporation's board declares the dividend, regardless of whether dividends are cumulative. In contrast, most debt instruments provide for the automatic accrual of interest—the obligation to pay interest typically is not conditioned upon board action. If a debt instrument has been recharacterized as stock under the proposed regulations, how would the accrual of interest on the debt instrument be treated?

    Example. USP owns CFC1, a calendar year corporation with $500 in accumulated earnings and profits. On July 1 of Year 1, CFC1 issues a 5-year debt instrument to USP, its sole shareholder. The debt instrument has a stated redemption price at maturity of $100; interest accrues at a 5% rate and is payable on June 30 of each year. The debt instrument's issue price is $100. The proposed regulations apply to recharacterize the debt instrument as non-voting preferred stock.[201]

    On December 31 of Year 1, does USP have $2.50 of dividend income on account of the recharacterized CFC debt instrument under section 305(c) and Treas. Reg. §§ 1.305-5 and 1.305-7?[202] Should the interest accrual be treated as a redemption premium or as an increase in redemption price that results in a constructive, taxable distribution of preferred stock ("baby preferred") for purposes of section 305? If so, does a constructive distribution occur each day as the interest accrues, or does it occur at the time of a payment date (or perhaps at year end)? When CFC1 transfers $5 to USP on June 30 of Year 2 to pay accrued interest, is the payment treated as a dividend-equivalent redemption of the "baby preferred" under sections 302(d) or 306(a)(2)? If so, USP should increase its stock basis in its CFC1 stock (or in the recharacterized debt instrument) by the amount of the "stock basis" it had in the "baby preferred" that was redeemed with the interest payment.

    Example. USP owns CFC1, a calendar year corporation with $500 in accumulated earnings and profits. On July 1 of Year 1, CFC1 issues a 5-year debt instrument to USP in exchange for $85 in money. The debt instrument does not bear adequate stated interest; the stated redemption price at maturity is $100, and the issue price is $85 (*i.e.*, it is an OID instrument). On December 31 of Year 1, CFC1 distributes $120 to USP; CFC1 has no current earnings and profits for Year 1 so the CYEP exception does not apply, but CFC1 does have a large amount of accumulated earnings and profits. On June 30 of Year 6, CFC1 transfers $100 to USP to retire the debt instrument, in what would be treated as a dividend-equivalent redemption of stock under the proposed regulations and section 302(d).

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[201] The CFC1 debt instrument could be treated as stock under the general rule of Prop. Treas. Reg. § 1.385-3(b)(2)(i) if it was distributed by CFC1 to USP. Alternatively, it could be treated as stock under the funding and *per se* rules if CFC1 were to make a distribution to USP in the same taxable year (say, a distribution of $120 of PTI) in excess of its current year earnings and profits (*i.e.*, assume that CFC1 has no current earnings and profits for Year 1).

[202] *See also* Prop. Treas. Reg. § 1.305-7(b), REG-133673-15, 81 Fed. Reg. 21795 (Apr. 13, 2016).

Viewed as stock, the recharacterized CFC1 debt instrument has a redemption premium of $15, which exceeds a *de minimis* amount. The rules of Treas. Reg. § 1.305-5(b)(1) would seem to require USP to include in its income some amount of the redemption premium as a constructive dividend on a daily basis, under the principles of section 1272(a). Over the 5-year term of the debt instrument, USP would end up with $15 in constructive dividend income, and would have a further $100 in dividend income when the recharacterized CFC1 debt instrument is repaid. The net result is $115 in dividends on account of a $100 debt instrument; in essence, the $15 redemption premium has been double-counted—once as it accrued, and a second time as it was redeemed. There does not appear to be a basis mechanism to mitigate this duplication.[203]

We recommend that the rules of the proposed regulations and the section 305 regulations be coordinated, to prevent duplicative income inclusions.

87. Interaction with sections 336(e) and 338. The operation of the rules in the proposed regulations is not clear in the context of a deemed asset transaction as a result of an election under section 336(e) in the case of a qualified stock disposition, or an election under section 338(g) or 338(h)(10) in the case of a qualified stock purchase.

> Example. FT owns all of the outstanding stock in FS1, FS2, and FS3. At the beginning of Year 3, FS2 holds a debt instrument issued by FS1 that would be recharacterized as stock, that was issued in Year 1. FT holds a debt instrument that was issued by FS2 in Year 2, a portion of which would be recharacterized as stock under the funding rule. FS3 holds a debt instrument that was issued by FT in Year 2, a portion of which would be recharacterized as stock under the funding rule. In Year 3, USP acquires all of the outstanding stock of FT in a qualified stock purchase. USP effects a section 338(g) election as to its purchase of FT, and as to the deemed purchases of FS1 and FS2.

As a result of the elections, "old FT" is deemed to have transferred all of its assets to "new FT", and similar transfers are deemed to occur with respect to "old FS1" and "old FS2." It would be helpful if rules and examples are added to the final regulations, if and when issued, to provide guidance on how the section 385 rules are intended to apply to the deemed transactions. For instance, does the debt instrument that "Old FS1" issued to "Old FS2" continue to represent stock, only this time in "new FS1," or is it treated as a debt instrument newly issued by "new FS1," to be tested under the general and other rules in the proposed regulations? If it is to be treated as stock, is this a new acquisition of EG member stock, such that it could cause debt instruments issued by FS2 to be recharacterized as stock under the general, funding, or *per se* rules? It does not appear that the exception in Prop. Treas. Reg. § 1.385-3(c)(3) for funded acquisitions of subsidiary stock could apply. Is "new FS2" to be treated as assuming the debt instrument issued by "old FS2," or is "new FS2" to be treated as issuing a new debt instrument? Are the "new" entities successors to the "old" entities, and the latter "predecessors" of the former, within the meaning of Prop. Treas. Reg.§ 1.385-3(f)(9)

[203] In this example, the CFC1 note would be retroactively recharacterized as stock upon its issuance. USP's "stock" basis in the recharacterized stock should equal the cost of the stock, or the $85 it actually paid for the recharacterized CFC1 debt instrument. As USP takes the $15 redemption premium into income as a constructive distribution, USP's basis in the recharacterized CFC1 debt instrument should increase *pro tanto*, by $15, to $100. Upon the retirement of the recharacterized CFC1 debt instrument, USP's basis in the actual stock it owns in CFC1 should increase by its $100 basis in the recharacterized CFC1 debt instrument, under Treas. Reg. § 1.302-2(c). In contrast, USP would had taken $115 into income as dividends on the recharacterized CFC1 debt instrument.

and (11), or are they unrelated as provided in Treas. Reg. § 1.338-1(b)(1) and thus not successors? And how might the rules apply to the partially recharacterized debt instrument that FT had issued to FS3? Finally, what would be the effect of all of these instruments on the QSP qualification for FT and its subsidiaries, and on the ADSP/AGUB calculations?